

Center for Regulatory Effectiveness

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May 16, 2007

Ms. Roberta K. McInerney
Assistant General Counsel
for Banking and Finance
Room 2304
Department of the Treasury
1500 Pennsylvania Avenue, NW.
Washington, DC 20220

RE: Duty of the Treasury Department and the Federal Reserve System to Conduct An Initial Regulatory Flexibility Analysis on the Prohibition on Funding of Unlawful Internet Gambling Proposed Rule (RIN: 1505-AB78)

Dear Ms. McInerney:

I am writing with respect to the non-discretionary duty of the Treasury Department and the Board of Governors of the Federal Reserve System to conduct an Initial Regulatory Flexibility Analysis (IRFA) of the forthcoming above-captioned proposed rule as required by the Regulatory Flexibility Act (5 U.S.C. 601 *et seq.*).

The law requires the agencies to “prepare and make available for public comment an initial regulatory flexibility analysis” describing “the impact of the proposed rule on small entities”¹ except in certain clearly defined circumstances.

The Requirement to Conduct A Preliminary Impact Analysis

Pursuant to Executive Order 13272, the Treasury Department established its own agency-specific policies and procedures to implement the Act.² Treasury’s Policies and Procedures explain that in certain circumstances the Regulatory Flexibility Act does not apply, such as Advance Notices of Proposed Rulemakings and regulations which do not require a notice-and-comment process. *None of the exemptions apply to this rulemaking.*

¹ 5 U.S.C 603.

² Found at <http://www.treas.gov/regs/2002-rfa-compliance.pdf>.

Treasury's Policies and Procedures *require* the Department "to undertake a preliminary analysis of who is affected by the regulation and, if the regulation affects small entities, the nature (quantified to the extent practicable) of that effect."³

Based on the preliminary analysis, if the agency determines that the regulation would "not have a significant economic impact on a substantial number of small entities" or "implements a statute...that... to the extent such impact flows directly from such statute" the Department must certify that a regulatory flexibility analysis is not required.⁴

- ▶ A certification that the rule will not have a significant economic impact on a substantial number of small entities "must be followed by a factual explanation of the basis for the certification."⁵ [Emphasis in original.]
- ▶ A certification that a rule does not require a regulatory flexibility analysis is subject to judicial review. See, 5 U.S.C. 611.

The Regulatory Impact Does Not Flow Directly From the Statute

When the agency does not have discretion regarding the regulation's burden on small entities, *i.e.* the burden "flows directly" from the law, Treasury's Policies and Procedures allow the agency to certify that a regulatory flexibility analysis is not required.

- The statute requiring the above-captioned regulation explicitly provides the agencies with considerable discretion in crafting the regulation. Moreover, the law *requires* the agencies to:
 - 1) Provide flexibility to participants covered by the regulation in deciding how to comply with the law's requirements. Specifically, the law states,

*to the extent practical, permit any participant in a payment system to choose among alternative means of identifying and blocking, or otherwise preventing or prohibiting the acceptance of the products or services of the payment system or participant in connection with, restricted transactions;*⁶

³ Department of Treasury, "Policies and Procedures to Ensure Consideration of Potential Impacts of Regulation on Small Businesses and Entities," 2(c)(1)(A)(i).

⁴ *Ibid.*, 2(c)(2)(A).

⁵ *Ibid.*

⁶ Public Law 109-347, Sec. 802.

- 2) Exempt those restricted transactions where enforcement is not reasonably practical. As the statute states,

exempt certain restricted transactions or designated payment systems from any requirement imposed under such regulations, if the Secretary and the Board jointly find that it is not reasonably practical to identify and block, or otherwise prevent or prohibit the acceptance of, such transactions;

- 3) Furthermore, in developing the proposed rule, the agencies are obligated to ensure that lawful transactions are not blocked. As the law explains, the Treasury Department and the Board of Governors must,

ensure that transactions in connection with any activity excluded from the definition of unlawful internet gambling...are not blocked or otherwise prevented or prohibited by the prescribed regulations.

CONCLUSION: The burden on small entities does not flow directly from the law since the statute provides agencies with substantial flexibility in developing a regulatory regime which provides covered parties with options for implementing the law's requirements and allows the agencies to exempt some transactions from the regulatory requirements.

The Rule Will Impact on a Substantial Number of Small Entities

There are, at a minimum, at least four types of small business that will be significantly impacted by the rule.

- Credit card issuers;
- Financial transactions processing companies;
- Firms engaged in other activities related to credit intermediation; and
- Small, innovative American technology companies.

