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Payment Systems Advisory ■

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Federal Reserve Board Issues Clarification on Treatment of Transactions-Monitoring Costs under Regulation II

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On August 14, 2015, the Board of Governors of the Federal Reserve System (the Board) published a clarification (the Clarification) of the Board's decision to include transactions-monitoring costs in establishing the 21-cent interchange-fee limitation set forth in Regulation II, Debit Card Interchange Fees and Routing (Regulation II).[1] The Clarification was issued in response to an order of the U.S. Court of Appeals for the D.C. Circuit[2] in *NACS v. Board of Governors of the Federal Reserve System (NACS v. Board)*, the long-running challenge by merchants and merchant trade associations to Regulation II's interchange-fee limitation. The appellate court's order upheld Regulation II as a whole but mandated that the Board provide further explanation of its decision to allocate such costs to the fixed component of the interchange-fee limitation, rather than to the fraud-prevention adjustment established elsewhere in Regulation II.

The Durbin Amendment's Interchange-Fee Limitation

The Durbin Amendment[3] requires interchange fees charged or received by certain debit card issuers[4] in conjunction with debit card transactions to be "reasonable and proportional" to the costs the issuer incurs in connection with such transactions.[5] The Durbin Amendment instructs the Board to issue rules to establish standards for assessing whether an interchange fee meets this standard. In so doing, the Durbin Amendment directs the Board to consider 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"[6] (referred to as "incremental ACS costs") and prohibits the Board from considering "other costs incurred by an issuer which are not specific to a particular electronic debit transaction."[7]

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1 Debit Card Interchange Fees and Routing, 80 Fed. Reg. 48684 (Aug. 14, 2015), *available at* http://www.gpo.gov/fdsys/pkg/FR-2015-08-14/pdf/2015-19979.pdf.

2 12 C.F.R. Part 235.

3 Electronic Fund Transfer Act, 15 U.S.C. § 16930-2, "Reasonable fees and rules for payment card transactions," referenced herein as the "Durbin Amendment."

4 Debit card issuers with assets of less than $10 billion are exempt from the interchange-fee limitation. 12 C.F.R. § 235.5(a)(2).

5 15 U.S.C. § 1693o-2(a)(3)(A).

6 15 U.S.C. § 1693o-2(a)(4)(B)(i)

7 *Id*. at 4(B)(ii).

In developing the interchange-fee limitation set forth in Regulation II, the Board interpreted the Durbin Amendment as requiring consideration of incremental ACS costs, prohibiting consideration of costs not specific to particular debit card transactions and permitting consideration of other costs that are "specific to a particular electronic debit transaction" (the third category costs). By the Board's reasoning, Congress only prohibited the Board, in its rulemaking, from considering issuer costs that are "not specific to a particular electronic debit transaction." As a result, the interchange-fee limitation established by the Board in Regulation II accounted not only for incremental ACS costs but also for the following third category costs: (i) certain fixed costs of authorization, clearing and settlement ("fixed ACS costs"), (ii) transactions-monitoring costs, (iii) fraud losses and (iv) network fees. After conducting a rulemaking proceeding (which included a survey and analysis of issuer costs, as well as review of more than 10,000 public comments on the initial proposed Regulation II), the Board set the interchange-fee limitation at 21 cents per transaction, plus five basis points of transaction value.[8] Transactions-monitoring costs ultimately accounted for 1.2 cents of the 21-cent fixed component of the permissible interchange fee amount.[9]

The Fraud-Prevention Adjustment

The Durbin Amendment also permits the Board to allow for a separate adjustment to the established interchange-fee limitation to account for certain fraud-prevention costs incurred by issuers that meet fraud-prevention standards established by the Board.[10] The Board conducted separate rulemaking with respect to the fraud-prevention adjustment. As a result of that rulemaking, the Board established standards that if satisfied by an issuer, qualify the issuer to receive an additional one-cent fee per transaction.[11] Consequently, the maximum interchange amount payable by a network to an issuer for a given debit transaction subject to Regulation II, assuming that issuer qualified for the fraud-prevention adjustment, is 22 cents, plus five basis points of transaction value.

The Merchant Challenge to Regulation II: NACS v. Board

After the release of final Regulation II, a group of individual merchants and merchant trade associations filed a challenge to the interchange-fee limitation established by the Board, asserting that the Board exceeded its statutory authority by considering costs other than those expressly stated in the Durbin Amendment when setting the interchange-fee limitation applicable to certain debit card transactions. The plaintiffs also challenged the prohibition on network exclusivity established by the Board in Regulation II. The Board's approach to that issue was ultimately upheld by the Court of Appeals and is not discussed here. A detailed summary of the plaintiffs' challenge to the network-exclusivity prohibition is included in our other advisories regarding NACS v. Board. In a strongly worded memorandum opinion issued on July 31, 2013, the D.C. District Court agreed with the plaintiffs' contentions, granted the plaintiffs' motion for summary judgment and declared its intent to vacate the challenged sections of Regulation II and remand to the Board for new rulemaking.[12]

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8 12 C.F.R. § 235.3(b).

9 Bd. of Governors of the Fed'l Res. Sys., *2009 Interchange Revenue, Covered Issuer Cost, and Covered Issuer and Merchant Fraud Loss Related to Debit Card Transactions (June 2011)*, available at http://www.federalreserve.gov/paymentsystems/files/debitfees_costs.pdf; Supplementary Material for Regulation II at 76 Fed. Reg. 43394, 43433–43434.

