STAY CURRENT
A Client Alert from Paul Hastings

PAUL HASTINGS

August 2011

Fed Interchange Rule: Beyond First Impressions

BY Chris Daniel, Stan Koppel, Kevin Petrasic & Ky Tran-Trong

Following a protracted, controversial and hard-fought political battle to block or delay its issuance, the Federal Reserve Board ("FRB") released the long-awaited Debit Card Interchange Fee and Routing Rule ("Interchange Rule") on June 29, 2011. The rule, which is generally scheduled to take effect October 1, 2011, represents a compromise of sorts between the interests of retail merchants that lobbied hard for inclusion of section 1075 of the Dodd-Frank Act ("DFA"), i.e., the so-called "Durbin Amendment," and those of bank issuers and payment card networks that originally opposed inclusion of the Durbin Amendment in the DFA last year and then attempted to delay its effective date this spring.

In issuing the rule, the FRB was effectively caught between a rock and hard place with respect to addressing and accommodating the competing concerns of the amendment's sponsor, Senator Durbin, and numerous bipartisan supporters on the Hill, backed by a number of influential players in the retail merchant space community, and similarly vocal, bipartisan Hill opposition to the amendment, including a number of influential members of the Senate Banking Committee, pushed by virtually the entire banking industry, including large banks, regional banks, small community banks and credit unions. Ultimately, the FRB found a way to implement a compromise that almost nobody likes but everybody appears to be able to live with, even if grudgingly so. In navigating between a proposed interchange fee cap viewed by the banking industry as overly restrictive and a "reasonable and proportional" cost recovery cap that is not directly tied to an issuer's specific costs opposed by merchants, the FRB effectively compromised by adopting a threshold stand-alone cap that, although higher than proposed, the banking industry still does not like, but which has also been heavily criticized by the retail merchant industry due to the increase from the proposed baseline fee from the proposal. The ultimate effects on the payments industry of the Interchange Rule, including delivery of promised benefits to merchants and consumers and impact on community banks, are not easy to predict. What is clear, however, is that the Interchange Rule will have immediate practical impacts on all organizations in the value chain of delivery of consumer payment services. These impacts arise not only from the revenue and cost re-distribution between issuers and merchants, but also from substantial infrastructure efforts necessary to implement the two-tier interchange rate structure applicable to covered and exempt issuers and products as well as the network exclusivity and routing provisions.

First Impressions

In terms of first impressions regarding the most important aspects of the Interchange Rule, the rule's fee provisions include the following:

- issuers may not receive or charge an interchange fee in excess of 21 cents (the base component) plus 5 basis points of the value (the ad valorem component) of an electronic debit transaction ("EDT");

- pursuant to an accompanying interim final rule, an additional fraud adjustment of 1 cent per transaction is allowable for fraud prevention, provided that an issuer satisfies certain fraud-related standards established by the FRB;

- issuers may not receive "net compensation" from a payment card network or otherwise circumvent or evade the interchange fee restrictions;

- issuers with consolidated assets of less than $10 billion (including affiliate assets) are exempt from the interchange fee restriction ("Small Issuer Exemption");

- certain general-use, reloadable prepaid cards are exempt from the interchange fee restriction, subject to certain conditions discussed below ("Reloadable Prepaid Card Exemption"); and

- debit cards issued by certain government-administered programs are exempt from the interchange fee restriction, also subject to certain conditions noted below ("Government Card Exemption").

With respect to the Interchange Rule's network exclusivity and routing provisions, the most significant aspects of the rule provide:

- issuers and payment card networks may not restrict the number of payment card networks on which EDTs may be processed to less than two unaffiliated networks, without regard to the method of authentication (e.g., a card may have one PIN-based network and one unaffiliated signature-based network enabled in compliance with the rule); and

- issuers and payment card networks may not restrict the ability of a merchant to direct the routing of an EDT over any network an issuer has made available to process an EDT.

Two important definitions in the final rule are also noteworthy:

- the rule excludes three-party systems from the definition of "payment card network" because three-party systems do not route transactions within the terms of DFA § 1075; and

- the definition of "account" excludes accounts established pursuant to bona fide trust arrangements (e.g., payroll cards administered through a bona fide trust account).

These general constructs are relatively straightforward under first impression; however, implementing these provisions raises significant questions and challenges, particularly given the fast approaching effective date of October 1, 2011 for the interchange fee standards.

