

Financial Services and Products ADVISORY

June 30, 2011

Federal Reserve Board Issues Final Rule to Implement Durbin Amendment

On June 29, 2011, the Federal Reserve Board issued a final rule to implement the Durbin Amendment to the Dodd-Frank Act, which, among other things, restricts interchange fees for certain debit card issuers and limits the ability of networks and issuers to restrict debit card transaction routing, including through exclusivity arrangements. The following is a summary of the final rule. A comparison of the final rule to the original proposed rule from December 16, 2010, is attached as [Appendix 1](#).

Interchange fees for debit card transactions are capped at 21 cents plus an ad valorem component of 5 basis points of the transaction value. The 21 cents plus 5 basis points serves as a de facto “safe harbor”—a debit card transaction interchange fee that does not exceed this threshold is conclusively reasonable and proportional. In addition, under an interim final rule issued concurrently with the final rule, an additional 1 cent per transaction “fraud prevention adjustment” to the interchange fee is available to those issuers that comply with certain standards outlined by the Federal Reserve Board.

- The 21-cents-per-transaction figure is substantially higher than the 12-cents-per-transaction cap included in the proposed rule, primarily due to the Federal Reserve Board’s inclusion of a much broader base of allowable costs under the final rule than had been considered under the proposed rule. The interchange fee caps under both the final rule and proposed rule were pegged to the 80th percentile of issuer allowable costs based on the Federal Reserve Board’s survey of covered issuers.
- The 5-basis-point ad valorem component adjusts for fraud losses, based on the average per-transaction fraud losses of the median issuer, as indicated in data from the Federal Reserve Board survey of covered issuers.
- The available fraud prevention adjustment of 1 cent per transaction represents the median fraud-prevention cost of 1.8 cents per transaction, as determined by the Federal Reserve Board survey of covered issuers, less the median fraud-monitoring cost of 0.7 cents per transaction (which was already included in calculating the 21-cent interchange fee cap figure), rounded to the nearest cent.

The interchange fee limitations apply unless one of three specific exemptions is met: small issuer, government programs or reloadable general-use prepaid cards.

- **Small Issuer:** Any debit card issuer with total worldwide assets (including assets of affiliates) of less than \$10 billion as of the end of the previous calendar year.
- **Government Programs:** Debit card transactions made pursuant to a government-administered payment program, even when the administration of such program is outsourced to a private third-party contractor.

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- **Reloadable General-Use Prepaid Cards:** Reloadable general-use prepaid cards, excluding open-loop gift cards that meet certain criteria; provided, however, that this exemption applies only if the prepaid card is the sole means of accessing the funds underlying the card for a payment transaction. Due to this additional requirement, many cards in the marketplace today that would have qualified for the reloadable general-use prepaid card exemption as included in the proposed rule will be subject to the interchange fee limitations under the final rule if they allow non-card methods of accessing prepaid funds (e.g., ACH access and check-writing).
- As of July 21, 2012, the Government Programs and Reloadable General-Use Prepaid Card exemptions are not applicable if the issuer of such cards charges either (1) an overdraft fee or (2) a withdrawal fee on the first withdrawal in any given month at an ATM in the issuer's designated ATM network.

The prohibitions on network exclusivity and merchant routing restrictions (a) require an issuer to enable at least two unaffiliated networks on each debit card ("Alternative A" from the proposed rule), (b) prohibit networks from entering into exclusivity arrangements and (c) restrict the ability of issuers or networks to mandate transaction routing requirements. Unlike the interchange fee limitations, there are no available exemptions.

- In adopting network exclusivity prohibition Alternative A from the proposed rule, the Federal Reserve Board has prohibited issuers and networks from limiting available routing options for debit card transactions to fewer than two unaffiliated networks per debit card. Accordingly, all debit cards will need to participate in at least two unaffiliated networks so that transactions initiated using those debit cards will have at least two independent routing channels. The two unaffiliated networks could be one PIN network and one signature network (the most common configuration), two signature networks or two PIN networks (in each case so long as the two networks are not affiliated). Recall that Alternative B from the proposed rule, if adopted, would have required issuers to enable at least two unaffiliated networks *per method of authorization on each debit card*.
- Even where an issuer has enabled two unaffiliated networks on its debit cards, the final rule prohibits networks from limiting the number of additional networks an issuer may enable on its debit cards.
- The prohibition on routing restrictions also eliminates the ability of an issuer or a network to require routing based on the card issuer's or network's preferences, and within certain limits, gives merchants control over debit card transaction routing, including via predetermined routing tables.
- These rules have general applicability and are not subject to any exemptions, including those available for small issuers, government programs and reloadable general-use prepaid cards that apply to the interchange fee limitations.