10 15 U.S.C. § 1693o-2(a)(5).

11 12 C.F.R. § 253.4.

12 *NACS v. Bd. of Governors of the Fed'l Res. Sys.*, 958 F. Supp. 2d 85 (D.D.C. 2013).

On appeal, a three-judge panel of the Court of Appeals for the D.C. Circuit reversed the District Court's grant of summary judgment and substantially upheld Regulation II as drafted.[13] The Court of Appeals found that in general, the Board had reasonably interpreted and applied the text of the Durbin Amendment in promulgating Regulation II. However, the court remanded one "minor" issue to the Board for further explanation—the treatment of transactions-monitoring costs.[14] Specifically, the Court of Appeals found that the Board had not adequately articulated the basis of the Board's decision to include transactions-monitoring in the 21-cent fixed-interchange-fee limitation rather than as part of the fraud-prevention adjustment.[15]

In its opinion, the Court of Appeals did not question the overall ability of issuers to recover such costs. However, the appellate court found that while the Board could reasonably have determined that transactions-monitoring costs are costs "specific to a particular...transaction"[16] in promulgating Regulation II, the Board had failed to "cogently explain" its decision to account for transactions-monitoring costs in setting the interchange-fee limitation rather than in establishing the fraud prevention adjustment.[17] Because the appellate court found that the Board's interchange-fee limitation as a whole "generally rests on a reasonable interpretation of the statute," the court remanded the transactions-monitoring costs issue to the Board to allow the Board to provide a legally adequate explanation for its decision to include such costs as costs that contributed to the interchange-fee limitation. Finding that the Board might be able "readily to cure [this] defect in its explanation of [its] decision" and that vacatur would have a significant disruptive effect on the marketplace, the Court of Appeals permitted Regulation II to remain in full effect during the Board's proceedings to address the deficiency.[18]

The plaintiffs subsequently submitted a , which was denied on January 20, 2015.[19]

The Board's Clarification

On August 14, 2015, the Board published its response to the directive of the Court of Appeals on remand, providing additional justification for Board's decision to include transactions-monitoring costs as third category costs that contributed to the interchange-fee limitation rather than as costs that should be accounted for under the fraud-prevention adjustment.

In the Clarification, the Board describes the principles that guided it in determining that third category costs, such as costs of transaction-processing equipment, hardware and software, should be included in setting the interchange-fee limitation. Such costs, the Board writes, "were properly included in the interchange fee standard because no particular transaction can occur without incurring these costs[.]"[20] The information provided by transactions-monitoring systems, such as neural networks and fraud-risk scoring systems, is similarly "integral to an issuer's decision to authorize a specific transaction," the Board notes.[21] In that sense, obtaining a response (or verifying a lack of response) from a

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13 *NACS v. Bd. of Governors of the Fed'l Res. Sys.*, 746 F.3d 474 (D.C. Cir. 2014) (the "*Circuit Court Opinion*").

14 *Id*. at 477.

15 *Id*. at 492-493.

16 *Id*. at 492 (internal citations omitted).

17 *Id*. at 492-493 (internal citations omitted).

18 *Id*.

19 .

20 Clarification at 5.

21 *Id*.

transactions-monitoring system is no different than any other step in the authorization process (and indeed, the Clarification notes, many steps in the authorization process, such as determining that an account is open and a card has not been reported lost or stolen, have the effect of preventing certain types of fraud).[22] Therefore, the expenses associated with such systems constitute costs "specific to a particular debit transaction," and are permitted by the Board to be considered in setting the interchange-fee cap.

The Clarification also distinguishes transactions-monitoring costs from the types of costs that, in the Board's view, Congress intended to be recovered through the fraud-prevention adjustment under the Durbin Amendment. As the Board notes, the Durbin Amendment does not direct the Board to consider the costs of a specific debit transaction in developing the fraud-prevention adjustment. Rather, the Durbin Amendment indicates that the Board should weigh the costs of fraud-prevention "in relation to electronic debit transactions."[23] That is, in establishing the fraud-prevention mechanism, the Board should take into account "an issuer's fraud prevention costs over a broad spectrum of transactions that are not linked to a particular transaction."[24]

Applying this justification, the Board determined that "programmatic costs" (such as development of new fraud-prevention technology and related research) incurred to address fraud "outside of the context of particular transactions" should be allocated to the fraud-prevention adjustment. In contrast, the Board allocated costs "necessary to effect a particular transaction" to the interchange-fee limitation.

Next Steps

The issuance of the Clarification is the Board's final obligation pursuant to the remand of *NACS v. Board*. However, the allocation of transactions-monitoring costs to the interchange-fee limitation could again by challenged by the *NACS* plaintiffs. In doing so, the plaintiffs would bear the burden of demonstrating that even taking into account the additional justification offered in the Clarification, the Board's decision to treat transactions-monitoring costs as third category costs violated Congress's intent under the Durbin Amendment and, therefore, violated the federal Administrative Procedure Act.

This advisory supplements our previous advisory regarding the District Court's memorandum opinion, our subsequent updates regarding the August 14, 2013 and August 22, 2013 status conferences and associated briefing, our advisory regarding the D.C. Circuit's grant of expedited review, our advisory regarding the oral arguments held before the D.C. Circuit on January 17, 2014, our alert and advisory regarding the D.C. Circuit's opinion and our advisory regarding the plaintiffs' petition of certiorari.

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22 *Id.* at 5-6.

23 *See* Clarification at 7.

24 *Id.*

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