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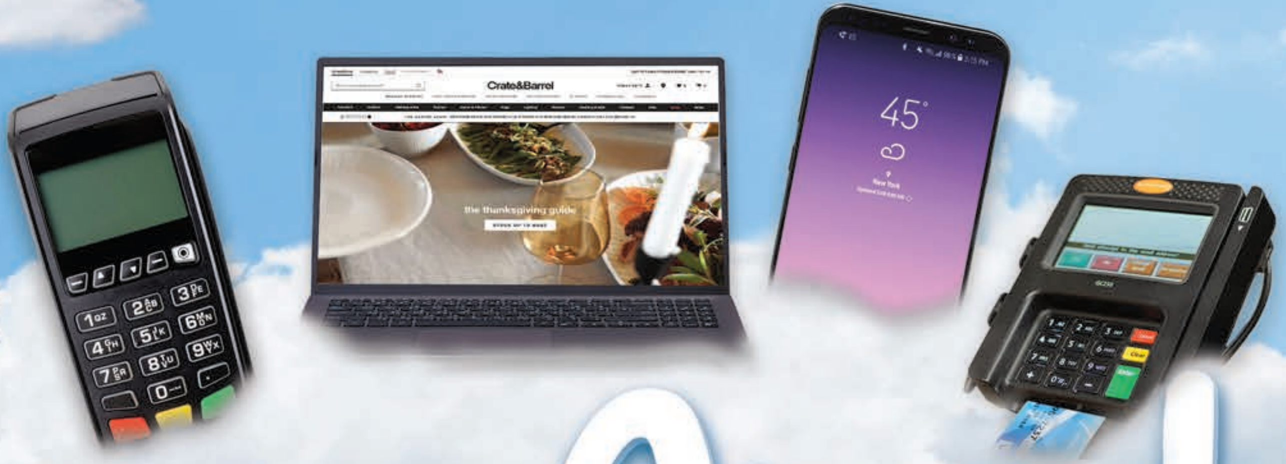

In the Cloud

The payments industry has forged a symbiotic relationship with cloud computing. That isn't likely to be swept away any time soon.

Volume Nineteen, Number Twelve • DigitalTransactions.net • December 2022

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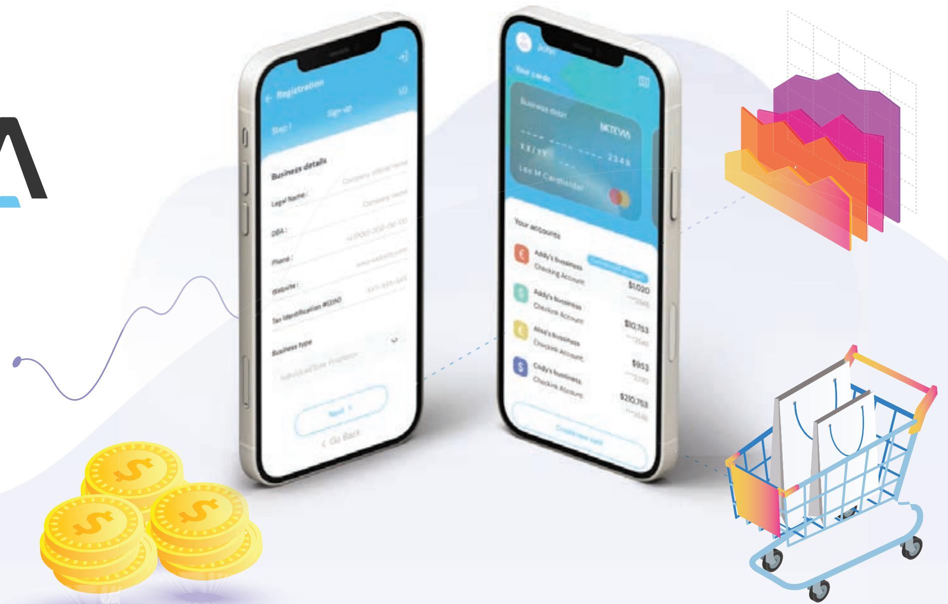

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Cover Illustration: Elizabeth Novak, 123rf.com

Digital Transactions (USPS 024-247) is published monthly by Boland Hill Media LLC, 800 Roosevelt Road, Building B, Suite 212, Glen Ellyn, IL, 60137. Periodicals Postage Paid at Glen Ellyn, IL, and at additional mailing offices. POSTMASTER: Send address changes to Digital Transactions, P.O. Box 493, Northbrook, IL 60065-3553.

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the gimlet eye

THE RACE FOR REAL TIME

AS THE MARKET for real-time payments continues to develop in the United States—and as the Federal Reserve prepares for a commercial launch of its own real-time network next year—the race is on to capture market share. There are a number of contenders, but one clear frontrunner is The Clearing House Payments Co., which celebrated last month the five-year anniversary of its own nationwide service.

The company's real-time payments network—known as RTP—went live in November 2017 with two participating institutions and quarterly volume of 1,000 transactions. Now, the system claims 285 participating institutions and an expected 50 million transactions for the December quarter, up from 45 million last quarter, according to numbers the company released a few weeks ago. Transaction volume has now grown at a rate of 10% or better for 16 straight quarters.

There have been a few surprises along the way for TCH, which is owned by many of the nation's biggest financial institutions. One of these has to do with the payroll application, which has won wider adoption on the RTP platform than TCH expected. "We thought payroll was done and dusted," Jim Colassano told us when we talked to him about real-time payments last month. Colassano is senior vice president of RTP product and development for New York City-based TCH.

But now, with the steady growth of digital functions such as earned-wage access, payroll is becoming "one of the dominant use cases" for RTP, he notes.

What else has surprised TCH along the way? Colassano points to the slow development of business-to-business volume. Ultimately, the company discovered its dollar limit per transaction was too low. "Businesses wanted to take the bulk of their payroll activity and move it over" to real-time processing, he recalls, leading TCH to raise its cap from $25,000 to $1 million. Now, TCH is "seeing business-to-business use cases open up," Colassano told us. With this kind of growth, TCH is eyeing new applications for RTP, including cross-border payments.

But RTP, perhaps the most ambitious exercise in real-time payments to date, will soon get an outsize challenger. FedNow, the Fed's real-time payment service, has been in development for three years and is set to launch in July. With the Fed behind it, this platform is expected to offer formidable competition. But even this development could offer certain benefits for the RTP system. "The Fed has really raised the visibility [of real-time payments] in the marketplace," Colassano told us.

The bottom-line lesson in all this is that competition is the tide that will ultimately lift all boats. That's worth cheering on, no matter what role you play in the industry.

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DECEMBER 2022 • VOL. 19, NO. 12

DIGITAL TRANSACTIONS
Trends in the Electronic Exchange of Value

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trends & tactics

DEBIT RULING? WHAT DEBIT RULING?

It was only a matter of time before the two big international card networks responded to a recent Federal Reserve requirement that issuers make at least two unrelated networks available to merchants for debit card transactions. That time arrived at earnings season.

During an earnings call with equity analysts in late October, Visa Inc.'s chief financial officer, Vasant Prabhu, said the impact of the Fed ruling would be "minimal, if any." He cited advantages of using networks like Visa, adding "people come to us for the value we create. We've competed for this business and merchants have chosen us."

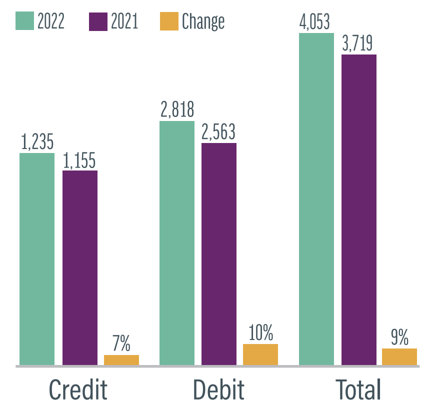
Indeed, chief executive Al Kelly, who along with Prabhu was discussing Visa's fiscal fourth-quarter results, downplayed the idea that the Fed's ruling, which goes into effect July 1 next year, will take transactions away from Visa's network. "A lot of merchants in the [United States] are very familiar with the strengths they get from doing business with us," he noted.

The ruling, which underscores a provision of the 2011 Durbin Amendment to the Dodd-Frank Act, addresses longstanding merchant complaints that issuers were not enabling a choice of networks for e-commerce transactions. The law's provisions, which apply to both online and in-store transactions., were designed to ensure that if one network in that choice was Visa, the other couldn't be Mastercard, and vice versa. The intent was to reinforce competition for merchant routing and drive down costs.

Many of the networks considered eligible to provide alternatives for merchants are so-called single-message systems, such as electronic funds transfer networks that combine authorization and settlement in the

IT'S IN THE CARDS

(Visa's total cards in circulation, in millions, in the last quarter of the year)



Source: Visa

same message. But Kelly argued merchants are likely to prefer what he argued are the advantages of dual-message networks like Visa.

"Dual message makes a big difference with car rental and hotels," he said by way of example. "A lot of merchants in the United States are very familiar with the strengths they get from doing business with us."

In the end, Kelly underlined Prabhu's point and expressed confidence Visa will come out ahead in any head-to-head comparison with other networks. In this respect, he cited Visa's ability to combat fraud. "The liability for fraud lies with the merchant, so they're going to be very careful [which network] they do business with," he said.

In other remarks, the two top Visa executives indicated the worst impact of the pandemic appears to be over. "We've been stable for the last nine months," Prabhu said, adding "consumers are [still] paying in the same way, which is critical to us. We're still seeing employment levels at a very healthy level."