ATM transactions, three-party networks and cards that access bona fide trust accounts are not subject to the final rule.

- The Federal Reserve Board observed that ATM transactions are not electronic debit transactions for purposes of the rule because (a) cash withdrawals are not "payments" (i.e., exchanges of money for goods or services) and, accordingly, a network providing only ATM services is not a payment card network, and (b) because ATM transaction interchange fees do not compensate an issuer.
- In opting to exclude three-party networks (when the system operator is acting as both network and debit card issuer) from the final rule, the Federal Reserve Board concluded that such three-party networks do not constitute "networks" that "route" transactions.

- Under the final rule, the Federal Reserve Board excluded accounts established pursuant to bona fide trust arrangements from the definition of “accounts.” Consequently, cards that access such accounts, including health savings accounts (HSAs) that qualify as bona fide trust accounts, are exempt from the final rule.

The final rule sets varying effective dates for the interchange fee limitations and the prohibition on network exclusivity and merchant routing restrictions.

- The interchange fee limitations (including the “fraud-prevention adjustment” established under the interim final rule) are effective October 1, 2011.
- The prohibition on network exclusivity arrangements has rolling effective dates, as follows:
 - October 1, 2011, for payment card networks;
 - April 1, 2012, for most debit card issuers;
 - April 1, 2013, for certain health and other benefit cards subject to IRS rules; and
 - April 1, 2013, for general-use prepaid cards that have been reloaded (or 30 days after being reloaded, if the first reload occurs on or after April 1, 2013).
- The prohibition on merchant routing restrictions is effective October 1, 2011.

The final rule will have an impact across all sectors of the payments industry, including issuers, networks, merchant acquirers, merchants and technology providers.

Appendix 1

Comparison Chart of the Federal Reserve Board's Regulation II
December 16, 2010 Proposed Rule
vs.
June 29, 2011 Final Rule

DECEMBER 16, 2010 PROPOSED RULE	JUNE 29, 2011 FINAL RULE
<p>Interchange Fee Standards</p> <ul style="list-style-type: none"> • <u>Alternative 1 (Issuer-Specific Standard with Safe Harbor and Cap)</u> - The interchange fee charged or received by an issuer for each electronic debit transaction is limited to "allowable costs" incurred by the issuer, on an average per-transaction basis, during the previous year, but may not exceed 12 cents per transaction. <p>Interchange fees set at 7 cents per transaction or lower are within a safe harbor exemption, within which issuers are not required to demonstrate allowable costs.</p> <p>Interchange fees may vary in accordance with the transaction dollar value and/or transaction type up to the lower of "allowable costs" or the 12 cents per transaction cap.</p> <ul style="list-style-type: none"> • <u>Alternative 2 (Cap)</u> – The interchange fee charged by an issuer for each electronic debit transaction is capped at 12 cents per transaction, regardless of, and without the need to demonstrate, allowable costs. Interchange fees may vary in accordance with the transaction dollar value and/or transaction type, but may not exceed the 12 cents per transaction cap. 	<p>Interchange Fee Standards</p> <ul style="list-style-type: none"> • The Federal Reserve Board determined that an issuer-specific rule was impractical and instead adopted a cap in line with <u>Alternative 2</u>: 21 cents plus an ad valorem component of 5 basis points of the transaction value. • The 21 cents per transaction figure is substantially higher than the 12 cents per transaction cap included in the proposed rule, primarily due to the Federal Reserve Board's inclusion of a much broader base of allowable costs under the final rule than had been considered under the proposed rule. The interchange fee caps under both the final rule and proposed rule were pegged to the 80th percentile of issuer allowable costs based on the Federal Reserve Board's survey of covered issuers. • The 5 basis point ad valorem component adjusts for fraud losses, based on the average per-transaction fraud losses of the median issuer, as indicated in data from the Federal Reserve Board survey of covered issuers. • The Federal Reserve Board expanded the base of allowable costs in the final rule because it concluded that certain costs excluded from the fee cap determination under the proposed rule were nevertheless required for an issuer to "effect" an electronic debit transaction, including network connectivity costs; costs of hardware, software and labor; network processing fees; and transaction monitoring costs.