1. Credit Card Issuers

The credit card industry is highly concentrated and is rapidly becoming ever more concentrated. According to one report, whereas the ten largest credit card issuers accounted for 66% of industry revenues in 1996, by 2005 only the four largest issuers accounted for the same (66%) share of industry revenues.⁷

⁷ Nadler, F., "The Credit Card Industry," Background Paper No. 15, August 25, 2005, p. 4. found at http://www.upu.int/news_centre/2005/en/paper_2005-08-15_pitney-bowes15_en.pdf.

Despite the industry's consolidation, there are still a substantial number of small credit card issuers. It is imperative that the rule not further erode their competitive standing relative to larger competitors. Additional consolidation of the credit card issuing industry resulting from costs imposed by the rule would further reduce competition and result in even higher credit card fees, charges and interest rates. *The indirect impact of the higher costs on small entities from reduced competition among credit card issuers needs to be analyzed as part of the IRFA.*

The Small Business Administration (SBA) defines a small credit card issuer (NAICS 522210) as having average assets of no more than \$165 million.⁸ Although the most recent publicly available government data for credit card issuers is based on number of employees rather than assets, *the federal data strongly suggests that most credit card issuers are small businesses.*

Specifically, according the most recent data (2004) from the Census Bureau:

- 52 of the 178 credit card issuers have 1-4 employees.
- 20 firms have 4-9 employees.
- 14 firms have 10-19 employees.⁹

The report also states that 28 firms have zero employees although it is not immediately clear how this should be interpreted. Based on the Census Bureau's data, **more than half (56%) the credit card issuers have fewer than 10 employees.** If the data is adjusted to exclude companies without employees, the results are about the same (57% of credit card issuers have fewer than 10 employees).

About two-thirds of credit card issuers have fewer than twenty employees (adjusted or unadjusted).

CONCLUSION: There is strong evidence that a substantial number of credit card issuers are small businesses.

2. Financial Transactions Processing Companies

Financial transactions processing, reserves and clearinghouse activities (NAICS 522320) is also a highly concentrated industry with a substantial number of small companies. According to a Census Bureau report issued in 2004, there are over 3,300 establishments (physical locations at

⁸ http://www.sba.gov/idc/groups/public/documents/sba_homepage/serv_sstd_tablepdf.pdf.

⁹ <http://www.census.gov/epcd/susb/2004/us/US52221.HTM>

which business in conducted, not firms) in this industry.¹⁰ Excluding the 50 largest firms, the average revenue per establishment is \$1.7 million. Although even smaller firms may have multiple establishments, the data suggests that there are a substantial number of firms in the industry with revenues not exceeding \$6.5 million, SBA's definition of a small business for this industry.

CONCLUSION: Census Bureau data strongly suggests that a substantial number small companies are in engaged in financial transaction processing services.

3. **Other Activities Related to Credit Intermediation** NAICS 52239. This industry includes “establishments primarily engaged in facilitating credit intermediation (except mortgage and loan brokerage; and financial transactions processing, reserve, and clearinghouse activities).¹¹

Excluding the 50 largest firms, the average revenue for the other 7,650 establishments is just over \$550,000, well under the \$6.5 million per firm set by SBA. Even allowing that some of those establishments are not stand-alone companies, it is reasonable to conclude that there are a substantial number of small businesses in this industry.

4. **Small, innovative American technology companies**

Anecdotal evidence indicates that there are a number of small and emerging innovative American technologies companies that would be directly or indirectly impacted by the rule. The agencies will need to analyze the impact of the rule on these companies when it conducts the IRFA. Examples of these firms include:

- **Innovative Credit Card Processing Equipment:** 3PEA Technologies. This firm makes a product call PayPad, “a computer peripheral that plugs into a home PC or laptop, in effect creating a home POS terminal.” This type of equipment could potentially be used for restricted transactions. See story, <http://www.greensheet.com/cprofiles/3peatechnologies.html>
- **Credit Card Cell Phones.** Cell phones can be embedded with an RFID tag to allow them to be waived in front of a reader as a means of making a purchase. The technology is becoming increasingly available. Thus, a person could potentially use a cell phone credit card as a means of placing a wager. The following article is about a small company, VIVOtech, that makes software supporting the credit card cell phones, <http://www.internetnews.com/ec-news/article.php/3662501>

¹⁰ U.S. Census Bureau, “Activities Related to Credit Intermediation: 2002, September 2004, p. 12, found at <http://www.census.gov/prod/ec02/ec0252i08.pdf>.

¹¹ Ibid., B-1.

CONCLUSION: Small, innovative American technology companies will be directly and/or indirectly impacted by the rule.