Kelly and Prabhu also cited milestones Visa has reached in recent months, including the fact that the network topped 1 billion tap-to-pay transactions in July, doubling the total from a year earlier. Visa has also issued more than 4.8 billion tokens, the technology that fights fraud by masking account numbers, Kelly said. He touted progress for Visa Direct, the company's real-time transfer network, adding the system has almost reached 7 billion endpoints.

But Kelly warned that the network will have to contend with an uncertain economy that could tip into a downturn. "We face some headwinds," he said. "A recession will have an impact." Prabhu, however, was quick to reassure the analysts that the company is not predicting a downturn.

"We do not have a view on a recession," he noted, adding, "We are planning no recession, but we will have a contingency plan in place" if one develops.

For the quarter, Visa reported net revenue of $7.8 billion, up 19% year-over-year. Revenue for the year ended Sept. 30 came to $29.3 billion, up 22%.

—John Stewart

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PAYPAL GOES ALL-IN WITH APPLE

PayPal Holdings Inc.'s multi-pronged omnichannel strategy with Apple Inc. is expected to enhance PayPal's offerings for both PayPal and Venmo merchants, as well as consumers.

Topping the list of PayPal's work with Apple are plans to support Apple Tap to Pay on iPhones. The initiative will enable PayPal merchants in the United States to accept contactless debit or credit cards and mobile wallets, including Apple Pay, using an iPhone and the PayPal or Venmo iOS app.

As a result, PayPal merchants can use their iPhone as a mobile point of sale terminal without the need for a dongle or other accessory device. Apple launched the technology in February.

"We believe that this along with our other in-store initiatives will continue to accelerate our opportunity to seamlessly process payments in the physical world for our merchants," PayPal chief executive and president Dan Schulman told analysts during a late October call, according to a Seeking Alpha transcript.

Schulman said that PayPal is also adding Apple Pay as a payment option to its unbranded checkout flows on its merchant platforms, including its PayPal Commerce Platform. PayPal is testing this initiative with several e-commerce platforms and merchants and anticipates a broader rollout in the coming months, Schulman added.

Unbranded checkouts refer to online sites where PayPal is accepted without the inclusion of a PayPal checkout button.

Finally, the agreement will allow consumers in the U.S. to add their PayPal and Venmo network-branded credit and debit cards to their Apple wallet, starting in 2023. Consumers will be able to use those cards online and in-store wherever Apple Pay is accepted.

"We anticipate this to be available in the first half of 2023, expanding the opportunity for our consumers to transact in-store," Schulman said, according to the transcript. "This is a significant step forward in our relationship with Apple and we are excited to work closely with them to bring these new capabilities to our mutual customers."

While taking questions from equity analysts during the call, Schulman said PayPal's initiatives with Apple will unlock several opportunities to better serve merchants and consumers. He cited PayPal's merchant fee of 2.29% plus 9 cents as a competitive advantage and said adding Apple to PayPal's unbranded flows will make the company more competitive, since PayPal can position its platform as a complete payment solution for small and mid-sized merchants.

"It enables us to offer more choice to our merchants, which is something we've been focused on for years and years now," Schulman said, according to the transcript.

Enabling PayPal customers to add their PayPal and Venmo credit and debit cards to their Apple Pay wallets will increase PayPal's branded transactions at checkout, Schulman added. To illustrate his point, he

UP AND DOWN AT PAYPAL

(Total payment volume, in billions, and year-over-year growth)

Source: PayPal

said PayPal has a similar arrangement with Google Pay. In Germany, for example, when Google Pay users add their PayPal credentials, there is a 20% increase in their branded checkout transactions.

"They also have the ability to create temporary digital cards that can even allow us to bring our buy now, pay later from branded checkout online, to everywhere a consumer shops," Schulman said, according to the transcript. "I think there's a lot of really nice unlocks."

In addition to announcing the initiatives with Apple, PayPal said it plans to have acceptance for its Venmo peer-to-peer payment service on Amazon.com fully ramped up for the peak holiday shopping season.

Schulman also said buy now, pay later has become an integral part of PayPal's checkout strategy. PayPal's Pay in 4 product has made 150 million different loans since its launch about two years ago. The payment option is accepted by 2.2 million unique merchants, according to Schulman.

"So not only do we have a great value proposition, but we have a real competitive advantage in knowing our customers, 90% of the people that use Buy Now, Pay Later, we have history on," Schulman said, according to the transcript. "We're really trying to imagine Buy Now, Pay Later as being fully omni as a capability. And we think that will unlock quite a bit for us as we look forward."

For the third quarter, PayPal posted net revenue of $6.8 billion, up from $6.1 billion in 2021's third quarter. Total payment volume for the quarter totaled $337 billion versus $309 billion a year earlier.

—Peter Lucas

ARE REGULATORS BLOCKING STABLECOINS? TCH SAYS YES

The Clearing House Payments Co. LLC last month issued a white paper alleging that federal regulators are effectively blocking national banks from issuing stablecoins. This is despite the agencies' own conclusion that the banks have the authority to issue the digital currency, the paper says.

The paper also follows an executive order from President Biden earlier this year intended to lay the groundwork for regulating digital assets, including stablecoins and Central Bank Digital Currencies.

"Banks are ready and willing to do this, but to date no agency has given supervisory approval," says Rob Hunter, managing director and deputy general counsel for TCH, a New York City-based company that offers payments services, including real-time transfers. TCH is owned by many of the nation's biggest banks.

Stablecoins are digital currencies whose value is tied to a national fiat currency, such as the dollar. Private firms have developed stablecoins in recent years and national governments have investigated—and some have issued—Central Bank Digital Currencies, a form of stablecoin.

TCH's 21-page white paper argues that regulatory inaction is "stifling the development of new products and services that are the subject of significant consumer demand," leaving "the issuance of stablecoins … solely in the hands of entities that are not subject to the full range of … requirements applicable to federally regulated banks."

The paper points out that one federal banking regulator, the Office of the Comptroller of the Currency, issued letters in 2020 and last year acknowledging the legal authority of national banks to issue stablecoins. Nonetheless, federal regulators have so far "precluded" federally regulated banks from issuing stablecoins or offering "other digital-asset-related services," the paper says.

Indeed, despite the OCC's "clear conclusion" that national banks have the legal authority to issue stablecoins, the TCH paper says, the preclusion "has occurred because the federal banking agencies have required that [insured depository institutions] receive approval for those activities on an individual IDI basis, but there have been no public statements of approval granted to federally regulated banking institutions to proceed with an issuance of customer-facing stablecoins."

Central bank digital currencies are digital tokens representing a national fiat currency. They are issued, as the name implies, by the nation's central bank, which must maintain reserves against them. Some 112 nations have at least looked into the technology, while 11 have launched a CBDC, according to research by The Atlantic Council, a Washington, D.C.-based think tank.

CBDCs may or may not be created through a distributed ledger like a blockchain. Some experts, however, argue there's little to be gained in managing a national digital currency via a blockchain.

—John Stewart

AMEX PARTNERS WITH TIKTOK TO DRIVE SALES AT SMALL BUSINESSES

American Express Co. is teaming up with the wildly popular social-media platform TikTok to launch the #ShopSmall Accelerator, a program intended to help small-business owners reach a new generation of shoppers on Small Business Saturday, Nov. 26, and throughout the rest of the holiday-shopping season.

The deal will provide business owners with access to digital tools and resources to become so-called TikTok creators, including an online tutorial on how to promote their business on the platform in a way that would appeal to TikTok users.

While TikTok originated as a way for users to create short videos to express themselves, and to share those videos across the platform's community, it has begun morphing into a product-recommendation, advertising and e-commerce platform. Among dance and prank videos, TikTok users can find content about brands and products. The platform is especially popular with Millennials and Gen Zers.

Making TikTok available to small merchants coincides with the platform's launch of TikTok Shop, the platform's e-commerce component, in the U.S. TikTok Shop allows consumers to make purchases directly through the TikTok platform. TikTok Shop is also available in the United Kingdom and seven countries in Southeast Asia.

An AmEx tutorial on using TikTok will instruct small businesses on how to use TikTok as a search engine, leverage sounds, trends, hashtags and communities, and drive engagement with users. To help small businesses get discovered by new audiences, AmEx has partnered with musical artist Chlöe Bailey to create a Shop Small Soundtrack, which small businesses can add to their content.

TikTok has an estimated 80 million monthly active users in the U.S. market, 60% of whom are age 16 to 24 and 26% are age 25 to 44, according to social-media advertising agency Wallaroo Media. In addition, 60% of TikTok's users are female, according to Wallaroo.

"The #ShopSmall Accelerator will help give small merchants the tools they need to reach the next generation of consumers on TikTok, where our Shop Small Impact Study found that 67% of Gen Z users have shopped from a small business that was displayed on [TikTok's] For You Page," Elizabeth Rutledge, chief marketing officer for AmEx says in a prepared statement.

If every Gen Z and Millennial shopper spent $10 at a small business on Small Business Saturday, the total spending would support $2 billion in local economic activity throughout the U.S., according to AmEx's "Small Business Economic Impact Study."

The study also found that 68 cents of every dollar spent at a small business in the U.S. stays in the local community.

"More and more American small businesses are turning to TikTok to take us inside their world in a fun, authentic way, and as a result, they are reaching new customers, hiring more employees, and growing their business," Sofia Hernandez, global head of business marketing for TikTok, says in a prepared statement.

—Peter Lucas

MONTHLY MERCHANT METRIC

Sept'22 (Trailing-3 Months) Account Attrition and Growth

This is sourced from The Strawhecker Group's merchant datawarehouse of over 3M merchants in the U.S. market. The ability to understand this data is important as SMB merchants and the payments providers that serve them are key drivers of the economy.

