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February 22, 2011

By Electronic Delivery

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

Re: Docket No. R-1404 (Debit Card Interchange and Routing)
Notice of Proposed Rulemaking, 12 C.F.R. Part 235

Dear Ms. Roseman:

On behalf of our company and millions of customers, Amazon.com, Inc. ("Amazon") respectfully submits the following comments in response to the Notice of Proposed Rulemaking ("NPRM") issued by the Board of Governors of the Federal Reserve System (the "Board") pursuant to Section 920 of the Electronic Fund Transfer Act ("EFTA" or the "Act").

Amazon appreciates the diligent work of the Board as reflected in the NPRM. The Board made a number of important determinations and substantial progress toward establishing regulations regarding debit card interchange that will begin to remedy the market failure that has harmed merchants and consumers alike. We write to bring the Board's attention to three issues of concern to Amazon and other card-not-present[1] merchants.

- Reasonable and Proportional Interchange Fees. A card is a card for the purposes of determining the costs of authorization, clearance, and settlement ("ACS"); interchange rates under the statute should not vary depending on whether a consumer uses her debit card in a physical store or online. Because costs of ACS for card-not-present debit transactions are virtually the same as the costs of ACS for card-present transactions, all merchants should pay the same basic rates of interchange.
- Fraud Adjustment. Any regulations drafted by the Fed to create rules that allow issuers to adjust interchange fees to compensate for the cost of fraud must (i) allow merchants the option of adopting or not adopting issuers' fraud solutions, (ii) not prescribe specific fraud-prevention technologies, and (iii) only allow issuers to recover fees that are set by the market of issuers and merchants and reflect issuers' performance in reducing merchants' fraud.

[1] Internet merchants, together with telephone, television, and mail-order merchants, are often referred to as "card-not-present" or CNP merchants. Although networks and issuers incorrectly use the term "card-not-present" as a synonym for "high-risk" and therefore as a rationale to justify discriminatory interchange and chargeback rules, we nonetheless use the term here for convenience.

I. Reasonable and proportional interchange fees should not vary across merchant categories.

A. Historically, card-not-present merchants have paid interchange rates that are significantly higher than the rates paid by similarly situated offline competitors, despite the fact that card-not-present merchants have complete liability for fraud costs and have made significant investments in their own fraud prevention systems.

1. Card-not-present merchants (regardless of their quality) pay interchange rates that are significantly higher the rates paid by their card-present competitors (regardless of their quality).

Beginning with catalogue and telephone sales, the payment industry has charged an arbitrarily higher interchange rate for card-not-present transactions than it has charged for traditional card-present transactions. Since the Internet became a commonly used medium for commerce in the 1990s, the payment industry has perpetuated this arbitrary distinction by requiring Internet card-not-present merchants to pay vastly higher interchange rates than those paid by their direct competitors in traditional card-present environments. These rates are often upwards of 98 basis points higher than card-present rates.[2] Payment networks initially claimed that card-not-present transactions posed higher risks to the system, which allegedly justified the extraordinarily high premium over card-present interchange rates. If it was ever valid, that justification has vanished over time.[3] Nor were these rates necessary to gain card acceptance, as the NPRM incorrectly observed.[4] Indeed, card-not-present debit interchange rates have steadily increased over time despite higher volume (which continues to grow at double-digit rates) and the maturation of the Internet and other card-not-present sales channels.[5] As observed in the NPRM, today card-not-present transactions comprise fully 14% of signature debit transactions and 10% of debit transactions overall. See NPRM at 81725 n.19. Those percentages continue to grow as online and mobile payments rapidly expand due to consumer preference.

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[2] *See* Visa U.S.A. Interchange Reimbursement Fees – October 2010, http://usa.visa.com/download/merchants/october-2010-visa-usa-interchange-rate-sheet.pdf (comparing "CPS/e-Commerce Basic" rate with "CPS/Retail Debit—Performance Threshold I" rate).

[3] For example, overall fraud loss rates for Internet merchants have steadily declined over the last 11 years as measured by CyberSource (now a subsidiary of Visa). *See* CyberSource Online Fraud Report 2011 at 4, 5, 19.

