Illinois
Credit Union League

September 29, 2011

VIA E-MAIL TRANSMISSION
www.regulations.gov

Jennifer J. Johnson, Secretary
Board of Governors of the
Federal Reserve System
20th Street and Constitution Avenue, NW
Washington, DC 20551

RE: ***Interim final rule governing adjustments to debit interchange fees for fraud-prevention costs***
RIN 7100-AD 63

Dear Ms. Johnson:

We appreciate the opportunity to respond to the interim final rule regarding adjustments to debit interchange fees for fraud prevention costs ("Rule"). We submit this response to the Federal Reserve System ("FRS") on behalf of the Illinois Credit Union League ("ICUL") and its four hundred (400) member credit unions which provide financial services to approximately three million consumers as well as on behalf of ICUL Service Corporation ("LSC"), which provides debit card services to credit unions and consumers in forty-seven (47) states. Our comments address the main issues under consideration.

The FRS' proposed one cent cap for issuer fraud prevention costs is not reasonable and the calculation does not include issuer-incurred costs as required by statute.

With the Administrative Procedures Act ("APA") as an afterthought, the FRS proposes Rules which exceed its Congressional authority. The APA ensures agency rulemaking is based in law and is politically responsible and fair. Agency action is unlawful if exceeds its statutory authority. 5 U.S.C.A. §706(2)(c). Courts do not read regulations in isolation, but interpret them in conjunction with their enabling statutes. *Comptroller of Treasury v. Citicorp Int'l.Comm'n, Inc.*, 884 A.2d 112 (2005). Agency action exceeds statutory authority if it conflicts with or contradicts the enabling statute or legislative intent. *Conway v. City of Madison, Board of Police & Fire Comm'rs,* 662 N.W.2d 335 (2003); *Tillmon v. Miss. Dept. of Health,* 749 So.2d 1017 (Miss. 1999); *Haney v. Mahoney,* 32 P.3d 1254 (2001); *Mallo v. Wisc. Dept. of Revenue*, 645 N.W.2d 853 (2002); *Foytik v. Chandler*, 966 P.2d 619 (1998). If the enabling statute does not expressly or implicitly authorize a regulation, it is invalid. *Pierce County v. State,* 185 P.3d 599 (2008). So too are regulations which expand the scope of the enabling statute. *Arkansas Dept. of Human Serv. v. Huff*, 65 S.W.3d 880 (2002).

As proposed, the Rules are an impermissible extension of regulatory authority, Through its seminal decision in *Chevron v. Natural Resource Defense Council*, 467 U.S. 837 (1984), the United States Supreme Court articulated an "either/or" test to determine the constitutional validity of an administrative agency's rulemaking. If the statute is clear about an agency's authority to make rules, it must be honored. Conversely, if the statute is silent or ambiguous about rulemaking authority, there is a statutory gap. When there is a gap, an agency may regulate, unless the regulations are arbitrary, capricious or manifestly contrary to statute. *Chevron*, 467 U.S. at 842-43. An agency's interpretation is not presumptively reasonable. *Whitman v. American Trucking Ass'n*, 531 U.S. 457, 480 (2001); *Household Credit Services, Inc. v. Pfenning*, 541 U.S. 323 (2004).

Section 1693o-2(a)(5) of the Dodd-Frank Act authorizes the FRS to make an adjustment to interchange transaction fees for fraud prevention costs subject to two conditions. The first is the following:

> (if the) adjustment is reasonably necessary to make allowances for costs incurred by the issuer in preventing fraud in relation to electronic debit transaction involving that issuer

15 U.SC.A. §1693o-2(a)(5). Based upon this language, the FRS may make "allowances for costs incurred by the issuer". The statute does not define "allowances" or "costs". Given a statutory gap, the FRS may interpret the terms, unless arbitrary, capricious or contrary to statute. It is from this language, the FRS determined the cap calculation.

The operative terms are "allowances" and "costs". Rather than define "allowances", the FRS defined "allow for" which means, "to give consideration to circumstances or contingencies". 76 Fed.Reg. 43475, 43482, fn 24 (July 20, 2011). From this definition, the FRS concluded it need not consider an issuer's actual costs. 76 Fed.Reg. at 43482. It reasoned that there does not need not be a direct connection between the fraud-prevention adjustment and actual issuer costs. *Id.* Instead, the FRS based the calculation on the median fraud prevention cost of (1.8¢) less fraud-prevention costs included in the 22 cent interchange fee (-.7¢) rounded to one cent. 76 Fed.Reg. 139 at 43482-83. The FRS' interpretation and calculation of the fraud cap is contrary to statute.