All data is for SMB merchants defined as merchants with *less than $5M in annual card volume.*

Metric Definitions: (Only use definitions related to an individual month's release)

Account Attrition - Total attrited accounts in given period divided by total portfolio active accounts from same period of the prior year

New Accounts Added - Total new accounts in given period divided by total portfolio accounts from same period of the prior year

Beginning	100.0%
Account Attrition	-20.4%
New Accounts Added	16.6%
Ending	96.2%

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THE DEATH AND BIRTH OF AN INDUSTRY

BY
GIDEON SAMID
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THE PANDEMIC DROVE people from brick-and-mortar stores, causing them to depend on card-not-present transactions. The fraudsters pounced, unleashing wily new schemes and hurting shoppers and shops alike. Merchants resorted to a vigorous identity-management strategy, exploiting artificial intelligence, tapping deep analytics, and using non-algorithmic randomness—a method invented by BitMint.

Business is good. Identity is under assault, and viable solutions are in great demand. Alas, one must raise one's eyes towards the horizon, where the picture is different: a gradual death for payment-validation identity management and an evolutionary growth for its replacement. After lots of trial and error, cyber-finance managed to emulate physical cash, and ascertain transactions on account of the validity of the exchanged payment, not on a stressed validation of payor and payee (level-demo.BitMint.com).

You can wear a brown bag over your head when you buy in a store, as long as you pay cash. Soon enough, the same will apply to digital money. The technology is here, but getting used to this big shift is what takes time.

In the near future, a merchant will be okay with your remaining anonymous while you purchase merchandise for which no prescription or license is needed. You will pass on your digital coins, which will be validated and accepted without having a clue who the payor is. And what about money laundering? For convenience, with low-denomination transactions, money laundering is not an issue. For larger sums, digital technology can easily comply with any regulatory imposition and still maintain a frictionless payment regimen.

A cash-like identity-undisclosed payment option is a very big thing. It takes a while to realize how many possibilities are opened up thereby. Using a masked IP address, one will be able to buy digital goods with robust anonymity. Physical goods could be waiting for their private buyer in lockers opened up by a code. One will be able to expose their most embarrassing psychological whims without revealing personal identity.

Since the payor is not a factor in the transaction, it need not be a human. Your refrigerator, noticing you've run out of eggs, will order a dozen and pay for them directly to your grocery store.

Cash-like digital coins can be passed around between payor and payee in a face-to-face mode. And as with cash, one can do it without relying on the Internet. A local Bluetooth, NFC, or touch technology will enable local transactions. They are all battery operated, but battery power can be generated through a local solar cell or through rotating a mechanical arm. Today, the entire payment system crashes when a terrorist or a storm shuts off the Internet. Identity bearing digital coins cannot come soon enough.

And what about credit? Credit coins will be paid like regular coins, with the merchant getting paid in real time by the credit issuer, while remaining clueless about the identity of the buyer.

High-denomination digital payments give an invasive visibility to government, imposing strict regulations on all financial institutions. Low-denomination digital payment will define a privacy space for the public to thrive in. Every society will decide for itself the boundaries of this privacy space. Technology will comply.

The demise of one industry and the rise of another is a projected step. Current identity-management payments might linger through the foreseeable future. By the time the new industry is ready to jump in, a new payment vision may steal the show. Way in the background lurks the specter of AI, robbing us of the joy and burden of payment. Stay tuned for more next month. DT

A COURT CLOUDS THE CFPB'S FUTURE

BY BEN JACKSON
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THE CONSUMER FINANCIAL Protection Bureau has been under fire since it was created. Now, though the bureau has survived a number of challenges, a recent court ruling has cast a cloud over its future.

In October, the Fifth Circuit Court of Appeals issued a ruling in Community Financial Services Association of America v. Consumer Financial Protection Bureau. In the decision, the court nullified the Bureau's 2017 Payday Lending Rule because the Bureau's funding method was unconstitutional.

"But one arrow has found its target: Congress's decision to abdicate its appropriations power under the Constitution, i.e., to cede its power of the purse to the Bureau, violates the Constitution's structural separation of powers. We thus reverse the judgment of the district court, render judgment in favor of the Plaintiffs, and vacate the Bureau's 2017 Payday Lending Rule," the court said in its ruling.

This is not the first challenge to the bureau's constitutionality. In June 2020, the Supreme Court ruled in Seila Law LLC V CFPB that the CFPB's structure violated the Constitution's separation of powers doctrine. The Court gave the president the power to fire the director of the Bureau at will. Previously, the director could only be removed for cause.

The Fifth Circuit decision likely will wind up before the Supreme Court. While it is impossible to guess the outcome, the Seila Law decision shows the justices have had concerns with the CFPB in the past. (For more on the CFPB, see page 28).

In the short term, the Fifth Circuit's opinion only applies to the Payday Lending Rule. To challenge the bureau's other rules on the same grounds would require parties with standing to sue and make a similar argument—potentially in other courts that might see things differently. So, the payments industry should not behave as though the bureau has been closed by the courts.

In the long term, there is another important aspect of the Fifth Circuit's opinion. The decision says that the Payday Lending Rule itself rests on solid legal grounds. It found that the Consumer Financial Protection Act gave the Bureau the power to determine whether products and services are "unfair" and "abusive," and rejects the plaintiffs' arguments that consumers can reasonably avoid harm from payday loans.

The Court also rejects the idea that the Bureau acted capriciously, saying that its process was a good way to gather information to create rules.

In other words, the court seems to be saying—and this is my interpretation— that the Bureau did a good thing but with bad funding, so the rule needs to be vacated.

The bureau's demise could lead to a worse regulatory environment for the industry. Since the rule itself was found to be legally sound, states could adopt it if they feel the federal government will not protect consumers. Inconsistent adoption could lead to a patchwork of regulations across multiple states, creating regulatory headaches for companies. We saw states create their own versions of the CFPB during the last administration, when they were afraid the CFPB itself would disappear.

The status of the bureau may hang in limbo as the Fifth Circuit case and others such as the PayPal case work their way through the courts. With a potentially divided Congress and no filibuster-proof majority in the Senate, a bill to reform the CFPB is unlikely to come before the next Congress.

So, while the bureau's future likely will be in flux until at least after the 2024 elections, payments providers should stay focused on consumer protection and keep their compliance programs current. DT

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CONTACTLESS: FAR FROM TAPPED OUT

The Covid-19 pandemic was a strong tailwind for the adoption of contactless payments. Two years later, the momentum is still there but challenges remain.

BY **PETER LUCAS**

WHETHER IT'S THE convenience of not dipping a card into a POS terminal or speedier transactions at the point-of-sale, consumers and merchants continue to embrace contactless payments in the post-pandemic world.

A recent study by S&P Global Market Intelligence and 451 Research, commissioned by Discover Global Network, reveals that 45% of consumers ranked contactless payments as one of their preferred in-store payment methods, second only to cash (55%). Factors cited by consumers as to why they prefer contactless payments include convenience (76%) and an improved customer experience (73%).

Merchants were equipping their stores for contactless acceptance long before the Covid outbreak, and there's been no letup now that the pandemic has waned. Stores have been aggressively deploying contactless terminals, with 92% saying they already accept or plan to accept contactless payments within the next 12 months, according to the S&P Global Market Intelligence report.

In addition, 82% of merchants surveyed say contactless payment, including tap and pay, is one of their most popular payment types. Indeed, observers say consumer usage of contactless payment technology, which includes contactless cards, mobile wallets and QR codes, shows no signs of abating.

"Contactless payment usage has not peaked. It may be getting close to peak in developed markets, but it has not peaked overall," says Holly West, senior director of retail at the big payments processor FIS Inc. "The infrastructure is there to support contactless, as all new merchant terminals have contactless capability and the consumer demand is there. The key is to find new use cases to expand the technology's reach."

Potential use cases include transit, restaurants, electric-vehicle charging stations, and micro-merchants looking to leverage their smart phone or tablet computer as a payment terminal without adding a peripheral device.

'A SMOOTHER PROCESS'

Of all these potential market segments for contactless, putting the

technology into the hands of micro-merchants represents an intriguing opportunity, payments experts say.

With contactless technology, micro-merchants can download an applet to their phone that leverages the near-field communication technology within the phone to communicate with a contactless card. To accept a contactless payment, merchants simply open their contactless payment app, enter the transaction amount, and have the consumer tap their card to the phone.

Visa Inc. and Mastercard Inc. both support tap-on-phone payments for Android and iPhone smart phones. The method's big advantage is that omits a card-reading attachment. "Tap-on-phone is a real benefit for micro-merchants because it spares them the cost of purchasing a dongle," says Ainsworth Clark, vice president, product management, at Fiserv Inc.

Another use case for tap-on-phone is that it can make new-card activation easier for consumers. New contactless cards can come equipped with chips featuring an applet that can interact with a smart phone's NFC chip and programmed so that when the card is tapped to a smart phone for the first time, the phone redirects the cardholder to the issuer's Web site. There, the cardholder can activate the card, according to Barb Else, vice president for output solutions at Fiserv.

"Cardholders no longer have to call the card issuer to activate their card," she says. "It's a smoother process."

Electric-vehicle charging stations represent an equally compelling opportunity, argues Oliver Manahan, senior director, business development, for Infineon Technologies AG, a Germany-based semiconductor manufacturer.

In Canada, for example, many charging stations require consumers to download an app in which payment credentials can be stored, according to Manahan. Next, the consumer preloads value from a payment card into the app's wallet, which is debited when charging. Enabling consumers to simply tap a contactless card instead would remove that friction, Manahan says.

'A SECURITY ISSUE'

Dine-in restaurants are another ripe opportunity. At many eateries, a server still brings the check to the table, takes the customer's card, carries the card to a POS terminal to run the transaction, and then brings the receipt and the card back to the table. Instead, bringing a contactless POS terminal to the table would eliminate that friction, observers say.

