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VIA E-MAIL AND FEDERAL EXPRESS

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, DC 20551

Re: Docket No. R-1404 (Debit Card Interchange Fees and Routing)

Dear Ms. Roseman:

The undersigned are co-lead counsel for the class of merchants (the "Class") in *In re Payment Card Interchange Fee and Merchant Discount Antitrust Litigation*, MDL-1720 (EDNY) ("MDL 1720"), appointed by the Court to represent the interests of all merchants. We respectfully submit the following comments and proposals in response to the notice of proposed rulemaking relating to debit card interchange fees and transaction routing, published by the Federal Reserve Board ("Board") in the Federal Register on December 28, 2010. *Debit Card Interchange Fees and Routing*, 75 Fed. Reg. 81,722 ("NPRM"). We submit these comments on behalf of the millions of merchants that we represent to express our views on the proposed rules based on the substantial knowledge and expertise that we have accumulated in the many years we have worked with merchants on payment card issues, including the 5 plus years of litigating the merchants' challenge in MDL 1720 to long-standing anticompetitive conduct by Visa and MasterCard and their member banks.

We commend you and your staff, and the Board, on the diligent and thoughtful manner in which it has studied, considered and drafted rules pursuant to Section 920 of the Electronic Fund Transfer Act, as amended by Section 1075 of the Dodd-Frank Wall

Street Reform and Consumer Protection Act. Given the time limitations contained in the rule-making direction to the Board in the statute, and the Board's lack of prior regulatory experience regarding debit card interchange fees, the proposed rules represent a significant achievement that will assist debit networks, debit card issuers, and merchants in delivering the substantial public benefits that result from the statutory limits on debit card interchange fees and the other statutory mandates in Section 920. Below we provide some context and background that we believe should become part of the record of these rule-making proceedings, followed by our comments for the Board's consideration in completing its final rulemaking. In particular, the vehement arguments now being advanced by banks attacking Section 920 as "government price-fixing"[1] should be seen as simply the latest manifestation of the banks' desire to continue to retain the ability to engage in *private* price-fixing to bolster banks profits.

Background

It is apparent that Congress' motivation in enacting Section 920 was the recognition that the markets for payment card services generally, and debit card services in particular, are broken and in need of regulatory intervention. The dominant payment card networks in the United States and around the world, Visa and MasterCard, have operated for over forty years as bank cartels. They have been the subject of antitrust scrutiny for much of that time, and have been the target of both public and private antitrust enforcement efforts, as well. As the Board knows, but the public generally does not, until very recently *both* Visa and MasterCard were owned, operated and controlled by the world's largest banks. Sitting as the boards of directors of Visa and MasterCard, generally twice each year the banks agreed on the prices they all would charge to merchants for processing credit and debit card transactions. This conduct is no different that the classic "price fixing" that has been unlawful in the United States since the passage of the Sherman Act in 1890.

Over the last decade or so, there has been increasing recognition on the part of competition authorities and central banks that this anti-competitive conduct had substantially elevated the costs to consumers of the goods and services sold by merchants who accept credit and debit cards. In that time, the conduct of Visa and MasterCard, and the banks that control them, has been the subject of investigations in over two dozen countries around the world, and in at least 22 countries Visa and/or MasterCard's interchange rates have been reduced by regulatory authorities or courts.[2]

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[1] *See, for example*: http://news.businessweek.com/article.asp?documentKey=1376-LGQAON07SXKX01-005NC8HC0MPQD17BJEMBT334CS

Thus, the limitations on debit card interchange fees imposed by Section 920 are neither unprecedented nor unnecessary.

After the lawsuits in which we are co-lead counsel were filed in June, 2005, the banks that controlled MasterCard and Visa finally acknowledged that there was significant risk that their collective setting of interchange fees and merchant restraint rules was unlawful under U.S. antitrust law. Determined to evade liability for their collusive conduct, while retaining the enormous revenue streams from the fixed interchange fees, the banks attempted to accomplish this goal by "re-structuring" their joint ventures as publicly-traded companies. The strategy recommended by their legal advisors was to re-create both Visa and MasterCard as publicly-traded companies, while limiting the ability of the new companies to deviate from the interchange fee driven business model the banks had built up over forty years. MasterCard completed its re-structuring via an initial public offering ("IPO") in May, 2006, less than a year after the commencement of MDL 1720. Visa completed its re-structuring not quite two years later, in March, 2008.