[4] The NPRM notes that, "Beginning in the early 1990s, signature debit networks also began creating separate categories for merchants in certain market segments (*e.g.*, supermarkets and card-not-present transactions) to gain increased acceptance in those markets." NPRM at 81724. While this statement may be partly correct – with respect to supermarkets where lower rates were created to induce acceptance – it is incorrect with respect to card-not-present merchants that always paid higher, discriminatory rates. These higher rates had nothing to do with inducing acceptance.

[5] Price discrimination is classic indicia of market power. *See, e.g., In re Brand Name Prescription Drugs Antitrust Litig.*, 186 F. 3d 781, 783 (7th Cir. 1999) ("price discrimination implies market power"); *United States v. Visa U.S.A. Inc.*, 163 F. Supp. 2d 322, 340 (S.D.N.Y. 2001) ("Defendants' ability to price discriminate also illustrates their market power."); *In re Visa Check/MasterMoney Antitrust Litig.*, 192 F.R.D. 68, 74 (E.D.N.Y. 2000) ("Another test of market power is the ability to engage in price discrimination".).

Low-fraud card-not-present merchants like Amazon effectively subsidize the payment networks through higher interchange rates and by bearing the cost of fraud prevention themselves. This subsidy exists because the existing interchange fee structure makes a blunt categorization (i.e., card-present and card-not-present) that ignores the quality of merchants' actual performance. The fact that networks differentiate pricing among card-present merchants and that interchange rates for card-not-present transactions have gone up even as overall card-not-present risk (which the payment networks claim justifies the distinction) has steadily declined demonstrates a market failure in the current payments system due to the long-standing lack of competition and the persistent market power of the payment networks.

2. *Card-not-present merchants are contractually obligated to absorb the cost of their fraud, which belies the "risk" justification for the two-tier interchange system.*

The inequities of this two-tier interchange system have been compounded by the fact that merchants contractually bear all of the fraud risks associated with card-not-present transactions through chargeback rules imposed by the payment networks. In addition, merchants are charged fees for every chargeback they represent, and pay additional fees if the chargeback is not reversed upon representment. The NPRM partially acknowledges this reality, noting that according to network and issuer surveys, merchants "assume approximately 76 percent of signature debit card fraud for card-not-present transactions." NPRM at 81741.[6] This is further evidence of a dysfunctional market.

3. *Many card-not-present merchants invest in risk management systems that reduce fraud and benefit the payment networks, but current interchange fees do not account for these investments.*

Discriminatory card-not-present interchange rates also fail to account for the investments many card-not-present merchants such as Amazon have made to develop their own risk management systems that rival (if not exceed) those employed by issuers,[7] with many merchants achieving fraud rates equal to or lower than many card-present merchants. Yet card-not-present merchants continue to pay unreasonable and discriminatory interchange rates while bearing the cost of fraud losses.

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[6] We are uncertain how the Board determined card-not-present merchants' liability for fraud is limited to 76%. Card-not-present merchants bear all of the fraud chargeback costs.

[7] In its 2011 annual survey of online fraud, CyberSource reports that one-third or more of merchants spend 0.5% or more of their online revenues to manage fraud. CyberSource Online Fraud Report 2011 at 21. CyberSource notes that "Online payment fraud impacts profits from online sales in multiple ways. Besides direct revenue losses, the cost of stolen goods/services and associated delivery/fulfillment costs, there are the additional costs of rejecting valid orders, staffing manual review, administration of fraud claims, as well as challenges associated with business scalability." *Id.* at 6. Indeed, the cost of addressing a single chargeback is substantial: "The average time spent overall was 1.8 hours, with a median time of 1 hour to handle a fraud chargeback (total time consumed for research, documentation, submission)." *Id.* at 17.

B. Reasonable interchange fees should be the same for all merchants.

The statute requires the Board to set standards to ensure that any interchange received or charged by regulated debit issuers is "reasonable and proportional" to costs incurred "by issuers or payment card networks in connection with the authorization, clearance or settlement of electronic debit transactions." As the costs of ACS do not vary by sales channel and the costs related to fraud are borne by the card-not-present merchants, any discrimination between card-present and card-not-present transactions should be prohibited.