Interchange Fee Standard

Certainly, the most visible and controversial aspect of the Interchange Rule is the interchange fee standard. In the FRB's original proposal,[1] this fee was generally capped at 12 cents per transaction – an amount that generated significant outcry from the banking industry. The FRB determined its initial proposed capped rate after taking into account certain allowable costs associated with authorizing, clearing and settling an electronic debit transaction, and using data from its 2010 Payment Study.[2]

The proposed cap of 12 cents reflected a significant reduction from an average interchange fee for all debit card transactions of 44 cents per transaction in 2009 as reported in the 2010 Payment Study.

In the final rule, the FRB made significant concessions to banking industry concerns regarding the effects of a fee cap of 12 cents per transaction on bank revenue and the potential impact on the availability and cost to consumers of deposit account services. The revised cap includes allowances for additional processing costs associated with effectuating an electronic debit transaction, plus an allowance for fraud losses. Thus, the resulting base transaction amount of 21 cents per transaction plus an ad valorem component of 5 basis points of the value of an EDT for fraud losses provides substantial relief for issuers from the proposed 12 cent cap. Nonetheless, the final cap amount represents a significant decline from the 44 cent average interchange fee currently received by issuers. The final rule also applies the same cap for all debit card transactions, without regard to the method of authentication (i.e., signature vs. PIN-debit), and whether or not a card is tied to a traditional DDA account or a prepaid account, despite data from the FRB's Payment Study indicating significant variance in the costs associated with processing the different transaction types, particularly in the case of prepaid card transactions.[3]

Overall, given that the interchange fee cap is the same for all EDTs, whether authenticated by PIN or signature, the motivations for issuance and acceptance of PIN vs. signature debit cards may be reversed under the Interchange Rule. Whereas many merchants have in the past attempted to steer cardholders to use PIN-debit which historically carries lower interchange fees compared to signature debit, that cost-driven motivation may now be reduced, especially when also taking into account the higher cost of PIN-based acceptance systems. On the other hand, given the substantially lower fraud loss experience on PIN-based EDTs, as cited by the Board, large issuers may be more inclined to favor PIN-based debit cards. Nonetheless, many other factors will also impact merchant and cardholder preferences at the point of-sale, including security considerations and checkout time.

In its accompanying interim final rule ("Fraud Rule"),[4] the FRB allows an additional "fraud adjustment" of 1 cent per EDT, provided an issuer complies with the fraud prevention provisions of the Durbin Amendment. Under the Fraud Rule, an issuer may receive the 1 cent fraud adjustment if it complies with the fraud-related standards established by the Board. These standards require an issuer to (i) develop, implement and annually update policies and procedures to identify and prevent fraudulent EDTs; (ii) monitor the incidence of, reimbursements received for and losses incurred from fraudulent EDTs; (iii) respond appropriately to suspicious EDTs in order to limit fraud losses that may otherwise occur and to prevent future fraudulent EDTs; and (iv) secure debit card and cardholder data. An issuer must also annually certify its eligibility for the fraud adjustment to the payment card networks in which it participates.

Finally, and importantly, the Interchange Rule contains provisions intended to "prevent circumvention or evasion" of the fee limits imposed on EDTs. The rule contains two provisions addressing circumvention or evasion: (i) a general prohibition on circumventing or evading the interchange fee restrictions; and (2) a specific prohibition on an issuer's receipt of "net compensation" from a network for EDTs.[5]

According to the preamble and accompanying staff commentary to the Interchange Rule, "an issuer has received net compensation from a payment card network if the total amount of payments or incentives received by the issuer from the payment card network during a calendar year in connection with [EDTs] or other debit card-related activity, excluding interchange transaction fees that are passed through to the issuer by the network, exceeds the total of all fees paid by the issuer to the network for [EDTs] or other debit card related activity during that calendar year."[6]

Generally, the net compensation restriction is designed to avoid situations in which a network fee could be used to indirectly compensate an issuer with respect to an EDT. In adopting the net compensation approach, however, the FRB arguably went beyond what was necessary under the statute. In particular, the final rule would more broadly capture any payments made by a network to an issuer for debit card related activity, regardless of whether the payment is tied to any fees that may be incurred by a merchant. Notably, the final rule includes additional payments by a network unrelated to the volume of debit card transactions in calculating the payments on the network side of the net compensation equation, and would cover, for example, network marketing incentives as well as signing bonuses (which may be allocated on an annual pro rata basis).