On behalf of the Class in MDL 1720, we challenged this attempt by the banks to evade liability while retaining their collusive profits. [3] The MasterCard re-structuring was also challenged, along with the fixing of interchange fees and the other anti-competitive conduct challenged in MDL 1720, by the Competition Directorate of the European Union.[4] In a decision dated December 19, 2007 the European Commission determined that MasterCard's rules fixing interchange fees and limiting the competitive options of merchants were antitrust violations. It also found the banks still had effective control of MasterCard and that "The banks agreed to the IPO and the ensuing changes in the organisation's governance in order to perpetuate the MIF[5] as part of a

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[2] *See e.g.* MasterCard 2006 SEC Form 10-K, pp. 24-25, 117; MasterCard 2008 SEC Form 10-K, p. 28; Visa Inc., Amendment Number 5 to SEC Form S-4 Registration Statement, 13 September 2007, pp. 10, 161; Visa 2008 SEC Form 10-K, p. 16. *See also e.g.* U.S. Government Accountability Office, "Credit and Debit Cards: Federal Entities Are Taking Actions to Limit Their Interchange Fees, but Additional Revenue Collection Cost Savings May Exist," GAO-08-558, May 2008, pp. 34-35. See also "Remarks on Central Bank Intervention on Interchange Fee Setting in Mexico," prepared for the Payments Conference, FRB of Chicago, May 2009, by Jose Negrin, Banco de Mexico. Additional details are available upon request from the authors of these comments.

[3] The MasterCard re-structuring is described and challenged as unlawful in the Class Plaintiffs' First Amended Supplemental Class Action Complaint in MDL 1720. The Visa re-structuring is described and challenged in Class Plaintiffs Second Supplemental Class Action Complaint.

[4] The Visa re-structuring was later also challenged by the EU.

[5] "Multi-lateral interchange fees," European parlance for interchange fees.

business model in a form which they perceived to be less exposed to antitrust scrutiny."[6] The Visa rules and IPO are the subject of a pending investigation in the EU, as well.

After the enactment of Section 920, the United States Department of Justice Antitrust Division completed its multi-year investigation and commenced an antitrust action after it concluded that both Visa and MasterCard had substantial market power which they exercised by adopting anti-competitive rules that harmed consumers. Rather than to try to defend their conduct, both Visa and MasterCard agreed to a consent judgment which required that many of their rules be eliminated or modified.[7]

It is against this background that objective observers should consider the necessity for, and the merit of, the Board's faithful implementation of the statutory mandates of Section 920.

Reasonable and Proportional Debit Interchange Transaction Fees

We agree with the Board's proposed ruling that interchange fees on electronic debit card transactions should, at most, be limited to those incremental costs directly related to the authorization, clearing and settlement of a particular transaction. We say this in light of the sound economic and historical rationale for a more stringent finding that debit card transactions should clear at "par." The fundamental approach of the Congressional mandate, under Section 920(a)(4)(A) of the EFTA, is that the Board should consider the functional similarities between debit transactions and check transactions. The traditional check system has evolved and thrived with payments clearing at par so that the payee's bank is not required to pay a fee to the payor's bank to receive the *full* value of the checks presented. By the 1980s, banks were touting "free" checking to attract depositors (from whose deposits banks make money through float). Free checking services proliferated for the next 20 years even with the advent of electronic debit transactions and even though paper checks were more expensive for banks to process than electronic debit. Less than twenty years ago, some banks even expressed skepticism of electronic debit, describing it as "a product searching for a demand."[8] Soon, however, these same banks understood that "signature" debit, and

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[6] A heavily redacted public version of this decision is available on the European Commission's website: http://ec.europa.eu/competition/antitrust/cases/dec_docs/34579/34579_1889_1.pdf

[7] The relevant pleadings and other materials are available on the Antitrust Division website at: http://www.justice.gov/atr/cases/americanexpress.html

[8] Comments of TCF Financial CEO, William Cooper, September 11, 1990 at http://nl.newsbank.com/nl-search/we/Archives?p_action=doc&p_docid=0EFE47B377595... 12/8/2010

thereafter "PIN" debit, offered the opportunity to reduce their processing costs while at the same time collect an interchange fee to enhance their profits.[9] Now, in 2011, having grown accustom to this windfall, debit card issuers claim that the current and ever-increasing interchange fees are necessary for them to profitably operate their depository account business. Yet no bank has answered the question of why they were at one time able to profitably offer their depositors "free" checking, clearing at par, but now cannot operate the same business with an electronic access device that is cheaper to process, unless they impose new maintenance fees on depositors to recoup the loss of interchange. And no opponent of these necessary reforms has an answer to the fact that many debit card networks around the world have operated highly successfully for many years with *no* interchange fees, *i.e.* the transactions clear at par like checks do in the United States.[10] Indeed, the economy that is most similar to the United States – Canada – has a national debit card network (Interac) that clears at par.[11]