"Most restaurants are old-school when it comes to payment," says Mike Russo, chief technology officer for Shift4 Inc., a major player in payment acceptance for restaurants. "If a POS terminal is brought to the table, we think consumers will be more inclined to make use of the tap-to-pay capabilities, especially if they are made aware of that option."

Shift4, which provides POS terminals to its merchants for free, has seen transactions made with contactless cards rise from 7% of its volume at the beginning of the Covid pandemic to more than 14% in October.

"Since Covid hit, we have shipped a lot of contactless pay-at-the-table devices to our restaurant merchants," Russo says. "And because we provide our merchants with free terminals, most have devices that are contactless-enabled, which has helped push up our contactless volume."

When it comes to transit, the business case for contactless is simple. Tap-and-go payment speeds throughput at the turnstile, especially during rush hour, payment experts say.

But experts argue consumer usage could rise even more by removing the requirement of entering a PIN for a contactless debit transaction and by raising the limit on the dollar amount of a transaction.

"It would strengthen the consumer's perception of the speed of this payment method," says Amit Chhabra, director of product management, merchants segment, at ACI Worldwide.

Card issuers have steadily increased the dollar limit on contactless transactions since the start of the pandemic, but payments experts question the wisdom of eliminating PINs for contactless debit. "It's a security issue," says Thad Peterson, a strategic advisor for the consulting firm Aite-Novarica Group. "Eliminating PINs for contactless debit transactions could lead to inconsistent adoption" by consumers and merchants, he adds.

A welcome piece of good news for the industry is that many chip manufacturers are signaling they intend to prioritize production of dual-interface chips, which allow cards to be used for both contact and contactless transactions, according to Fiserv's Else. With that development, card issuers will have no choice but to issue contactless-enabled cards, and that in turn will expand the number of consumers carrying the cards.

"It will require some cardholder education by issuers about the tap-

and-pay feature, but it will increase contactless card issuance," says Else. "There are only so many chipmakers, and they are increasingly deciding to put their capacity behind dual-interface chips, which is more profitable for them."

As a result, Fiserv is telling its card-issuing customers not to expect to be able to get contact-only chips in 2023, Else says.

CONFUSED CONSUMERS

Despite the opportunities for expanding contactless payments among merchants, some large merchants still have not jumped on the bandwagon.

Grocery chain Kroger Co. is an example, according Aite-Novarica's Peterson. In addition, other large merchants are wavering on acceptance of some forms of contactless payments, such as The Home Depot Inc., which reportedly does not accept Apple Pay, according to payment experts.

For some merchants, the decision to replace POS terminals with devices that support contactless payments typically comes down to their terminal replacement cycles, payment experts say.

"Because almost all new deployed payment terminals are contactless enabled, the main barrier large merchants face is their own payment-device replacement cycle, as they will not accelerate it just to offer contactless capabilities," Chhabra, says. "However, within their conventional refreshing cycle, they will eventually receive the additional benefit of contactless enablement."

Other factors include the cost of training staff to support the technology and whether or not the merchant's processor supports contactless payments. "Not every processor supports contactless acceptance yet," says Manahan. "If that is the case, a merchant either needs to sign with a new processor that supports contactless acceptance or strike a relationship with a second processor just for contactless acceptance."

When it comes to consumer acceptance, one factor slowing consumer adoption is that it is not always clear to consumers where to tap on the POS terminal. "The location of the antenna on the terminal for tap-and-pay transactions can vary by terminal maker," Peterson says. "A consistent location for the antenna would make more sense."

For consumers, this can be an embarrassing moment that sours them on using the technology again. "The biggest complaint we've seen consumers report in surveys has to do with ease of use," says Sheridan Trent, director of Market Intelligence for the consulting firm The Strawhecker Group.

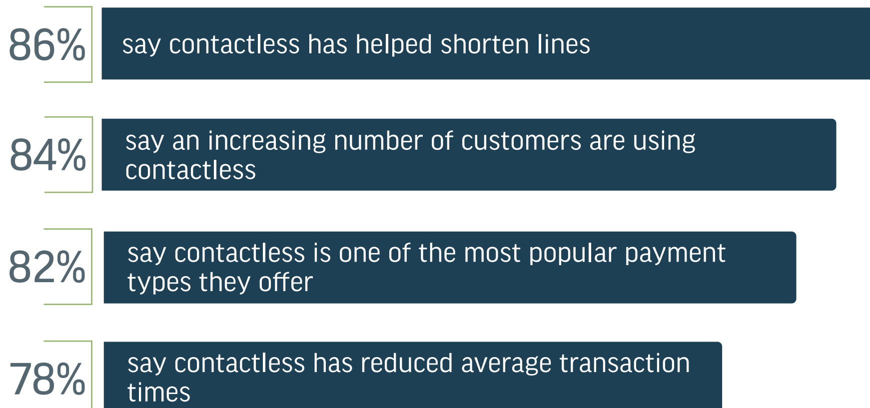
"Some consumers have issues with NFC technology at checkout working properly or they are not sure where to hold the card in order for the terminal to accept payment. [When that happens], some of those consumers have referenced feeling embarrassed when contactless options fail and a decreased likelihood of trying them again in the future," she notes.

Despite the surge in contactless payments, some payment experts argue that contactless is still in the early stages of becoming mainstream payment technology, especially in the United States, where merchant adoption and card issuance have lagged that in other countries.

"Contactless adoption is still in its early days, and we believe that there is a more than five-year journey ahead to even represent most of the general processed transactions," says Chhabra, who adds that one of the biggest obstacles remains changing "legacy consumer behavior" when it comes to using the technology.

"That said, this trend is highly regional and demographic-specific," he adds, "But the good news is that the overall contactless usage is just starting, so the road ahead is exciting." DT

MERCHANTS' REACTION TO CONTACTLESS



Source: 451 Research and Discover custom merchant survey

THE $100-BILLION QUESTION

About three-quarters of online shoppers walk away when they get to checkout, erasing more than $100 billion a year in potential revenue. What is to be done?

BY JOHN STEWART

MOST PEOPLE CELEBRATE December because they're expecting to enjoy the season's good cheer—as well as some long-expected gifts. Merchants, of course, like the month because of all that spending.

But there's a big lump of coal awaiting online retailers, and what's more, they know it. It's the tens of billions of dollars in sales they lose when customers walk away, often in the middle of checking out.

And a lot of them walk away. It's called cart abandonment, and fully three out of four customers do it, according to a study by Coresight Research. And the walkaway rate rises to 81% if you focus just on mobile devices like tablets, according to Crone Consulting, a San Carlos, Calif.-based consultancy.

Whether desktop or mobile, the cost in lost sales rings up a fearful toll—anywhere from $111 billion to $136 billion per year, according to Coresight's estimates.

Don't think sellers aren't aware of the problem. "Eighty-four percent are tracking abandonment, getting those rates," says Primel Konok, a retail and tech analyst at Coresight. "A lot of retailers are thinking about it, especially coming into this year's holiday season."

But some payments players say too many merchants are still too blasé about the extent of the problem. Indeed, some e-commerce processors have grown frustrated with their clients' vague grasp of abandonment rates. "You've got to wake up and see what's going on. We show this to people, and they're just shocked," says Ralph Dangelmaier, chief executive of BlueSnap Inc., a Waltham, Mass.-based payments provider. "I don't get it."

THERE'S A HITCH

The question is, what are sellers doing—or can they do—about it? The answer lies in the reasons for abandonment, as well as with what approaches address those reasons, and which don't. The expected avalanche of customers traditionally seen in the fourth quarter may concentrate some minds. "A lot of retailers are thinking

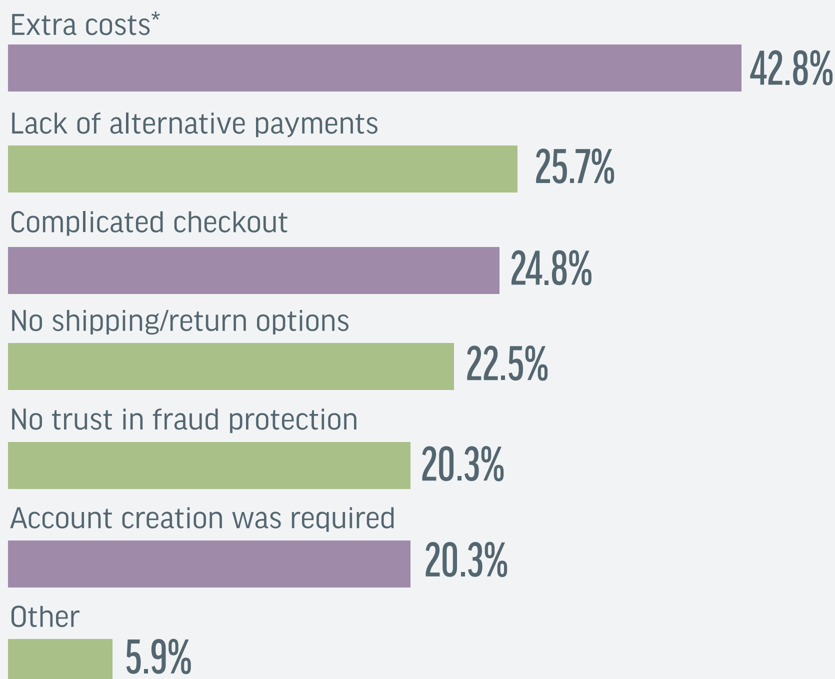
about it, especially coming into this year's holiday season," says Konok.

So, what triggers shoppers to abandon their carts, even when they've got to the point of checking out and paying? Coresight's research found the top three factors—those cited the most often by consumers—are: unexpected costs, such as shipping fees or taxes; an absence of alternative payments; and a complicated checkout (chart). "Extra costs are by far the biggest reason," says Konok. "It's that shock [customers] get at the end."

