The Clearing House

THE FINANCIAL SERVICES ROUNDTABLE

November 1, 2010

Louise L. Roseman
Director
Division of Reserve Bank Operations and Payment Systems
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue NW
Washington, D.C. 20551

Re: Rulemaking pursuant to the debit interchange transaction fee restrictions in the Dodd-Frank Act

Dear Ms. Roseman:

The Clearing House Association L.L.C.[1] ("The Clearing House") and the Financial Services Roundtable[2] (the "Roundtable," collectively, with The Clearing House, the "Associations") respectfully submit to the Board of Governors of the Federal Reserve System (the "Board") the following observations for the Board's consideration in exercising its rulemaking authority pursuant to the debit interchange transaction fee restrictions prescribed by the Dodd-Frank Act[3] (the "Debit Interchange Amendment").

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[1] Established in 1853, The Clearing House is the nation's oldest banking association and payments company. It is owned by the world's largest commercial banks, which employ 1.4 million people in the U.S. and hold more than half of all U.S. deposits. The Clearing House is a nonpartisan advocacy organization representing through regulatory comment letters, amicus briefs and white papers the interests of its owner banks on a variety of systemically important banking issues. The Clearing House Payments Company provides payment, clearing, and settlement services to its member banks and other financial institutions, clearing almost $2 trillion daily and representing nearly half of the automated clearing-house, funds-transfer, and check-image payments made in the U.S. See The Clearing House's web page at www.theclearinghouse.org.

[2] The Roundtable represents 100 of the largest integrated financial services companies providing banking, insurance, and investment products and services to the American consumer. Member companies participate through the Chief Executive Officer and other senior executives nominated by the CEO. Roundtable member companies provide fuel for America's economic engine, accounting directly for $74.6 trillion in managed assets, $1.1 trillion in revenue, and 2.4 million jobs.

[3] Section 1075 of the Consumer Financial Protection Act of 2010 ("CFPA"), which amends the Electronic Fund Transfer Act (15 U.S.C. 1693 *et seq.*) ("EFTA").

I. Introduction

Most electronic debit transactions processed in the U.S. are initiated using debit cards issued by members of the Associations.[4] Given their extensive experience in the market sector that will be most directly impacted by the Debit Interchange Amendment, particularly The Clearing House's expertise as a payments system operator, the Associations are in a unique position to provide observations for the Board to consider in exercising its Debit Interchange Amendment rulemaking authority.

Specifically, based on their understanding of retail payment systems, including electronic debit transactions, and analysis of the Debit Interchange Amendment, the Associations strongly believe the Board should:

(1) note the significant cost and benefit differences between electronic debit transactions and checking transactions, and should account for the true costs to issuers associated with electronic debit transactions and debit card programs;

(2) apply the terms "reasonable" and "proportional" consistent with their administratively and judicially interpreted meanings, which dictate that allowable interchange transaction fees should account for all costs incurred in connection with electronic debit transactions plus a return on capital; and

(3) take account of the unintended negative externalities that may result from certain rulemaking approaches the Board may consider in implementing the Debit Interchange Amendment.

II. The Board should note the significant cost and benefit differences between electronic debit transactions and checking transactions, and should account for the true costs to issuers associated with electronic debit transactions and debit card programs

The Debit Interchange Amendment calls for the limitation of any debit interchange transaction fee to an amount that is "reasonable and proportional to the cost incurred by the issuer with respect to the transaction."[5] To accomplish this objective, the Debit Interchange Amendment directs the Board to "prescribe regulations . . . to establish standards for assessing whether the amount of any interchange transaction fee . . . is reasonable and proportional to the cost incurred by the issuer with respect to the transaction."[6] In prescribing such regulations, the Board is expressly directed to:

(1) consider the functional similarity between electronic debit transactions; and checking transactions that are required within the Federal Reserve bank system to clear at par;[7] and

(2) distinguish between the incremental cost incurred by an issuer for the role of the issuer in the authorization, clearance, or settlement of a

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[4] Top U.S. Debit Card Issuers, The Nilson Report, Issue 947, April 2010, at 1.

[5] EFTA § 920(a)(2).

[6] EFTA § 920(a)(3)(A).

