

**REGULATION OR COMPETITION?:
THE DURBIN AMENDMENT,
THE SHERMAN ACT, AND
INTERVENTION IN THE
CARD PAYMENT INDUSTRY**

*Harrison J. McAvoy**

INTRODUCTION..... 310

I. Background: Card Payment Industry..... 312

 A. *The Structure of Card Payment Systems* 312

 B. *Economics of Interchange Fees* 316

 C. *Important Network Operating Rules* 319

 D. *Critical Review of Interchange System* 322

 1. Criticisms of Overall Structure of Interchange 323

 2. Criticisms of Operating Rules..... 328

II. Potential Solutions 332

 A. *Direct Regulation: Price Ceilings on Interchange*..... 334

 1. Durbin Amendment 334

 2. Critical Review of Direct Regulation 337

 B. *Competition-Based Intervention*..... 341

 1. Antitrust Lawsuits..... 341

 2. Critical Review of Competition-Based Intervention 344

CONCLUSION 346

* J.D., Rutgers School of Law-Newark, 2013; B.S., Finance, Lehigh University, 2008.

INTRODUCTION

Debit and credit cards, or electronic payment cards, occupy an increasingly important role as forms of payment in the United States.¹ These card payment transactions are processed in a complex manner involving multiple components. One of the most important components in a typical card payment transaction is referred to as the interchange fee.² It is the largest part of a fee that merchants are obligated to pay on every card transaction, and it is paid to the banks that issue debit and credit cards.³ However, the consumer—the driver of each and every transaction—is largely unaware of the interchange fee’s existence, much less its importance or effect. On the other hand, merchants, card-issuing banks, and card networks—for example, Visa—are well aware of its existence, and all are fighting, both in the federal courts⁴ and in Congress⁵ over the future of this fee.

¹ There were 65.5 billion electronic payment card transactions in 2009, all of which incurred an interchange fee. *See* FEDERAL RESERVE SYSTEM, 2010 FEDERAL RESERVE PAYMENTS STUDY: NONCASH PAYMENT TRENDS IN THE UNITED STATES: 2006-2009 4 (Apr. 5, 2011) [hereinafter FED PAYMENTS STUDY], available at http://www.frbservices.org/files/communications/pdf/press/2010_payments_study.pdf. The total number of transactions in 2009 increased 31% over the number of similar transactions made in 2006. *See id.* While the number of credit card transactions has remained relatively static, debit card usage has increased dramatically, thus driving the increase. *See id.* Credit card transactions alone were estimated to account for 26% of the dollar value of goods and services purchased in 2006. Adam J. Levitin, *Priceless? The Economic Costs of Credit Card Merchant Restraints*, 55 UCLA L. REV. 1321, 1326-27 (2008). Debit and prepaid card transactions in 2009 were valued at \$1.4 trillion. BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM, 2009 INTERCHANGE REVENUE, COVERED ISSUER COST, AND COVERED ISSUER AND MERCHANT FRAUD LOSS RELATED TO DEBIT CARD TRANSACTIONS 6 (June 2011) [hereinafter FED SURVEY], available at http://www.federalreserve.gov/paymentsystems/files/debitfees_costs.pdf.

² *See* Barbara Pacheco & Richard Sullivan, *Interchange Fees in Credit and Debit Card Markets: What Role for Public Authorities?*, FED. RESERVE BANK OF KAN. CITY ECON. REV., 1st Quarter 2006, at 87 (“Interchange fees are an integral part of the pricing structure of credit and debit card transactions.”).

³ *See* U.S. GOV’T ACCOUNTABILITY OFFICE, GAO-10-45, CREDIT CARDS: RISING INTERCHANGE FEES HAVE INCREASED COSTS FOR MERCHANTS BUT OPTIONS FOR REDUCING FEES POSE CHALLENGES 6 (2009), available at <http://www.gao.gov/products/GAO-10-45>.

⁴ *See, e.g.,* United States v. Am. Express Co., 2011 WL 2974094 (E.D.N.Y. July 20, 2011).

⁵ *See, e.g.,* Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203 § 1075, 124 Stat. 2060 (codified at 15 U.S.C. § 1693 (2006)).