DECEMBER 16, 2010 PROPOSED RULE	JUNE 29, 2011 FINAL RULE
	<ul style="list-style-type: none"> • The Federal Reserve Board declined to consider other costs they determined were not incurred to effect an electronic debit transaction, including costs of corporate overhead, costs for establishing an account, card production and delivery, marketing, R&D, network membership fees, costs of rewards programs or customer inquiries. • Issuer supervisors must verify that issuers do not obtain fee revenue in excess of that permitted. • The Federal Reserve Board has committed to periodically conduct surveys of covered issuers to reassess and potentially reset these standards.
<p>Fraud Prevention Adjustment</p> <ul style="list-style-type: none"> • Allowable adjustments to interchange fees for fraud prevention open to comment and no specific regulatory provision was proposed by the Federal Reserve Board. The Federal Reserve Board suggested two possible fraud-prevention adjustment approaches: a technology-specific approach with a focus on major innovations and a more flexible non-prescriptive approach. 	<p>Fraud Prevention Adjustment</p> <ul style="list-style-type: none"> • Under an interim final rule issued concurrently with the final rule, a 1-cent-per-transaction “fraud prevention adjustment” to the interchange fee is available to those issuers who comply with certain standards outlined by the Federal Reserve Board. • The available fraud prevention adjustment of 1 cent per transaction represents the median fraud prevention cost of 1.8 cents per transaction, as determined by the Federal Reserve Board survey of covered issuers, less the median fraud-monitoring cost of 0.7 cents per transaction (which was already included in calculating the 21 cent interchange fee cap figure), rounded to the nearest cent. • The Federal Reserve Board’s fraud prevention standards are designed to be non-prescriptive as to particular technologies, and instead require policies and procedures to (i) identify and prevent fraudulent electronic debit transactions; (ii) monitor the incidence of, reimbursements received for, and losses incurred from fraudulent debit card transactions; (iii) respond appropriately to suspicious debit card transactions so as to limit losses and prevent future fraudulent transactions; and (iv) secure debit card and cardholder data. • An issuer seeking recovery of the fraud prevention adjustment must certify annually to its payment card networks that its fraud prevention standards comply with the Federal Reserve Board’s standards, but the payment card networks are responsible for developing processes for identifying issuers eligible under the Federal Reserve Board’s standards.

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<p>“Small Issuer” Exemption</p> <ul style="list-style-type: none"> Any issuer with total worldwide assets (including assets of affiliates) of less than \$10 billion as of the end of the previous calendar year is exempt from the interchange fee limitations. 	<p>“Small Issuer” Exemption</p> <ul style="list-style-type: none"> The Federal Reserve Board retained the exemption with some additional points, as noted below. The Federal Reserve Board also added that it will publish lists of exempt issuers to help enable networks to offer tiered pricing. The Federal Reserve Board will survey issuers and networks annually and publish a list annually of the average interchange fees provided by each network to covered and exempt issuers. The Federal Reserve Board clarified that asset size does not include trust assets under management.
<p>“Government-Administered Program” Exemption</p> <ul style="list-style-type: none"> Government-administered payment programs are exempt from the interchange fee limitations, even when the administration of such a program is outsourced to a private third-party contractor. 	<p>“Government-Administered Program” Exemption</p> <ul style="list-style-type: none"> This exemption was retained as proposed, with some clarifications added to the commentary.
<p>“General-Use Prepaid Card” Exemption</p> <ul style="list-style-type: none"> Reloadable prepaid cards, excluding open-loop gift cards that meet certain criteria, are exempt from the interchange fee limitations. 	<p>“General-Use Prepaid Card” Exemption</p> <ul style="list-style-type: none"> The Federal Reserve Board retained the exemption with clarifications added to the commentary, along with the additional, narrowing restriction below. The Federal Reserve Board added a new provision to clarify that the exemption applies only if the card is the only means to access the funds underlying the card, except when all remaining funds are provided to the cardholder in a single transaction.
<p>Limitation of Certain Interchange Fee Exemptions</p> <ul style="list-style-type: none"> As of July 21, 2012, the “government-administered programs” and “general-use prepaid cards” exemptions are not applicable if the issuer of such cards charges either (1) an overdraft fee or (2) a withdrawal fee on the first withdrawal in any given month at an ATM in the issuer’s designated ATM network. 	<p>Limitation of Certain Interchange Fee Exemptions</p> <ul style="list-style-type: none"> This exemption limitation was retained as proposed, with some clarifications added to the commentary.