[7] EFTA §§ 920(a)(4)(A)(i)-(ii); *see also* Regulation J § 210.4(c) confirming that the Reserve Banks must receive cash items and other checks at par.

particular electronic debit transaction, which cost shall be considered [in prescribing regulations]; and other costs incurred by an issuer which are not specific to a particular electronic debit transaction, which costs shall not be considered [in prescribing regulations].[8]

A. The Board should note the significant cost and benefit differences between electronic debit transactions and checking transactions

The first directive under the Debit Interchange Amendment regarding interchange transaction fee rulemaking requires the Board to "consider the functional similarity between electronic debit transactions; and checking transactions that are required within the Federal Reserve bank system to clear at par."[9] While there are certain similarities between these transaction types, there are also significant and noteworthy differences. Electronic debit transactions offer merchants beneficial features that checking transactions do not, such as a guarantee of settlement and faster settlement.[10] Costs associated with such features are generally borne by debit card issuers, which mitigate the costs through the collection of interchange transaction fees. Similar features for checking transactions are available to merchants at additional costs, which should be considered by the Board in its rulemaking under the Debit Interchange Amendment. In addition, the costs to merchants of interchange transaction fees are mitigated by cost savings associated with acceptance and processing of electronic debit transactions relative to checks.

Guarantee of settlement

Once a merchant receives an approved authorization response from the issuer in connection with an electronic debit transaction, current payment card network rules guarantee that the merchant will be funded for the transaction even if the asset account associated with the debit card used in the transaction lacks sufficient funds to cover the transaction at the time of settlement[11] (provided the merchant follows certain procedural requirements). In contrast, when a merchant accepts a check, the merchant bears the risk of not being able to collect on

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[8] EFTA § 920(a)(4)(B). The Debit Interchange Amendment also contains a third express directive, which requires the Board to consult with financial institution prudential regulators in prescribing regulations. EFTA § 920(a)(4)(C). This directive suggests that the Board should consider safety and soundness risks in interchange transaction fee rulemaking (which would seem to preclude rulemaking that may result in unsustainably low interchange transaction fees).

[9] EFTA §§ 920(a)(4)(A)(i)-(ii). Inefficiencies associated with efforts to avoid check exchange fees (such as routing checks through multiple correspondent banks that did not assess exchange fees)—not a statutory mandate to align fees with check processing costs—led to the Federal Reserve's institution of a rule under which it would not process checks that did not clear at par. Such inefficiencies are not present in the electronic debit transaction system. *See* Bruce J. Summers and R. Alton Gilbert, Clearing and Settlement of U.S. Dollar Payments: Back to the Future?, Federal Reserve Bank of St. Louis Review, September/October 1996; Regulation J § 210.4(c).

[10] *See* Rising Interchange Fees Have Increased Costs for Merchants, but Options for Reducing Fees Pose Challenges, U.S. Government Accountability Office (GAO), November 2009; Mercator Advisory Group, Special Report: The Durbin Amendment: Impact Analysis, June 2010.

[11] *See* Robin A. Prager et al., Interchange Fees and Payment Card Networks: Economics, Industry Development and Policy Issues, Federal Reserve Board Divisions of Research & Statistics and Monetary Affairs, May 2009.

the check (unless the merchant pays a substantial premium for a third-party check guarantee service, which, according to a recent Nilson Report study costs an average of 92 basis points above the standard costs to the merchant of check handling and processing[12]). If the check is returned unpaid, the merchant will bear the loss and may also be required by the depositary bank to pay a returned item fee (which fee may, in turn, be passed along to the check writer). In contrast, debit card issuers incur the risk of loss in the amount of the underlying electronic debit transaction when they provide approved authorization responses and thereby become obligated to fund settlement of such transactions. Debit card issuers currently cover the cost of such risk of loss partly through interchange transaction fees. An accurate comparison of functional and cost similarities and differences between checking transactions and electronic debit transactions should account for a check guarantee service, and its associated costs, in the checking transaction comparison baseline.