Interchange fees are important to all parties involved in a card payment transaction. For card-issuing banks, interchange fees are an enormous source of revenue⁶ and are used by card networks as a carrot to induce banks to issue cards on their network.⁷ To merchants, interchange fees represent the largest transactional cost associated with accepting debit and credit cards.⁸ Because this cost is factored into every card-accepting merchant's cost of business, consumers feel the effects of interchange fees in the form of higher priced goods and services.⁹ In addition, because not all consumers pay using debit and credit cards, those that choose to use other forms of payment such as cash or check are paying higher prices without receiving any sort of benefit.¹⁰

Over the last few decades, as both card usage and interchange fees have skyrocketed, interchange fees have become the subject of scrutiny by elected officials, antitrust authorities, and private plaintiffs. Intervention into the United States card payment industry has primarily taken two forms: direct regulatory intervention and antitrust lawsuits against the card networks under the Sherman Act. These forms of intervention attack interchange fees using very different approaches. Direct regulation such as the Durbin Amendment, a little-known amendment to Dodd-Frank Wall Street Reform and Consumer Protection Act, has a very direct effect: capping the amount of interchange that can be charged on an individual debit transaction.¹¹ On the other hand, antitrust suits have largely been directed at eliminating restrictive operating provisions that card networks indirectly impose on merchants, such as the prohibition on charging different prices depending on the consumer's method of payment.¹²

These two different forms of intervention have only recently come to fruition, and their consequences, both for the industry and consumer, are still largely unknown. Yet the success or failure of these

⁶ AMY DAWSON & CARL J. HUGENER, *DIAMOND MANAGEMENT AND TECHNOLOGY CONSULTANTS, A NEW BUSINESS MODEL FOR CARD PAYMENTS* 1 (2006).

⁷ See U.S. GOV'T ACCOUNTABILITY OFFICE, *supra* note 3, at 13.

⁸ See *id.* at 9.

⁹ *Id.* at 27-28.

¹⁰ *Id.* at 28.

¹¹ See Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. 111-203 § 1075, 124 Stat. 2060 (codified at 15 U.S.C. § 1693 (2006)).

¹² See, e.g., *United States v. Am.Express Co.*, 2011 WL 2974094 (E.D.N.Y. July 20, 2011).

interventions will undoubtedly have broad ramifications for consumers, merchants, and the card-payment industry. This Article seeks to describe the underlying characteristics of the industry and review both approaches, both by analyzing theoretical economic justifications and reviewing the available scholarship on empirical effects. Thus, this Article begins in Part I with the introduction of some background information on the payment card industry, including a review of the structure of a typical transaction, an overview of the economic theory behind interchange fees, a look at some of the important operating provisions promulgated by the card networks, and a critical review of the industry absent intervention. In Part II, this Article examines the two alternative approaches to intervention in the card payment industry—(1) direct regulation of interchange fees through the Durbin Amendment and (2) antitrust enforcement through the encouragement of competition—and compares the benefits and drawbacks of each.

I. Background: Card Payment Industry

A. The Structure of Card Payment Systems¹³

Electronic payment cards, including both debit and credit cards, occupy an increasingly important role as a form of payment in the United States¹⁴ and are processed in a complex manner involving multiple cost components. In the most typical type of card payment transaction, there are five parties involved: the consumer (or cardholder), the card-issuing bank (“issuer”) (e.g., Bank of America),¹⁵ the card network (typically Visa or MasterCard),¹⁶ the acquiring

¹³ The following description of a typical card payment transaction applies to both credit and debit cards. For the purposes of this Article, the term “credit cards” will also encompass charge cards.

¹⁴ See *supra* note 1.

¹⁵ The issuer of a debit card is the bank that the cardholder holds an account with. Credit cards, while issued by a variety of institutions, are primarily issued by only the largest of banks. U.S. GOV’T ACCOUNTABILITY OFFICE, *supra* note 3, at 6 (52% of outstanding credit card balances in 2008 were held by the top three issuing banks: JP Morgan Chase, Bank of America, and Citibank).