In addition, the final rule provides that circumvention or evasion of the interchange fee standards is not limited to circumstances in which an issuer receives net compensation from a network. Although the FRB stated that a finding of circumvention or evasion will depend on the facts and circumstances, the Interchange Rule and the accompanying Supplemental Information do not suggest how the circumvention or evasion provision will be monitored or enforced.

Exemptions, Exceptions and Exclusions

The Interchange Rule exemptions are as notable for what is included as for what is excluded from the final rule. The rule closely tracks the statutory exemption language, creating a number of interesting scenarios in which certain transactions are eligible for multiple exemptions while other, similar transactions appear to be subject to the interchange fee restriction. For example, health savings account ("HSA") cards qualify for exclusion if operated pursuant to a bona fide trust agreement. In contrast, however, other cards tied to similar health benefit accounts, such as health care flexible spending accounts or health reimbursement accounts, would not qualify for exclusion under the rule to the extent the underlying funds are not held in trust. Similarly, some card programs may be covered and others excluded depending on whether the underlying funds are held in individual accounts or in an omnibus account with all cardholder funds with subaccounts. The Interchange Rule exemptions are discussed below.

Small Issuer Exemption

Pursuant to the Small Issuer Exemption, an issuer with consolidated assets of less than $10 billion – including the assets of its affiliates, but excluding assets held in trust – is exempt from the Interchange Rule's interchange fee limits. Accordingly, small issuers would potentially be enabled to price deposit services, including debit card payment services, more competitively compared to large institutions, thereby imposing market constraints on fees that large institutions can charge to offset interchange fee revenue losses.

This exemption, however, sparked significant debate among the banking industry and in Congress about whether such a two-tier fee structure (with exempt and non-exempt tiers) is viable amidst concern that market forces and merchants' routing choices could effectively erode the pricing differences between the two tiers. If not, small issuers could become subject to a fee close to or at the lower fee cap amount, negating the benefits of the statutory exemption. The banking industry also expressed concern that merchants might choose to discriminate against higher-cost small issuer cards in favor of debit cards covered by the rule.[7]

Although the FRB acknowledged some of these concerns, it ultimately adopted the Small Issuer Exemption consistent with the statute. Nonetheless, the FRB took certain steps intended to facilitate availability of and compliance with the Small Issuer Exemption. First, the FRB announced that it would publish an annual list of issuers that qualify for the exemption.[8] Second, the FRB will survey payment card networks annually and publish a list of the average interchange transaction fee each network provides to covered and exempt issuers to allow small issuers to more readily compare the interchange revenue they would receive from each network. Finally, during their deliberations on the rule during the public Board meeting, Board members recommended that the Board undertake further studies to measure the effectiveness of the Small Issuer Exemption. Each of these initiatives is intended to provide additional information to help exempt issuers, Congress, the FRB and others monitor the implementation of the Interchange Rule to determine whether it is having the intended policy result.

Reloadable Prepaid Card Exemption

The Interchange Rule exempts certain reloadable general-use prepaid cards from the interchange fee cap restriction, provided all of the following conditions are satisfied:

- Issued in Exchange for Payment. A threshold question is whether a reloadable prepaid card qualifies as a "general-use prepaid card." The final rule adopts the same definition of "general-use prepaid card" as set forth in the FRB's final Gift Card Rule.[9] In particular, a key element of the definition is that the card must be issued "in exchange for payment" (as well as "redeemable at multiple, unaffiliated merchants for goods and services").[10] It should be noted, however, that the definition of "general-use prepaid card" in the statute itself does not incorporate the "in exchange for payment" language.

- Pooled/Omnibus Account. The funds for the card must be held in a pooled or omnibus asset account. Specifically, as stated in the rule, an exempt reloadable prepaid card may not be "issued or approved for use to access or debit any account held by or for the benefit of the cardholder," other than a subaccount used to track funds purchased or loaded onto the card. It is noteworthy that the discussion in the preamble highlights that general-use prepaid cards accessing funds in an omnibus account and identifiable to the cardholder by virtue of a subaccount, and thus eligible for FDIC pass-through insurance coverage, qualify under this condition.[11]

- Reloadable/No Gift Purpose. The card must be "reloadable and not marketed or labeled as a gift card or gift certificate."[12] It is important to note, however, that the card need not be "continuously" loadable. Generally, the rule follows the approach undertaken in the FRB's final Gift Card Rule and takes an expansive view of what constitutes "marketing as a gift card," including even occasional promotion of a card as a gift card. In this regard, a network-branded general-purpose reloadable card could be deemed a gift card and thus ineligible for the exemption based on an advertisement suggesting a gift use or purpose for the card.