1. Variation among interchange fees should be prohibited unless tied to allowable ACS costs.

Sanctioning continued price discrimination would be antithetical to the fundamental purposes of the Act. Rather, Congress intended that only actual authorization, clearance and settlement costs incurred by an issuer for a particular transaction comprise a reasonable interchange fee. *See* NPRM at 81734. Those costs do not vary materially for card-not-present transactions. Indeed, the NPRM does not refer to any quantification of cost differences between the two types of transactions for issuers. Yet Proposed Commentary 3(b)-4 (NPRM at 81759) and 3(b)-1 (NPRM at 81760) would allow (or considers allowing) for "variation among interchange fees" – including for card-not-present transactions – so long as fees remain below the safe harbor or cap. NPRM at 81736. Such variation is not permitted under the statute.

As the Board recognized, the Congressional intent behind the EFTA was to strictly limit debit card interchange fees to the actual processing costs of issuers. NPRM at 81733-34. As the Board is aware, the transaction messaging flow for debit transactions is identical for card-present and card-not-present transactions. NPRM at 81724. Allowing variation of ACS costs for different types of merchants ignores the fact that, as properly defined, allowable ACS costs are virtually the same regardless of merchant category.[8] Without substantiation of purportedly higher and properly allowable ACS costs to issuers for particular card-not-present transactions, variation by type of merchant should not be permitted under the statute.

2. The rules should exclude the cost of fraud, chargebacks and customer disputes from any allowable costs of interchange.

Amazon supports the Board strictly limiting the costs allowed to be considered in setting interchange to the costs attributable the issuer's role in authorization, clearance, and settlement, and excluding costs associated with fraud prevention. This is in accord with the clear intent and plain text of the statute. *See* NPRM at 81734-35 ("This formulation includes only those costs that are specifically mentioned for consideration in the statute."). The Board properly rejected efforts by issuers and payment networks to distort ACS costs, such as by importing fraud prevention through an overly broad definition of authorization. *See* NPRM at 81760 ("An issuer

[8] For example, the identity of the transaction flow for card-present and card-not- present transactions can be seen in a 2003 publication of the Federal Reserve Bank of Kansas City, which presents several flowcharts setting forth "authorization," "processing" and "settlement." Terri Bradford et al., *Nonbanks in the Payments System*, 24-26 (Nov. 2003). In each chart, the messaging flows and processing steps for credit and signature debit (also known as "offline debit") are the same for card-present and card-not-present transactions.

generally performs separate activities with the primary purpose of fraud-prevention in connection with authorization. Those separate activities are not considered to be part of an issuer's role in authorization under § 235.3(c)(1).").

While the Board properly rejected efforts to import customer service costs into ACS, noting for example that *inquiries* about transactions are not part of clearance costs (NPRM at 81760), the Board's decision to allow the costs of "non-routine transactions" such as "chargeback messag[ing]" effectively imports unrelated costs into the ACS calculation. *See* NPRM at 81739.

As for chargebacks, there are two broad categories of chargebacks. The first is referred to as a "service chargeback," which occurs when customers notify their issuers of service concerns regarding a merchant (*e.g.,* the customer did not receive an item or the item was not as described). The second category of chargebacks is often referred to as "fraud chargebacks." Fraud chargebacks result from transaction fraud tied to the unauthorized use of the card (*e.g.,* the cardholder did not authorize the transaction.).

Including any chargeback costs into the allowable interchange fee is improper under the Act since those costs have nothing to do with ACS. Service chargebacks shift liability after an issuer has authorized, cleared, and settled a transaction, and merchants separately pay significant fees in connection with those chargebacks. Those fees far exceed the administrative costs of providing chargeback services, so including service chargeback costs into the ACS calculation would significantly over-compensate networks and issuers for service chargebacks.