How merchants can address fees and taxes may depend, at least in part, on requirements in their home state. But if there's no leeway to reduce or even eliminate the costs, then the key, experts say, is to make them more obvious so they're not such a shock at checkout that the customer simply clicks to another site.

On the other hand, there is more merchants can do regarding alternative payments and clunky checkouts. Visa and Mastercard several years ago introduced Secure Remote Commerce (SRC), a token technology intended to authenticate customers and smooth the payment process for online checkouts.

You can think of SRC—also often referred to as click-to-pay— as the card-not-present version of EMV, the chip technology introduced some years ago to secure in-store transactions for the major-brand credit and debit cards. Indeed, some experts say the effectiveness of EMV in combatting physical-store fraud is in part what has driven up fraud attempts online.



But there's a hitch. "In order for SRC to really have an impact, it has to be ubiquitous, and it's a long way from ubiquitous," says Thad Peterson, a strategic advisor at the Boston-based consultancy Aite-Novarica Group.

Processors like ACI Worldwide Inc. are testing the technology and seeing some good results in the early going. "There's a benefit from SRC but we need to do extended testing," says Basant Singh, global head of merchant products at Coral Gables, Fla.-based ACI.

Similarly, BlueSnap's Dangelmaier says SRC is sound technology, and the company has implemented it. But, he says, no single party or set of concerned parties are promoting SRC to the wide range of online sellers. "We have no incentive at BlueSnap to market it," he adds.

Another slick approach, Peterson and others say, involves eheckout in one click with technology that links to a previously designated card in an approach called embedded payments. Users of Facebook Pay or shoppers on Amazon or Shopify are likely familiar with this technology.

Trouble is, smaller merchants on their own may be put off by the coding, time, and expense in adopting embedded payments. "It's pretty easy to do if your name is Meta [the parent of Facebook Pay], harder to do if you're a smaller merchant,"

Peterson says. A payment facilitator like Stripe Inc. can offer the same technology, he notes, directly or through a platform like Shopify.

'MEASURE OF INTENT'

Still, the idea of a customer who has effectively checked in before he checks out is "the key to solving" the abandonment problem, notes Richard Crone of Crone Consulting.

Once the merchant knows who the customer is, he can link communications to that potential buyer with an inducement to go through with the purchase. "When somebody puts something in a shopping cart, you have the ultimate measure of intent," Crone says.

Accepting the so-called Pays—Apple Pay, Google Pay, and Samsung Pay—can offer the same benefit, Crone advises. The mobile-wallet transactions will trigger a higher acceptance cost for the merchant. But the reduced abandonment, increased conversion, and "monetization" of the shoppers' shopping list, he argues, "offsets the higher transaction fees for the Pays."

Another approach harnesses the increasingly popular buy now, pay later checkout option. Customers who arrive at checkout expecting to break their purchase into installments may walk away if BNPL isn't available. So ACI has launched ACI Pay After, working with "most" of the BNPL providers to offer prime and subprime choices, says Singh.

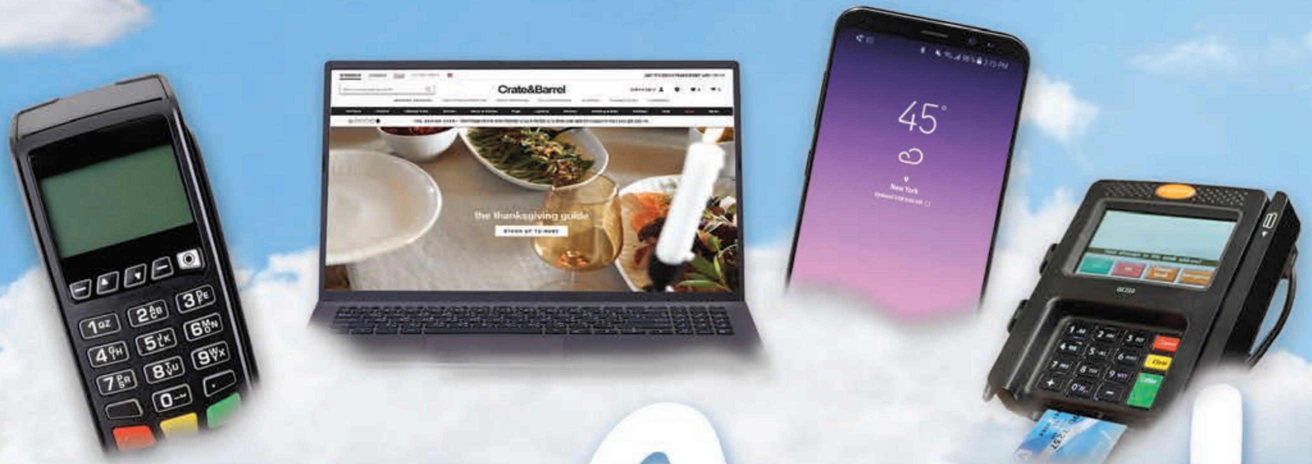
In the end, the psychology behind converting the sale, Singh adds, is "how to reduce the thinking process to buy or not to buy."

CURRENCY MISMATCHES

But many times customers will reject their cart because a processor has rejected their card. Insufficient data for issuers and a major hike in cross-border shopping, leading to currency mismatches, are the big culprits, says BlueSnap's Dangelmaier, who says his company has recently seen a "massive" jump in such rejections among the processors it links to.

Proponents of e-commerce like to point to the steady and substantial rise in online sales. U.S. e-commerce in the second quarter this year, the latest for which the Department of Commerce has numbers, totaled $257.3 billion, nearly 7% higher than the same period in 2021.

With some technology, and some finesse, in addressing cart abandonment, it appears that number could be measurably higher. DT



In the Cloud

THE PAYMENTS INDUSTRY HAS FORGED A SYMBIOTIC RELATIONSHIP WITH CLOUD COMPUTING. THAT ISN'T LIKELY TO BE SWEPT AWAY ANY TIME SOON.

BY KEVIN WOODWARD

More than two years ago, Global Payments Inc. took a big leap into marrying cloud computing with payments. The big payment processor signed an agreement with Amazon.com Inc. to use its Amazon Web Services for a cloud-based issuer-processing platform. At the time, Global Payments said the platform handled 27 billion transactions annually.

Within a year, the Atlanta-based company said its acquiring technology would migrate to Google Cloud. It would also act as the worldwide merchant acquirer for Google.

These actions would prove to be transformational.

Earlier this year, Visa Inc. announced its Visa Acceptance Cloud, a new platform that enables acquirers, payment service providers, point-of-sale system makers, and Internet of Things developers to move payment-processing software from hardware devices to the computing cloud.

Then, this summer, tech giant Oracle Corp. launched its Oracle Food and Beverage Payment Cloud Service to offer contactless payments and mobile-wallet acceptance with fixed rates—not long-term contracts or monthly minimum-volume requirements. The move is expected to make it easier for restaurants to accept multiple payment methods without requiring multiple software integrations.

"The role of cloud computing in our business is growing, driven by the explosion of services we offer through our cloud-based API gateway," says Jason Sharples, Global Payments' executive vice president and chief technology officer for merchant acquiring.

"Today, the majority of our merchant services are available this way," Sharples adds. "But cloud computing is much more than just running things in the cloud. We're adopting cloud methodologies, where we can, to optimize our internal development and delivery practices."

Mobile First

Global Payments is not alone is this transformation. "Today, payments are at the center of all human activities," says Vugranam Sreedhar, distinguished engineer at Kyndryl Holdings Inc., a New York City-based information-technology infrastructure services provider. Kyndryl was spun off from IBM Corp. in 2021. "As our world becomes increasingly more digitized, cloud computing has become fundamental to enabling modern payment services," Sreedhar adds.

The cloud, in the sense of a network of physical servers linked by Internet connections, has existed as a concept for some time. But there are lots of reasons cloud computing in general has blossomed. For payments, it has a special appeal because it can move the transaction off a dedicated device, leaving behind many security issues associated with physical devices.

Cloud computing in payments gained a lot of ground when tablet-based point-of-sale systems emerged. Built on Apple Inc.'s iPad and tablets using Google's Android operating system, these systems use customized software and Internet access to alleviate many merchant headaches regarding security and compliance with PCI Security Standards Council requirements.

They also empower smaller merchants, which typically could not afford advanced POS systems that provide functions such as sales reporting, employee time management, inventory reports, and content-management system access—features that much larger organizations have traditionally used.

The first iPad and Android tablets launched in 2010, but it took time for these devices to make inroads as POS systems. Even now, they haven't completely displaced the conventional countertop terminal. Mobile point-of-sale devices also played a role in raising the profile of payments for smaller merchants.

POS software from Square was an early player—it launched in 2009—in creating cloud-based payments services. The Square dongle, joined by others, soon became common. Now, payment terminals designed as mobile devices first are prevalent just as tap-to-pay

on iPhone capability comes into the market, bypassing terminals and dongles completely in favor of the consumer device.

"Many small and midsize enterprises still use standalone payment terminals, just providing the ability to take card payments," says Ron van Wezel, strategic advisor for retail banking and payments at Aite-Novarica Group, a Boston-based consultancy. "Enterprise merchants can integrate payment software through the APIs into their business applications, but such integration used to be out of reach for SMEs."

The arrival of mobile POS changed that, he says. "MPOS provides a card reader connected to a basic [electronic POS] app running on a tablet or smart phone. Merchant onboarding is simple and fast, and the service is delivered on a pay-as-you-go model." Initially developed for micromerchants, the technology has since been welcomed by larger ones.