¹⁶ Visa and MasterCard possessed a combined 83% share of the credit card transaction market in 2008. Levitin, *supra* note 1, at 1327 (internal citation omitted). Coincidentally, these same companies also possessed 83% of the debit transaction market. Steven C. Salop et al., MERCHANT PAYMENTS COALITION, ECONOMIC ANALYSIS OF DEBIT CARD REGULATION UNDER SECTION 920 at 10 (Nov. 2, 2010) [hereinafter SALOP-MERCHANTS’ ANALYSIS], available at

financial institution (“acquirer”),¹⁷ and the merchant (e.g., Macy’s).¹⁸ When a consumer uses either her debit or credit card to make a purchase from a merchant, an electronic request for the specific dollar amount of the transaction is sent to the acquirer and then forwarded to the card network.¹⁹ The network acts an intermediary between the issuer and the acquirer, performing authorization, clearing, and settlement (ACS) services.²⁰ Once an issuer—the party responsible for funding the transaction—authorizes the purchase, the acquirer can then credit the merchant’s account for the price of the goods, less a so-called merchant discount fee.²¹ The merchant discount fee is divided among the institutional participants in the transaction. A small portion is retained by the acquirer, a small portion goes to the card network, and the majority is paid to the issuer as an interchange fee.²²

By way of illustration, a typical electronic payment transaction might proceed as follows. First, a consumer making a \$100 purchase will be charged \$100 by his issuing bank, either in the form of a debit from his account or in the form of a credit card bill. Next, the acquirer will pay the merchant \$98 after deducting the merchant discount fee. Of the \$2 merchant discount fee, the acquirer might retain \$0.70 and pass on the remaining \$1.30. The card network will receive \$0.15²³ in the

http://www.federalreserve.gov/newsevents/files/merchants_payment_coalition_meeting_20101102.pdf (2010).

¹⁷ The acquirer can be understood as a purchaser of the merchant’s accounts receivable, hence, an “acquirer.” Levitin, *supra* note 1, at 1328.

¹⁸ Some credit card transactions involve only four parties—the card network also acts as issuer. Debit Card Interchange Fees and Routing, 76 Fed. Reg. 43,394, 43,395 (July 20, 2011) (to be codified at 12 C.F.R. pt. 235). This model is representative of the processing system employed by American Express and Discover. U.S. GOV’T ACCOUNTABILITY OFFICE, *supra* note 3, at 8-9. Because the majority of electronic card payments are processed by Visa and MasterCard, this section of the Article will illustrate the mechanics of the five-party system. The concept of the four-party system is very much the same, except there is no additional need for interaction between the card network and the issuer. Further, since the elimination of certain exclusivity rules that prevented issuers from issuing cards on the American Express and Discover, the distinction has been blurred. Now, American Express and Discover process cards on a five-party model as well a four-party model. *See infra* Part II.D.2.

¹⁹ Debit Card Interchange Fees and Routing, 76 Fed. Reg. 43,394, 43,396.

²⁰ Levitin, *supra* note 1, at 1328.

²¹ U.S. GOV’T ACCOUNTABILITY OFFICE, *supra* note 3, at 7.

²² Debit Card Interchange Fees and Routing, 76 Fed. Reg. at 43,396.

²³ The Federal Reserve Board conducted a legislatively-authorized survey of industry participants affected by Durbin Amendment regulations and determined that card networks receive an average of \$0.11 per debit transaction, in the form of charges to both the acquirer

form of processing fees (for coordinating the transaction), and the issuing bank will receive \$1.15 in the form of an interchange fee.²⁴

In any given transaction, the driving factor in determining the merchant discount fee is the interchange fee.²⁵ This results from the fact that the interchange fee is both the largest cost component of the merchant discount fee; the remaining fees are generally set in response to interchange.²⁶ Interchange fees are unilaterally set by the card networks²⁷ and vary on the basis of a number of factors related to characteristics of the transaction, including the type of card being used (e.g., credit versus debit, or high rewards versus low rewards), the type of merchant for which the card is being used, the transaction volume of the merchant, and the form of processing (e.g., point-of-sale versus over the phone, or PIN versus signature).²⁸ These factors are believed to both account for the risk associated with accepting payment from certain types of merchants and provide incentives to certain merchants to accept a particular card network's cards.²⁹

and the issuer. FED SURVEY, *supra* note 1, at 12. This example uses \$0.15 for the sake of simplicity and round numbers. It is worth noting that card networks, such as Visa, dispute this characterization of a typical transaction. Visa asserts that the interchange fee is an exchange between the acquirer and the issuer. VISA INC., ANNUAL REPORT 13 (2010). However, card networks charge both the acquirer and issuer for its ACS services on a transaction basis, thus making their fees a relevant component of the entire transaction cost. See FED SURVEY, *supra* note 1, at 8.

²⁴ The Fed survey found this to be the average interchange fee per debit transaction. FED SURVEY, *supra* note 1, at 8.