Including fraud chargeback costs in the calculation of interchange for ACS imports significant fraud costs into the ACS calculation and creates the risk of double-counting those costs. Under the Act, any adjustment to interchange based upon fraud prevention costs clearly belongs in a separate rulemaking under a different provision, EFTA § 920(a)(5). The Act's plain text and structure mandate separate consideration of issuers' ACS costs and any "adjustments" for fraud prevention costs. This is confirmed by the Act's legislative history. Senator Richard Durbin, the principal sponsor of this part of the Act, stated on the Senate floor that "It should be noted that any fraud prevention adjustment to the fee amount would occur after the base calculation of the reasonable and proportional interchange fee amount takes place, and fraud prevention costs would not be considered as part of the incremental issuer costs upon which the reasonable and proportional amount is based."[9]

[9] 156 Cong. Rec. 105, S5925 (July 15, 2010) ("Further, any fraud prevention cost adjustment would be made on an issuer-specific basis, as each issuer must individually demonstrate that it complies with the standards established by the Board, and as the adjustment would be limited to what is reasonably necessary to make allowance for fraud prevention costs incurred by that particular issuer.").

3. *If the Board considers the cost of fraud, chargebacks and customer disputes as part of ACS, that cost should be based on merchants' management of those costs.*

If the Board were to consider allowing costs generated from customer disputes about specific transactions (*e.g.,* the cost of handling customer service calls, processing chargeback transactions, etc.), those calculations should be tied to the experience of individual merchants, rather than using arbitrary categories such as card-not-present or card-present that do not properly serve as a proxy for merchant quality. Issuers and payment networks have historically argued that card-not-present transactions result in higher dispute rates than card-present transactions. In truth, many high-quality card-not-present merchants have fraud and dispute rates that are comparable to, or lower than, many card-present merchants. Most reputable merchants would prefer to resolve these customer service issues themselves rather than having a valued customer resort to disputing a transaction through his or her card issuer.

In fact, the payment networks have historically managed the issue of disputes by setting a threshold acceptable rate for disputed transactions. Merchants (card-present and card-not-present alike) who experience chargeback rates in excess of these thresholds are routinely fined and risk being removed from the network. So, payment networks are ideally positioned to, and are already capable of, metering the number of disputes generated by each merchant, assessing fees or fines for those events and allowing issuers to recover those costs from the specific merchants imposing the costs.

If the cost of customer disputes are to be included in the interchange calculation (which we believe is not supported by the statute), then we would recommend that a "normal" or "safe harbor" threshold be established for chargeback rates and be covered by interchange rates to be charged and that any excessive disputes be recovered through a per item charge on each merchant. This would ensure that the costs associated with customer disputes are reasonably tied to the performance of the merchant while preventing improper cross-subsidies that can occur when merchant categories are used as a proxy for something that is actually measurable.

4. *Permitting issuers or networks to average transaction costs conflicts with the Act and invites continued discrimination and improper subsidies across merchant categories.*

The Board requested comment on whether to permit issuers or networks to exceed the thresholds if "average" transaction costs fell within the safe harbor or cap. NPRM at 81738-39. We are strongly opposed to this approach because it is simply a veiled invitation for the networks to set card-not-present rates above the cap and permit fees which are not reasonable or proportional to the cost incurred with respect to card-not-present transactions, in clear violation of the Act.[10]

[10] Indeed, the averaging proposal likely originated in comment letters from Visa and certain unidentified banks during the first phase of the Board's rulemaking. *See* Letter from Visa to Federal Reserve Board (Nov. 8, 2010), http://www.federalreserve.gov/newsevents/files/visa_comment_letter_20101108.pdf; Letter from Oliver Ireland, Morrison Foerster LLP to Federal Reserve Board (Nov. 5, 2010),

While the NPRM mentions the purported increased "flexibility" of this proposal, there is no discussion about what that means, let alone why flexibility in debit interchange rates is needed or consistent with the statute. The NPRM refers only to the ability to adjust pricing to "reflect differences in risk, among other things." NPRM at 81738. Transaction risk for debit card transactions concerns fraud and should be addressed in the rulemaking on any fraud adjustment – a rulemaking that, as the statute requires, must account for the cost of fraud to merchants, among others.[11] To the extent this reference to risk relates to card-not-present merchants, it is worth noting that such merchants currently bear nearly all the risk of fraud, and thus charging them higher rates under the guise of "flexibility" and higher fraud risk cannot be justified.

