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Payment Systems

Federal Reserve Board Adopts Final Rule to Amend Regulation II

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On October 3, 2022, the Board of Governors of the Federal Reserve System (“Board”) published a final rule (“Final Rule”) amending Regulation II and the related Official Board Commentary (“Commentary”). The amendments (1) expand the obligation of debit card issuers to enable two unaffiliated payment card networks on each of their debit cards; and (2) narrow the scope of payment card networks that may independently qualify as one of the two unaffiliated debit card networks an issuer must enable on its debit cards.

The Board notice of proposed rulemaking (“NPRM”) to amend the network enablement requirements under Regulation II, released in May 2021, raised a number of interpretive and substantive questions. As discussed in more detail below, the Final Rule clarifies many of the interpretive concerns from the NPRM and, in so doing, narrows the substantive concerns raised by industry participants during the notice-and-comment period. On balance, these substantive changes and clarifications should result in an outcome that is much closer to the status quo for certain industry participants, including, in particular, debit card issuers, than what the NPRM would have required. Despite these changes from the NPRM to the Final Rule, Governor Michelle W. Bowman voted against it. In a statement, Governor Bowman referenced the “substantial concerns” raised by community banks and her view “that significant questions remain about how the rule will affect banks, and particularly community banks, with respect to both fraud and the cost of compliance.”¹

The Final Rule will be effective as of July 1, 2023, giving industry participants less than nine months to implement any necessary changes to come into compliance with its new requirements.

This client advisory is divided into three parts. Part I provides a summary of the amendments to Regulation II in the Final Rule. Part II provides a summary of the noteworthy changes between the amendments proposed in the NPRM and the amendments adopted in the Final Rule. Part III provides initial insights and analysis on the practical implications of the Final Rule.

Cumulative Summary of Amendments to Regulation II in the Final Rule

As adopted by the Board, the Final Rule:

- Amends 12 C.F.R. § 235.7(a)(2) of Regulation II to provide that an issuer satisfies the prohibition on network exclusivity “only if the issuer enables at least two unaffiliated payment card networks to process an electronic debit transaction (i) [w]here such networks in combination do not, by their respective rules or policies or by contract with or other restriction imposed by the issuer, result in the operation of only one network or only multiple affiliated networks for a geographic area, specific merchant, particular type of merchant, or particular type of transaction, and (ii) [w]here 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.”²

¹ Federal Reserve System Board of Governors, Press Release, Statement on Final Amendments to Regulation II to Clarify the Prohibition on Network Exclusivity by Governor Michelle W. Bowman (Oct. 3, 2022), <https://www.federalreserve.gov/newsevents/pressreleases/bowman-statement-20221003.htm>.

² Federal Reserve System Board of Governors Notice: Debit Card Interchange Fees and Routing, Docket No. R – 1748, RIN 7100-AG15, Final Rule: Regulation II, Federal Reserve System Board of Governors (proposed Oct. 3, 2022), <https://www.federalreserve.gov/newsevents/pressreleases/files/bcreg20221003a1.pdf>.

- Amends 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 performed with such card can be processed on at least two unaffiliated payment card networks.”³
 - Provide that the configuration requirement for debit cards must “be satisfied for each geographic area, specific merchant, particular type of merchant, and particular type of transaction for which the issuer’s debit card can be used to perform an electronic debit transaction.”⁴
 - Specify that an issuer need not satisfy the configuration requirement for debit cards for each method of cardholder authentication so long as the issuer satisfies the requirement “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 perform an electronic debit transaction.”⁵
 - Indicate, by way of example, that an issuer can satisfy the prohibition on network exclusivity by issuing debit cards that can perform signature-authenticated transactions only over one payment card network and PIN-authenticated transactions only 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 perform an electronic debit transaction.”⁶
- Amends the Commentary to add new comment 7(a)-(2) (Issuer’s role) to:
 - Clarify that the prohibition on network exclusivity “does not require an issuer to ensure that two or more unaffiliated payment card networks will actually be available to the merchant to process every electronic debit transaction.”⁷
 - Clarify that “it is sufficient for an issuer to configure each of its debit cards so that each electronic debit transaction performed with such card can be processed on at least two unaffiliated payment card networks, even if the networks that are actually available to the merchant for a particular transaction are limited by, for example, the card acceptance technologies that a merchant adopts, or the networks that the merchant accepts.”⁸
- Renumbers Comment 7(a)-2 (Permitted networks) as Comment 7(a)-3 and amends the Comment to:
 - Remove as redundant language in previous 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.⁹

³ *Id.* at 51–52.