"The next stage in this evolution is the availability of dedicated tablet-based EPOS software for SMEs, provided in the cloud on a subscription model," van Wezel says. "This development empowers SMEs with access to business intelligence similar to that of large enterprises, with payments integrated as just one of the many functions that the business needs."

Cloud Connectivity

Being able to offer payment and related services to merchants of all sizes is vital, especially as scale is increasingly important to payments providers. "In addition to enhanced product delivery and reliability, as well as improved productivity as a company, a key advantage of the cloud is our ability to provide point-of-sale software that is both hardware-agnostic and uniquely suited to the needs of the various verticals that Global Payments services," Sharples says.

The cloud affords companies like Global Payments the adaptability necessary for today's payments industry. Kyndryl adds that approximately 50% of his firm's customers are in the financial-services industry.

"In in simplest form, making payments available on the cloud opens the door for new ways for organizations to increase efficiencies and streamline processes," Kyndryl's Sreedhar says.

"For example, a business could leverage cloud technology to receive identity verification from a consumer's financial institution with each credit card transaction, reducing the risk of fraud." Sreedhar adds. "Another organization may leverage the cloud to increase communication with their customers while simultaneously reallocating internal resources by implementing real-time end user alerts."

The cloud has enabled technologies such as MagicCube Inc.'s i-Accept platform for mobile Android devices and Apple's Tap to Pay on iPhone to extend payment acceptance beyond a dedicated payment device to an over-the-counter, commercially available mobile device.

"We minimized what's on the device and took a lot of it to the cloud," says Sam Shawki, MagicCube's chief executive and cofounder. "We left a small footprint on

Sharples: "In the near future, only one authorization service will be needed."

Shawki: "We minimized what's on the device and took a lot of it to the cloud."

the device." That's important to understand because payments in the cloud almost always are not 100% in the cloud, he says. "When you go to the store and put your card in to be read, it's a conversation between the card and the device that accepts it," Shawki says.

Earlier this year, MagicCube released an i-Accept version for enterprise and big-box merchants. It added multi-acquirer and multi-merchant support and direct integration capabilities, among other features, to its earlier version.

But that connectivity to multiple processors resides in the cloud, Shawki says. Key management—critical for ensuring a transaction is cryptographically secure—is the cloud too, he says. "The important piece in the device is the high-security level our trusted environment provides," Shawki adds.

Chucking Checkouts

In addition to the ease of collecting payment data residing in the cloud, many organizations can learn more about their users.

"Cloud-based payments have allowed us to unify the customer journey in ways that were previously not possible," says Tony DiPaolo, vice president of retail solutions at Manhattan Associates, an Atlanta-based supply-chain and omnichannel-commerce technology provider. "The same payment technology powering online experiences can power physical retail experiences, leading to delivering truly omnichannel experiences."

That data, which not only can reveal buying patterns and related sales information, also can be applied to advanced computing technologies, such as artificial intelligence and anti-money laundering applications, to make them more predictive, DiPaolo says.

"In doing so, we will be able to do everything from better predicting demand to replenishing inventory before it is even purchased, and see where the inventory is so it can be shipped from the shortest distance possible in the quickest time," he says.

Recent Manhattan Associates research found that two-thirds of consumers would prefer to ditch traditional in-store checkouts, DiPaolo says.

"Advancement in cloud-based payment technology is one of the reasons we are quickly moving towards a world where customers can ditch long checkout lines and pay from anywhere in the store, in multiple ways," he says. "With increasing pressure on the operating margin in retail, it's safe to say that cloud-based payments is one of the core strategies retailers can take to evolve their business in the most cost-effective way while maintaining growth and building customer loyalty."

Cloud computing has had a democratization effect on access to payment technology, especially for smaller merchants. As Sharples says about the Global Payments partnership with Google, "This game-changing collaboration democratizes technology for

SMBs, enabling them to seamlessly manage payments, launch marketing campaigns, enable omnichannel ordering, offer loyalty programs, and more."

'A Seismic Leap Froward'

Cloud computing has already helped the payments industry evolve, and there's no doubt it will continue to have an impact on payments. The form or forms that will take is uncertain. One possible outcome may further erode the presence of hardware terminals.

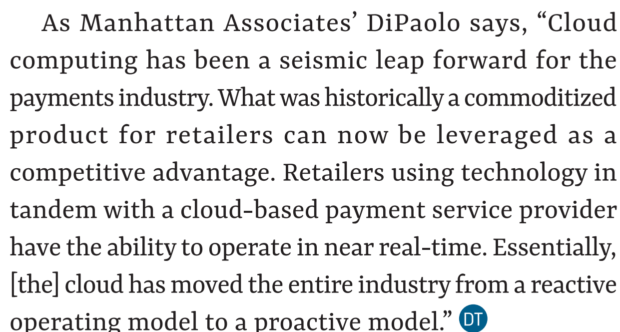
"The question is if, or when, the final step can be made and the hardware terminal will disappear," van Wezel says. "Payment acceptance will then become as easy as downloading an app, with all the functionality and security programmed in software."

Apple and MagicCube illustrate the first steps in this direction.

"The jury is still out on whether the hardware terminals can be replaced altogether," van Wezel says "But the act is that the value chain and distribution model of traditional acquirer and independent sales organization is already challenged by fintech providers of mPOS solutions, particularly for the SME segment. Acquirers must focus on the business needs of their customers, offering solutions that center around business intelligence, not payments alone."

At Global Payments, the future with the cloud means it can more easily reconfigure its offers. "For Global Payments, moving to the cloud means we can recompose our business capabilities so that we're offering services at a lower cost with greater agility and more innovation," Sharples says.

"Before the cloud, for example, you often had overlapping card authorization systems for different lines of business," he adds. "In the near future, only one authorization service will be needed, because the cloud methodologies enable us to abstract business capabilities as services that can be consumed independently and plugged in anywhere. That enables us to scale innovation faster and at a lower cost, making the business capabilities more attractive to customers."



Large or small, fintech or long-standing payments players alike view cloud computing as essential. It has become a part of payments that is unlikely to be decoupled.

As Manhattan Associates' DiPaolo says, "Cloud computing has been a seismic leap forward for the payments industry. What was historically a commoditized product for retailers can now be leveraged as a competitive advantage. Retailers using technology in tandem with a cloud-based payment service provider have the ability to operate in near real-time. Essentially, [the] cloud has moved the entire industry from a reactive operating model to a proactive model." DT

DiPaolo: "Cloud computing has been a seismic leap forward for the payments industry."

PAYMENT CARD ROUTING IS ALL POLITICS

The real winners from the Fed's latest debit card routing rule aren't the merchants. And they certainly aren't the banks. Guess who?

BY SARAH GROTTA
Sarah Grotta is head of payments at LSBX

IN THE LAST DECADE, the flow of funds across debit card networks has curiously become a concern of Congress and the Federal Reserve. It all began with the Durbin Amendment to the Dodd–Frank Wall Street Reform and Consumer Protection Act, which was implemented by Regulation II.

Reg II regulates the interchange income that large banks (defined as having $10 billion or more in assets) can receive and requires that every debit card issued, regardless of the issuer's size, include at least two networks available for merchants to route transactions. These networks are required to be unaffiliated with each other, meaning they cannot have mutual ownership.

Issuers responded to the regulation when it was implemented in 2011 by having a global network, Mastercard or Visa, paired with an EFT debit network such as Accel, NYCE, Pulse, Star, or Shazam. Because payments executed across EFT debit networks are often much less expensive for merchants to accept, particularly for small businesses with lower transaction volume, Sen. Richard Durbin, the creator of this rule, could rightly claim his support for Main Street merchants.

Merchants who understood the complexity and nuances of global versus EFT debit routing cheered, as they just received a potential decrease in their processing costs. The EFT debit networks could celebrate as well, as they had just been handed a guaranteed place in the payments industry as long as debit cards exist as a payment vehicle.

A NEW TRANSACTION TYPE

Since the implementation of Reg II, however, the world has changed. A significant percentage of consumer buying has moved to remote, card-not-present (CNP) channels. The Federal Reserve estimates that in 2019, CNP activity controlled 23% of debit volume. That has only increased in recent years, spurred by the Covid pandemic.

The EFT debit networks and acquirer processors initially were not ready for this shift. The lower fees these networks charge means they have less funding to invest in new solutions, including a transaction that

works for a remote purchase.

The EFT debit networks' legacy technology relies on consumers entering a PIN through a POS device. PIN entry is immensely effective at decreasing fraud losses for in-person purchases, but it doesn't support e-commerce. There isn't an effective method to enter a PIN through your computer or mobile device.

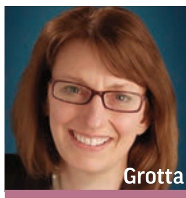
While the PIN can be dropped as a transaction requirement, the EFT debit networks needed to develop a new transaction type.

A PIN transaction operates using a single message, meaning that the authorization and clearing communication is accomplished simultaneously. But what e-commerce and other remote transactions need is a dual-message function. This allows a merchant to first authorize a transaction when the purchase is made, then clear the funds in a separate activity when goods are shipped, which, with a CNP purchase, could be days later.

The EFT debit networks began to recognize the rise in CNP activity. They developed two-message transaction solutions, and dropped the PIN requirement, to be competitive with their larger, global competitors.

But another interesting trend was occurring. More of the EFT debit networks were being snapped up by the global core processors. Fiserv, for example, purchased First Data, which owned the Star network. Fiserv also owns the Accel network. Earlier, another big processor, FIS, had purchased Metavante, which brought along the NYCE network.

The core processors began to require their banking customers to accept the dual-message PINless product offered by their EFT debit networks


Grotta

Grotta: What has the Fed's Final Rule actually achieved?

as a requirement of their vendor relationship. This was particularly hard for smaller financial institutions to resist, since they lack the bargaining power to push back.

