



February 22, 2011

Ms. Jennifer J. Johnson  
Secretary, Board of Governors of the Federal Reserve System  
20<sup>th</sup> Street and Constitution Avenue, N.W.  
Washington, D.C. 20551  
Via email: [regs.comments@federalreserve.gov](mailto:regs.comments@federalreserve.gov)

**RE: Regulation II, Debit Card Interchange Fees and Routing; Docket No. R-1404**

Dear Secretary Johnson:

This letter is submitted on behalf of PayPal, Inc. (“PayPal”) in response to the proposed rule published in the Federal Register on December 28, 2010, regarding debit card interchange fees and debit card network routing. The rule was proposed by the Board of Governors of the Federal Reserve System (the “FRB”) pursuant to authority granted under Section 1075 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Section 1075”) which was signed into law on July 21, 2010 (Pub. L. No. 111-203, 124 Stat. 1376 (2010)).

PayPal is a leading online payments company, with more than 94 million active user accounts internationally, supporting payments in 24 currencies. Headquartered in San Jose, California, PayPal has offices in several states in the United States, along with its International headquarter in Singapore and European headquarter in Luxembourg. PayPal’s payments solution connects into and leverages the traditional payment networks (whether ACH, bank card networks, or PIN networks) enabling its users to make and receive payments in a safe, efficient and cost effective manner.

PayPal is one of the largest payment card acceptors in the United States. Utilizing several types of products, PayPal enables a variety of micro merchants to more easily accept payments by providing them with various value added services, including underwriting the risk of transaction reversals (such as those from consumer disputes) and refunds. As a merchant, PayPal pays a merchant discount rate to its acquiring banks in order for them to facilitate the processing (authorization, settlement and clearing) of PayPal merchant transactions.

PayPal also offers a co-branded MasterCard debit card product to select customers, giving them another vehicle to withdraw funds from their PayPal account. As further discussed below, the PayPal debit card is funded from the customer’s PayPal balance with amounts controlled by the PayPal user, usually from payments received as a seller of goods or services, and the card may be debited up to the amount of said balance. PayPal offers these debit cards through a sponsorship arrangement with JP Morgan Chase, the member bank authorized by

MasterCard to issue these cards, and First Data, a large payments processor. Most of these debit cards are issued to sole proprietors and small businesses as commercial debit cards.

PayPal is concerned about the potential implications of Section 1075 on the payments industry, particularly on alternative payment providers, and appreciates the opportunity to submit these comments for the FRB's consideration. PayPal respectfully requests the FRB to consider the concerns and suggestions set forth below.

## **I. General Comments.**

### **A. Section 1075 puts the Federal Reserve in an awkward position.**

Even before the enactment of Section 1075, the FRB occupied a unique position in the U.S. payment industry as both a market participant and a regulator. Although the FRB has managed to balance these responsibilities in the past, the shift away from paper payment instruments to electronic payments, coupled with Section 1075's dramatic expansion of the FRB's regulatory role, has put the FRB in a difficult position.

The FRB has played a role as a market participant in the U.S. retail payment industry since its formation in the early part of the last century. The Federal Reserve Act of 1913 charged the FRB with the creation of elastic currency and gave it the authority to create a national check clearing system. Starting in the early 1970s, the FRB began operating an Automated Clearing House system among bank participants, and continues today as the largest ACH operator. The ACH system clearly is an alternative and competitor to payment card networks.

Although the FRB's systems were the dominant means of retail value exchange through the end of the last century, the FRB's regulatory role with respect to private payment systems was significantly more limited. Under the Truth in Lending Act first enacted in 1968, the FRB played a regulatory role with respect to consumer protection for credit cards, and subsequently for debit cards under the Electronic Fund Transfer Act. However, the FRB did not have the power to set the rates that private payments systems could charge participants or the strategies that they could use to induce consumers, merchants and financial institutions to use their systems rather than the alternatives.

Now these restrictions on the FRB's authority have been significantly reduced with respect to debit cards. Electronic payments have grown to the point that cash and check volumes have actually declined on a year over year basis. And the Dodd-Frank Act has significantly expanded the FRB's regulatory role. The interchange, routing and exclusivity provisions put the FRB in the awkward position of having to review and, possibly, restrain practices that private payment systems have used to draw volume away from their FRB owned competitor.

PayPal strongly recommends that the FRB take these considerations into account when finalizing its proposed rules and not read into the statutory language of Section 1075 mandates and authority that are otherwise absent or unclear. This type of restraint would better serve the interests on both sides of this equation – the FRB and the private payments industry – by creating a more balanced position than that set forth in the proposed rules.

