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Federal Reserve Board Issues Final Rule on Interchange

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Today the Federal Reserve Board issued the final version of Regulation II, which sets new rules for debit card transactions. The Final Rule implements Section 1075 of the Dodd-Frank Wall Street Reform and Consumer Protection Act—known in the payment industry as the Durbin Amendment. Signed by the President on July 21, 2010, the Act gave the Fed one year to draft the proposed regulation, obtain public comment and issue a final, revised rule.

The Fed issued its proposed regulation—Proposal II—on December 16, 2010. The Proposal included two proposed alternative interchange fees standards and provisions governing transaction routing. The draft rule attracted thousands of comments from consumers, lawmakers, academics, and the industry. Although Fed Chairman Ben Bernanke asked Congress to extend the deadline to propound the final rule, the legislative effort to do so failed earlier this month, and barring a court ordered stay, today's final rule will go into effect on October 1, 2011—a new deadline set by the Fed.

Most of the attention paid to Reg II has centered on two issues—the limits on debit interchange fees and the interpretation of the routing and exclusivity provisions. Today's final rule answers those questions. The Final Rule sets a cap of 21 cents on transactions that fall within its scope (plus 5 basis points on the transaction value) and requires issuers to place two unaffiliated marks, on every debit card. But the final rule does not answer every question that had been raised in or about the original draft, and it

does not account for many of the concerns raised in the public comments. Here are the highlights:

Pricing Proposals

The Proposed Rule requested comment on two alternative proposals for interchange fees. One of the alternatives contains an issuer-specific standard with a safe harbor (of 7 cents per transaction) and a cap (of 12 cents per transaction), and the other simply provides the 12 cent per transaction cap.

The Final Rule adopts a modified version of the second alternative: issuers may charge up to 21 cents per transaction, plus five basis points of the transaction value (the ad valorem component). On a \$40 transaction, this represents a 48% cut in revenue, which is a substantial improvement, from an issuer perspective, on the 75% cut originally proposed.

Routing Provisions

The Proposed Rule requested comment on two alternative approaches: one alternative would require at least two unaffiliated networks per debit card, and the other would require at least two unaffiliated networks per debit card for each type of cardholder authorization method (such as signature or PIN). Under both alternatives, the issuers and networks would be prohibited from inhibiting a merchant's ability to direct the routing of debit card transactions over any network that the issuer enabled to process them.

The Final Rule adopts the first alternative. Issuers must put two unaffiliated networks on each card.

Fraud Adjustment

The Proposed Rule did not set a standard for an allowable fraud adjustment, although the Fed recognized that an adjustment to the statutorily-set interchange fee prices may be appropriate to account for costs associated with fraud prevention programs. The Fed instead left this adjustment to be determined at a future time.

The Final Rule recommends a standard cap of 1 cent per transaction to account for fraud prevention and seeks comment on whether that cap should be adjusted. Issuers can only take advantage of this adjustment if they develop and implement fraud procedures designed to meet the standards for an effective fraud-prevention program set forth in the Final Rule.

Three-Party Networks

In the Proposed Rule, the Board requested comment on the application of the interchange fee standards to three-party systems, in which a single payment card network typically operates as both the card issuer and merchant acquirer. The Board noted potential complications, including the potential for such a network to apportion all fees to its acquirer function (which is not covered by the interchange fee standards) rather than its issuer function (which is covered). The Board also raised the potential for complications caused by its proposed routing and exclusivity regulations on these traditionally “closed” systems.

The Final Rule excludes three-party networks from its definition of “payment card networks.” The Final Rule also excludes from the definition of “card, other payment code or device” any card, code or device only used to initiate general ledger transactions not issued or approved for use through a payment card network.

Reloadable Prepaid Cards

In addition, the Proposed Rule listed exemptions, including certain reloadable prepaid cards that are (i) not issued or approved for use to access or debit accounts held by or for the benefit of individual cardholders; and (ii) reloadable and not marketed or labeled as gift cards or gift certificates. 12 C.F.R. § 235.5(c). Thus, the exemption would apply to prepaid cards that access underlying funds held in an omnibus account or subaccounts created for accounting purposes, but not to prepaid cards that accessed separate accounts established by the issuer.

Rule II now clarifies that a general-use prepaid card is only exempt from the Rule’s requirements either (1) if the card is the only means to access the funds underlying the card; or (2) unless all remaining funds are provided to the cardholder in a single transaction.

Exclusion of ACH Transactions

Under the Proposed Rule, “Debit Card” was defined as: “any card, or other payment code or device, issued or approved for use through a payment card network to debit an account, regardless of whether authorization is based on signature, personal identification number (PIN), or other means, and regardless of whether the issuer holds the account,” and “[i]ncludes any general-use prepaid card.” (Proposed) C.F.R. § 235.2(f)(1)-(2).

Further, the term debit card did not include: “(i) Any card, or other payment code or device, that is redeemable upon presentation at only a single merchant or an affiliated group of merchants for goods or services; (ii) A check, draft, or similar paper instrument, or an electronic representation thereof; or (iii) An account number, when used to initiate an ACH transaction to debit a person’s account.” (Proposed) 12 C.F.R. § 235.2(f)(3). Account numbers used to initiate ACH transactions used to debit individual users’ accounts were specifically excluded from the definition of

“debit card.” (Proposed) 12 C.F.R. § 235.2(f)(3)(iii). However, the Board suggested that decoupled debit arrangements—which involve ACH debit instructions sent by an issuer to a non-affiliated account-holding institution—were included in the definition of “debit card.” (Proposed) Comment 2(f)(3).

Under the Final Rule, certain forms of decoupled debit cards are included within the definition of “debit card.” Specifically, decoupled debit cards that are processed solely through ACH are not included, but decoupled debit cards that involve any processing over payment card networks are considered “debit cards.” The Final Rule defines the issuer of a decoupled debit transaction as the entity that provides the card to the consumer and initiates a preauthorized ACH debit from the consumer’s account held at an unaffiliated financial institution. Furthermore, the Board removed the language explicitly exempting ACH transactions, but noted in the Federal Register Notice that such transactions are not covered.

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