For these reasons, an averaging approach would be inconsistent with the statute and would only result in the continued imposition of excessive and unjustified interchange fees on card-not-present merchants. Differential rates would also perpetuate the current structure, where high-quality merchants whose business is limited to card-not-present transactions subsidize low-quality merchants across all merchant categories.[12] As the Board recognizes, such an approach would also conflict with the text of the Act, which focuses on the costs to "the" particular issuer for "the" particular transaction – costs which do not vary by merchant type. NPRM at 81738.

Finally, we share the Board's concern that an averaging approach that requires an *ex ante* calculation of differential rates could result in the average exceeding the cap. This concern is aggravated by the possibility, if not the likelihood, that averaging based on *ex ante* calculations may understate actual card-not-present volumes (which are increasing and will continue to do so with rapid consumer adoption of online and mobile payments), thereby enabling the networks to continually overcharge merchants such as Amazon. We see no easy corrective for this other than to require issuers to provide inherently unreliable growth forecasts for card-not-present transactions before each year and to rebate any such overcharges *ex post*. For these reasons, in addition to being unprincipled, this approach will present difficulties in administration that the Board should avoid.[13]

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http://www.federalreserve.gov/newsevents/files/morrison_and_foerster_comment_letter_20101105.pdf (substantially similar letter, using much of the same language, submitted on behalf of "a number of institutions" which are not identified). These letters proposed averaging so that "a network could set different rates based on merchant size, merchant segment, acceptance channel (e.g., card present vs. card not present)," without any suggestion that these transactions varied in actual cost to issuers. (Visa Comment Letter at 18.) The letters were also careful to note that "[t]he Board would need to periodically update the Average Effective Debit Interchange Rate as the underlying aggregate issuer cost profiles change over time" – thereby insuring that "average" costs would continue to rise with the growth of card-not-present transactions.

[11] The Act's separate fraud adjustment provision dictates that the Board broadly consider "the nature, type, and occurrence of fraud" in debit transactions, EFTA § 920(a)(5)(B)(ii)(I), and account for the liability of all parties for fraud loss and fraud prevention costs, EFTA § 920(a)(5)(B)(ii)(IV &V).

[12] It is important to note that low-quality merchants that create risks for the system exist in both the card-present and card-not-present environments.

[13] If the Board were to allow averaging across networks or issuers, higher interchange rates should not be imposed upon all card-not-present merchants. Rather, higher rates should be limited to demonstrably higher-risk merchants,

C. The Board should adopt Alternative 1 with its potential for lower fees and the express definition of allowable costs

Amazon supports the Board's proposed standard in 12 C.F.R. § 235.3 mandating that any interchange fee be "reasonable and proportional" to the cost incurred by the issuer for the transaction, albeit with lower thresholds.

1. Alternative 1 properly defines ACS costs.

The interchange fee standard proposed under Alternative 1, 12 C.F.R. § 235.3(c), most closely follows the text of the Act, which contemplates an issuer-specific determination of ACS costs. *See* EFTA §920(a)(2) (interchange an issuer may receive with respect to an electronic debit transaction must be "reasonable and proportional to the cost incurred by the issuer with respect to the transaction").

As the NPRM notes, this alternative defines as allowable "only those costs that are specifically mentioned for consideration in the statute." NPRM at 81734-35. In contrast, the rules proposed for Alternative 2 do not define allowable costs. Although presumably the same definition of allowable costs would be used to make any adjustments to the fee cap in Alternative 2, we believe it is important that these definitions be part of the regulations. Limiting allowable costs to an issuer's role in ACS – and explicitly defining such costs in § 235.3(c) – thus follows the intent of Congress and the plain text of the statute.

2. Issuer-specific cost calculations may result in lower interchange fees, whereas under Alternative 2 issuers will default to the cap.