The statutorily appropriate terms are "allowance for fraud costs". "Allowance" is defined "as a sum granted as a reimbursement…for expenses". Merriam Webster Dictionary (online version, September 24, 2011). "Expense" is defined as something expended to secure a benefit, financial burden or outlay. *Id.* "Costs" are defined as "the amount or equivalent paid or charged for something or the price, outlay or expenditure made to achieve an object." *Id.* There should be no "consideration of median costs as interpreted by the FRS. By definition, the FRS should consider an issuer's actual fraud prevention costs when calculating the cap. This is logical as the costs of fraud and fraud prevention costs are closely-related. Richard Epstein, *Cybersecurity in the Payment Card Industry*, 75 Uni.Chic.Law Rev. 203, 210 (2008). The FRS cherry picks median, rather than actual costs. Median costs are different than actual costs. The FRS is limited by statute to actual costs. To calculate otherwise is a statutorily impermissible exercise of authority.

Further evidence of statutorily impermissible consideration is the following statement:

> The Board believes the median allowance helps to offset the fraud prevention costs while placing cost discipline on issuers to ensure fraud prevention costs are cost effective.

76 Fed.Reg. at 43483 (July 20, 2011)

By its admission, the cap is designed for disciplinary and putative purposes. This is impermissible and is evidence that the Rules are drafted to satisfy the interests of merchants, at the expense of issuers. The slant is so one-sided that the FRS even entertained that issuers at their expense, should provide merchants with fraud-prevention technology. *Id.*

The statutorily appropriate calculation includes reimbursements for the following issuer fraud prevention costs:

Neural network costs
Transaction scoring
Name and address verification
Software systems
Plastic card insurance
Charge back costs

Fraud prevention costs comprise approximately nineteen percent (19%) of debit card fees. Historically, debit card issuers received a 44 cent interchange fee which has been reduced to 24 cents. Nineteen percent (19%) of the 24 cent interchange fee is attributable to fraud prevention costs, which is 4.56 cents per transaction. This is a more reasonable cap, consistent with statutory direction.

The fraud prevention cap disproportionately shifts the burden on issuers to implement fraud prevention devices without reasonable compensation.

Not only is the cap arbitrary and capricious, it disproportionately shifts fraud prevention burdens on issuers, Debit cards benefit merchants, consumers, issuers and payment card networks. Debit cards provide consumers with convenience-consumers do not need to carry cash. Merchants benefit by transaction speed and authentication. Issuers and payment card networks receive interchange fees. Convenience and speed compete with the need for security. Security authentication methods reduce fraud while preserving the debit card attributes.

Despite the multi-dimensional relationships, issuers assume the primary fraud costs. Historically, card issuers bear 62% of fraud losses; merchants bear 38%. 76 Fed.Reg. at 43481. Merchants account for the largest share of breaches and third largest share of compromised records. Richard J. Sullivan, *The Changing Nature of U.S. Card Payment Fraud: Industry and Public Policy Options,* Federal Reserve Bank of Kansas City Econ. Rev. 101, 107(Second Quarter 2010). Nonbank processors account for a small share of breach incidents but are responsible for largest share of compromised. Clearly, issuers assume the majority of fraud losses yet do not cause the largest share of breaches.

Issuers bear the losses and technological costs, with insufficient compensation. Given reduced interchange fees, issuers operate under budgetary and operational constraints. Absent appropriate cost and duty allocation, issuers have little incentive to invoke technologically efficient fraud measures. This especially is true since merchants have no incentive to implement security procedures to safeguard information, such as authenticating passwords and providing secure pop up internet windows. Similarly, a consumer has little incentive to protect his or her password or debit card. The bidirectional authentication layer has been imposed solely upon the issuer, without appropriate compensation.

The inability to obtain appropriate compensation is problematic, as an issuer does not have an alternate avenue to recover costs for the intervening negligent acts of third parties. Judicially, issuers are denied recovery when seeking reimbursement from merchants and affiliate banks for failure to secure data systems. *See Sovereign Bank v. BJ's Wholesale Club, Inc.*, 533 F.3rd 162 (3rd Cir. 2008); *In re: TJX Companies Retail Sec. Breach Litigat'n*, 564 F.3d 489 (1st Cir. 2009) (Issuer denied recovery for retailer's failure to comply with credit card operating rules which resulted in data breach and loss to issuer); *Cumis Ins. Society v. BJ's Wholesale Club, Inc.*, 918 N.E2d 36 (2009) (Issuers denied recovery for losses associated with retailer's failure to improperly store cardholder data). Courts preclude issuer recovery for fraud loss; regulations prohibit recovery for fraud costs.

The FRS has created a system which provides benefits to some, at the expense of others. A risk bearer takes precautions to avoid risk. If a party assumes risks, it should be compensated. These are insurance-oriented principles. Without sufficient compensation or risk allocation, one member of the network bears the burdens while others do not. Network security becomes less than optimal. *Richard J. Sullivan*, at p.118. For the payment card system to be secure, each component must be secure. Security responsibilities must be delegated amongst all participants or the primary risk taker must be compensated appropriately.

