

MEMORANDUM

July 16, 2010

TO: Henry Armour, NACS

FROM: Doug Kantor
Lizzy Glidden

RE: Legislation Regulating Interchange Fees

On July 15, 2010, Congress passed the Wall Street Reform and Consumer Protection Act, H.R. 4173 (“the legislation”), which we anticipate will be signed into law by the President on July 21, 2010.¹ The legislation directs the Federal Reserve Board (“the Fed”) to write rules relating to interchange fee rates on debit cards. This is a significant victory for NACS members. Historically, interchange fee rates have been set by card companies on behalf of their member banks in cartel-like fashion without any regulation.

In addition to interchange fee regulation, the legislation allows merchants to set a minimum dollar value for accepting credit cards, choose which network will process their transactions, and offer discounts and incentives to customers based on the form of payment they use (for example, a merchant can offer a discount to customers for using a debit card or cash).

Over the next nine to twelve months, the Fed will issue a series of rules that will clarify how the new law will work. This memorandum explains the provisions of the legislation and how the legislation will affect your business.

¹ The date that the legislation is signed into law is also referred to as the “date of enactment” of the legislation.

Regulation of Interchange Fees

Under the new legislation, the Fed will write rules regarding interchange fee rates. Card issuers will only be allowed to charge interchange transaction fees² on debit card purchases that are “reasonable and proportional” to the cost of processing the transaction. Within the next nine months, the Fed will issue regulations that establish specific guidelines for determining whether a fee meets the “reasonable and proportional” standard.³ These regulations will become effective one year after the legislation is signed into law.

There are several open questions for the Fed to resolve during this rulemaking. For example, the Fed will need to provide guidance regarding the issuer’s cost of processing a transaction, determine which costs may not be considered, and explain how to determine when an interchange fee rate is “reasonable and proportional” to the transaction costs.

The Fed may adjust the interchange fee rate for a particular card issuing bank if the bank can demonstrate that the adjustment is reasonably necessary to cover its fraud prevention costs. The Fed will issue additional rules on fraud prevention that clarify how a bank can attain certain

² The term “interchange transaction fees” means any fee established, charged or received by a payment card network for the purpose of compensating an issuer for its involvement in an electronic debit transaction. *See* HR 4173 § 1075(a), establishing new § 920(c)(8).

³ When the Fed drafts these regulations, it must consider the functional similarity between electronic debit transactions and paper check transactions, distinguish between incremental costs incurred by an issuer for an electronic debit transaction vs. other costs, and the Fed must consult with various other regulators. HR 4173 § 1075(a), establishing new § 920(a)(4).

adjustments to the interchange fee rate.⁴ Adjustments will only be available to issuers that follow the Fed's forthcoming rules on fraud prevention. These rules will require issuers seeking an adjustment to take steps to reduce the occurrence and costs of fraud in electronic debit transactions. The steps will include using cost-effective fraud prevention technology. As with the overall regulations regarding debit card interchange fees, the regulations regarding adjustments for fraud prevention are scheduled to be published within nine months of the date of enactment of the legislation.

There are several exemptions from the new regulation of interchange fees. Small issuers with assets valued at less than \$10 billion will be exempt from the rules on debit card fees.⁵ Additionally, the legislation exempts debit and prepaid cards issued as part of a federal, state or local government benefits program. Privately issued prepaid cards will also be exempt so long as they meet certain requirements limiting the types of fees they charge consumers. The Fed will issue an annual report on government pre-paid cards and the fees charged with respect to those cards, which may provide a factual basis for re-examining these exemptions in the future.

The legislation also provides the Fed with the explicit power to get information it needs to write these rules. The Fed may request necessary information from the banks that issue cards

⁴ The Fed will have nine months to draft new rules pertaining to the adjustment of interchange fee rates. In issuing these regulations, the Fed is required to consider a number of factors, such as how often electronic debit fraud occurs, which types of debit transactions are associated with fraud, the available and economical means by which fraud may be reduced, who bears the costs of fraud prevention and fraudulent transactions, and the extent to which interchange transaction fees have in the past affected incentives to reduce fraud.

⁵ The term "issuer" is limited to the holder of the asset account that is debited. HR 4173 § 1075(a), establishing new § 920(a)(6)(B).

and the card networks. Further, every two years the Fed will publish a report on the relevant charges and costs of interchange fees to ensure that this information is available to the public.

Network Fees

Under the new legislation, the Fed will be able to regulate network fees charged on debit card transactions – that is, the fees charged by Visa, MasterCard and Discover as opposed to those charged by card issuing banks – but will only be able to do so for limited purposes. The Fed’s regulations will ensure that network fees are not, in any way, used to compensate issuers or otherwise circumvent its regulations relating to interchange fees. The Fed will have nine months from enactment of the legislation to write regulations regarding network fees, and those regulations will become effective twelve months after enactment.

Routing of Debit Transactions

Within one year of enactment of the legislation, the Fed will also write rules regarding the networks over which debit transactions may be routed. Networks and issuers have with increasing frequency entered into deals limiting the number of networks over which debit card transactions can be routed to a single network. The new rules will address this practice by doing two things. First, the Fed will prohibit networks and issuers from limiting the networks over which a debit card can be routed to only one network (or multiple networks that are affiliated as part of the same corporate family). This will ensure that debit cards do not have exclusive arrangements and that some competitive choice exists in routing all debit transactions. Second, the Fed’s rule will ensure that merchants will be able to choose the network over which their transactions will be routed (from among the choices available for each card).

There are many issues for the Fed to contemplate and address as it implements these two requirements, but having this type of pricing competition on every debit transaction will be of tremendous benefit to NACS members.

Network Restrictions

As soon as the legislation is signed into law, networks will no longer be able to penalize merchants for offering discounts or in-kind incentives to customers who use the form of payment preferred by the merchant. That preferred form of payment may be debit cards, checks, cash, or even credit cards, depending on an individual merchant's preference. It is important to note that networks will be able to require that the discounts be neutral with regard to the card network or card issuer. That means, for example, that a merchant could offer a certain percentage or dollar discount for using any debit card, but likely will not be able to limit that discount only to Discover Cards (to take one example) or to debit cards issued by a particular bank. Retailers should also be aware that discounts will have to comply with state and local pricing laws, many of which require discounts to be generally offered to all customers, and be clearly and conspicuously disclosed.

Another provision that takes effect as soon as the legislation is enacted will end the card networks' rules that prevent merchants from setting minimum dollar amounts for credit card purchases. Therefore a retailer can set a minimum dollar amount for credit card purchases, so long as the minimum amount is \$10 or less. The Fed can, however, increase that dollar amount in the future. As with the discounting provisions, this provision does not guarantee merchants the right to have minimums for some credit cards (for example, those of a particular network or

bank issuer) and not for others. It is expected that, due to card network rules, the minimum will need to apply equally to all credit cards or not apply at all.

Enforcement

The new legislation will be enforced by the Federal Trade Commission, but criminal penalties will not be available.

Summary

While this memorandum provides an overview of the new legislation, the rulemaking process will provide critical guidance regarding how the new requirements will work. We will continue to monitor this issue and update NACS members as the rulemaking process develops.