**FEDERAL RESERVE SYSTEM**

**12 CFR Part 235**

**Regulation II; Docket No. R-1404**

**RIN No. 7100-AD 63**

**Debit Card Interchange Fees and Routing**

**AGENCY:** Board of Governors of the Federal Reserve System

**ACTION:** Clarification.

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**SUMMARY:** The Board is publishing a clarification of Regulation II (Debit Card Interchange Fees and Routing). Regulation II implements, among other things, standards for assessing whether interchange transaction fees for electronic debit transactions are reasonable and proportional to the cost incurred by the issuer with respect to the transaction, as required by section 920 of the Electronic Fund Transfer Act. On March 21, 2014, the Court of Appeals for the District of Columbia Circuit upheld the Board's Final Rule. The Court also held that one aspect of the rule—the Board's treatment of transactions-monitoring costs—required further explanation from the Board, and remanded the matter for further proceedings. The Board is explaining its treatment of transactions-monitoring costs in this Clarification.

**DATES:** Effective [Insert date of publication in the Federal Register]

**FOR FURTHER INFORMATION CONTACT:** Stephanie Martin, Associate General Counsel (202-452-3198), or Clinton Chen, Attorney (202-452-3952), Legal Division; for users of Telecommunications Device for the Deaf (TDD) only, contact (202-263-4869); Board of Governors of the Federal Reserve System, 20th and C Streets, N.W., Washington, DC 20551.

## SUPPLEMENTARY INFORMATION

### I. Background

The Dodd-Frank Wall Street Reform and Consumer-Protection Act (the "Dodd-Frank Act") was enacted on July 21, 2010.[1] Section 1075 of the Dodd-Frank Act amends the Electronic Fund Transfer Act ("EFTA") (15 U.S.C. 1693 *et seq*.) to add a new section 920 regarding interchange transaction fees and rules for payment card transactions.[2] EFTA section 920(a)(2) provides that the amount of any interchange transaction fee that an issuer receives or charges with respect to an electronic debit transaction must be reasonable and proportional to the cost incurred by the issuer with respect to the transaction.[3] Section 920(a)(3) requires the Board to establish standards for assessing whether an interchange transaction fee is reasonable and proportional to the cost incurred by the issuer with respect to the transaction. Without limiting the full range of costs that the Board may consider, section 920(a)(4)(B) requires the Board to distinguish between two types of costs when establishing standards under section 920(a)(3). In particular, section 920(a)(4)(B) requires the Board to distinguish between "the incremental cost incurred by an issuer for the role of the issuer in the authorization, clearance, or settlement of a particular electronic debit transaction," which the statute requires the Board to consider, and "other costs incurred by an issuer which

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[1] Pub. L. No. 111-203, 124 Stat. 1376 (2010).

[2] EFTA section 920 is codified as 15 U.S.C. 1693*o*-2. EFTA section 920(c)(8) defines "an interchange transaction fee" (or "interchange fee") as 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.

[3] Electronic debit transaction (or "debit card transaction") is defined in EFTA section 920(c)(5) as a transaction in which a person uses a debit card.

are not specific to a particular electronic debit transaction," which the statute prohibits the Board from considering.

Under EFTA section 920(a)(5), the Board may allow for an adjustment to the amount of an interchange transaction fee received or charged by an issuer if (1) such adjustment is reasonably necessary to make allowance for costs incurred by the issuer in preventing fraud in relation to electronic debit card transactions involving that issuer, and (2) the issuer complies with fraud-prevention standards established by the Board. Those standards must, among other things, require issuers to take effective steps to reduce the occurrence of, and costs from, fraud in relation to electronic debit transactions, including through the development and implementation of cost-effective fraud-prevention technology.

The Board promulgated its final rule implementing standards for assessing whether interchange transaction fees meet the requirements of section 920(a) in July 2011. (Regulation II, Debit Card Interchange Fees and Routing, "Final Rule," codified at 12 CFR part 235).[4] Among the provisions of the Final Rule was one relating to transactions-monitoring costs. Transactions-monitoring costs are costs incurred by the issuer during the authorization process to detect indications of fraud or other anomalies in order to assist in the issuer's decision to authorize or decline the transaction. The Board included transactions-monitoring costs as part of the interchange fee standard called for in section 920(a)(3)(A) (costs incurred by an issuer for the issuer's role in the authorization of a particular transaction) based on the Board's determination that these

[4] Regulation II also implemented a separate provision of section 920 relating to network exclusivity and routing.

costs are incurred in the course of effecting a particular transaction and an integral part of the authorization of a specific electronic debit transaction.

The Board amended Regulation II on August 3, 2012 to implement the fraud-prevention cost adjustment permitted by EFTA section 920(a)(5).[5] Fraud-prevention costs included in that adjustment included costs associated with research and development of new fraud technologies, card reissuance due to fraudulent activity, data security, and card activation.[6] These costs are not incurred during the transaction as part of the authorization process.

On March 21, 2014, the Court of Appeals for the District of Columbia Circuit upheld the Board's Final Rule relating to the interchange fee standard. *NACS v. Board of Governors of the Federal Reserve System*, 746 F.3d 474 (D.C. Cir. 2014).[7] The Court of Appeals held, however, that one aspect of the rule—the Board's treatment of transactions-monitoring costs—required further explanation from the Board, and remanded the matter for further proceedings. The Court of Appeals agreed with the Board's position that "transactions-monitoring costs can reasonably qualify both as costs 'specific to a particular transaction' (section 920(a)(4)(B)) and as fraud-prevention costs (section 920(a)(5))." 746 F.3d at 492. The Court held, however, that the Board had not adequately articulated its reasons for including transactions-monitoring in the interchange fee standard rather than in the fraud-prevention adjustment.