In contrast, large banks and credit unions scrutinized Reg II. They determined that, because two unaffiliated networks were available on their cards, they were compliant—regardless of the ability of merchants to access both options for CNP activity.

This approach didn't do much for large financial institutions' interchange income because that is capped at the regulated level. It did, however, preserve the volume going through the global networks.

So the current environment finds that many, but not all, small institutions offer an unaffiliated debit network that works in a CNP environment, at the instance of their core provider. But many of the largest financial institutions, which have the most debit customers, do not.

THE FED ACTS

This state of debit routing caused the Senator from Illinois to write a letter in July 2020 to Jerome Powell, chairman of the Federal Reserve, calling out that the lack of an unaffiliated debit network on some debit cards that work in CNP channels violates the regulation.

It's the Fed's job to enforce Regulation II, so Durbin stated that routing choice had been *"periodically undermined by the dominant networks' efforts to circumvent and limit routing choice,"* and asked the Fed to do something about it.

The Fed responded in May 2021 with a Notice of Proposed Rule Making, and invited public comment. The notice included information showing that very few CNP transactions were processed through the unaffiliated debit networks.

The Fed acknowledged that, when Reg II was implemented, PINless options weren't available. But now that the unaffiliated debit networks had caught up to their global competitors, it was time for all issuers to ensure that merchants had a choice of networks for CNP transactions.

Thousands of merchants and issuers responded with comments. Issuers' primary arguments against the proposed changes to the regulation can be summarized as the following:

a) Small financial institutions with less than $10 billion in assets that did not already offer PINless transactions would struggle with a loss of revenue due to reduced interchange they would receive from the EFT debit networks;

b) Financial institutions would incur elevated fraud levels with a greater number of CNP transactions routed through the EFT debit networks as these transactions are less secure;

c) The Notice unfairly burdened financial institutions as the parties solely responsible for ensuring routing choice, when in fact merchants and their acquiring processors have a role to play to acquire these transactions.

WHAT THE FED SAID

The Fed considered the responses it received, and in October published the "Final Amendments to Regulation II to Clarify the Prohibition on Network Exclusivity." The Fed concluded that Reg II requires all financial institutions to offer a PINless option.

It also apologized (sort of) for implying that issuers are solely responsible for creating the environment for merchants to accept unaffiliated debit networks, and, without evidence, denied banks' and credit unions' concerns about fraud. And it downplayed the impact to smaller financial institutions, saying most are already compliant.

When the final rule was published, Fed Governor Michelle W. Bowman had this rather foreboding statement:

"During the public comment process, community banks raised substantial concerns with the proposal. Although the Board has attempted to identify the likely effects of the proposed rule based on available information, I believe that significant questions remain about how the rule will affect banks, and particularly community banks, with respect to both fraud and the cost of compliance. Given this continued uncertainty, I do not support the final rule."

WINNERS AND LOSERS

The result of the final rule is that the Fed has created winners and losers in this battle over debit routing.

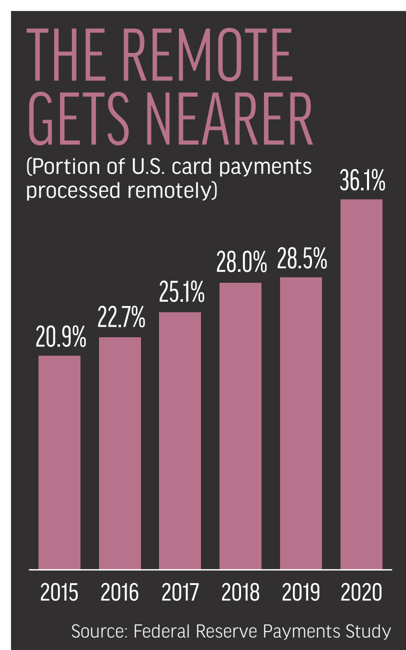
Main Street merchants could see a decline in interchange costs for CNP debit card purchases, which are fewer than one-quarter of all debit card traffic and an even smaller portion of total transactions. Of course, their processors need to be able to recognize the unaffiliated debit network and pass along the savings.

Big merchants won't see a measurable cost difference because their rates are negotiated. But they get to declare victory over the global networks, which, they believe, have far too much power.

Global networks, namely Mastercard and Visa (oddly, Reg II doesn't apply to most of American Express's or Discover's business), will lose some transaction activity from merchants of all sizes.

Unaffiliated debit networks get a victory lap. Through their efforts to enforce Regulation II for CNP transactions, the transaction losses the global networks experience are their gains.

Big financial institutions that have not already adopted a PINless network have a little project on their hands to update the networks on their cards and adjust their fraud monitoring. They will see little monetary loss as interchange is already regulated.



Small financial Institutions that have not already adopted a PINless network are the most impacted party. Like their large bank brethren, they will need to fund projects to make the necessary adjustments to their card portfolio. Since today they are receiving the higher global network interchange rate, they will incur a drop in non-interest fee income. This comes at a particularly painful time for community banks that are struggling under other hefty regulatory requirements and tough competition from fintechs.

IT'S NOT OVER YET

The construct of Reg II gave the Fed no option. It could not arrive at a conclusion other than what it articulated in the Final Rule. While some may feel that merchants were getting a bad deal, this ruling merely shifts the burden to banks, hurting community banks the most.

Indeed, the latest clarification does not improve the payments industry. It doesn't make the payment networks more secure. It doesn't make the market for card processing more competitive than it already is. Nor does it offer merchants true parity for CNP transactions. That would mean that the EFT debit networks would have to develop functionality similar to that of Mastercard and Visa, including global network reach. It certainly has done nothing to help consumers.

So what has this Final Rule achieved? It has secured a platform for politicians to appear as defenders of small business and to vilify banks and the global networks. In fact, this positioning has worked so well for Sen. Durbin, he has now turned his sights on politicizing credit card processing. DT

TIME TO REFORM THE CFPB

The Fifth Circuit's ruling that the way the agency is funded is unconstitutional opens the door to rewrite its remit and take politics out of its decisions.

BY **ERIC GROVER**

PARAPHRASING LEON TROTSKY, payment systems, processors, fintechs, and financial-services firms may not be interested in the CFPB, but the CFPB is interested in them.

Former acting director Mick Mulvaney warned that the bureau was "all too powerful," with its single head simultaneously serving as "a one-man legislature empowered to write rules to bind parties in new ways; as an executive officer subject to limited control by the President; and as an appellate judge presiding over the Bureau's in-house court-like adjudications."

He added that it was "primed to ignore due process and abandon the rule of law in favor of bureaucratic fiat and administrative absolutism."

This was by design. The CFPB was established in 2011 with near-plenary authority, insulated from congressional and executive accountability, and informed by a distrust of industry, a paternalistic view of consumers, and supreme confidence in the ability of regulatory overlords to do good. Enforcement of 18 existing statutes by seven agencies was consolidated into the CFPB.

The bureau has been subject to multiple legal challenges. In *Seila Law LLC v. Consumer Financial Protection Bureau*, the Supreme Court ruled on June 29, 2020, that a single director who is removable only for cause is unconstitutional because it violates the separation of powers.

However, by severing the for-cause removal provision from the rest of Dodd-Frank, the court preserved the bureau. The decision remedied Mulvaney's concern the President couldn't control the Bureau's director.

PLAYING CHICKEN

The latest constitutional challenge is more consequential. The U.S. Court of Appeals for the Fifth Circuit, in *Community Financial Services Association of America et al v. CFPB*, ruled on Oct. 19 that the bureau's "Payday, Vehicle-Title, and Certain High-Cost Installment Loans" rule violated the constitution's appropriations clause. If it stands,

the ruling will be a seismic check on CFPB absolutism.

The ruling is based on the idea that insulating the CFPB from congressional funding, and therefore accountability, violates the Constitution's structural separation of powers.

The Fifth Circuit said: "An expansive executive agency insulated (no, double-insulated) from Congress's purse strings, expressly exempt from budgetary review, and headed by a single Director removable at the President's pleasure is the epitome of the unification of the purse and the sword in the executive" – a reference to founder George Mason's warning "the purse and the sword ought never to get into the same hands."

The bureau will request a review by the full 17-member Fifth Circuit or immediately make a request for certiorari to the Supreme Court. In a recent en banc Fifth Circuit decision, *CFPB v. All American Check Cashing Inc.*, in a concurrence filed by Judge Edith Jones, five judges said the CFPB's funding mechanism was unconstitutional. The bureau might, therefore, calculate an en banc Fifth Circuit review wouldn't be its best shot.

Starved of funds, even the most energetic regulator can't do much within, much less beyond, its statutory mandate. The CFPB self-appropriates from the Fed up to 12% of the Fed's operating expenses, adjusted for inflation. As with any government bureaucracy, its spending and activity increase with available funding.

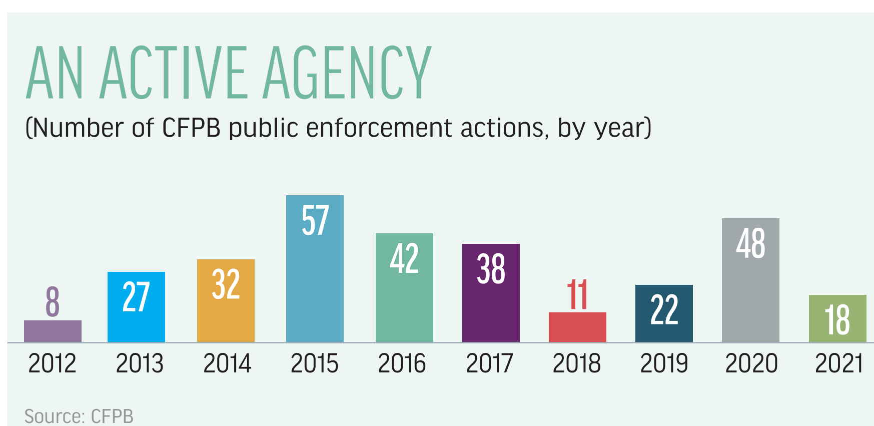
In 2022, the CFPB is drawing $692 million from the Fed, which is 94.3% of the bureau's maximum, and up 15.7% year-over-year. In 2023 it plans to self-appropriate $731.7 million, which will be 98.2% of its maximum.