- Only Means of Access. Finally, in a new condition added in the final rule much to the unwelcome surprise of the prepaid card industry, to qualify for the Reloadable Prepaid Card exemption, a reloadable prepaid card must be the "only means of access to the underlying funds, except when all remaining funds are provided to the cardholder in a single transaction."[13] Thus, access to underlying funds via check or ACH would cause a reloadable prepaid card to be subject to the interchange fee restrictions. Similarly, account sweep arrangements with a customer's checking or other asset account would also void the Reloadable Prepaid Card exemption. The new condition presents challenges for many prepaid card programs that offer additional functionality such as bill payment and are marketed to the unbanked and underbanked as a means to the financial mainstream.

A significant issue raised in the context of the Reloadable Prepaid Card exemption is its availability for HSAs, Flexible Spending Accounts ("FSAs") and Health Reimbursement Accounts ("HRAs"). Notwithstanding numerous comments urging the FRB to explicitly exempt these account types from the Interchange Rule (based, in part, on Congressional statements during deliberation of the Durbin Amendment suggesting this was intended), the FRB declined to do so by noting the statutory language does not provide for such an exemption. As a result, there could be disparate treatment of HSAs, FSAs and HRAs, depending on whether they are established as individual accounts or as subaccounts in an omnibus account arrangement.[14]

Government Card Exemption

Debit cards issued pursuant to a government-administered payment program are also exempt from the interchange fee restrictions provided the card can be used only to "transfer or debit funds, monetary value, or other assets" provided pursuant to the program. This exemption is not limited to card programs used to deliver government benefits but may also broadly cover programs in which there is government involvement in administering the program, such as a payroll card program in which the government is the employer or a government-administered workers' compensation program. In addition, a government program outsourced to a (non-government) third party service provider will qualify for the Government Card Exemption. It should be noted that, however, the FRB takes the view that HSAs, FSAs and similar accounts will not qualify under this exemption unless the program is for the employees of a government employer.

Exception to Reloadable Prepaid Card and Government Card Exemptions

An important caveat to the availability of the Reloadable Prepaid Card and Government Card exemptions is a one-year grace period (until July 21, 2012) after which the exemptions from the interchange fee restrictions will not be available for an issuer's cards if the issuer imposes overdraft fees or fees on the first ATM withdrawal per month out of the issuer's designated ATM network.

Network Routing and Exclusivity Requirements

While the network routing and exclusivity requirements of the Interchange Rule did not garner a similar amount of attention as the interchange fee issue, these requirements also raise significant implementation and competitiveness issues for the industry.

Network Exclusivity

The network exclusivity restriction addresses the restrictions an issuer or network may place on the networks that may be available on a card for processing a debit card transaction. Although the original proposal raised the possibility of requiring an issuer to enable on each of its debit cards at least two unaffiliated networks for each method of authentication (e.g., PIN- or signature-based), the final rule does not distinguish between transaction authentication methods and requires only that at least two unaffiliated payment card networks be available for each electronic debit transaction made using a debit card. Thus, an issuer may comply with the network exclusivity provisions by issuing a card enabled on one signature-debit network and one unaffiliated PIN-debit network. A card that may only be used for PIN-debit transactions will satisfy the rule if it is accepted on at least two unaffiliated PIN-debit networks. Although the final network exclusivity provisions alleviated considerable concern for the banking industry by not requiring two unaffiliated signature-debit networks enabled on each debit card, the result is likely much less satisfactory for retailers who may still be restricted to a single network for processing a particular EDT in many cases, either because the merchant only offers a single method of authentication or because the cardholder has selected a single method of authentication for a particular transaction.

A difficult issue presented by the two unaffiliated networks requirement is the impact on geographically limited or regional networks. The FRB in the preamble noted that an issuer could most effectively comply with the network exclusivity provisions by offering a debit card that is enabled on two unaffiliated payment card networks that operate throughout the United States. Nonetheless, the FRB acknowledged that a payment card network operating on a nationwide basis should not be the sole means by which an issuer could satisfy the network exclusivity provisions, as such an approach could, for example, reduce network choice for issuers, with little benefit to merchants in instances where the vast majority of debit card transactions for an issuer's cardholders take place within the network's geographic coverage area.