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[5] *See* 77 FR 46,258 (Aug. 3, 2012).

[6] *See* 77 FR at 46,264.

[7] The U.S. Supreme Court denied the retailers' petition for a writ of certiorari on January 20, 2015. 135 S. Ct. 1170 (2015).

## II. Rationale for Including Transactions-Monitoring Costs in the Interchange Fee Standard

In the Final Rule, the Board identified the types of costs that could *not* be included in the interchange fee standard under section 920(a)(4)(B)(ii) (other costs "not specific to a particular transaction") on the basis of whether those costs are "incurred in the course of effecting" transactions.[8] Costs that were "not incurred in the course of effecting any electronic debit transaction" were determined to be outside of the allowable ambit of the interchange fee standard, but the standard could include "any cost that is not prohibited – i.e., any cost that *is* incurred in effecting any electronic debit transaction."[9] Thus, for example, the costs of equipment, hardware, software, and labor associated with transactions processing were properly included in the interchange fee standard because no particular transaction can occur without incurring these costs, and thus these costs are "specific to a particular transaction."[10] In upholding the rule, the Court of Appeals found this to be "reasonable line-drawing."[11]

The same rationale supports including transactions-monitoring costs in the interchange fee standard. Transactions-monitoring systems, such as neural networks and fraud-risk scoring systems, assist in the authorization process by providing information needed by the issuer in deciding whether the issuer should authorize the transaction before the issuer decides to approve or decline the transaction. Like other authorization steps, such as confirming that a card is valid and authenticating the cardholder, transactions-monitoring is integral to an issuer's decision to authorize a specific

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[8] 76 FR 43,394, 43,426 (July 20, 2011).

[9] *Id*.

[10] 76 FR at 43,430.

[11] 746 F.3d at 490.

transaction.[12] In fact, most costs of the authorization process (which are costs Congress required to be considered in determining the interchange fee) assist in preventing some type of fraud. Steps in the authorization process may include ensuring that the transaction is not against an account that has been closed, checking to be sure the card has not been reported lost or stolen, checking that there is an adequate balance, and authenticating the cardholder. Like transactions-monitoring, these authorization steps are all "specific to a particular transaction" in the sense that they occur in connection with each transaction that is authorized or declined. Because the statute requires the Board to consider incremental authorization costs in setting the interchange fee standard, the Board concluded that that it should consider the costs of all activities that are integral to authorization, even if those costs are also incurred for the dual purpose of helping to prevent fraud.

By contrast, fraud-prevention costs that the Board used to calculate the separate fraud-prevention adjustment authorized under section 920(a)(5) were not necessary to effect a particular transaction and were not part of the authorization, clearing, or settlement process, and thus a particular electronic debit transaction could occur without the issuer incurring these costs. As the Board stated in the Final Rule, the types of fraud-prevention activities considered in connection with the fraud-prevention adjustment were those activities designed to prevent debit card fraud at times other than when the issuer is authorizing, settling, or clearing a transaction.[13] For example, in setting the fraud-prevention adjustment, the Board considered costs associated with research and

[12] 76 FR at 43,430-31.

[13] 76 FR at 43,431.

development of new fraud prevention technologies, card reissuance due to fraudulent activity, data security, and card activation.[14]

As noted above, section 920(a)(4)(B) specifically directs the Board to consider in establishing the interchange fee standard the costs "incurred by the issuer for the role of the issuer in the authorization, clearance or settlement of a particular transaction." Transactions monitoring is an integral part of the authorization process, so that the costs incurred in that process are part of the authorization costs that the Board is required by the statute to consider when establishing the interchange fee standard. In addition, the statutory language of section 920(a)(5), which differs in important respects from section 920(a)(4)(B), supports the Board's decision to include transactions-monitoring costs in the interchange fee standard rather than in the separate fraud prevention adjustment. The costs considered in section 920(a)(5)(A)(i) are those of preventing fraud "in relation to electronic debit transactions," rather than costs of "a particular electronic debit transaction" referenced in section 920(a)(4)(B). Congress's elimination of the word "particular" and its use of the more general phrase "in relation to," along with its use of the plural "transactions," indicates that the fraud-prevention adjustment may take into account an issuer's fraud prevention costs over a broad spectrum of transactions that are not linked to a particular transaction.

Moreover, section 920(a)(5) permits the Board to adopt a separate adjustment "to make allowance for costs incurred by the issuer in preventing fraud *in relation to electronic debit transactions involving that issuer*" if certain standards are met, and directs that those standards include that the issuers take steps to "reduce the occurrence

[14] 77 FR at 46,264.

of, and costs from, fraud in relation to electronic debit transactions," including "development and implementation of cost-effective fraud prevention technology." Section 920(a)(5)(A)(i), (A)(ii)(II) (emphasis supplied). The use of the general phrase "fraud in relation to electronic debit transactions" and the specific reference to developing fraud prevention technology suggest a Congressional intent to use the fraud prevention adjustment to encourage issuers to develop and adopt programmatic improvements to address fraud outside of the context of particular transactions that incur costs for authorization, clearance, or settlement. The types of costs the Board included in the separate fraud prevention adjustment are programmatic costs, such as researching and developing new fraud prevention technologies and data security, and other costs that encourage enhanced fraud prevention that are not necessary to effect particular transactions.

The Board is publishing this explanation in accordance with the opinion of the Court of Appeals.

**By order of the Board of Governors of the Federal Reserve System, August 10, 2015.**

Robert deV. Frierson (signed)

Robert deV. Frierson,
Secretary of the Board.