



## **Payment Systems**

# Federal Reserve Board Proposes Expansion of Regulation II Network Enablement Requirements

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## Introduction

On May 7, 2021, the Board of Governors of the Federal Reserve System (“Board”) published a notice of proposed rulemaking (“NPR”) to amend Regulation II and the Official Board Commentary on Regulation II (“Commentary”).<sup>1</sup>

As discussed in more detail below, the Board proposes to modify Regulation II and the Commentary related to the prohibition on network exclusivity for card-not-present transactions and to update and standardize the use of certain terms in the Commentary. While described by the Board and Board staff as non-substantive, clarifying changes that “[are] not intended to impose new obligations with respect to card-not-present transactions,”<sup>2</sup> the Board, in the NPR and accompanying staff memorandum, articulates a shift in views on the permissibility of certain industry practices under Regulation II and proposes substantive modifications to Regulation II and the Commentary that, if finalized in their current form, would result in new compliance obligations for industry participants. The NPR also raises a number of questions about the intended scope of the proposed expansion of the prohibition on network exclusivity that the Board likely will need to answer through the rulemaking process.

Comments to the NPR must be submitted to the Board no later than 60 days following the publication of the NPR in the *Federal Register*.

## Background

In June 2011, the Board issued a final rule, Regulation II, to implement Section 1075 of the Dodd–Frank Wall Street Reform and Consumer Protection Act of 2010, commonly known as the “Durbin amendment.” Among other things, the Durbin amendment modified the Electronic Fund Transfer Act to impose limits on certain issuer and payment card network practices, including a prohibition on restricting the number of payment card networks on which electronic debit transactions could be processed (also referred to as the “prohibition on network exclusivity”) and a prohibition on inhibiting the routing of electronic debit transactions over any payment card network enabled on a debit card (also referred to as the “prohibition on routing restrictions”).<sup>3</sup>

### *Overview of Existing Prohibition on Network Exclusivity*

The prohibition on network exclusivity precludes an issuer or payment card network from “restrict[ing] the number of payment card networks on which an electronic debit transaction may be processed to less than two unaffiliated networks”<sup>4</sup> and specifies that an issuer can satisfy this requirement “only if the issuer allows an electronic debit transaction to be processed on at least two unaffiliated payment card networks, each of which does not, by rule or policy, restrict the operation of the network to a limited geographic area, specific merchant, or particular type of merchant or transaction, and each of which has taken steps reasonably designed to enable

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<sup>1</sup> See Federal Reserve System, Docket No. R – 1748, RIN 7100-AG15, Notice of Proposed Rulemaking: Regulation II (Debit Card Interchange Fees and Routing) (May 7, 2021).

<sup>2</sup> Federal Reserve System, Proposed Amendments to Regulation II (Debit Card Interchange Fees and Routing) to Clarify the Prohibition on Network Exclusivity; Biennial Report on 2019 Interchange Fee Revenue, Covered Issuer Costs, and Covered Issuer and Merchant Fraud Losses Related to Debit Card Transactions, Staff Memorandum (April 30, 2021).

<sup>3</sup> See 12 C.F.R. § 235.7.

<sup>4</sup> 12 C.F.R. § 235.7(a)(1).

the network to process the electronic debit transactions that the network would reasonably expect will be routed to it.”<sup>5</sup>

In the Commentary, the Board clarifies the intended application of the prohibition on network exclusivity, articulating that the mandate for debit cards to be enabled on at least two unaffiliated payment card networks does not require two or more unaffiliated networks to be enabled for each method of cardholder authentication.<sup>6</sup> In illustrating this point, the Board sets forth examples of network enablement combinations that could be used by issuers to comply with the prohibition on network exclusivity and indicates that the enablement of debit cards on one signature-based network and one unaffiliated PIN-based network, on two unaffiliated signature-based networks, or on two unaffiliated PIN-based networks satisfies the prohibition on network exclusivity.<sup>7</sup> While the Board recognizes that issuers could use a smaller payment card network to comply with the prohibition on network exclusivity, the Board specifically identifies payment card networks available “only at a limited category of merchants (such as a particular grocery store chain, merchants located in a particular shopping mall, or a single class of merchants, such as grocery stores or gas stations)”<sup>8</sup> as insufficient to meet the standards of the prohibition on network exclusivity.<sup>9</sup>

