

February 22, 2011

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

RE: Docket No. R-1404 and RIN No. 7100 AD63

Dear Ms. Johnson:

We write to express our concern that the Federal Reserve Board has not to date taken the prudent and, importantly, *legally required* step of conducting a competitive impact analysis of Regulation II, which implements the interchange fee provisions of section 1075 of the Dodd-Frank Act (Pub L. 111-203). We consider this to be one of the most significant legal changes to the payment system's competitive landscape since the Electronic Funds Transfer Act in 1978. This dramatic statutory and subsequent regulatory change will undoubtedly trigger a complex set of consequences for all firms participating in the payment system as well as for consumers purchasing both retail goods and financial services. **The Federal Reserve's obligation to conduct a competitive impact analysis of Regulation II is an appropriate and prudent safeguard against legal change with potentially pernicious consequences for the economy and consumers. Given the Board's own well-crafted standards, we do not believe it is appropriate for the Board to move forward in implementing Regulation II without the required competitive impact analysis.**

The Board's bulletin setting forth its role in the payments system lays out the policy that the Fed is supposed to follow "when considering ... a legal change ... if that change would have a direct and material adverse effect on the ability of other service providers to compete effectively with the Federal Reserve in providing similar services due to differing legal powers or constraints or due to a dominant marketing position deriving from such legal differences." The bulletin explicitly promises that "[a]ll operational or legal changes having a substantial effect on payments system participants will be subject to a competitive-impact analysis even if the competitive effects are not apparent on the face of the proposal."

There is little doubt that Regulation II qualifies for the required competitive impact analysis by this standard as it will likely have a "substantial effect on payment system participants." Further, several aspects of the proposal impose "differing constraints" on different institutions. The proposal, for example, exempts Fed-sponsored payment systems such as the ACH system from the scope of the regulation while sweeping in alternate

payment providers, even though such provider systems are functionally indistinguishable in relevant respect.

The bulletin goes on to provide details of the required competitive impact analysis. For example, the Board must “first determine whether the proposal has a direct and material adverse effect on the ability of other service providers to compete effectively with the Federal Reserve in providing similar services.” If so, the Board must then “ascertain whether the adverse effect is due to legal differences or due to a dominant market position deriving from such legal differences.” If legal differences or a dominant market position deriving from those legal differences are detected, the analysis must then turn to assessing the benefits of the proposed legal change and determining whether those benefits could be “reasonably achieved with a lesser or no adverse competitive impact.” Indeed, the bulletin indicates that “the Board would then either modify the proposal to lessen or eliminate the adverse impact on competitors’ ability to compete or determine that the payments system objectives may not be reasonably achieved if the proposal were modified.” As the bulletin anticipates, such a detailed and careful analysis is fully appropriate to better understand the competitive impact of a significant legal change in the payment system before it is implemented.

As Federal Reserve Board Governor Sarah Bloom Raskin observed in recent Congressional testimony, “Commenters also have differing perspectives on the potential effect of the statute and the proposed rule on consumers,” and “the magnitude of the ultimate effect is not clear and will depend on the behavior of various participants in the debit card networks.”

We agree with Governor Raskin’s observations and conclude that an economic impact analysis of the competitive effects of Regulation II, while a complex endeavor, is a critical one to protect competition in the payment system and consumers. We urge the Board to conduct an impact analysis of Regulation II and to make this analysis available for public comment before implementation of Regulation II.

If you have any questions please contact either Alex Brill at (202) 862-5931 or alex.brill@aei.org or Joshua Wright at (703) 993-8236 or jwrightg@gmu.edu.

Sincerely,

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