⁴ *Id.* at 52.

⁵ *Id.* at 53.

⁶ *Id.*

⁷ *Id.*

⁸ *Id.*

⁹ *Id.* at 53–54.

- Add a new comment, Comment 7(a)-3(iii), to clarify that an arrangement of payment card networks would be acceptable under the prohibition on network exclusivity if, “[f]or each 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 perform an electronic debit transaction, an issuer [enables] at least two unaffiliated payment card networks.”¹⁰
- Clarify in new comment 7(a)-3(iii) that the two unaffiliated payment card networks enabled on an issuer’s debit cards “do not necessarily have to be the same two payment card networks for every transaction.”¹¹
- Add a new comment, Comment 7(a)-3(iii)(A), to set forth examples of how an issuer could comply with the “geographic area” requirement 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 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.¹²
- Add a new comment, Comment 7(a)-3(iii)(B), to set forth examples of how an issuer could comply with the “particular type of transaction” requirement 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 transactions and card-not-present transactions, or the enablement of three unaffiliated networks, where the first network can process card-present transactions and card-not-present transactions, the second network can process card-present transactions, and the third network can process card-not-present transactions.¹³
- Renumbers Comment 7(a)-7 (Application of rule regardless of form) as Comment 7(a)-8 and amends the Comment to provide that “[t]he network exclusivity provisions in § 235.7(a) apply to electronic debit transactions performed with any debit card as defined in § 235.2, regardless of the form of such debit card” and to provide examples of forms of debit cards, including “a plastic card, a supplemental device such as a fob, information stored inside an e-wallet on a mobile phone or other device, or any other form of debit card, as defined in § 235.2, that may be developed in the future.”¹⁴
- Amends Comment 7(b) (Prohibition on Routing Restrictions) to:
 - Make certain nonsubstantive changes.
 - Make certain clarificatory changes, including that the prohibition on routing restrictions “does not require that an issuer allow a merchant to route a transaction over a payment card network that the issuer did not enable to process transactions performed with that debit card.”¹⁵

¹⁰ *Id.* at 54.

¹¹ *Id.*

¹² *Id.*

¹³ *Id.* at 54–55.

¹⁴ *Id.* at 56.

¹⁵ *Id.*

Summary of Noteworthy Changes Between the NPRM and the Final Rule

In the Board's discussion of the Final Rule, the Board addressed a range of comments provided by industry participants and identified modifications made by the Board to the previously proposed amendments under the NPRM to address concerns raised by commenters.

Changes to Proposed Amendments to § 235.7(a)(2)

The most significant revisions to the NPRM for debit card issuers relate to § 235.7(a)(2) of Regulation II. Under the NPRM, the Board proposed to amend § 235.7(a)(2) 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."¹⁶ In response to concerns that the Board's proposed amendments under the NPRM would transform the prohibition on network exclusivity into an obligation of issuers to guarantee the availability of two unaffiliated payment card networks for every transaction at every merchant anywhere in the United States, the Board, in the Final Rule, abandoned the NPRM formulation and adopted an two-part test based on network characteristics for determining whether a debit card issuer's enablement of payment card networks on its debit cards is sufficient to satisfy the prohibition on network exclusivity.¹⁷

Under the first prong of the test, the payment card networks an issuer enables on its debit cards collectively "must not, by their respective rules or policies, or by contract with or other restriction imposed by the issuer, result in the operation of only one network or only multiple affiliated networks for a geographic area, specific merchant, particular type of merchant, or particular type of transaction."¹⁸ With these changes, the Board intended "to foreclose [an] overly broad reading"¹⁹ of § 235.7(a)(2) and "make[] more prominent"²⁰ the prohibition against the practice of issuers "actively disabling, or failing to enable, the card-not-present capabilities"²¹ of payment card networks enabled on their debit cards in a manner that would result in impermissible outcomes (i.e., the availability of less than two unaffiliated payment card networks to process a debit card transaction for any merchant anywhere in the United States).²² With these changes, the Board also reaffirmed an issuer's right to rely on the rules and policies of a payment card network under current § 235.7(a)(2) of Regulation II, as proposed by some commenters, in determining whether the configuration of the issuer's debit cards avoids impermissible outcomes.²³

Under the second prong of the test, the Board carried forward the existing language under Regulation II to provide that the payment card networks enabled on an issuer's debit cards "must have each taken steps reasonably designed to be able to process the electronic debit transactions that they would reasonably expect will be routed to them, based on expected transaction volume."²⁴

¹⁶ Debit Card Interchange Fees and Routing, 86 Fed. Reg. 26189, 26194 (May 13, 2021) (to be codified at 12 C.F.R. pt. 235).