Accordingly, the final rule provides additional flexibility for issuers as well as networks by permitting an issuer to comply with the network exclusivity provisions by choosing a network that does not, "by rule or policy, restrict the operation of a network to a limited geographic area, specific merchant, or particular type of merchant or transaction." The network must also take steps reasonably designed to enable it to process the electronic debit transactions that the network reasonably expects will be routed to it, based on projected transaction volume.[15] Thus, a smaller network willing to take steps to expand its coverage could qualify as one of the two required unaffiliated networks for an issuer under the final rule.

Another important aspect of the network exclusivity provisions is the prohibition on the ability of a payment card network to restrict or limit an issuer's ability to contract with other payment card networks that may process an EDT. This provision would, for example, prohibit any network rules or restrictions specifying the other networks that may or may not be enabled on a debit card issued on the network or requiring that only the network's logo appear on a card.

Network Routing

Under the rule's network routing provisions, an issuer or payment card network is prohibited from directly or indirectly inhibiting the ability of a merchant to direct the routing of EDTs over any network that processes such transactions. The FRB clarified in the final rule that this refers to a merchant's ability to route EDTs only over those networks available with respect to a particular card rather than over any network of the merchant's choosing (including networks not enabled on the card). The FRB also noted that the routing provisions would allow a merchant to influence cardholders by providing incentives to use, for example, a PIN-based EDT over a signature option available with the same card.

Although the new routing provisions give merchants greater choice regarding the network over which an EDT may be processed, it is not clear to what extent merchants will be motivated to exercise that flexibility in light of the fee restrictions limiting the amount of interchange that may be imposed for each transaction, without regard to the method of authentication. Nonetheless, the added routing flexibility for merchants may come at the expense of frustrating consumer choice regarding the network over which an EDT may be processed as well as reducing network efficiency and reliability with respect to the processing of transactions. Since there is no requirement in the rule or legislation that merchants inform consumers that their purchase transaction will not be processed over the network of their choice, consumers may well blame that network for failures caused by the alternative routing chosen by the merchant. Finally, a network's ability to monitor transaction patterns that identify fraud by "seeing" all authorization requests arising on a card is likely to be diminished as transactions involving the card become fragmented across competing networks.

Important Terms

Several important terms outline the scope of coverage and context of the Interchange Rule. Chief among these are the definitions of "account" and what qualifies as a "bona fide trust" for purposes of exclusion from the definition of "account," and the definition of "payment card network."

Definition of "Account" and "Bona Fide Trusts"

Pursuant to the final rule, the definition of "account" includes a "transaction, savings, or other asset account . . . established for any purpose and that is located in the United States."[16] Excluded from the definition are accounts held under a "bona fide trust agreement" that are excluded from the definition of "account" under the Electronic Funds Transfer Act ("EFTA") and Regulation E.[17] Accordingly, an account held in trust would not be deemed an "account" for purposes of the Interchange Rule and transactions involving trust accounts would not be subject to the interchange fee restrictions or the network exclusivity or routing provisions.

As noted in the preamble, "[f]or purposes of Regulation E, the [FRB] has stated that whether an agreement is a bona fide agreement or arrangement is a question of state or other applicable law."[18] Further, the preamble notes that bona fide trust agreements are "those done in good faith and not merely a device to evade a law."[19] Left unclear in the Interchange Rule, however, is whether restructuring an otherwise legitimate trust from an existing non-trust account would be subject to greater regulatory scrutiny if an issuer's purpose for doing so was based on avoidance of the Interchange Rule alone. While such an action may give some initial pause from a regulatory perspective, it would appear a better view is that restructuring into a trust arrangement should withstand scrutiny, where the trust is legitimately established under state law, there is a reasonable nexus between the applicable state law and the situs of the trust, and similar trust arrangements are in existence and/or can be identified for particular account types such as HSAs.