Faster settlement

A merchant will typically receive settlement for an electronic debit transaction sooner than it will receive settlement for a checking transaction. Settlement for electronic debit transactions generally occurs within one business day of the transaction date (provided the merchant follows certain procedural requirements),[13] while settlement for checking transactions generally occurs within two business days *from the date of deposit with the merchant's bank* [14] (but may take longer if a checking transaction is subject to a depositary bank hold for any number of reasons[15]). Transaction messages related to electronic debit transactions are processed electronically and in real-time using sophisticated infrastructure connecting acquiring financial institutions, payment card networks, processing entities and debit card issuers. In contrast, checking transactions are generally processed through a more rudimentary system. Processing does not begin until a check is deposited with the merchant's bank, after the merchant has incurred the time delay and costs of handling individual physical checks, batching the checks and either transporting physical batches to the depositary bank (including, for example, by armored car service) or sending electronic batches to the depositary bank after image capture. Finally, the daily settlement cutoff for electronic debit transactions is typically much later than the daily settlement cutoff for checking transactions. All of these differences contribute to what typically amounts to (1) significant unreported costs associated with check processing by merchants that are eliminated or reduced in electronic debit transaction processing, and (2) significant benefits to merchants of electronic debit transactions associated with faster settlement. The implementation and maintenance of sophisticated systems necessary to provide these merchant benefits result in material costs to debit card issuers, and such costs are currently funded through interchange transaction fees.

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[12] Check Authorization - 2009, The Nilson Report, Issue 953, July 2010, at 7.

[13] *See, e.g.,* Visa Debit Processing Service, http://www.visadps.com/services/settlement_services.html. Generally, PIN-based transactions (where a consumer provides a PIN number at the point of sale rather than a signature) settle on the same day as the authorization.

[14] Paul W. Bauer and Geoffrey R. Gerdes, The Check is Dead! Long Live the Check! A Check 21 Update, Economic Commentary, September 21, 2009, http://www.clevelandfed.org/research/commentary/2009/0609.cfm.

[15] *See* Regulation CC § 229.13(a)-(f).

In summary, while electronic debit transactions and checking transactions both serve as vehicles for transferring funds out of checking accounts, there are substantial benefits associated with electronic debit transactions that are not available with standard checking transactions. These benefits to merchants and consumers have a positive impact on the economy as a whole, leading to increased sales, lower labor costs (resulting from a reduction in tender time at check out and the elimination of time required to handle and process deposits of physical instruments) and the reduction or elimination of bad check losses.[16] However, these benefits come at a cost. Account-holding financial institutions incur costs in connection with electronic debit transactions that they do not incur in connection with checking transactions. Debit card issuers make ongoing investments in authorization, clearance and settlement infrastructure that have no direct corollary in the checking transaction system. These costs are necessary for the effectuation of electronic debit transactions with the efficiency, security and convenience currently expected by the marketplace, and should therefore be taken into consideration by the Board in its rulemaking process.

B. The Board should account for the true costs to issuers associated with electronic debit transactions and debit card programs

Since the Debit Interchange Amendment requires interchange transaction fees to be linked to "cost incurred by the issuer with respect to the transaction,"[17] how the Board determines such cost is of paramount importance. The second directive under the Debit Interchange Amendment related to interchange transaction fee rulemaking requires the Board to "distinguish between the incremental cost incurred by an issuer for the role of the issuer in the authorization, clearance, or settlement of a particular electronic debit transaction, which cost shall be considered [in prescribing regulations]; and other costs incurred by an issuer which are not specific to a particular electronic debit transaction, which costs shall not be considered [in prescribing regulations]."[18] From this directive, it seems clear that the Debit Interchange Amendment requires the Board's regulations to include in the determination of "cost incurred by the issuer with respect to the transaction" variable processing costs associated with authorizing, clearing and settling electronic debit transactions, such as per-transaction third-party processor costs and per-transaction payment card network fees. On the other end of the spectrum are costs wholly unrelated to electronic debit transactions, which the Debit Interchange Amendment expressly disallows from the Board's determination of "cost incurred by the issuer with respect to the transaction." However, while the directive is prescriptive regarding costs at the ends of the spectrum of the universe of debit card issuer costs (i.e., in defining costs that must be included and costs that must be excluded), it is not instructive regarding many of the other costs associated with electronic debit transactions.

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[16] *See* Rising Interchange Fees Have Increased Costs for Merchants, but Options for Reducing Fees Pose Challenges, U.S. Government Accountability Office (GAO), November 2009; Zywicki, Todd J., The Economics of Payment Card Interchange Fees and the Limits of Regulation, Research Paper 10-26, George Mason University School of Law and Economics, June 2010.