Alternative 1's more flexible structure allows for variability in issuers' costs. Further, it could to some degree promote issuer competition to increase efficiency, particularly if issuers attempt to get below the safe harbor to increase their profits. As the NPRM notes, requiring issuers to demonstrate that their actual allowable costs exceed the safe-harbor provides an incentive to keep these costs below it. NPRM at 81738. Under Alternative 2, on the other hand, we believe it is likely that all issuers will charge the maximum 12 cents per transaction, and we see no reason why allowing issuers to default to that amount is the correct result from a statutory or policy perspective.

To the extent the Board believes that networks may set interchange rates below 12 cents to induce merchants to preferentially route to them by taking advantage of § 235.7, such an approach will be ineffective unless and until most merchants have multiple routing options, including those that accept only signature debit. Because PIN debit (or any other alternative) is not widely available to card-not-present merchant, these merchants will have little or no alternative under Alternative A to § 235.7, (*i.e.,* one signature and one PIN alternative) and little or no alternative until 2013 under Alternative B (two signature and two PIN alternatives). NPRM at 81753. This reinforces our view that Alternative 2 will result in issuers defaulting to

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whether card-not-present or card-present. As noted above, networks already measure merchant performance and could do so if the Board permitted averaging.

12 cents per transaction, a result that cannot be justified under the statute given that 12 cents substantially exceeds issuers' true ACS costs.[14]

II. The Board must adopt fraud adjustment rules that address all merchants and can be administered without significant, additional burden on the Board, issuers, payment networks, or merchants.

The Board must decide whether an adjustment is "reasonably necessary to make allowance for costs incurred by the issuer in preventing fraud," and, if so, what fraud-prevention costs the adjustment should cover and what standards the Board should prescribe for issuers to meet in order to receive the adjustment.

A. Any fraud prevention adjustment solution must (i) allow merchants the option of adopting or not adopting issuers' fraud solutions, (ii) not prescribe specific fraud-prevention technologies, and (iii) only allow issuers to recover fees that are set by the market of issuers and merchants and reflect issuers' performance in reducing merchants' fraud.

We believe the Board should implement a fraud adjustment that promotes three key principles: (1) technological neutrality, (2) merchant choice in determining whether to adopt any issuers' fraud prevention solution, and (3) performance-based and market-based pricing for issuers' fraud prevention products. A fraud adjustment that adopts these principles is the only way to address the Act's requirement that an adjustment be "reasonably necessary to make allowance for costs incurred by the issuer in preventing fraud" and help the Board avoid cumbersome administration of the adjustment.

Unlike ACS costs, which do not vary across or within merchant channels, merchants in different retail channels, and even differently situated merchants in the same channel, may have variable tolerances for fraud costs and alternative approaches for reducing fraud. Mandating the use of a particular technology ignores these differences, stifles innovation, and creates a fixed target for perpetrators of fraud to attack. The Board should design an adjustment that encourages issuers to develop a variety of fraud prevention techniques that are tailored to the many types of merchants and their differing needs.[15]

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[14] As the NPRM points out, the weighted average cost to issuers is actually 4 cents per transaction. NPRM at 81737. Average transaction cost is a more economically meaningful measure than median issuer cost. The true costs of ACS – "three least expensive steps in the debit service" – are nominal. Complaint ¶ 94, *TCF Nat'l Bank v. Bernanke*, No. 10 Civ. 4149 (D.S.D. Oct. 12, 2010). We believe that reported costs were improperly inflated by the inclusion of fees paid to processors performing outsourced ACS services, where the processor's profit margin is likely included in the fees, and therefore such fees should be excluded. *See* NPRM at 81735.

[15] Limited fraud prevention options, even within a narrow market, often fail to address merchant preferences and economic realities. For example, despite Visa's and MasterCard's efforts over several years to impose their Verified by Visa and SecureCode services on e-commerce merchants, these services have not been widely adopted. *See* Cybersource 2010 at 8 (showing only 16% of larger Internet merchants use either product). Cybersource noted that "despite significant interest in implementing payer authentication systems over the past few years, we have seen relatively slow actual adoption of payer authentication since we started tracking this tool in 2003." *Id.* at 9 and chart 3; *see also Kate Fitzgerald, Report: 3-D Secure Not What Name Suggests*, Am. Banker (Feb. 3, 2010).