#### *Overview of Existing Prohibition on Routing Restrictions*

The prohibition on routing restrictions precludes an issuer or payment card network from “inhibit[ing] the ability of any person that accepts or honors debit cards for payments to direct the routing of electronic debit transactions for processing over any payment card network that may process such transactions.”<sup>10</sup> In the associated Commentary, the Board states that an “issuer or payment card network is prohibited from inhibiting a merchant’s ability to route or direct an electronic debit transaction over any of the payment card networks that the issuer has enabled to process an electronic debit transaction for that particular debit card.”<sup>11</sup> The Commentary also sets forth specific examples of activities that would be precluded by the prohibition on routing restrictions.<sup>12</sup>

### **Summary of Amendments Proposed in the NPR**

In the NPR, the Board proposes various changes to Regulation II and the Commentary related to the prohibition on network exclusivity and proposes non-substantive changes to the Commentary related to the prohibition on routing restrictions. If finalized by the Board in its current form, the NPR would:

- Amend Section 235.7(a)(2) of Regulation II to provide that an issuer satisfies the prohibition on network exclusivity “only if, for every geographic area, specific merchant, particular type of merchant, and particular type of transaction for which the issuer’s debit card can be used to process an electronic debit transaction, such issuer enables at least two unaffiliated payment card networks to process an electronic debit transaction, and where each of these networks has taken steps reasonably designed to be able to process the electronic debit transactions that it would reasonably expect will be routed to it, based on expected transaction volume.”<sup>13</sup>

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<sup>5</sup> 12 C.F.R. § 235.7(a)(2).

<sup>6</sup> 12 C.F.R. pt. 235, app. A, at 7(a)-1.

<sup>7</sup> *Id.*

<sup>8</sup> *Id.* at 7(a)-2.

<sup>9</sup> *Id.*

<sup>10</sup> 12 C.F.R. § 235.7(b).

<sup>11</sup> 12 C.F.R. pt. 235, app. A, at 7(b)-1.

<sup>12</sup> *Id.* at 7(b)-2.

<sup>13</sup> Federal Reserve System, *supra* note 1, at 21–22.

- Amend Comment 7(a)-1 (Scope of restriction) of the Commentary to:
  - Provide that the prohibition on network exclusivity “requires an issuer to configure each of its debit cards so that each electronic debit transaction initiated with such card can be processed on at least two unaffiliated payment card networks ... for every geographic area, specific merchant, particular type of merchant, and particular type of transaction for which the issuer’s debit card can be used to process an electronic debit transaction.”<sup>14</sup>
  - Specify that an issuer need not satisfy the debit-card configuration requirements for each method of cardholder authentication so long as the issuer satisfies the debit-card configuration requirements “for every geographic area, specific merchant, particular type of merchant, and particular type of transaction for which the issuer’s debit card can be used to process an electronic debit transaction.”<sup>15</sup>
  - Indicate, by way of example, that an issuer can satisfy the prohibition on network exclusivity by issuing debit cards enabled for signature-authenticated transactions over one payment card network and PIN-authenticated transactions over another unaffiliated payment card network so long as “each network can be used to process electronic debit transactions for every geographic area, specific merchant, particular type of merchant, and particular type of transaction for which the issuer’s debit card can be used to process an electronic debit transaction.”<sup>16</sup>
- Amend Comment 7(a)-2 (Permitted networks) of the Commentary to:
  - Specify that a payment card network can be used to satisfy the prohibition on network exclusivity so long as the network is capable of processing the electronic debit transaction volume it reasonably expects to be routed to it or is willing to expand its capabilities to do so, and so long as the network does not limit, by policy or practice, its ability to expand.<sup>17</sup>
  - Remove as redundant the language in Comment 7(a)-2(ii) specifying that a payment card network accepted only at a limited category of merchants would not be sufficient to comply with the prohibition on network exclusivity.<sup>18</sup>
  - Add a new comment, Comment 7(a)-2(iii), to clarify that an arrangement of payment card networks would be acceptable under the prohibition on network exclusivity if, “[f]or every geographic area (e.g., New York State), specific merchant (e.g., a specific fast food restaurant chain), particular type of merchant (e.g., fast food restaurants), and particular type of transaction (e.g., card-not-present transaction) for which the issuer’s debit card can be used to process an electronic debit transaction, an issuer [enables] at least two unaffiliated payment card networks.”<sup>19</sup>
  - Add a new comment, Comment 7(a)-2(iii)(A), to set forth examples of how an issuer could comply with the geographic-area component of the prohibition on network exclusivity through the enablement of various combinations of payment card networks for electronic debit transactions, such as the enablement of two unaffiliated networks available in all 50 U.S. states

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<sup>14</sup> *Id.* at 22.

