

November 18, 2010

Writer's Direct Contact  
202.778.1614  
OIreland@mofocom

*By Electronic Delivery*

Stephanie Martin  
Associate General Counsel  
Legal Division  
Board of Governors of the Federal Reserve System  
Washington, D.C. 20551

Re: Regulations to Implement Dodd-Frank Debit Provisions

Dear Ms. Martin:

As you will recall, Section 920 was modified before passage to specifically exclude the routine regulation of network fees, and therefore was not intended to regulate the structure, amount, or complexity of non-interchange fees set by networks. Nevertheless, in an apparent effort to prevent the use of network fees as a substitute for interchange transaction fees, the statute also provides that the Board may prescribe regulations regarding any network fee to ensure that the fee is not used to: (1) directly or indirectly compensate an issuer with respect to an electronic debit transaction; and (2) circumvent or evade the restrictions of this subsection and regulations prescribed under such subsection.<sup>1</sup> In this regard, the statute defines the term "network fee" as "any fee charged and received by a payment card network with respect to an electronic debit transaction, other than an interchange transaction fee."<sup>2</sup>

In one of our meetings, you noted that in creating its interchange standards the Board will need to consider how it will implement the non-interchange network fee language of the statute. While the purpose of the statutory language described above appears clear, what is less clear is how it can be implemented in a manner that prevents circumvention but without limiting a payment card network's ability to apply new or modified fees for new or enhanced products and services, create incentives for issuers, acquirers and merchants or unnecessarily constrain network competition because of uncertainty in how the provision may be applied.

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<sup>1</sup> 15 U.S.C. §§ 1693o-2(a)(8)(B)(i), (ii).

<sup>2</sup> 15 U.S.C. §§ 1693o-2(c)(10).

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Currently, networks may set fees to achieve key strategic network objectives such as processing integrity and acceptance expansion. For example, a network may apply fees to its issuing and acquiring clients to incent processing behavior that promotes the overall security and soundness of the system and provides tailored fees to expand acceptance (*e.g.*, small ticket fee incentives). Moreover, ideally any standards for non-interchange network fees should continue to provide networks with the flexibility to grow, compete, innovate and provide clear economic incentives benefiting all network participants. Setting and modifying fees consistent with these objectives would not in any way be designed to circumvent the Board's regulation. Said differently, it is in the best interest of competition and innovation to allow networks to maintain flexibility in how they set non-interchange fees, provided there is no intent to evade the interchange restrictions.

In addressing the non-interchange network fee issue, you may want to consider certain factors. Debit interchange fees in the U.S. are not currently (*i.e.*, prior to Section 920) subject to any legal restrictions or limitations. Therefore, there should be a presumption that current non-interchange network fees, discounts and issuer incentive payments are not intended to compensate issuers for debit transactions in a manner that functions as a merchant "add on" to interchange. Therefore, existing non-interchange network fees, fee structures and issuer incentives should be "grandfathered" under the Board's regulation. In this regard, the Board's regulations could provide that any non-interchange network fees, fee structures, incentives and the amount of fees and incentives as of a specific date are not prohibited under the regulations. Further, specific network fee structures may be modified in response to competitive risk, or other factors, but potential changes to those fees and incentives may be subject to greater scrutiny.

A "safe harbor" in this area would provide guidance to networks that operate in a highly competitive environment. Providing networks with a "safe harbor" would provide certainty for networks seeking to comply with the Board's regulations. Such a safe harbor could have multiple components. First, it could include, for example, establishing a relationship or threshold between issuer fees paid by any one issuer and the incentives paid to that issuer for going-forward issuing agreements. Second, it could also include a quantifiable "safe harbor" measure of acquirer or merchant fee increases that would be presumptively acceptable.

Under the second component, the Board's regulation could provide a "safe harbor" that an overall effective decrease or increase across all "grandfathered," non-interchange mandatory network acquirer or merchant fees during a time certain was presumptively not evasive where the modification was below a specified percentage (*e.g.*, at or below 10%). In the event overall fee increases or decreases exceeded such a specified threshold, individual acquirer or merchant fee increases or decreases would not be considered evasive where, for example, (1) there was no demonstrable linkage between the fee increase or decrease and a

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payment or discount to issuers or acquirers (*e.g.*, a simultaneous increase in an acquirer fee of 10% or more that is not offset by a comparable decrease in issuer fees); and (2) there is a showing that the fee increase or decrease serves other legitimate business purposes.<sup>3</sup>

A similar standard could be used for new network acquirer or merchant fees that are implemented following the Board's regulation where such fee may be outside the percentage-based safe harbor. For example, the Board's regulation could provide that a new mandatory (*i.e.*, not for an optional product or service) non-interchange acquirer or merchant network fee would not be considered evasive where: (1) there was no a demonstrable linkage between the fee and a payment or discount to issuers; and (2) the network is able to show that the fee change serves other business purposes.

In any event, any regulation in this area should not be so prescriptive as to result in the effective regulation of non-interchange network fees.

If you have any questions concerning these comments, or if I may otherwise be of assistance in connection with this matter, please do not hesitate to contact me, at (202) 778-1614.

Sincerely,



Oliver I. Ireland

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<sup>3</sup> Ten percent is used for illustrative purposes only and is not meant to imply that networks would actually raise their rates based on the safe harbor; in fact, rates may decrease as well. However, the safe harbor should be sufficiently high to permit flexibility and normal pricing adjustments, and not trigger direct regulation where the Act clearly indicated that regulation should only occur where such network fees resulted in an evasion of the debit interchange restrictions in the statute. In all events, debit networks will be subject to the disciplining force of competition in keeping their rates low, in order to win acquirer participation, preserve and expand merchant acceptance and win individual routing decisions at the point of sale.