In order to ensure that the issuer is actually using the additional fees to successfully prevent fraud, it is critical that merchants have the right to adopt or not to adopt issuers' fraud prevention technologies and pay the fraud adjustment that compensates issuers for these technologies. For a fraud adjustment to be "reasonably necessary," it should compensate issuers[16] for providing a service that a merchant values and is either unwilling or unable to provide for itself. A merchant may have its own or third-party created fraud prevention technology or processes that prevent or reduce fraud. In such cases, the merchant may reduce fraud more efficiently than an issuer. The statute allows merchants the right to use its own fraud technologies in lieu of issuer technologies by requiring that the Board consider "the fraud prevention and data security costs expended by each party involved in electronic debit transactions." In addition, issuers should only receive fraud adjustments to the extent they actually "reduce the occurrence of, and costs from, fraud in relation to electronic debit transactions." If an issuer's product does not reduce fraud for a merchant, the Board should not compel a merchant to adopt or pay for an issuer's technology.[17]

The Board should not specify a fixed amount or cap[18] for issuer fraud adjustments, but instead should allow issuers to compete and set prices that merchants will pay for their fraud prevention services. Fixing fees or introducing a cap is undesirable for several reasons. First, this ignores the statutory requirement that any adjustment be "reasonably necessary to make allowance for costs *incurred by the issuer* in preventing fraud." Individual issuer costs are what the statute identifies as the relevant measure. Second, a fixed fee or cap ignores the Act's requirement that the Board consider offsetting expenses incurred by other participants in preventing fraud. Merchant costs are implicitly addressed in a competitive market for fraud prevention because issuer offerings will be more or less cost-effective depending on a merchant's own fraud-prevention spending.[19] Third, different merchants will assign different values to an issuer's fraud prevention technologies due to merchants' different product mixes, margins, and fraud-prevention technologies. Indeed, some "fraud prevention" technologies might not materially reduce fraud for some merchants, but instead might suppress legitimate

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[16] Issuing regulations that are technology neutral, preserve merchant choice, and require performance- and market-based pricing stimulate competition among issuers. For any service or technology to qualify for an adjustment, a specific *issuer* must deploy it and offer it competitively to merchants; networks are not permitted to recover fraud adjustments under the Act. The Act's focus on potential issuer compensation for fraud adjustment costs reflects the fact that issuers are in a better position to prevent fraud than networks and limits additional abuse of market power by the networks.

[17] Preserving the right of merchants to implement or not implement an issuer's fraud service and pay the fraud adjustment will encourage innovations in fraud prevention technologies. Both issuers and third-party developers (from whom issuers can purchase or license technology) will have an incentive to develop solutions to reduce fraud for all types of merchants.

[18] Setting a cap will incent issuers to set the amount of fraud adjustment at the cap.

[19] We do not believe that all merchant "fraud prevention and data security costs" are addressed by this mode. For example, merchants' PCI costs and other network-mandated measures, which have varying levels of cost effectiveness, will not be addressed. Although we do not agree that some of these costs are justifiable, we recognize that all payment system participants bear some costs that are less than optimal given their particular preferences and business models. The Board cannot reasonably be expected to address all of those costs, just as the Board cannot reasonably be expected to tally all issuer costs that theoretically help reduce fraud (e.g., customer identification procedures) and are generally spread across multiple financial products.

sales. Only a market-based pricing mechanism will allow merchants and issuers to set an efficient price for issuers' fraud prevention services and ensure that legitimate sales are not suppressed.

B. If the Board does not adopt these principles for all merchants, the Board should adopt a proposal that recognizes how card-not-present merchants, issuers, and card networks have addressed fraud prevention.