Definition of "Payment Card Network"

Another important definition relates to the entities included and excluded by the definition of "payment card network." Under the statute, a "payment card network" is defined as "an entity that directly, or through licensed members, processors or agents, provides the proprietary services, infrastructure, and software that route information and data to conduct debit card or credit card transaction authorization, clearance, and settlement, and that a person uses in order to accept as a form of payment a brand of debit card, credit card or other device that may be used to carry out debit or credit transactions."[20] The definition is relevant to distinctions regarding four-party versus three-party payment systems, as well as with respect to the application of the Interchange Rule to emerging payment systems.

In its analysis on the coverage of three-party systems under the rule, the FRB noted that there is a meaningful difference between four-party and three-party payment systems based on the routing of transaction information that occurs in a four-party system, but not in a three-party system. Specifically, in a four-party system, transaction data are routed through a network to an issuer, and such networks provide services and infrastructure to transfer such information from a merchant to an issuer. In contrast, in a three-party system, a single entity operates the system and holds the cardholder accounts (and, typically, the merchant accounts). All required action and authorizations to settle a transaction in a three-party system are managed by the entity operating the system; thus, information is not "routed" in such systems. Further, merchants can negotiate directly with the issuer in three-party systems to set fees.[21]

Thus, in the final rule, the FRB concluded that three-party systems are not ''payment card networks'' within the meaning of the statute because they do not provide the network routing and related services and infrastructure required to transfer payment information to an issuer bank from the merchant's acquirer bank. Accordingly, three-party systems are not subject to the interchange fee restrictions or the network exclusivity and routing provisions of the rule.

It is not clear how many, if any, three-party systems issue traditional debit cards, since they typically are not operated by or affiliated with depository institutions holding the asset account. However, three-party systems do issue non-exempt reloadable prepaid cards, including gift cards, which would be subject to the Interchange Rule but for the FRB's interpretation of the term "payment card network." In addition, to the extent a three-party system licenses unaffiliated issuers to issue debit or general-use prepaid cards in its network, it would seem to become a four-party network as to such cards, and EDTs using such cards would be subject to the Interchange Rule if the issuer is not otherwise exempt, e.g., under the Small Issuer Exemption. In this regard, the Interchange Rule applies also to "decoupled" debit cards in which the issuer initiates an ACH transaction to fund transactions from accounts not held by the card issuer (provided that such transactions are processed over a payment card network), thus preventing structuring programs in this way in order to avoid the interchange fee caps.[22]

Another issue with the definition of "payment card network" is coverage of non-traditional and emerging payment systems or technologies. Generally, the FRB takes the view that if an emerging payment system "routes transaction information and data between acquirers and issuers, and not to an intervening payment card network," it will be considered a payment card network, and those transactions would be subject to the Interchange Rule (unless an exemption applies).[23] However, an entity will not be deemed a ''payment card network'' if, similar to a three-party system, it does not send transaction information and, instead, simply makes book-keeping entries.[24]

Finally, the FRB noted with respect to emerging technologies that access existing networks, "new or emerging access devices are included within the scope of the [final] rule if they are issued or approved for use through a payment card network and otherwise meet the criteria for being a debit card as the term is defined in [the final] rule."[25] Thus, for example, a contactless device (e.g., as may be issued as a separate card or fob or included on or accessible through a mobile phone) could be subject to the rule if it is issued or approved for use through a payment card network, and qualifies as a debit card as defined under the final rule.

Timing and Implementation

The Durbin Amendment provides for an effective date of July 21, 2011 (with final regulations required by April 21, 2011) for the interchange fee standards. Nonetheless, given the difficulties that the FRB experienced with resolving the numerous implementation issues and challenges raised by the Amendment, as well as uncertainty surrounding a possible legislated delay, it was deemed appropriate to delay effectiveness of the interchange fee restrictions in order to permit the industry some time to make the required changes and determinations regarding coverage and the availability of exemptions. Thus, the Interchange Rule is generally effective October 1, 2011.

With respect to the network exclusivity and routing provisions, which did not have a mandatory effective date under the statute:

- Issuers generally have until April 1, 2012 to comply with the network exclusivity requirement (but payment card networks must generally comply by October 1, 2011).
- For cards that use transaction qualification or substantiation systems (e.g., HSA and FSA programs), the compliance date is April 1, 2013, to provide systems sufficient time to develop the capability to handle transactions using these cards on multiple signature-debit networks or on PIN-debit networks.
- Non-reloadable general-use prepaid cards sold prior to April 1, 2013 are not subject to the rule, but such cards sold after that date will be subject to the rule.
- Reloadable general-use prepaid cards sold and reloaded prior to April 1, 2013 are subject to a May 1, 2013 compliance date.
- Reloadable general-use prepaid cards sold prior to April 1, 2013, and reloaded after April 1, 2013, must comply within 30 days after the date of reload.