²⁵ Debit Card Interchange Fees and Routing, 76 Fed. Reg. 43,394, 43,396 (July 20, 2011) (to be codified at 12 C.F.R. pt. 235).

²⁶ See Levitin, *supra* note 1, at 1333.

²⁷ E.g., VISA INC., ANNUAL REPORT 13 (2010). This feature of a payment card transaction, a centrally determined interchange fee, came into existence by way of Visa and MasterCard's previous form, a joint venture among member banks, or issuers. See Jean-Charles Rochet & Jean Tirole, *Cooperation Among Competitors: Some Economics of Payment Card Associations*, 33 RAND J. ECON. 549, 550 (2002). A coordinated fee contributed efficiency and convenience—i.e., avoidance of coordination of pricing amongst thousands of member-banks. See *id.* However, many member banks of Visa were also member banks of MasterCard, prompting antitrust scrutiny. See discussion *infra* Part III.B.1.

²⁸ U.S. GOV'T ACCOUNTABILITY OFFICE, *supra* note 3, at 9-10.

²⁹ *Id.* This characterization of the component factors belies the complexity of card network's determination of interchange fees. Card networks categorize merchants into a plethora of distinct categories and distinguish between transactions on many bases. See generally VISA U.S.A. INTERCHANGE REIMBURSEMENT FEES, VISA INC. (2011), available at <http://usa.visa.com/download/merchants/visa-usa-interchange-reimbursement-fees-october2011.pdf> (providing the current interchange fee rates as of Oct. 2011).

In contrast, acquirers determine their mark-up—their portion of the merchant discount fee—by looking to the interchange fee and setting a level that incorporates both their processing costs and a margin for themselves that is competitive within their segment of the industry. Acquirers provide a commodity-like service and thus compete to attract merchants primarily on price.³⁰ In addition, acquirers bear the risk of merchant default due to bankruptcy or otherwise.³¹ Yet, despite bearing such risks, acquirers are beholden to card networks and their determination of interchange; Card networks, through their determination of interchange fees, are in control of the relative costs of an electronic payment transaction and thus set the baseline for electronic payment fees as a whole.³²

Corresponding with the increase in credit and debit card use over the last ten years,³³ alarming increases in interchange fees have been a cause for concern among merchants and industry watchers. In 1991, Visa and MasterCard's highest interchange rates were 1.91% and 2.08% respectively; in 2009, the highest rates for the companies were 2.95% and 3.25%, respectively.³⁴ In addition, an estimate from the Federal Reserve pegged the total value of interchange fees for Visa and MasterCard debit and credit products at \$35 billion to \$45 billion in 2007, up from about \$20 billion in 2002.³⁵ Other estimates pegged interchange revenue in 2009 at \$62 billion,³⁶ indicating a severe upward

³⁰ ANN KJOS, FED. RESERVE BANK OF PHILA., *THE MERCHANT-ACQUIRING SIDE OF THE PAYMENT CARD INDUSTRY: STRUCTURE, OPERATIONS, AND CHALLENGES* 10 (2007) available at http://www.philadelphiafed.org/payment-cards-center/publications/update-newsletter/2008/summer/summer08_02.cfm.

³¹ U.S. GOV'T ACCOUNTABILITY OFFICE, *supra* note 3, at 9.

³² See Alan S. Frankel & Allan L. Shampine, *The Economic Effects of Interchange Fees*, 73 ANTITRUST L. J. 627, 631 (2006) ("The interchange fee puts a floor under the merchant discount. Indeed, since the acquiring side of the business is fairly competitive, one can expect changes in merchant discounts to generally reflect changes in interchange fees." (quoting DAVID EVANS & RICHARD SCHMALENSEE, *PAYING WITH PLASTIC* 199 (2d. ed. 1999))).

³³ See *supra* note 1.

³⁴ U.S. GOV'T ACCOUNTABILITY OFFICE, *supra* note 3, at 15. Fees for American Express and Discover are negotiated directly with merchants, *id.* at 9 n.8, and are not publicly available, see, e.g., *Our Pricing*, AM. EXPRESS, <https://merchant.americanexpress.com/accept-card/merchant-account-rates-pricing>.

³⁵ *Id.* at 14. These figures, indicating total volume of interchange revenue, must be taken with a grain of salt as an indication of an increase in interchange fees, as the total number of card payment transactions has also increased dramatically of the same time period. See *supra* note 1.

