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Ms. Jennifer J. Johnson
Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, N.W.
Washington, D.C.

Re: Comments Re Docket No. R-1404 (Debit Card Interchange Fees and Routing)
RIN No 7100 AD63

Dear Ms. Johnson:

This letter is submitted on behalf of Sears Holdings Corporation ("Sears") in response to the notice of proposed rulemaking published by the Federal Reserve Board ("Board") in the Federal Register on December 28, 2010, 75 Fed. Reg. 81,722 ("Proposed Rule") regarding Debit Card Interchange Fees and Routing.

Sears is the nation's fourth largest broad line retailer with approximately 3,900 full-line and specialty retail stores in the United States and Canada. Sears operates through its subsidiaries, including Sears, Roebuck and Co., Kmart Corporation and Lands' End, Inc. Sears accepts debit card transactions at its retail outlets, pays the interchange transaction fees ("Interchange Fees") dictated to it by the various networks or issuers for processing these debit card transactions and submits these comments in response to the Proposed Rule.

The Proposed Rule would implement provisions of the Act to the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the "Act"). Specifically, the Act requires that the Federal Reserve Board issue regulations outlining a framework for how Interchange Fees are set, using a guideline that the fees must be "reasonable and proportional" to the costs incurred by the issuing banks in authorizing, clearance and settlement ("ACS") of debit card transactions. The Proposed Rule requested comment on two different alternatives for a safe harbor provision for the setting of Interchange Fees that were based on cost structure submissions to the Board by various debit card issuing institutions. In addition, the Proposed Rule requested comment on two different alternatives on network requirements to provide the network authorization communication channels that are utilized in performing the ACS function between the issuing banks and merchants.

Sears wishes to comment on the two sets of alternative proposals. In addition, Sears agrees with and supports the comments provided to the Board by the Merchants Payments Coalition in the two comment letters submitted in response to this proposal separately.

Before we comment on the proposals, however, we would like to make a comment on the survey results that form the basis of the Board's recommendations. Based on the requirement to set out a framework for how Interchange Fees would be set that would comply with the Act's requirement that such fees be reasonable and proportional to the actual costs of ACS of debit card transactions, the Board surveyed the banks that would be subject to the proposed rule [1] to ascertain each bank's cost structure to actually process ACS for debit card transactions. Of the approximately 130 banks surveyed, only approximately 90 banks responded. Given that these responses to the Board's surveys would be used to set the formula for setting Interchange Fees, any given card issuer's incentives to maximize its reported ACS costs would be strong, and no third party would be in a position to review those cost data submissions. In addition, certain low cost issuers chose not to respond to the Board's survey request. Thus, Sears believes that the survey results were skewed higher than they would otherwise be if the costs submitted could be reviewed and all major issuers had submitted responses to the Board's survey.

Therefore, Sears believes that the survey results showing the average and mean cost figures for processing of ACS transactions for debit cards were skewed higher than the true average and mean cost figures would have been if all relevant data had been submitted and verified. Despite these misgivings about the figures submitted, Sears will comment on the two safe harbor fee proposals.

<u>Safe Harbor Provision for Interchange Fees</u>

Alternative 1 is More Faithful to the Statute, But its Safe Harbor Should be Tied to the Mean Cost of ACS Rather than the Median Cost Chosen by the Board.

Proposed Alternative 1 ("Fee Alternative 1") calls for a safe harbor of 7 cents per transaction for Interchange Fees, with an upward adjustment to a cap of 12 cents based upon an issuers allowable ACS costs. In contrast, proposed Alternative 2 ("Fee Alternative 2") calls for what is effectively both a safe harbor and a cap of 12 cents per transactions for Interchange Fees.[2] Both alternatives would allow for additional fees to reimburse issuers for demonstrable fraud prevention technology costs.

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[1] It should be noted that only those issuing banks with assets greater than $10 Billion would be subject to the Interchange Fee restrictions created through this rulemaking process.

[2] Although Fee Alternative 2 is not labeled specifically as a "safe harbor, it acts as one because there are no circumstances under which an issuer would fail to qualify for a 12 cent interchange transaction fee under that proposal.