If issuers are expected to the bear fraud prevention costs, the cap should include an allocation for actual fraud-prevention costs, as required by statute. A cap which does not provide reasonable fraud compensation and which places the sole responsibilities on issuers is arbitrary, capricious and contrary to statute. The FRS needs to recalculate the cap to include issuer fraud prevention costs.

The examples in Appendix A, comment to 235.4(b)(2) should be stricken as arbitrary, capricious, contrary to statute and a mischaracterization of issuer responsibilities.

The Rules impose strict liability on issuers for activities, some of which they have no control. Illustrative of this bias are the examples contained in Appendix A in which the FRS concludes the issuer is the appropriate party to prevent fraud, as follows:

1. A thief steals the cardholder's wallet and uses the debit card to purchase goods without the authority of the cardholder;

2. A cardholder makes a $100 purchase at a merchant. Subsequently, the merchant's employee uses information from the debit card to initiate a subsequent transaction for an additional $100 transaction, without the authority to the cardholder; and

3. A hacker steals cardholder account information from a merchant processor and uses that information to make unauthorized purchases of good and services.

76 Fed.Reg.at 43487, Appendix A. The FRS incorrectly superimposed fraud responsibilities on an issuer. The duties should be imposed on the merchant or processor as they had the opportunity to prevent the unauthorized transactions - not the issuer.

In the first example, the merchant could have prevented unauthorized purchases by requiring cardholder identification. In the second example, merchants must be liable for losses caused by employee theft. Simple agency law governs these principles. In the third example, merchants and their processors could have prevented the loss by implementing PCI industry standards as well as intrusion detection devices. It is the merchant and processor's disregard for security and transaction authorization procedures which caused the losses, not the issuer. In these examples, there are few measures an issuer could have taken to prevent losses caused by the failure to exercise ordinary care.

To impose liability on issuers in these instances is to make issuers guarantors of transaction authenticity. This is not the law. The purpose the EFTA is to encourage financial institutions to institute reasonable safeguards against fraud, not to become insurers of fraud. *Official Commentary to Article 4A-203* cmt. 5 The FRS may not make issuers insurers against fraud. The examples in Appendix A, comment to 235.4(b(i)-(iii) should be stricken as arbitrary, capricious, contrary to statute and a mischaracterization of issuer responsibilities.

The FRS requests comment on whether the Rules should define "fraud" or "fraudulent electronic debit transaction," and if so, what would be an appropriate definition.

Answer: The FRS should not define "fraud" or "fraudulent electronic debit transaction". "Fraud" is a legal term, subject to judicial interpretation and definition. Courts define questions of law. 5 U.S.C.A. §706. The definition of fraud should not become a pigeon-holed term coined by a regulatory agency.

The FRS requests comment on whether an issuer's policies and procedures should require an issuer to assess whether its customer rewards or similar programs provide inappropriate incentives to use an authentication method that is demonstrably less effective in preventing fraud.

Answer: Rewards programs should not be subject to fraud prevention methods. This exceeds the scope of the FRS' regulatory authority- it is designated with the responsibility for addressing debit interchange fees- not rewards or "similar" programs, which are undefined. The FRS may not regulate arenas in which it has no authority, regardless of whether individuals who comment on the Rules, agree or disagree. Congress determines the scope of regulatory authority, not individuals who comment on Rules. The scope of regulatory action is governed by statute, which cannot be altered, enlarged or limited by an agency. *Camera Center, Inc. v. Cabinet Review of Ky,* 34 S.W.3d 39 (Ky.2000).

The FRS requests comment on whether the rule should establish a consistent certification process and reporting period for an issuer to certify to a payment card network that the issuer meets the FRS' fraud-prevention standards and is eligible to receive or charge the fraud-prevention adjustment.

Answer: The Payment Card Network should establish a certification process by which issuers, merchants and payment cardholder comply with the fraud-prevention adjustments and share authentication responsibilities. To impose requirements on issuers alone is incongruous. Merchants initiate transactions and have the opportunity to prevent fraud.

Payment networks have the financial and technological advances to prevent fraud. They need to bear associated responsibilities, especially in light of the reduced interchange fees. Specifically, merchants should be required to purchase updated fraud prevention software, comply with PCI standards developed specifically for merchants. Merchant noncompliance should result in fines, up to and including disqualification from network participation.

We appreciate the opportunity to comment on the Rule. Please feel free to contact either of us, if you have any questions.

Very truly yours,

ILLINOIS CREDIT UNION LEAGUE and
ICUL SERVICE CORPORATION

By: ______________________

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