While the evolution of debit cards as a less expensive alternative to traditional paper checks would indicate that "par" clearance is justified, we recognized that Section 920(a)(4) directs the Board to consider the incremental costs incurred by an issuer in authorizing, clearing and settling a particular debit card transaction when it makes rules to establish "reasonable and proportional" interchange fees. In this regard, we agree with the Board's approach of excluding from this calculus other costs that may be incurred by issuers, such as network processing fees, issuing plastic, generating statements, customer services and cardholder rewards. NPRM at 81375. Allowing issuing banks to recover network processing fees, for example, would have the danger of creating socially negative outcomes for merchants and consumers. The networks that set these "switch fees" are unconstrained by the competitive input of merchants and cardholders. Moreover, Visa and MasterCard, who completely control the processing of signature debit (and in the case of Visa, dominate PIN debit), were at one time owned completely, and are still largely controlled, by their member banks.

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[9] The evolution of debit cards is described in MPC submission of Stephen C. Mott, October. 29, 2010, at http://www.federalreserve.gov/newsevents/files/merchants_payment_coalition_meeting_20101102.pdf.

[10] *See*, Fumiko Hayashi, "Payment Card Interchange Fees and Merchant Services Charges—An International Comparison," Lydian Payments Journal, Vol. 1, Issue 3 (January 2010) (containing analysis of many of these at par domestic debit payment networks), at http://www.pymnts.com/assets/NewFolder/Lydian-Payments-Journal-Volume-1-Issue-3.pdf

[11] *See*, http://www.interac.ca:80/about.php

With regard to measuring the incremental cost of authorizing, clearing and settling a particular debit card transaction, we believe the Board's methodological approach of adopting a average variable cost standard based on survey percentiles is sound from both an economic and practical standpoint. NPRM at 81735. In particular, we believe that "Alternative 1—Issuer-Specific up to a Cap, With a Safe Harbor" is the better approach. By implementing Alternative 1, the Board allows for the greatest amount of flexibility for most issuers to recover the costs of authorizing, clearing and settling debit transactions and avoids negative incentives through the use of the recommended cap of 12 cents and safe harbor of 7 cents per transaction.

As the Board has proposed, we agree that there should be no differentiation between Signature debit and PIN debit in connection with setting allowable interchange fees under Alternative 1. NPRM at 81737. From the merchants' perspective, Signature debit is the least desirable debit product currently offered in the marketplace. Signature debit is less efficient and prone to significantly higher fraud rates than PIN debit, NPRM at 81741 (relating to fraud losses), and should not be encouraged with a higher interchange rate than the rate allowed for PIN debit.

If the Board, in considering comments to its proposed rules, determines that Alternative 1 places too heavy of an administrative burden on networks and banks, then a second alternative should be to impose a maximum interchange fee at 7 cents per transaction. A maximum debit interchange fee cap of 7 cents (instead of 12 cents) is justified because: (1) it represents the "approximate median in the distribution of estimated per-transaction variable costs" (NPRM at 81378); (2) it creates the greatest incentives to banks to lower their costs; (3) it further incentivizes the use of PIN debit, or enhanced technology chip/pin devices, which are less prone to fraud; and (4) it would still allow for the most efficient issuers to benefit from the spread between costs and the cap. Of course, the most effective and easily managed outcome would be the complete elimination of any interchange on debit card transactions. This result would be consistent with paper check processing and the par clearance of PIN debit in the 1980s before Visa purchased Interlink in 1991.[12] Furthermore some of the world's most successful debit payment systems as measured by cardholder and merchant penetration and transaction volume developed and continue today without any interchange fee. These include Canada, Netherlands, Denmark, Belgium, Norway, New Zealand, Finland, and Luxembourg.[13]

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[12] *See,* Report of Stephen C. Mott, ¶22 and fn. 43.

[13] Hayashi, Lydian Payments Journal, Vol. 1, Issue 3 (January 2010), Fig. 4 at http://www.pymnts.com/assets/NewFolder/Lydian-Payments-Journal-Volume-1-Issue-3.pdf; EU

Fraud Prevention Adjustment

We appreciate the thoughtful and thorough analysis by the Board in connection with potential adjustments in debit interchange rates for fraud prevention costs as promulgated in Section 920(a)(5). We believe the comments and proposals of the Merchant Payments Coalition, submitted to the Board by letter dated January 20, 2011, provide a reasonable and comprehensive proposal for a fraud prevention adjustment. We would emphasis in response to Question 4 (NPRM at 81742), however, that any adjustment should be limited to fraud-prevention costs for PIN-based debit transactions. It makes little sense to provide further incentives for signature-based authorization when fraud prevention costs for Signature debit are double the costs for PIN debit and the fraud losses for Signature debit are almost 4 times greater than PIN debit. NPRM at 81741.