<sup>15</sup> *Id.*

<sup>16</sup> *Id.* at 23.

<sup>17</sup> *Id.*

<sup>18</sup> 12 C.F.R. pt. 235, app. A, at 7(a)-2(ii); *see also* Federal Reserve System, *supra* note 1, at 23.

<sup>19</sup> Federal Reserve System, *supra* note 1, at 23–24.

or the enablement of three unaffiliated networks, where the first network is available in all 50 U.S. states, the second network is available in the 48 contiguous U.S. states, and the third network is available in Alaska and Hawaii.<sup>20</sup>

- Add a new comment, Comment 7(a)-2(iii)(B), to set forth examples of how an issuer could comply with the transaction-type component of the prohibition on network exclusivity through the enablement of various combinations of payment card networks for electronic debit transactions, such as the enablement of two unaffiliated networks, each of which can process card-present and card-not-present transactions, or the enablement of three unaffiliated networks, where the first network can process card-present and card-not-present transactions, the second network can process card-present transactions, and the third network can process card-not-present transactions.<sup>21</sup>
- Amend Comment 7(a)-7 (Application of rule regardless of form factor) of the Commentary to replace the term “form factor” with the term “means of access,” to provide that a debit card must comply with the prohibition on network exclusivity for each means of access, to add examples of an existing means of access, and to contemplate new means of access developed in the future.<sup>22</sup>
- Amend Comment 7(b) (Prohibition on Routing Restrictions) of the Commentary to make certain non-substantive changes.<sup>23</sup>

In its discussion of the NPR, the Board highlights and explains certain issues that prompted the Board to issue the NPR. First, the Board discusses technological developments since the adoption of Regulation II that enable most single-message payment card networks to process card-not-present transactions.<sup>24</sup> Despite these advancements, the Board notes, single-message payment card networks continue to process a disproportionately low volume of card-not-present transactions.<sup>25</sup> Second, the Board addresses the industry practice of issuers enabling one dual-message payment card network and one unaffiliated single-message payment card network on their debit cards to comply with the prohibition on network exclusivity.<sup>26</sup> Although the Board characterizes this practice as generally compliant with Regulation II for card-present transactions, the Board indicates that this practice prevents merchants from routing card-not-present transactions to single-message payment card networks and results in the processing of card-not-present transactions over dual-message payment card networks.<sup>27</sup> Finally, the Board, citing data collected by the Board and information received by the Board from industry participants, asserts “that some issuers do not make single-message networks available to process card-not-present transactions on any of their cards, while some other issuers make single-message networks available to process card-not-present transactions only on a subset of their cards.”<sup>28</sup> The Board expresses a view that the “failure by an issuer to enable at least one single-message network for card-not-present transactions, combined with the common industry approach of only enabling one dual-message network on each card, results in only one network – the dual-message network – being available to process card-not-present transactions.”<sup>29</sup> The Board describes “these practices ... as inconsistent with

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<sup>20</sup> *Id.* at 24.

<sup>21</sup> *Id.*

<sup>22</sup> *Id.* at 26.

<sup>23</sup> *Id.* at 26–27.

<sup>24</sup> *Id.* at 9–12.

<sup>25</sup> *Id.* at 11.

<sup>26</sup> *Id.* at 9–12.

<sup>27</sup> *Id.* at 10–12.

<sup>28</sup> *Id.* at 12.

<sup>29</sup> *Id.*

Regulation II because they restrict the number of payment card networks on which card-not-present transactions can be processed to fewer than two unaffiliated networks.”<sup>30</sup>

## Insights and Analysis

If the NPR simply consisted of non-substantive clarifications of existing obligations under Regulation II, as the Board suggests, it would not be necessary for the Board to go through the formal process of amending Regulation II and the Commentary. Rather, as it has done in the past, the Board could issue guidance in the form of frequently asked questions to clarify the Board’s expectations for industry participants regarding the prohibition on network exclusivity. As noted at the outset of this article, however, the proposed amendments to Regulation II and the Commentary would result in new compliance obligations for industry participants, which may explain, at least in part, why the Board elected to propose amendments to Regulation II and the Commentary instead of issue guidance.