B. PayPal does not present the specific policy problem that the statutory language was designed to solve.

Section 1075 grew out of a long battle between merchants on the one hand and the card networks and their financial institution members on the other hand about what price brick and mortar retailers should pay for access to funds held in demand deposit accounts. The battle fundamentally was about whether there was adequate competition in the payment card industry to rely on the market to set reasonable prices and terms. The first skirmish in this battle was waged in court. Merchants, led by Wal-Mart, sued Visa and MasterCard over their Honor All Cards<sup>1</sup> rules on the theory that the existence of those rules enabled the networks to set interchange rates at levels that could not otherwise be justified, and thus had the effect of imposing a tax on consumers who pay with cash or check. Although the card networks repealed their rules and agreed to a substantial payment to bring those lawsuits to an end, the demise of the Honor All Cards rules did not yield the result that merchants had sought—free or very low cost access to consumer funds held in bank accounts. And they sought in Congress what they could not accomplish in Court. That political campaign eventually culminated in Section 1075.

As should be clear from the preface, the concerns associated with debit card interchange do not apply to PayPal's core business model. PayPal operates almost exclusively in on-line environments where cash and checks work poorly. PayPal is enhancing competition in the payments industry by establishing ACH-originated payments as a viable online competitor to credit and debit cards, while also providing choice to consumers who prefer to use their credit or debit card. Whatever merit may exist to the argument that high interchange on electronic payments in brick and mortar environments serves to shift costs to users of legacy payment instruments does not apply in environments in which all payment instruments feature discount fees. Moreover, interchange fees - which are the explicit target of Section 1075 - do not exist on the PayPal system. The interchange problem only exists in payment systems that feature multiple issuers and acquirers. Four-party systems, such as the Visa and MasterCard system, need mechanisms to ensure that acquirers get paid when their merchants accept transactions made by customers of other banks, and that issuers ultimately receive the right to collect payment from the consumers responsible for generating transactions. And all of the major four-party payment systems (including ATM systems) rely on interchange fees to solve that coordination problem.

PayPal operates very differently from the payment networks operated by Visa, MasterCard and other debit systems. PayPal provides a payment solution that leverages the rails of various payment networks (and pays all the standard associated fees) to provide its users a safe payment transaction environment. PayPal contracts directly with users on both sides of its platform -- merchants and consumers. These merchants and consumers can engage in a variety of payment transactions -- whether person to person, consumer to business, business to business, or business to consumer using various tools and services supported by PayPal. PayPal then pulls and pushes funds from and to the underlying accounts or financial instruments using the payment

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<sup>1</sup> Prior to the resolution of the *In re Visa Check/ MasterCard Antitrust Litigation*, both networks had rules requiring merchants to accept all cards bearing the marks of the respective networks. This meant that a merchant that wanted to accept Visa credit cards was also required to accept Visa debit cards.

card networks and the ACH network. Unlike the four-party payment systems, PayPal does not vary its fees based on the type of merchant or the funding source they choose (e.g., credit card, debit card, verified bank account or existing PayPal balance). PayPal's pricing is, thus, clear and readily ascertainable by its users.

PayPal strongly encourages the FRB to restrict its rule making to cover only those issuers that charge debit card interchange transaction fees and not alternative payment service providers such as PayPal that do not charge such fees. PayPal competes with Visa and MasterCard merchant acquirers, American Express and Discover (collectively, "acquiring banks") to process transactions for online sellers. Like those acquiring banks, PayPal charges a discount fee, not interchange. The FRB is not proposing to regulate discount fees charged by acquiring banks, and indeed does not have the statutory authority to do so under Section 1075. Any attempt to regulate the discount fees charged by PayPal without regulating acquiring banks would create serious distortions and would only stifle new entrants and enhanced competition in payment processing.

C. Regulating emerging payment technologies will quash innovation and stifle the U.S. payments market.

Section 1075 exists to solve a long running feud between merchants on the one hand and open payment networks as well as their financial institution members on the other hand. As noted above, there is no policy reason to extend the reach of this legislative resolution to alternate payment systems such as PayPal which are increasing competition, not reducing it. But even if there existed some reasonable basis to support this extension of the statutory license, this extension would have real costs for the U.S. economy.

As noted above, private payment systems in the U.S. have only recently emerged. PayPal is at the leading edge of a growing vanguard of companies that seek to take advantage of broadband technologies to change how consumers, merchants, financial institutions and others interact. Although many of these transactions ultimately rely on a connection to a consumer deposit account or its analog (e.g., a billing statement provided by a telecommunications company), they orchestrate the exchange of value between the participants through mechanisms radically different than the ones relied upon by four-party payment systems such as Visa and MasterCard.