The Supreme Court should be sympathetic to the idea of separating the power of the purse from that of the sword. And if it is, any such ruling might also impact agencies like the Federal Deposit Insurance Corp., the Office of the Comptroller of the Currency, and the Securities and Exchange Commission. These longstanding agencies, while not double-insulated or enjoying the CFPB's expansive power, aren't funded by Congress.

For now, the ruling only binds the Fifth Circuit. But it invites more challenges. If the Supreme Court upholds the decision, all the CFPB's actions since inception, and its current activities, will be vulnerable to challenge.

The remedy would be for Congress to modify Dodd-Frank to fund the Bureau by periodic congressional appropriations.

For this, Republicans might demand a price in the form, for example, of circumscribing the CFPB's remit and establishing a bipartisan board *à la* the Federal Trade Commission and the FDIC in lieu of a sole executive. Even with a razor-thin House margin, Republicans could play chicken over the CFPB's survival.



CONSTANTLY EXPANDING

After the president, the CFPB director is one of the most powerful individuals in government. Personnel matter. On his first day in office, President Biden demanded and received director Kathy Kraninger's resignation. Her replacement was Sen. Elizabeth Warren protégé Rohit Chopra, who was confirmed without a single Republican vote.

Silver-tongued Chopra is smart, hugely ambitious, political, and distrustful of, and hostile to, the financial-services and payments industries. Chopra's CFPB is highly politicized. Deploying 1,650 full-time employees, it's constantly expanding the scope and prescriptiveness of its regulation and *de facto* law-making.

In October 2021, it ordered Amazon, Apple, Facebook, Google, PayPal, and Block (Square) to provide information about their payments practices. Meanwhile, a spate of headlines over fraud in peer-to-peer payment systems like PayPal, Venmo, Cash App, and Zelle have attracted the CFPB's interest.

Chopra is keen to impose bigger financial penalties. The CFPB reportedly is pressing Wells Fargo to settle a slew of investigations for more than

$1 billion. Fines collected compensate consumers harmed, but also fund politically aligned "consumer education and financial literacy" groups.

Dodd-Frank requires that financial institutions give consumers access to their data, but doesn't specify how. In October, at the Money 20/20 trade show in Las Vegas, Chopra said the CFPB will issue a new rule requiring financial institutions to provide consumers' data upon their request.

He hopes this will reduce consumers' switching costs, spurring greater competition between financial institutions. It would be best, however, if the rule leaves the means to industry.

Chopra derides the U.S. payment system as behind that of other countries, intimating more direction from regulators is needed. The stark reality is otherwise. From retail, P2P, interbank and electronic bill presentment and payment systems and processors to e-wallets, the U.S. payments ecosystem is the most competitive and innovative in the world.

While the CFPB is charged with enforcing Federal consumer financial law to ensure markets for consumer financial products are competitive, the Department of Justice and the FTC are America's principal antitrust regulators. Nevertheless, the director is near obsessed with, and hostile to, industry oligopolies.

FEAR OF SUPER APPS

At Money 20/20, Chopra inveighed against: credit-reporting "conglomerates" Equifax, Experian, and TransUnion; "the card networks" Mastercard and Visa; and core processors Finastra, FIS, Fiserv, and Jack Henry.

He bizarrely contended it's critical that no one "owns" critical infrastructure. To the contrary, it's vital that someone own, and have an interest in maintaining and enhancing, essential payments infrastructure. Unowned shared assets are subject to overuse and underinvestment—the tragedy of the commons.

Chopra told community banks and credit unions that he's concerned "core services providers that small players rely on have too much power in the system." He worries "tech companies, gatekeepers, and middlemen" have too much control and make things harder for smaller players and new entrants.

The truth is payment networks, credit bureaus, core processors, and digital wallets have significant network effects and scale economies. Consumers, merchants, and banks, consequently, often are better served by a handful of fierce large competitors rather than by hundreds of smaller players.

In this way, the market dynamically determines the optimal number of competitors better than the savviest central planner.

Chopra charged merger review is "unmoored from the rule of law and the text of longstanding statutes." Who knew he was a textualist! The director also worried about China's super-app model and the possibility in the U.S. that an oligopoly of tech giants will reap rents as consumers' primary dashboards for financial services and payments.

Traditional U.S. antitrust policy holds that there has to be market power and consumer harm for there to be a problem. It doesn't preemptively intervene based on speculation because a competition problem may develop.

While Chopra professes to want to lower entry barriers and enable greater competition, a hyperactive, prescriptive CFPB does the opposite. It creates a regulatory moat for incumbents. Large players can better cope with regulatory burdens than small players and new entrants.

UN-MADISONIAN

Chopra would also like to control prices. He's on a crusade against late, over-limit, and not-sufficient-funds fees, deriding them as "junk fees."

But penalty fees serve a purpose. They encourage consumers to behave more responsibly, are consensual, and generate revenue. Further restricting penalty fees will discourage financial institutions from serving underserved and risky consumers, or shift the costs of services to responsible consumers.

Cryptocurrency Exchange FTX's bankruptcy—with at least $1 billion in customer funds and perhaps as much as $2 billion going missing—and FTX's sharing of consumer funds with trading firm Almeda, which shares its owner with that of FTX, fortify the CFPB's interest in regulating cryptocurrencies. Congress needs to spell out which agencies should regulate crypto.

An absolutist CFPB is at odds with Madisonian tripartite separation of powers. It suppresses competition and innovation in financial services and payments, and harms consumers. If the Supreme Court upholds the Fifth Circuit's ruling that the CFPB must be funded by and accountable to the legislature, this would be a real opportunity to reform the agency and make it an apolitical nightwatchman. DT

DIGITAL PAYMENTS' BIG PAYOFF FOR SMALL SELLERS

One legacy of the pandemic is how the shift to contactless, remote, and other forms of payment has enabled small businesses to compete with big enterprises.

BY **BRAD BRODIGAN**

Brad Brodigan is managing director and global head of SMB payments at J.P. Morgan Chase.

DURING THE PANDEMIC, retail commerce shifted almost overnight from primarily cash, card, and in-person transactions to primarily contactless, digital, and remote payments. For merchants, this meant quickly adopting new contactless technologies to align with changing customer demands.

This change, which is still evolving, is now essentially permanent. As shoppers become more comfortable with newer iterations of these payments systems—like tap-to-pay and digital wallets—point-of-sale (POS) technologies are increasingly performing more and more tasks, both for businesses and consumers.

It's no longer just about simplicity and convenience for customers. POS technologies are now transforming how small enterprises manage their businesses, and these technologies are even becoming drivers of growth.

At first glance, digital payments systems have often been seen by small merchants as expensive. And some people are, in general, reluctant to embrace new technologies.

But smart POS technologies are not costly, are fast evolving, and the services they provide are quickly moving up the value chain. The whole smart POS ecosystem gives merchants access to fintech startups offering all kinds of previously inaccessible specialized solutions and innovative technologies. For small enterprises especially, this can be an absolute game-changer.

THE DATA TROVE

Convenience aside, merchants now expect POS technology to do much more than before. They want it to handle tasks like inventory control, omnichannel sales management, shipment tracking, invoice distribution, and fraud detection. If a customer places an order online, for example, it's expected that the order should be trackable via a POS terminal.

But the most significant long-term benefit of the third-party app ecosystem in POS tech will likely be leveraging data in the network to get unique insights into customer preferences and trends that small retailers could not see otherwise. This will likely become so much more important that the actual transaction of money will become part of the background in the customer's shopping experience.

It's important to realize that big retailers already have most of

these capabilities. What these new technologies mean is that the "little guy" can, for the first time, compete with the big tech platforms on things like loyalty programs, customer acquisition, and retail trend-spotting. This is a critical concern for many small businesses, as one of the economic consequences of the pandemic was how it solidified the power of giant tech platforms over brick-and-mortar retail in much of the U.S. economy.

Many retailers clearly see new technology as enabling them to compete. According to a Chase Small Business Pulse Survey published in May, 73% of small-business owners say they are likely to adopt new technology in the next year.

Smart POS helps level the playing field, even if entering the digital-payments ecosystem means the retailer temporarily gives up some control over the customer relationship. Restaurants, for example, might dislike using third-party delivery companies—which cut into profits and risk degrading the quality of service—but through POS technology they can now use the customer data collected by those services to build and reach their own customer base.

The same opportunity exists for other retailers that are willing to work with third-party applications to broaden their reach.

GROWTH DRIVER

Shoppers will continue to migrate from cash and cards to digital as these shopping experiences become more familiar. And as they do, they will expect retailers to both know them and anticipate their preferences, making their shopping experiences more personal, convenient, and delightful.

For both consumers and merchants, what started as a reaction to a crisis has now settled into a likely permanent habit. Digital payments systems will continue to transform the shopping experience and help drive business growth by giving retailers access to essential data that they couldn't access otherwise.

Chase is developing our own smart POS capabilities, and supporting other best-in-class providers for commercial clients. By embracing this technology—ideally through or with a partner that has a broad and deep ecosystem of startups and innovators—merchants can set themselves up for long-term success. DT

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