¹⁷ Federal Reserve System Notice, *supra*, note 1, at 18.

¹⁸ *Id.*

¹⁹ *Id.* at 19.

²⁰ *Id.* at 20.

²¹ *Id.*

²² See *id.*

²³ See *id.*

²⁴ *Id.* at 18.

Changes to Proposed Amendments to the Commentary

The Board adopted Comment 235.7(a)-1 largely as proposed in the NPRM, making only minor changes to better align the terminology in the comment with the terminology used elsewhere in Regulation II.²⁵

In conjunction with the changes to § 235.7(a)(2), the Board adopted new Comment 235.7(a)-2 to provide additional details regarding an issuer's obligations under the expanded prohibition on network exclusivity.²⁶ Through this Comment, the Board seemingly acknowledged concerns raised by commenters that issuers may be powerless to guarantee the availability of two unaffiliated payment card networks to all merchants.²⁷ Specifically, the Board reiterated that an issuer is not required "to ensure that two or more unaffiliated payment card networks will actually be available to the merchant to process every electronic debit transaction"²⁸ and that an issuer's configuration of "each of its debit cards so that each electronic debit transaction performed with such card can be processed on at least two unaffiliated payment card networks"²⁹ is sufficient to comply with the requirement in § 235.7(a).³⁰

Additionally, the Board noted in its discussion of the Final Rule that Comment 235.7(a)-3 "permits issuers to use more combinations of [payment card] networks to satisfy the prohibition on network exclusivity," including payment card networks whose operations may be geographically limited, so long as issuers satisfy the two-pronged network enablement test described above. The Board emphasized that this approach provides issuers with "greater flexibility" than current § 235.7(a)(2).³¹

In Comment 235.7(a)-8, the Board walked back the proposed amendments under the NPRM to substitute the term "form factor" with "means of access."³² Based on feedback from commenters, the Board determined that the substitution of the term "is unnecessary, would create confusion, and would undermine clarity" and instead included a modified version of the comment in the Final Rule that leverages the definition of "debit card" under § 235.2 of Regulation II and provides a list of examples of forms a debit card may take.³³

Insights and Analysis

One of the more significant challenges presented by the NPRM was the feasibility of the Board's imposition of an affirmative obligation on issuers to ensure that at least two unaffiliated payment card networks would be available for every geographic area, specific merchant, particular type of merchant, and particular type of transaction for which an issuer's debit card could be used to process an electronic debit transaction. By abandoning its proposed approach of requiring issuers to ensure ubiquitous debit card acceptance through two unaffiliated payment card networks in favor of a more pragmatic two-part test based on network characteristics in the Final Rule, the Board seems to have acknowledged the impracticable outcome that could have resulted from a plain reading of the language in the NPRM. Under the new formulation, an issuer generally should be able to comply with the prohibition on network exclusivity so long as the issuer enables its debit cards on two unaffiliated payment card networks that together satisfy the relevant requirements (i.e., the

²⁵ Specifically, the Board replaced uses of the terms "process" and "initiate" with the term "perform." *Id.* at 23.

²⁶ *Id.* at 21.

²⁷ *Id.*

²⁸ *Id.*

²⁹ *Id.*

³⁰ *Id.*

³¹ *Id.* at 22.

³² *Id.* at 24.

³³ *Id.*

payment card networks (1) do not have rules, policies, or contracts with or other restrictions imposed by the issuer such that their resulting coverage is less than each geographic area in the United States (i.e., each U.S. state), specific merchant, particular type of merchant, and particular type of transaction for which the issuer's debit card can be used to perform an electronic debit transaction; and (2) have "taken steps reasonably designed to be able to process the electronic debit transactions that [they] would reasonably expect will be routed to them, based on expected transaction volume"³⁴).

In explaining the intended application of the prohibition on network exclusivity, the Board articulated important protections for issuers by clarifying in the Commentary that the prohibition on network exclusivity does not obligate issuers to guarantee that two unaffiliated payment card networks will be available to every merchant for every electronic debit transaction. The Board also acknowledged in the Commentary that two unaffiliated payment card networks may not actually be available to a merchant for an electronic debit transaction, depending on the card acceptance technologies adopted by the merchant or the payment card networks accepted by the merchant. The Board's acknowledgement suggests that issuers will not be held responsible for any merchant-driven limitations beyond the issuers' control.