In most instances, PayPal transactions are accomplished via a customer initiated push to a merchant. That is, a customer, having agreed to the terms of sale with a merchant, contacts PayPal and, after authenticating herself, instructs PayPal to push funds to the merchant. If and when the customer's funding source is approved, PayPal will credit the merchant, usually in a matter of seconds. The merchant can then use the transferred funds through PayPal or request that PayPal move the funds to their bank account. The PayPal push model is fundamentally incompatible with routing and exclusivity requirements imposed by Section 1075. The customer's reliance on PayPal to fund the transaction is what defines a PayPal transaction. It is not possible to provide the merchant with some alternate way to route the transaction to the customer's PayPal account. Also, PayPal does not impose exclusivity on its customers – consumers can choose any of their Visa, MasterCard, American Express or Discover credit or

debit cards, or a charge to their bank account through the ACH system, and in any of those cases the consumer does not pay a fee.

It is similarly difficult to imagine how the requirements of Section 1075 would apply to other emerging payment technologies. Telecommunications providers are just beginning to provide their customers with the ability to settle transactions against their monthly statements. These statements, however, are necessarily associated with a single carrier. In order to allow the recipient of such a transaction multiple options to route that transaction to the consumer, a given phone (and its associated statement) would seemingly need to connect to multiple carriers – a capacity that would completely change the economics of the telecommunications industry (in addition to constant sharing of customer private information among carriers).

## **II. Specific Comments.**

### **A. The definition of “payment card network” should not be interpreted to cover alternative payment service providers such as PayPal.**

The FRB has specifically mentioned PayPal as an alternative payment provider that *may* fall within the definition of a payment card network. PayPal does not believe that it is a payment card network, as that term is defined or used by the FRB in proposed Regulation II.

A payment card network is defined in proposed Section 235.2(m) as an “entity that (1) directly or indirectly provides the services, infrastructure, and software for authorization, clearance and settlement of electronic debit transactions; and (2) establishes the standards, rules, or procedures that govern the rights and obligations of issuers and acquirers involved in processing electronic debit transactions through the network.”

Unlike, the four-party systems, PayPal does not have issuers and acquirers that participate in its system. PayPal provides the front end interface and technology for merchants to be able to accept payment transactions. Through processing and sponsorship agreements with various large banks, PayPal also enables the authorization, clearing and settlement of these same transactions. However, PayPal does not establish the rules, standards, or procedures that “govern the rights and obligations of issuers and acquirers” that are involved in processing transactions through PayPal. To the contrary, PayPal is subject to the rules of each applicable card network (such as Visa and MasterCard) as a merchant, and must pass these rules through to its micro-merchants for any card payments they may accept. Accordingly, if its merchants are accepting MasterCard transactions (albeit indirectly), PayPal and its merchants must comply with the MasterCard operating rules. Similarly, if its merchants are accepting Visa, American Express or Discover, each of these merchants must comply with the operating rules of each of these networks. While PayPal may layer its own requirements on top of these rules, these requirements are only specific to what happens within the PayPal ecosystem; they do not apply to the various other players, including issuers and acquirers, that may be involved in a transaction.

Finally, as noted in Section I.B. above, PayPal does not believe that Congress intended to regulate alternative payment providers as payment card networks. Such alternative payment providers leverage the traditional payment networks but offer value added products and services that enhance the traditional payment vehicles. For example, PayPal pays the fees associated with

debit card interchange just like any other merchant, as part of its process to help micro-merchants process payments and in support of the safe and efficient exchange of value between its users. It does not independently act as an intermediary between issuers, acquirers, merchants and customers as a rule making body or even as a common infrastructure between them.

PayPal further notes that consideration of alternative payment providers as a payment card network would by most standards negate the business models of these companies. Specifically, PayPal points to the network non-exclusivity provisions of the proposed rules. If PayPal is considered a payment card network and PayPal accounts are considered debit cards (as further discussed in Section II.B. below), the proposed regulations would require that a PayPal transaction be route-able over at least one other unaffiliated network. This would impose massive difficulties and costs for PayPal in reconciling and settling transactions. Clearly, this conclusion is neither reasonable nor supportive of the policy considerations driving Section 1075. To the contrary, payment companies such as PayPal would no longer be able to offer these much needed and desired payment services. And, new companies that are breaking into the payments space may be deterred from investing in the infrastructure and systems necessary to launch their companies because these companies will be forced to allow competitors to free ride by leveraging the infrastructure the company has developed. PayPal does not believe that this result will benefit anyone – neither the consumer, nor the merchant, nor the payments industry – and strongly urges the FRB to clarify in its final rule that PayPal (and other similar alternative payment providers) are not payment card networks.