We believe that the principles described above address most of the Board's questions and concerns enumerated in the NPRM. However, if the Board elects not to propose a mechanism for determining issuer fraud adjustments for all merchants that incorporates the principles above, then the Board must recognize that card-not-present merchants – with the participation of the payment networks, issuers, and acquirers – have developed business models and fraud prevention techniques that reflect these principles. Eliminating these merchants' choice to purchase fraud-adjustment technologies will adversely affect card-not-present merchants and their customers. Thus, any proposal that differentiates among retail channels or market segments must also mandate technological neutrality, preserve merchant choice in determining whether to adopt any issuers' fraud prevention solution, and establish performance- and market-based pricing for issuers' fraud prevention products.

1. Card-not-present merchants already manage their fraud risk without liability protection from issuers or networks.

Card-not-present merchants bear most of the fraud and chargeback risks associated with their transactions through the chargeback rules imposed by the payment networks. These rules require card-not-present merchants to absorb most of the fraud costs associated with payment card transactions. Card-not-present merchants understood these commercial terms and developed or purchased fraud detection systems, customer authentication methods, and other systems and processes to manage liability for fraudulent transactions. These systems and methods have cost hundreds of millions of dollars to develop and refine over a period of almost twenty years. The most effective systems developed with these investments produce rates of fraud equivalent to, or below, the rates experienced by card-present merchants while preserving checkout processes that impose minimal disruption on the vast majority of their customers.

Despite the inherent disadvantages that card-not-present merchants faced due to payment network rules, card-not-present merchants have nonetheless learned to operate without any fraud liability protection from card networks or issuers. As a result, it would not be reasonable or necessary to require card-not-present merchants to bear additional fraud prevention costs that would not provide them with adequate benefit. Since card-not-present merchants already bear virtually all risks associated with fraud chargebacks, they are in the best position to determine what constitutes an "adequate" benefit provided by an issuer fraud-prevention technology. Also, mandating that card-not-present merchants utilize any issuer's fraud prevention techniques could have unintended and unwelcome consequences to merchants and consumers by unnecessarily increasing their costs and by negatively affecting their users' experiences.

2. *Issuers may offer, and card-not-present merchants may purchase, fraud prevention solutions.*

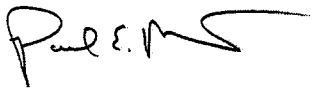
Many card-not-present merchants purchase fraud management tools from third parties and use them successfully. For example, many card-not-present merchants have implemented network-provided fraud detection services such as CVN (card verification number) validation and AVS (address verification service), which are either free or inexpensive, are relatively easy to implement, are not disruptive to customers, and may add some amount of incremental value to a merchant's determination of whether a transaction might be fraudulent. These fraud detection services are adopted even though card-not-present merchants receive no guarantee against fraudulent transactions. Merchants therefore decide whether to purchase fraud prevention tools based on whether their anticipated return on investment is attractive given other investment opportunities.

Some fraud prevention solutions impose unacceptable costs to the merchant or its customers. For example, Visa's Verified by Visa and MasterCard's 3D Secure products have gained limited acceptance, even though they provide, under some circumstances, a guarantee against fraud liability. Card-not-present merchants have determined that these network products are cumbersome for consumers and ineffective in reducing fraud. The network charges for these services, combined with low consumer adoption and networks' suggestion or requirement that merchants maintain their existing fraud mechanisms, often lead card-not-present merchants to avoid these supposed fraud "solutions" due to their overall high costs and low benefits.

Card-not-present merchants are willing to entertain new fraud prevention and customer authentication techniques offered by any provider, including issuers. However, different merchants may legitimately reach different conclusions about the efficacy and economic attractiveness of any given issuer's fraud prevention technology. Therefore, to ensure that any fraud allowance is reasonably necessary the Board should preserve card-not-present merchants' right not to make bad investments by ensuring that issuers' fraud adjustment technologies are voluntary, private contracts that are based on negotiated commercial terms and pricing, and not mandatory fees imposed by the Board.

Thank you in advance for your attention to the comments in this letter. Please let me know if you have any questions. I can be reached at pmisener@amazon.com or 202-347-7390.

Sincerely yours,



Paul Misener
Vice President for Global Public Policy