[17] EFTA § 920(a)(2).

[18] EFTA §§ 920(a)(4)(B)(i)-(ii).

While Congress did not provide explicit direction to the Board in the treatment of these other costs, the very text of the underlying statutory requirement, that an interchange transaction fee be "reasonable and proportional to the cost incurred by the issuer with respect to the transaction," dictates that Board rulemaking allow for recovery through interchange transaction fees of *all* costs associated with electronic debit transactions. This proposition is bolstered by administrative and judicial interpretations of the terms "reasonable" and "proportional," which are more fully discussed in Section III below. While not inclusive, an exemplary list of costs incurred by a debit card issuer that are fundamental to an issuer's operation of a debit card program, that directly relate to electronic debit transactions and that positively correlate with the number of electronic debit transactions include costs associated with:

a) maintaining electronic debit transaction records;
b) responding to alleged and actual erroneous electronic debit transactions and absorbing associated fraud losses (which are mandated by the Electronic Fund Transfer Act[19] and Regulation E[20]);
c) regulatory compliance and disclosures (including compliance with the Electronic Fund Transfer Act and Regulation E requirements);
d) reissuance of lost or compromised debit cards;
e) responding to alleged and actual data breaches involving electronic debit transactions;
f) fraud prevention[21];
g) customer service, including call centers and online and in-branch support services where general and transaction-specific customer concerns are addressed;
h) debit program research and development; and
i) customer education and marketing regarding use of debit cards and customer rights and responsibilities.

As noted above, the Debit Interchange Amendment's mandate that any interchange transaction fee be "reasonable and proportional to the cost incurred by the issuer" mandates that such cost inputs and other similar cost inputs must be included in the Board's determination of the cost baseline.

As illustrated by the above examples, the cost inputs to be considered in accurately determining "cost incurred by the issuer" are many and may not be consistently categorized across issuers. Consequently, while the Board should set clear parameters regarding the costs that constitute a "cost incurred by the issuer with respect to the transaction," such parameters should be delineated along broad functional lines and general expense types and not constrained to narrow cost allocation names and categories. For example, if the Board's

[19] 15 U.S.C. § 1693f (EFTA § 908).
[20] 12 C.F.R. § 205.11.
[21] EFTA § 920(a)(5) expressly permits issuers to recover costs associated with fraud prevention. However, if and to the extent certain costs are not considered to fall under EFTA § 920(a)(5), such costs should be considered a "cost incurred by the issuer with respect to the transaction" under EFTA § 920(a)(2).

regulations include "third party processing costs" (without additional clarification) as a permitted cost input, issuers may be incentivized to move processing to third parties, even where doing so may not be operationally efficient or, absent such regulation, cost effective. In contrast, if the Board's regulations instead account for inclusion of all processing costs, whether third party or in-house, issuers will make efficient processing decisions without artificial incentives that may undermine efficiency. Clear and explicit parameters will provide market certainty with respect to allowable cost considerations and avoid gamesmanship or inefficiency resulting from debit card issuer attempts to recharacterize costs to maximize recovery.

III. The Board should apply the terms "reasonable" and "proportional" consistent with their administratively and judicially interpreted meanings, which dictate that allowable interchange transaction fees should account for all costs incurred in connection with electronic debit transactions plus a return on capital

The Debit Interchange Amendment requires any debit interchange transaction fee to be "reasonable and proportional to the cost incurred by the issuer with respect to the transaction."[22] For the reasons noted in Part II above, thoughtful parameters regarding cost baseline determinations will be a critical component of any Debit Interchange Amendment rules promulgated by the Board. However, the determination of "cost incurred by the issuer with respect to the transaction" establishes only the baseline reference point in the determination of a permissible interchange transaction fee under the Debit Interchange Amendment.