**B. Definition of “debit card” should make clear that account numbers are not considered debit cards within the scope of the rule if the underlying transaction is merely a general ledger entry.**

The FRB’s proposed definition of debit card includes any card, code or device that is used through a “payment card network” to debit an “account”. The account being debited need not be held by the issuer of the card, code or device. The definition of debit card includes general purpose reloadable cards; however, it does not include cards, codes or devices that are redeemable only at a single merchant or affiliated group of merchants (closed loop transactions) or an account number when used to initiate an ACH transaction.

PayPal is concerned about this very broad definition of debit card. Specifically, in the PayPal environment, users open PayPal accounts for the purpose of conducting payment transactions without having to divulge their financial information to any third party other than PayPal. Funds may be transferred through PayPal from a variety of sources, including a bank issued debit card or credit card, but funds may be pre-loaded into a PayPal account only through an ACH transaction (explicitly excluded from the definition of “debit card”), or through arrangements with prepaid provider Green Dot. Once loaded into the PayPal account, these funds are actually held in pooled bank accounts at various FDIC insured banks. Thus, when a user initiates a PayPal transaction using their account balance (as opposed to pulling funds directly from their credit card or debit card to make a payment, which is by far the most common method of payment through PayPal<sup>2</sup>), PayPal registers this transfer of funds on its general ledger

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<sup>2</sup> Note that the risk associated with this funding mechanism is fundamentally different from the risk associated with a traditional debit card transaction that is pulling funds from a deposit account at an issuing institution. In

(GL) but there is no movement of funds in the underlying pooled account. It is PayPal's position that this GL change should not be viewed as a debit to an account, and therefore the password used to initiate the GL entry should not be considered a debit card. This position is further supported by PayPal's comments in Section II.A., above that PayPal is not a payment card network.

C. To the extent the PayPal account is deemed to be a debit card, it should be made clear that it would be a general purpose reloadable prepaid card.

Proposed Section 235.5(c) creates an exemption for certain reloadable prepaid cards that are (i) linked to funds, monetary value, or assets purchased or loaded on a prepaid basis; (ii) not issued or approved for use to access or debit any account held by or for the benefit of the cardholder (other than a subaccount or other method of recording or tracking funds purchased or loaded on the card on a prepaid basis); (iii) redeemable at multiple, unaffiliated merchants or services, or automated teller machines; (iv) used to transfer or debit funds, monetary value, or other assets, and (v) reloadable and not marketed or labeled as a gift card or gift certificate.

PayPal accounts, if treated as the equivalent of a card account, fall closer to this definition than to a traditional debit card. The value being exchanged using a PayPal account has been loaded into the user's account prior to being transferred to any other party. The amounts are determined by the user and can be reloaded by the user at its discretion. And, the funds are all held in an omnibus account prior to and after being transferred for so long as they are within the PayPal system. The factors set forth above for general purpose reloadable cards are easily applied to the PayPal account. Thus, even if the PayPal account is deemed to be a debit card, PayPal requests the FRB to make clear via its commentary that this type of account would fall with the definition of general purpose reloadable prepaid cards.

As a further note, PayPal assumes that Congress' intent in carving out this set of "cards" was to insulate this relatively new area of payment products from onerous regulations that may limit their availability in the marketplace. This concern may be based in part on the fact that many general purpose reloadable cards are used by the unbanked and under-banked, helping bring them into the mainstream payments space and helping law enforcement and the regulatory authorities to better track the flow of funds within and by those populations.

These same public policy issues must be considered in the context of PayPal accounts. PayPal's business model helps provide Internet merchants, that may otherwise not be able to accept payments, participate in a global marketplace. By underwriting these micro-merchants and providing them with value added services, PayPal enables merchants to create online storefronts and allows consumers and merchants to exchange value – something many of them

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the case of such deposit account, the issuer does not need to take any risk when pulling and paying funds to a merchant because it knows whether there are good funds available at the time of the transaction. In the case of PayPal and other similar alternative payment providers, however, funds are typically not available in the customer's "account" at the time of a transaction. As such, these alternative payment providers take on the risk of making payment to a merchant and then receiving funds from their customers. This increased risk must be considered by the FRB when considering whether alternative payment providers should be regulated.

otherwise would not be able to do or would do it in a limited and potentially un-traceable manner.