The Act calls for interchange transaction fees to be based upon each issuer's ACS costs.[3] Sears recognizes the Board's attempt to ease administrative burdens by providing the two fee alternative formulas. Sears believes that Fee Alternative 1 is the better approach of the two because (1) it is more faithful to the language in the Act about how Interchange Fees should be set; (2) it has a safe harbor closer to the average ACS costs of the issuers surveyed, and (3) its more flexible structure is better designed to reflect the variability in individual issuers' costs.

However, in the context of the actual statutory requirement to reflect each issuer's ACS costs, Sears believes that any safe harbor should be tied to the lower "mean" (weighted average) level of ACS costs rather than the higher "median" (average) level. In addition to more closely reflecting a true cost, tying the safe harbor to the lower mean measure of costs would also create greater incentives to decrease costs. These incentives would lead issuers to move from signature debit to the more secure and lower-cost PIN debit as well as to adopt even newer technologies and procedures that offer additional cost savings and security features.

Alternative 1's safe harbor is still 75% higher than the 4-cent weighted average ACS costs reported by the issuers themselves in their rulemaking survey responses while Alternative 2's safe harbor of 12 cents without taking actual costs into account is 200% higher than these costs.[4] We also note that the cost estimates based upon the survey responses provided likely reflects a substantial upward bias because they include prepaid cards that are exempt from the interchange fee limitations under the act[5] and the fact that certain low cost issuers chose not to respond to the survey, thus keeping their lower ACS cost figures from entering into the mean or median calculations. Even if Alternative 1 is chosen, using the mean ACS costs (the lower 4 cent level) the safe harbor is likely too high given the likelihood of upward bias from the survey responses, and allowing less efficient issuers to charge up to a cap of 12 cents allows them to recover 300% of the industry mean ACS costs and does little, if anything, to encourage these highest cost issuers to do any better at lowering their costs. Lower safe harbors and caps create economically sound incentives to reduce costs over time.

Section 920(a)(4)(B) in the Act clearly directs the Board to consider certain costs and not to consider other costs in establishing standards to assess debit interchange fees. Specifically, this provision requires the Board to consider incremental ACS costs incurred by an issuer in a particular debit transaction and prohibits the Board from considering any issuer costs that are not specific to a particular electronic debit transaction. Costs such as maintaining call centers, or mailing out the debit cards are costs that should not be included because the banks would and have incurred those costs just by having ATM cards for their customers whether or not they allow merchant access for purchases (i.e. debit functionality).

In addition, there is one loophole in Alternative 1 regarding network-affiliated third party processors that Sears believes should be closed. If a network owns a third-party processor, even if that processor's costs are less than 1 cent per transaction, it can charge the issuer 12

[3] Section 920(a)2), (a)(4)(B)
[4] Notice of Proposed Rulemaking at page 81737
[5] Section 920(a)(7)

cents per transaction, impose a 12-cent interchange transaction fee, and pass that fee through to the issuer.[6] The 12 cents paid by an issuer to a network for "network processing" or "optional services" are counted as compensation paid to networks, but interchange transaction fees that reimburse issuers for that payment are NOT counted as compensation paid to issuers.[7] There is no prohibition on a network charging merchants 12 cents per transaction in other network fees to fund this second 12 cent payment to the issuer. Thus, the merchant could end up paying 24 cents per transaction to networks that then simply pass it on to issuers. This would be wholly inconsistent with Section 920(a).

To close this loophole, for all third-party processors affiliated with a network, only the ACS costs of that third-party processor (and not the entire fee charged to the issuer) should be considered a variable cost for the issuer. In addition, under the "net compensation" provision, either (1) fees paid by an issuer to a network for third-party processing should not be counted as compensation paid to networks, or (2) interchange transaction fees that networks pass through to reimburse issuer for that payment should be counted as compensation paid to issuers.

<u>Prohibition on Network Exclusivity</u>

Alternative B is the Approach Most Faithful to the Language and intent of the Statute

Sears agrees with the Board's conclusion that since the merchants are the party obligated to pay for the routing of transactions, then the merchants, not the issuers or the networks, must be able to designate preference for the routing of transactions, and that the merchant's preference must take priority over the issuer's or network's preference.[8] We also agree with the Board's conclusion that Section 235.7(b) should reach issuer or card network rules or requirements that prohibit merchants from "steering" transactions from one authentication method to another (usually from signature to PIN debit).