The Debit Interchange Amendment requires interchange transaction fees to be tethered to the baseline of costs incurred. However, the calculation of actual interchange transaction fees turns on reasonableness and proportionality relative to that baseline. The term "reasonable" suggests that an appropriate margin should be built into interchange transaction fees. Similarly, the term "proportional" suggests that interchange transaction fees should not merely allow for recovery of "costs incurred by the issuer with respect to the transaction" but rather interchange transaction fees should be some multiple of such costs incurred. The inclusion of the terms "reasonable" and "proportional" in the Debit Interchange Amendment vests the Board with latitude in rulemaking to allow for recovery of electronic debit transaction costs plus a reasonable return on investment regardless of the outcome of the Board's cost baseline determination. The Board's previous interpretation of the phrase "reasonable and proportional" in the context of rulemaking pursuant to the Credit Card Accountability, Responsibility and Disclosure Act of 2009 is instructive. There, the Board noted that it was not aware of any accepted definition for the phrase as a whole, but that "reasonable" as a separate legal term has been defined as "fair, proper or moderate" and is often used by Congress in granting an agency with broad discretion in rulemaking, and "proportional" is commonly defined as "having the same or a constant ratio."[23]

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[22] EFTA § 920(a)(2).

[23] Final Rule implementing 12 C.F.R. Part 226, Board of Governors of the Federal Reserve System, effective August 22, 2010.

Further, there is case law suggesting that rate regulation by federal or state governments must be "just and reasonable" to meet constitutional requirements.[24] Specifically, the United States Supreme Court noted in a natural gas rate regulation case that:

> it is important that there be enough revenue [from a regulated rate] not only for operating expenses but also for the capital costs of the business . . . . [T]he return to the equity owner should be commensurate with returns on investments in other enterprises having corresponding risks. That return, moreover, should be sufficient to assure confidence in the financial integrity of the enterprise, so as to maintain its credit and to attract capital.[25]

According to this standard, government regulated rates required to fall below the threshold of cost recovery plus a return on investment would be unconstitutional. While this body of law arises from utility and insurance rate regulations, the constitutional principle should apply also in the context of interchange transaction fee regulations.

Finally, from a practical perspective, if the Board does not interpret the terms "reasonable" and "proportional" to allow for recovery of all costs incurred by issuers with respect to electronic debit transactions plus a reasonable return on investment, debit card issuers would inevitably seek to reduce costs (and associated services) or pass along costs to consumers in the form of new or increased fees, both of which would negatively impact consumers and/or the broader economy, as further discussed below.

IV. The Board should take account of the unintended negative externalities that may result from certain rulemaking approaches the Board may consider in implementing the Debit Interchange Amendment

As many scholars and policymakers have noted, the challenges associated with implementing interchange transaction fee regulations are many and the outcomes of such regulations are difficult to predict.[26] Given the complexity of regulating interchange transaction fees, the Board should carefully consider the impact on consumers and the general debit transaction market of any rules it may adopt.

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[24] FPC v. Hope Natural Gas, 320 U.S. 591 (1944).

[25] *Id.* at 603.

[26] *See* Rising Interchange Fees Have Increased Costs for Merchants, but Options for Reducing Fees Pose Challenges, U.S. Government Accountability Office (GAO), November 2009; Wilko Bolt and Sujit Chakravorti, Economics of payment cards: A status report, 2008; Robin A. Prager et al., Interchange Fees and Payment Card Networks: Economics, Industry Development and Policy Issues, Federal Reserve Board Divisions of Research & Statistics and Monetary Affairs, May 2009.

Possible negative impact on consumers

Although electronic debit transaction interchange is an issue affecting relationships between commercial entities and not a consumer protection issue,[27] proponents of government-mandated interchange transaction fee reductions have argued that the benefit to merchants of lower interchange transaction fees would trickle down to consumers as pass-through cost savings in the form of lower prices for goods and services. Evidence from other markets where payment card interchange transaction fees have been lowered through regulatory intervention suggests that such a result may occur only where the rate regulating authority mandates pass-through of benefits to consumers. A self review of the Reserve Bank of Australia's reduction of credit interchange transaction fees in that country by approximately 50% without a pass-through mandate revealed that merchants generally did not pass the cost savings associated with lower fees on to consumers in the form of lower retail prices.[28]