DECEMBER 16, 2010 PROPOSED RULE	JUNE 29, 2011 FINAL RULE
<p>Prohibition on Circumvention or Evasion of Interchange Fee Restrictions</p> <ul style="list-style-type: none"> Generally, efforts to circumvent or evade the interchange fee limitations are prohibited. Issuers may not receive net compensation from a network, other than allowable interchange fee limitations, with respect to debit transactions. 	<p>Prohibition on Circumvention or Evasion of Interchange Fee Restrictions</p> <ul style="list-style-type: none"> This prohibition was retained as proposed, with some clarifications added to the commentary and with comment 6-1i regarding net compensation in the proposed rule being moved into the text of the final rule as 235.6(b).
<p>Network Exclusivity Prohibition</p> <ul style="list-style-type: none"> Alternative A - An issuer or network shall not directly or indirectly restrict the number of networks on which a debit card transaction may be processed to less than two unaffiliated networks, <i>regardless of authorization methods that may be used by the cardholder.</i> Alternative B - An issuer or network shall not directly or indirectly restrict the number of networks on which a debit card transaction may be processed to less than two unaffiliated networks <i>for each method of authorization that may be used by the cardholder.</i> 	<p>Network Exclusivity Prohibition</p> <ul style="list-style-type: none"> The Federal Reserve Board selected Alternative A. An issuer or network shall not directly or indirectly restrict the number of networks on which a debit transaction may be processed to less than two unaffiliated networks, <i>regardless of authorization methods that may be used by the cardholder.</i>
<p>Routing Restriction Prohibition</p> <ul style="list-style-type: none"> Issuers and networks may not directly or indirectly inhibit the ability of a merchant to route a debit card transaction for processing over any network enabled by the issuer on the debit card that is capable of processing that debit transaction. 	<p>Routing Restriction Prohibition</p> <ul style="list-style-type: none"> This restriction was retained as proposed, with some clarifications added to the commentary.

DECEMBER 16, 2010 PROPOSED RULE	JUNE 29, 2011 FINAL RULE
<p>No Exemptions for Network Exclusivity and Routing Restrictions</p> <ul style="list-style-type: none"> The prohibitions on network exclusivity and routing restrictions have general applicability and are not subject to any statutory exemptions, including the interchange fee exemptions for small issuers, government-administered programs and general-use reloadable prepaid cards. 	<p>No Exemptions for Network Exclusivity and Routing Restrictions</p> <ul style="list-style-type: none"> The absence of exemptions from the network exclusivity and routing restrictions was retained as proposed, with some clarifications added to the commentary. <p><i>However</i>, as indicated in the effective date analysis below, implementation deadlines are delayed for certain types of cards that present technological or operational impediments to the issuer's ability to comply with the rules (e.g., health and benefit cards, prepaid cards).</p>
<p>Effective Dates</p> <ul style="list-style-type: none"> The interchange fee limitations are effective July 21, 2011. The Dodd-Frank Act sets no effective date for the prohibitions on network exclusivity and routing restrictions, but the Federal Reserve Board sought comment on two possible effective dates for these restrictions, depending on which alternative approach is adopted (Alternative A—October 1, 2011; Alternative B—January 1, 2013). 	<p>Effective Dates</p> <ul style="list-style-type: none"> The interchange fee limitations (including the “fraud-prevention adjustment” established under the interim final rule) are effective October 1, 2011. The prohibition on network exclusivity arrangements has rolling effective dates, as follows: <ul style="list-style-type: none"> October 1, 2011, for payment card networks; April 1, 2012, for most debit card issuers; April 1, 2013, for certain health and other benefit cards subject to IRS rules; and April 1, 2013, for general-use prepaid cards that have been reloaded (or 30 days after being reloaded if the first reload occurs on or after April 1, 2013). The prohibition on merchant routing restrictions is effective October 1, 2011.

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