The Board requested comment on two alternative approaches to Section 235.7(a) of the legislation which requires multiple networks be made available to process debit card transactions. Under Alternative A, issuers and payment card networks can comply if "the number of payment card networks on which an electronic debit transaction may be processed is not limited to less than two unaffiliated payment card networks."[9] Issuers and payment card networks could comply with Alternative A by placing one signature and one PIN debit network on debit cards, which for reasons stated below we do not support. By contrast, under Alternative B, issuers and payment card networks are prohibited "from directly or indirectly restricting the number of payment card networks on which an electronic debit transaction may be processed to less than two unaffiliated networks for each method of authorization that may be used by the cardholder.[10]

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[6] Notice of Proposed Rule Making at 81760 "any per-transaction fee the third party processor charges is a variable cost for the issuer"
[7] Notice or Proposed Rule Making at 81747.
[8] Notice of Proposed Rule Making at 81751
[9] Notice of Proposed Rule Making at 81749.
[10] Notice of Proposed Rulemaking at 81750 citing Proposed Section 235.7(a)(1) Alternative B

Section 920(1)(b) of the legislation prohibits limiting the number of payment card networks on which an electronic debit transaction may be processed to only one network (or two or more networks that are affiliated).[11] In order to give full effect to this provision there must be at least two network options for each authentication method. Some debit cards are limited to signature only functionality, such as health care cards, and the banks and networks have contended that these cards are not well suited to PIN debit. Assuming that to be true that further supports the need to interpret Section 920(b)(1)(A) to require at least two signature debit networks on all debit cards that possess that functionality. Otherwise such cards will be limited to only one debit network option which is in clear violation of the statute as well as give no relief or benefit to merchants that cannot readily accept PIN debt cards.[12]

Alternative B is also the only option that adheres to Congress's expressed rationale for enacting this provision. Senator Durbin explained in reference to this section that "[t}his paragraph is intended to enable each an every electronic debit transaction – no matter whether that transaction is authorized by a signature, PIN or otherwise – to be run over at least two unaffiliated networks . . . ."[13]. Given that some debit cards and some merchants are limited to one authentication technology, this requirement can only be accomplished with Alternative B. Providing this network competition for merchant acceptance will hopefully have a positive effect on lowering interchange and network fees, something that is absent from the marketplace today.

In addition, while there are several networks available in the PIN debit arena today, only Alternative B is likely to result in new entrants offering signature debit. With the exception of Discover's signature-debit product launched in 2006 which has only achieved very limited growth in volume, Visa and MasterCard have completely monopolized the signature-debit portion of this market. Under Alternative B this would end, and PIN debit networks would almost certainly jump into this portion of the market where entry has been stymied and there has been little competition to date.[14]

While the Notice of Proposed Rule Making states that multiple signature debit networks will require substantial changes to software and hardware for networks, issuers, acquirers and processors, it does not explain what those changes might be. Sears understands that some technical changes will need to be made, particularly at the acquirer/processor level, to facilitate the implementation of multiple signature debit networks on debit cards, but we believe that merchants will be willing to make those changes in exchange for substantial benefits from the ability to route to lower cost networks, and that those changes can be made well before the end of 2012, particularly if the industry cooperates and develops common message formats and other appropriate standards to replicate the efficient and seamless routing that exists today with PIN debit.

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[11] See Section 920(b)(1)(A)

[12] See Notice of Proposed Rule Making at 8149 discussing that T&E merchants cannot accept PIN debit).

[13] 156 Cong Rec. S5926 (July 15, 2010)

[14] Entry has been blocked by exclusive deals that Visa and MasterCard have with all of the major banks to block competition in signature debit network processing.

It is worth noting that issuers do not need to reissue their cards to meet the timelines or open net networks for existing cards. Issuers could comply with the requirements of Alternative B by establishing the necessary linkages, perhaps through a gateway, and by ensuring that their routing BINs are included in the alternative debit network's accepted BIN table. Then, only new cards issued after the implementation of this requirement would have to bear the marks of the accepted networks on either the front or back of the cards and could be done at normal card replacement cycle.

Finally, to the extent that the Board elects not to regulate or cap network fees, it is important that Alternative B be chosen to ensure that all merchants have some ability to discipline network fees, whether they accept both signature and PIN debit or only one.

Sears appreciates the opportunity to share its views with FRB on the proposed rule. We would be pleased to discuss this with you further at your convenience.

Very truly yours,

Susan P. Ehrlich
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