The Rule Will Have A Significant Economic Impact

In order to trigger the Regulatory Flexibility Act requirement to conduct an IRFA, it is not enough for the rule to impact a substantial number of small companies, but also the direct or indirect impact of the rule on small businesses must be significant.

The strongest evidence that the rule will have a significant economic impact on industry is found in the text of the statute itself. By explicitly directing the Secretary and the Board of Governors of the Federal Reserve System, in consultation with the Attorney General, to permit participants to the extent practical “alternative means of identifying and blocking, or otherwise preventing or prohibiting the acceptance of the products or services of the payment system or participant...” Congress was:

- 1) Recognizing the significant burden carrying out the law would place on participants; and
- 2) Directing the agencies to minimize the burden on businesses.

Congress further recognized the law’s potential for placing extraordinary burdens on companies when it authorized Treasury to create exemptions for “certain restricted transactions or designated payment systems from any requirement imposed under such regulations, if the Secretary and the Board jointly find that it is not reasonably practical to identify and block, or otherwise prevent or prohibit the acceptance of, such transactions.”

The economic burdens of the proposed rule will be disproportionately heavy on small card issuers and representatives of the transaction processing industries since they have a smaller number of transactions and/or cards over which to spread the various information systems, management, legal counsel and other costs of complying with the rule. Given the computer programming and testing, management planning and oversight, and reporting and recordkeeping requirements needed to identify and block restricted transactions, the costs associated with the rule will be extensive.

Even if small entities outsource some of the compliance functions, they will still be have to pay for those services, costs which will place them at a further competitive disadvantage to larger companies with extensive in-house technical, management and legal expertise. The technology, management, legal and other costs will also heavily impact small technology companies developing innovative products and services related to the financial transactions processing.

CONCLUSION: The rule will place significant direct and indirect burdens on a substantial number of small entities, potentially altering the competitive situation in financial transactions industries and leading to further consolidations in already highly concentrated industries.

NEXT STEPS

- ▶ The Treasury Department and the Board of Governors of the Federal Reserve System have a series of mandatory legal obligations under the Regulatory Flexibility Act. Actions the agencies need to take include:
 - Notifying “the Chief Counsel for Advocacy of the Small Business Administration and provide the Chief Counsel with information on the potential impacts of the proposed rule on small entities and the type of small entities that might be affected.”¹²
 - Convening “a review panel for such rule consisting wholly of full time Federal employees of the office within the agency responsible for carrying out the proposed rule, the Office of Information and Regulatory Affairs within the Office of Management and Budget, and the Chief Counsel.”¹³
 - Assuring “that small entities have been given an opportunity to participate in the rulemaking for the rule” beyond those provided by publication of a *Federal Register* notice.
 - *The Center for Regulatory Effectiveness (CRE) hereby requests that Treasury and the Board of Governors hold a public hearing concerning the impact of the rule on small entities as discussed in 5 U.S.C. 609(a)(4).*
 - Begin preparing an Initial Regulatory Flexibility Analysis including:
 - A “description of, and where feasible, an estimate of the number of small entities to which the proposed rule will apply;”
 - A “description of the projected reporting, recordkeeping and other compliance requirements of the proposed rule, including an estimate of the classes of small entities which will be subject to the requirement and the type of professional skills necessary for preparation of the report or record;” and
 - Discussion of “significant alternatives to the proposed rule which accomplish the stated objectives of applicable statutes and which minimize any significant economic impact of the proposed rule on small entities.”¹⁴

¹² 5 U.S.C. 609(b)(1).

¹³ 5 U.S.C. 609(b)(3).

¹⁴ Department of Treasury, “Policies and Procedures to Ensure Consideration of Potential Impacts of Regulation on Small Businesses and Entities,” 2(d).

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About CRE

The CRE is a regulatory watchdog established in 1996 by former senior career officials from the Office of Management and Budget, http://www.thecre.com/emerging/Jim_Tozzi_Bio.html. In its role as a watchdog, CRE intervenes from time to time in regulatory proceedings through the comment process, filing Data Quality Petitions, and/or other mechanisms. CRE was the primary proponent of the DQA, http://www.thecre.com/pdf/20021111_fedtimes-tozzi.pdf.

Sincerely,

/s/

Jim Tozzi

Member, Board of Advisors

cc: The Honorable Robert J. Portman, Director, The Office of Management and Budget
The Honorable Thomas M. Sullivan, Chief Counsel for Advocacy, U.S. Small Business Administration
Mr. Scott G. Alvarez, General Counsel, The Board of Governors of the Federal Reserve System
Mr. Peter A. Bieger, Deputy Assistant General Counsel, Banking and Finance
Dennis W. Carlton, Ph.D., Deputy Assistant Attorney General for Economic Analysis