Prohibition on Network Exclusivity

Section 920(b)(1)(A) is designed to ameliorate merchant restraints caused by "network exclusivity" rules currently in place. The Board is directed to prescribe rules prohibiting a payment card network or an issuer from restricting the number of networks over which a debit card transaction may be processed to fewer than two unaffiliated payment card networks. Section 920(b)(1)(B) requires related rulemaking that prohibits networks and issuers from "inhibiting" the ability of a merchant to direct the routing of debit transactions over any payment card network that may process the transaction. We understand, as does the Board based on its comments in the NPRM, that these two provisions are intended work in tandem and compliment each other.

Regarding the prohibition on network exclusivity, the Board has considered and seeks comments on two different alternatives, borne of the fact that Section 920(b) does not delineate between Signature debit, processed over either the Visa or the MasterCard networks in the United States, and PIN debit, for which there are alternative networks beyond Visa and MasterCard. Alternative "A" suggests that the prohibition on network exclusivity under Section 920(b)(1)(A) would be met as long as debit cards were enabled to be processed over at least two different unaffiliated networks regardless of authorization method. NPRM at 81749. For example, it would be sufficient for a debit card to have one signature network routing option and one unaffiliated PIN routing option. The benefits of this alternative, simply stated, are that

Commission Decision of 19001/2007 (MasterCard), ¶ 556 at:
http://ec.europa.eu/competition/antitrust/cases/dec_docs/34579/34579_1889_1.pdf; EFTPOS Industry Working Group, Discussion Paper, July 2002, p. 6 (New Zealand) at: http://www.rba.gov.au/payments-system/reforms/debit-card-systems/eftpos-fee-reform.pdf

is would be easiest to implement, may be accomplished in a shorter time frame and could help to promote new authorization methods beyond signature and PIN, such as biometrics. The primary drawback of Alternative A is that it could limit the merchant's routing choice to one network once the cardholder chooses his or her authorization method. Furthermore, for those merchants who do not have PIN capability, or those merchant categories that are not amenable to single message processing (e.g. hotels, car rental), Alternative A would effectively provide only one routing choice.

Alternative "B" suggested by the Board to fulfill Section 920(b)(1)(A) would require that a debit card have at least two unaffiliated networks available for processing a transaction for each method of authorization available to the cardholder. NPRM at 81749. The clear benefit of this alternative is the promotion of the greatest number of merchant routing options and the competitive enhancements this would provide. The drawback of this option rests primarily with the lack of signature debit routing options in the United States—currently limited to Visa and MasterCard. The Board has also reported that requiring compatibility with both Visa and MasterCard signature networks might necessitate significant changes in existing payments infrastructure and require a lengthy implementation period. In our view, one of the biggest drawbacks of Alternative B is that it promotes a long-term commitment to the inferior Signature debit product.

Although either of the Board's two alternatives would be consistent with the mandate of Section 920, neither is entirely satisfactory. Therefore, we suggest a third alternative. Our third alternative would consist of rules requiring: (1) all debit cards be enabled for both signature and PIN authorization; (2) the availability of transaction routing over at least one signature network; and (3) the availability of transaction routing over at least two, unaffiliated PIN networks. The implementation of these requirements, along with rules under Section 920(b)(1)(B) that prohibit networks and issuers from "inhibiting" the ability of a merchant to direct the routing of debit transactions, would appear to avoid most of the drawbacks of Alternatives A and B.

Conclusion

In the weeks since the Board's proposed rules were published, there have been many submissions and press accounts regarding the proposed rules—many of which raise the specter of "unintended consequences" and question the beneficial impact on consumers. Most of these concerns have been fueled by card-issuing banks, payment card networks, and their related stakeholders who fear a significant decline in interchange fees from which they have profited for that last 30 years. This din of hyperbole is no different than the objections raised by the Networks and banks during the legislative process which resulted in this legislation, and it ignores the historical development of the bankcard networks to a point of ubiquity and market power, their

methodology for fixing interchange fees at supra-competitive levels, and their promulgation of POS merchant rules that restrain merchants' ability to promote less expensive forms of payment. The Board's proposed rules under Section 920 of the EFTA are a positive step in the right direction to help the debit payment card market in the United States to heal itself.

We appreciate the efforts of you and your team in preparing the NPRM issued in December and your consideration of theses comments. Please let us know if you wish to discuss any of these issues further.

Sincerely,

ROBINS, KAPLAN, MILLER & CIRESI L.L.P.

s/K. Craig Wildfang

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