Although the two-part test set forth in the Final Rule provides more certainty to industry participants, the Board declined to provide much clarity on the proper application of the "geographic area," "specific merchant," and "particular type of merchant" requirements proposed by the Board in the NPRM and reaffirmed by the Board in the Final Rule and Commentary.

Based on the example provided by the Board in new Comment 7(a)-3(iii)(A), industry participants can glean that a "geographic area" will be considered to be any of the 50 U.S. states.

The Board also provided an example for each of the "specific merchant" and "particular type of merchant" requirements, referencing a specific fast food restaurant chain and fast food restaurants, respectively. However, these examples do not support reliable inferences by industry participants as to how these requirements might generally be interpreted or applied by the Board. Because these requirements could be construed broadly by the Board, a payment card network operator seeking to manage risk by prohibiting or limiting participation in its payment card network by individual merchants or certain types of merchants that pose unacceptable risk, or otherwise threaten the safety, stability, or security of its payment card network, may, in turn, jeopardize its ability to broadly satisfy the relevant requirements of the prohibition on network exclusivity.

The Board also declined to further clarify what it means by "particular type of transaction" beyond characterizing card-present transactions as one type of transaction and card-not-present transactions as another type of transaction. According to the Board, "it [was not] necessary to further define what constitutes a 'particular type of transaction' because the prohibition on network exclusivity applies to each debit card transaction performed with a debit card."³⁵ Additionally, the Board expressed concern "that providing additional examples of particular types of transactions could create the misimpression that types of transactions not enumerated in the [F]inal [R]ule are not subject to the prohibition on network exclusivity."³⁶ The Board's reticence to further define transaction types or to provide additional examples of transaction types could reflect a level of uncertainty at the Board as to where lines should be drawn between authentication methods and transaction types. For example, it remains unclear whether the Board would characterize a card-present transaction initiated using tap-to-pay capability of a debit card constitutes a type of transaction for

³⁴ *Id.* at 51.

³⁵ *Id.* at 21.

³⁶ *Id.* at 22.

which two networks must be enabled by the issuer or a method of authentication for which the issuer is not required to enable two networks on the debit card.

Finally, as we noted in [our previous advisory](#), one of the questions raised by the NPRM was whether the NPRM effectively would require issuers to support all acceptance and authentication options offered by a payment card network to avoid violating the prohibition on network exclusivity. In the Final Rule, the Board adopts the statement in the Commentary that an issuer is not required to satisfy the configuration requirements for debit cards for each method of cardholder authentication as long as the issuer satisfies such configuration requirements for each geographic area, specific merchant, particular type of merchant, and particular type of transaction. Thus, the Final Rule does not appear to require issuers to enable all available methods of cardholder authentication so long as at least one method of cardholder exists for each particular type of transaction.

Given the nine-month compliance deadline for the Final Rule, industry participants, namely issuers and payment card networks, should begin to reevaluate their debit card arrangements, agreements, policies, and rules. Among other things, each issuer of debit cards should:

- Analyze its debit card programs and enablement configurations, determine whether its current debit card configurations comply with the Final Rule, and identify any modifications necessary for its debit card configurations to enable it to comply with the Final Rule.
- Review its brand/incentive agreements for all relevant payment card networks to determine whether its rights and responsibilities are consistent with the Final Rule; evaluate whether any additional representations, warranties, or covenants should be included in such brand/incentive agreements; and to formulate a strategy for requesting and negotiating any necessary amendments to such agreements.
- Consider whether new or replacement relationships with operators of payment card networks are necessary in order to comply with the Final Rule.

Among other things, each operator of a payment card network should:

- Review, evaluate, and formulate a plan for addressing any rules, policies, or contracts with issuers that could potentially prevent issuers from complying with the prohibition on network exclusivity under the Final Rule.
- Determine the geographic footprint of its payment card networks to determine the extent to which any of them may not satisfy the geographic area requirement under the Final Rule.
- Review and determine the nature and scope of any prohibitions or limitations imposed by the operator with respect to participation in any of its payment card networks by individual merchants or particular types of merchants.
- Formulate a plan to respond to and address compliance-related requests from issuers and to enter into new or replacement brand/incentive arrangements with issuer participants.

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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