Further, if the interchange transaction fees recoverable by debit card issuers are too low (below costs plus a reasonable return on investment), the issuers will either need to discontinue their money-losing debit programs or seek subsidizing revenue from other sources to sustain operations. Impacted debit card issuers may seek subsidies for their debit card programs by instituting or raising fees associated with checking accounts and/or online banking, or reducing or eliminating cardholder benefits. This possibility is supported by evidence from the experience in Australia. In reaction to the Reserve Bank of Australia's reduction of interchange transaction fees, Australian card issuers reduced the value of card reward programs and increased card annual fees, effectively increasing the price of credit card transactions to many consumers.[29] The Reserve Bank of Australia's regulations also led to a reduction in the number of new issuers in the marketplace; made it more difficult for smaller issuers to compete; encouraged issuers to favor customers who carry a balance (and therefore incur interest charges); and reduced the incentive for issuers to invest in new types of cards and payment system innovations.[30]

In addition to a negative impact on the general consumer population, regulations implementing the Debit Interchange Amendment could disproportionately impact particularly vulnerable groups of consumers. If interchange transaction fees were lowered, debit card issuers may elect to stop issuing debit cards to certain less profitable customers.

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[27] The CFPA, as part of its consumer protection mandate, transfers regulatory authority under the EFTA to the Bureau of Consumer Financial Protection ("CFPB"). CFPA § 1084. However, Congress expressly excluded the Debit Interchange Amendment from the oversight of the CFPB, therefore acknowledging that the Debit Interchange Amendment was not driven by consumer protection motives. CFPA § 1084(a)(2)(B).

[28] Reform of Australia's Payments Systems: Preliminary Conclusions of the 2007/08 Review, Reserve Bank of Australia, April 2008. Interestingly, the Reserve Bank of Australia, in setting interchange transaction fee standards, did not view interchange transaction fees as a mechanism for issuers to recover specific costs. *Id.* at 7.

[29] *Id.* at 17.

[30] Robert Stillman et al., Regulatory Intervention in the payment card industry by the Reserve Bank of Australia: Analysis of the evidence, CRA International, April 2008.

Possible impact on innovation and efficiency in the electronic debit transaction market

Current infrastructure and technology supporting debit card payment systems are the result of large and sustained investments in research and development by debit card issuers, acquirers, payment card networks, third party service providers and merchants. Innovations to the debit card payment system continue today, with rapid advances in the development of authorization, fraud detection and data security technology, and the use of novel form factors such as mobile electronic devices for electronic debit transactions. Such innovations increase the efficiency of electronic debit transactions as a payment type, promote e-commerce and benefit consumers and merchants alike through increased ease of use, expanded access and enhanced security, ultimately leading to increased consumer spending and investment in the economy.[31] If all or a portion of the costs of innovation were not recoverable by debit card issuers under interchange transaction fee regulations implemented by the Board, the debit card payment system could deteriorate and such innovations would slow or halt. The Board has in the past been sensitive to the risks that regulations pose to innovation. In 2006, when proposing rules to extend the scope of Regulation E protections to payroll card accounts, the Board expressly declined to also regulate general use prepaid cards. The Board justified its measured approach to extending Regulation E coverage, in part, on the grounds that regulations could stifle innovation, and noted that "coverage of [general use prepaid cards] could impede the development of other card products generally."[32]

In addition to stifling innovation, over the long-run, artificially low debit interchange transaction fees will most likely cause debit card issuers to terminate unprofitable debit programs, thereby reducing competition. A slowdown in innovation and a lack of competition among debit card issuers could lead to increased use of less efficient payment systems such as cash or checks, which could ultimately negatively impact consumer spending and the economy as a whole.

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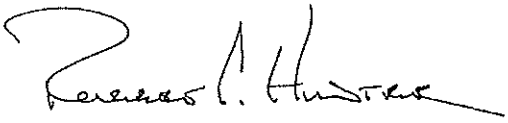
[31] *See*, e.g., W. Scott Frame & Lawrence J. White, Technological Change, Financial Innovation, and Diffusion in Banking, Federal Reserve Bank of Atlanta Working Paper 2009-10, March 2009; Mercator Advisory Group, Special Report: The Durbin Amendment: Impact Analysis, June 2010, at 5, 9.

[32] 71 Fed. Reg. 1475 (January 10, 2006).

Thank you for your consideration and review of these observations. If you have any questions or wish to discuss the comments of The Clearing House and The Financial Services Roundtable, please do not hesitate to contact us.

Yours very truly,



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