D. Definition of "account" should be limited to consumer accounts opened primarily for personal, household or family purposes only.

Section 235.2(a) of the proposed rule defines an "account" as a transaction, savings, or other asset account (other than an occasional or incidental credit balance in a credit plan) established "for any purpose" and that is located in the United States.

Historically, the Electronic Funds Transfer Act (EFTA) and Regulation E (Reg. E) have both defined an account as an account established primarily for personal, household or family purposes. This definition was premised on the understanding that consumers merited greater protection than commercial enterprises, and therefore the enhanced dispute resolution, disclosure, and notice requirements of Regulation E and the EFTA presumably would protect consumers from unfair activities of account holding institutions. For years, the FRB has expanded the products covered by Reg. E by expanding the definition of account. However, at no point has the FRB expanded coverage of the EFTA or Reg. E to commercial accounts.

The newly proposed rules are being proposed as a new Regulation II but are still included within the EFTA (by way of a new Section 920). PayPal would encourage the FRB to consider the philosophical and public policy objectives of the EFTA and its historic perspective that this is a consumer protection statute. To expand the statute to cover commercial accounts would create inconsistencies and potential ambiguities with respect to new product innovation, and should only be done with explicit Congressional direction, which does not exist in Section 1075.

PayPal strongly recommends that the FRB limit the scope of the final rules to only cover consumer accounts and avoid the slippery slope that will result from this ad hoc expansion of the EFTA.

E. Implementation Timelines.

Congress has set the effective date for the interchange transaction fee restrictions as July 21, 2011. Backing out of this date, the FRB is required to issue final rules implementing Section 1075 by April 21, 2011. PayPal is concerned that this 3 month window is extremely short and is not realistic in allowing the various impacted parties in the payments chain to take the steps necessary to comply with the regulation.

PayPal is further concerned about the effective dates that are being proposed for the network non-exclusivity and the merchant routing provisions. The FRB has proposed an effective date of October 1, 2011 if issuers are required to offer two unaffiliated networks (whether signature or PIN) on each card. And, the FRB has proposed an effective date of January 1, 2013 if issuers are required to offer two unaffiliated networks within each form of debit card authorization (i.e., two unaffiliated signature networks if signature authorization is offered; or, two unaffiliated PIN networks if PIN authorization is offered; or both, if both are offered).

It is imperative to note that irrespective of whether the FRB's proposed alternative A or alternative B are adopted, the network non-exclusivity provisions create a fundamental change in the way the payment card networks, issuers, and merchants (like PayPal) have done business in the past. These changes will take time to institute from a systems perspective (for each issuers, acquirers, merchants and payment card networks), from a disclosure perspective, from a contractual perspective, from a financial perspective, and from a product perspective. The parties impacted must have sufficient lead time to be able to strategize about their product offering, renegotiate their existing contractual agreements, make systems changes necessary to institute these changes (at the same time that they are also instituting the many other changes required by Reg. II), and change their customer facing materials.

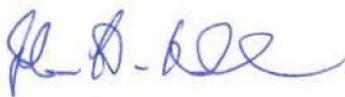
PayPal understands that the FRB is constrained by the language in Section 1075 and encouraged that there is some activity in Congress that may result in extension of these timelines. Notwithstanding, PayPal strongly recommends that the FRB exercise its rule making authority to provide impacted parties with greater lead time to comply with the proposed regulations. This type of balanced rule making will allow the various players to continue to offer these products, which also benefits consumers and merchants, without undue risk of non-compliance and unnecessary financial hardship.

### **III. Conclusion.**

PayPal appreciates the opportunity to submit this letter for the FRB's consideration in drafting its final rule. As a major player in the alternate payments space, PayPal is committed to serving the payments needs of its users in a cost effective and customer friendly manner. That said, PayPal is concerned that the FRB's proposed rule has drifted too far from the Congressional mandate and is setting regulatory standards that may irreparably harm the payments industry by reducing competition and increasing the market power of the four party networks. Given that the private payments industry (and in particular the alternative payments industry) is still relatively young and in a state of tremendous growth, PayPal would urge the FRB to consider all of the comments and suggestions herein, and to promulgate a final rule that more concisely focuses on the Congressional objectives of Section 1075 without undue extension of those objectives.

If you have any questions or would like to discuss any of the issues raised herein, please do not hesitate to contact me at (408) 967-1233 or [jmuller@PayPal.com](mailto:jmuller@PayPal.com).

Sincerely,



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