Agency and Industry Challenges

Among the most pressing challenges created by the Interchange Rule are the certifications that will ultimately be required by networks regarding verification of compliance by issuers and the availability of exemptions for certain types of cards. Complicating this already difficult task are the numerous uncertainties regarding interpretations, definitions and legislative and regulatory intent with respect to a host of issues that the FRB staff are already encountering in implementing the new rule. In addition, the potential emergence of a two-tiered pricing structure almost certainly will have long-term ramifications for the payments industry, including networks, large and small issuers, and merchants. The new rule will also have significant impact in an industry dominated by significant technological advances and improvements that are expected to continue for many years. Such advances and improvements may now be driven by factors that have less to do with promoting efficiency and innovation than with compliance considerations. In the midst of all of this, the FRB will be required to withstand the inevitable unintended consequences that come with this type of legislated rulemaking while being nimble and flexible in ensuring that it provides answers and maintains a strong focus on both the underlying purpose of the Interchange Rule and the numerous compelling public policy issues concerning the use and proliferation of payment cards, as well as access to payment systems for the unbanked and underbanked.

Action Plan – Initiate Compliance Steps and Raise Issues Early

In many respects, the Interchange Rule is quite unique, raising numerous novel questions and issues regarding the relationship between banks, customers, merchants and the systems that allow these parties to conduct daily commerce. The rule is significantly constrained by difficult and narrow legislative language that is susceptible to significant differences of opinion with respect to interpretation. Certainly, the technological aspects and issues raised by the rule present significant challenges with respect to banking and payment industry compliance.

Given all of these factors, regardless of whether you are a bank, a payment network provider or a service provider contributing somewhere in the payments system value chain, you should undertake a thorough review of your existing payment cards, practices, services and products to assess the overall impact of the Interchange Rule and, most immediately, determine the steps you must take to ensure compliance by October 1, 2011 (if such date is applicable to some or all of your payment card products, systems and/or services). As with any new regulatory compliance requirement, an important challenge is to understand the nature of the underlying vulnerabilities of your existing payment program and potential risks to your entity's ongoing operations, policies and programs. Certainly, one of the most important steps you can take will be to reach out to advisors, experts and regulators, as well as industry peers, when issues arise. Most important, you should be well-informed over the coming weeks and months regarding the regulatory and supervisory issues and developments with the FRB's implementation of the Interchange Rule. In particular, you should consider participating in all opportunities to hear from the regulators and other industry advisers regarding new developments.

You should also carefully review your existing payment programs to evaluate the potential operational, compliance, reputational and other risks to your organization. Key areas to monitor throughout your organization include the following:

- Identify all payment products and services subject to the requirements of the Interchange Rule;
- Determine the steps you must take, if any, with respect to each of the products and services you identify to be in compliance with the rule;
- Initiate discussions with legal advisors and consultants to ensure that you are taking the appropriate steps to be in compliance with the rule by the effective date;
- Identify services, products and programs for which you rely on third-party service providers and ensure that they are taking all necessary steps to ensure their and your compliance with the rule by the applicable effective date(s);
- Raise issues and questions early both to inform the regulators regarding potential issues or concerns and to provide ample time to make any required adjustments to your payment programs, products and services;
- Conduct an assessment of the potential operational, compliance, reputational and other risks to your organization arising from the rule;
- Work closely with program and network partners to understand compliance expectations and certifications that will be required on their part to ensure program and network compliance with the rule; and
- Most important, fully understand all of the requirements with which your organization will be expected to comply, including the interchange fee restrictions and network routing and exclusivity requirements of the rule.

Paul Hastings lawyers are actively working with clients to identify and address the issues and risks related to implementation of the Interchange Rule, including issuer and network compliance, and are available to advise you with respect to your payment system programs, products and services.