If finalized in their current form, the proposed amendments would represent an expansion of the prohibition on network exclusivity, which currently can be satisfied through the deployment of various enablement combinations, including one signature-based payment card network and one unaffiliated PIN-based payment card network, even when the PIN-based network does not support, or offers limited support for, card-not-present transactions.<sup>31</sup>

In its December 2010 notice of proposed rulemaking for Regulation II, the Board proposed two alternatives for the prohibition on network exclusivity, examined the alternatives, and acknowledged in its discussion of the alternatives that the effectiveness of the alternative it ultimately adopted, “Alternative A,” “could be limited in some circumstances if an issuer can satisfy the requirement simply by having one payment card network for signature debit transactions and a second unaffiliated payment card network for PIN debit transactions.”<sup>32</sup> The Board proceeded to identify and explain certain instances where the effectiveness of Alternative A would be limited, recognizing that only a limited proportion of merchant locations accepted PIN debit transactions and that PIN debit functionality was not available for certain categories of merchants or certain types of transactions, including internet purchase transactions.<sup>33</sup> In these instances, the Board acknowledged, there would be only one payment card network available to process electronic debit transactions.<sup>34</sup> Despite these limitations, the Board adopted Alternative A and included a comment in the Commentary, Comment 7(a)-1, to clarify that an issuer could satisfy the prohibition on network exclusivity by issuing debit cards that operate on one signature-based payment card network and one unaffiliated PIN-based payment card network.

In further describing the characteristics of a network that would broadly qualify as one of the necessary unaffiliated payment card networks enabled on a debit card under Regulation II, the Board did not dictate specific standards for supported geographic areas, supported merchants or merchant types, or supported transaction channels other than to say that “[a] payment card network that is accepted only at a limited category of merchants (such as a particular grocery store chain, merchants located in a particular shopping mall, or a single class of merchants, such as grocery stores or gas stations) would not satisfy the rule.”<sup>35</sup>

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<sup>30</sup> *Id.*

<sup>31</sup> 12 C.F.R. pt. 235, app. A, at 7(a)-1; *see also* Federal Reserve System, *supra* note 1.

<sup>32</sup> Regulation II (Debit Card Interchange Fees and Routing), 75 Fed. Reg. 81,763, 81,749 (proposed Dec. 28, 2010) (to be codified at 12 C.F.R. pt. 235).

<sup>33</sup> *Id.* at 81,749–50.

<sup>34</sup> *Id.*

<sup>35</sup> 12 C.F.R. pt. 235, app. A, at 7(a)-2(ii).

Under the proposed amendments in the NPR, the Board would replace the presumption that a payment card network generally qualifies as sufficient to satisfy the prohibition on network exclusivity as long as the network does not restrict its operation to a limited geographic area, specific merchant, or particular type of merchant or transaction with a new set of prescriptive and more demanding network qualification criteria. Consequently, the Board-endorsed enablement configurations described in current Regulation II and Commentary would no longer satisfy the prohibition on network exclusivity unless at least two unaffiliated payment card networks enabled on each debit card can process an electronic debit transaction for every geographic area, specific merchant, particular type of merchant, and particular type of transaction.

The Board's proposed amendments raise several issues, including:

- Is it feasible to obligate issuers to ensure that at least two unaffiliated payment card networks they enable on each of their debit cards are accepted by every specific merchant? As a practical matter, merchants choose which payment card networks (and often, which payment types and which means of access) they will accept, so it may not be reasonable to subject issuers to merchant payment acceptance choices. Even if an issuer enabled every debit card network currently in market on its debit cards, there still may be merchants that accept only one of those debit card networks.
- What should constitute a "geographic area" under the proposed amendments? The example provided by the Board in proposed new Comment 7(a)-2(iii)(A) suggests a geographic area would be considered to be each of the 50 U.S. states, meaning issuers would be obligated to deploy enablement combinations on their debit cards that provide nationwide coverage by state. However, this interpretation would exclude U.S. territories, the District of Columbia, and Puerto Rico.
- What would constitute a "particular type of merchant" under the proposed amendments? The Board's proposed new Comment 7(a)-2(iii) suggests that it is intended to group merchants by category, such as fast-food restaurants. However, given the lack of discussion by the Board on this topic, industry participants are left with little insight into how, or the extent to which, merchants would be classified by type, whether the Board would require payment card networks to adopt and use uniform merchant category codes to facilitate compliance with this requirement, or whether issuers and networks would be forced to enable their debit cards for use at every category of merchant, including merchants that operate in high-risk categories.
- How does the proposal affect merchants' obligations to deploy acceptance or authentication technologies offered by networks, and must issuers now support all acceptance and authentication options offered by a network to avoid violating the rule?

The proposed amendments in the NPR will impact all sectors of the payments industry, and payment system participants should begin considering the potential implications on their businesses.

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If you have any questions or would like additional information, please contact Duncan Douglass, Chris Huffaker, or another member of our [Payment Systems Team](#).

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