If you have any questions concerning these developing issues, please do not hesitate to contact any of the following Paul Hastings lawyers:

Atlanta

Todd W. Beauchamp
1.404.815.2154
toddbeauchamp@paulhastings.com

Chris Daniel
1.404.815.2217
chrisdaniel@paulhastings.com

Kevin Erwin
1.404.815.2312
kevinerwin@paulhastings.com

Diane Pettit
1.404.815.2326
dianepettit@paulhastings.com

Palo Alto

Cathy S. Beyda
1.650.320.1824
cathybeyda@paulhastings.com

San Francisco

Stanton R. Koppel
1.415.856.7284
stankoppel@paulhastings.com

Washington, DC

Erica Berg-Brennan
1.202.551.1804
ericaberg@paulhastings.com

V. Gerard Comizio
1.202.551.1272
vgerardcomizio@paulhastings.com

Amanda M. Jabour
1.202.551.1976
amandajabour@paulhastings.com

Lawrence D. Kaplan
1.202.551.1829
lawrencekaplan@paulhastings.com

Helen Y. Lee
1.202.551.1817
helenlee@paulhastings.com

S. Scott Lieberman
1.202.551.1751
scottlieberman@paulhastings.com

Kevin L. Petrasic
1.202.551.1896
kevinpetrasic@paulhastings.com

Ky Tran-Trong
1.202.551.1733
kytrantrong@paulhastings.com

[1] 75 Fed. Reg. 81724 (Dec. 28, 2010).

[2] 2010 Federal Reserve Payments Study, available at http://www.frbservices.org/files/communications/pdf/2010_payments_study.pdf.

[3] The broad scope of debit cards captured by the rule also captures so-called "deferred debit" cards which are offered in connection with many brokerage accounts and debit the cardholder's asset accounts. See 76 Fed. Reg. 43407. Under network rules and under the settlement in the 2003 Merchant Antittrust Litigation, these cards are currently afforded credit card interchange fees if the card balance is paid by an asset account sweep held by the sponsoring broker no more frequently than every 14 days. This treatment will no longer be permitted by the Interchange Rule unless the issuer qualifies for the Small Issuer Exemption, discussed below, which is unlikely to be the case. As a result, the economics of those card programs will be substantially impacted.

[4] 76 Fed. Reg. 43478 (July 20, 2011).

[5] 76 Fed. Reg. 43394, 43441 (July 20, 2011).

[6] 76 Fed. Reg. 43443.

[7] 76 Fed. Reg. 43436. An important point highlighted in the rule's preamble, however, is that under card network rules currently, merchants are prohibited from discriminating between debit cards within a payment card network on the basis of the issuer of the debit card. See also EFTA Section 920(b)(4)(A), as added by the Durbin Amendment, providing that the statutory provisions on network exclusivity and routing shall not be construed as authorizing any person to discriminate between debit cards within a network on the basis of the issuer of a debit card.

[8] *See* Interchange Fee Standards: Small Issuer Exemption at http://www.federalreserve.gov/paymentsystems/debitfees.htm.

[9] 12 CFR 205.20; *see* 75 Fed. Reg. 16580 (April 1, 2010).

[10] 12 CFR § 235.2(i)(1).

[11] 12 CFR 235.5 (c)(1)(i).

[12] 12 CFR 235.5 (c)(1)(ii).

[13] 12 CFR 235.5 (c)(1)(iii).

[14] Alternatively, as further discussed below, HSA and similar accounts established as *bona fide* trust accounts may be excluded from the Interchange Rule altogether due to the carve out in the definition of "account" for trust accounts.

[15] 72 Fed. Reg. 43448-49.

[16] 12 CFR § 235.2(a)(1).

[17] 12 CFR § 235.2(a)(2).

[18] 76 Fed. Reg. 43405.

[19] *Id.*

[20] EFTA Section 920(c)(11).

[21] 76 Fed. Reg. 43416.

[22] The FRB noted, however, that decoupled debit cards which can be used to directly initiate ACH transactions without being processed over a card network for any part of a transaction are not subject to the Interchange Rule because an ACH operator itself is not a "payment card network" for purposes of the Interchange Rule as the account numbers used to initiate an ACH debit are not "brands" of cards, or other payment codes or devices that a person accepts as a form of payment. See 76 Fed. Reg. 43414. Similarly, the FRB concluded that ATM transactions are not "electronic debit transactions" subject to the Interchange Rule because ATM networks are not "payment card networks" as a cash withdrawal is not considered to be a "form of payment" for purposes of the "payment card network" definition. See 76 Fed. Reg. at 43417.

[23] 76 Fed. Reg. 43414.

[24] 76 Fed. Reg. 43418.

[25] 76 Fed. Reg. 43419.