³⁶ Catherine Clifford, *Retailers Score in Swipe Fee Fight*, CNNMONEY (June 23, 2010),

trend. These trends have led to increased regulatory scrutiny.³⁷

B. *Economics of Interchange Fees*

The payment card industry is characterized by economists as a two-sided market.³⁸ Two-sided markets are those in which one intermediary, through the pricing and structuring of the market, provides benefits to two distinct types of customers.³⁹ While almost all markets involve transactions with multiple parties (e.g., a firm with suppliers and consumers), two-sided markets are distinguishable in that the intermediary—or platform—can affect the volume of transactions by shifting the cost of the transaction from one side to the other—i.e., adjusting the price structure⁴⁰ (as opposed to simply adjusting the prices to each side).⁴¹ Further, the benefits received by both sets of participants increase as the number of participants on either side increases.⁴²

Two-sided markets are prevalent in a variety of settings. This type of market is well-illustrated by the matchmaking industry, as in a dating club or bar: men are often charged while women may be allowed in for

http://money.cnn.com/2010/06/23/smallbusiness/small_business_interchange_fees/index.htm.

³⁷ See *infra* Part III.

³⁸ See, e.g., James MacAndrews & Zhu Wang, *The Economics of Two-Sided Payment Card Markets: Pricing, Adoption, and Usage* 1 (Fed. Reserve Bank of Kan. City, Econ. Research Dep't, Research Working Paper No. 08-12) (2008), available at www.kc.frb.org/PUBLICAT/reswkpap/pdf/RWP08-12.pdf.

³⁹ See Jean-Charles Rochet & Jean Tirole, *Two-Sided Markets: A Progress Report*, 37 RAND J. ECON. 645, 645 (2003) [hereinafter Rochet & Tirole, *Progress Report*]; Jean-Charles Rochet & Jean Tirole, *Platform Competition in Two-Sided Markets*, 1 J. EURO. ECON. ASSOCIATION 990, 990 (2003) [hereinafter Rochet & Tirole, *Platform Competition*]; see also Geoffrey G. Parker & Marshall W. Van Alstyne, *Two-Sided Network Effects: A Theory of Information Product Design*, 51 MGMT. SCI. 1494, 1494 (2005) (identifying the practice in industries of discounting or giving away products for free in order to encourage the purchase of another product).

⁴⁰ Price structures, as distinguished from price levels, refer to *how* the parties in the transaction are charged, not *what* the parties are charged. That is, instead of shifting a pure per transaction cost from the cardholder to the merchant (i.e., making a consumer pay 30% of a transaction cost and a merchant 70%), a two-sided market can adjust the price structure and make a merchant pay a transaction cost while a cardholder pays a membership fee or receives rebates in the form of rewards, and by doing so, increase the volume of transactions. See Marc Rysman, *An Empirical Analysis of Payment Card Usage*, 55 J. INDUS. ECON. 1, 7 (2007).

⁴¹ Rochet & Tirole, *Progress Report*, *supra* note 39 at 665.

⁴² David S. Evans, *It Takes Two to Tango: The Economics of Two-Sided Markets*, 1 PAYMENT CARD ECON. REV. 1, 3 (2003).

free in order to achieve a balance in the sexes that benefits both types of participants.⁴³ Another example exists in the video game industry.⁴⁴ The manufacturers of video game systems derive their profits from royalties paid by game developers, as they sell the game console at cost or for a loss.⁴⁵ Developers make more money if more consumers buy the console, and consumers benefit if more developers produce games for that console. As a result, the console developer must set prices that induce both developers and consumers to participate in the market.⁴⁶

Similarly, the structure of the card payment industry involves multiple participants that are coordinated by the card network, which serves as an intermediary.⁴⁷ Card payments can be understood as a service offered by suppliers—the issuer and the acquirer—to both merchants and cardholders, facilitated by a platform in the card network.⁴⁸ Issuers and acquirers incur costs in providing this service from which merchants and cardholders benefit.⁴⁹ Thus, card networks, which set interchange rates, charge a transfer payment. This transfers the utility of merchants and cardholders to issuers and acquirers in order to encourage them to participate, or in the language of economists, in order to “facilitate efficient card transactions.”⁵⁰ Therefore, the card

⁴³ *Id.* at 3.

⁴⁴ Rochet & Tirole, *Progress Report*, *supra* note 39, at 645.

⁴⁵ *Id.* at 659.

⁴⁶ *Id.* at 645. Other examples of two-sided markets abound. Perhaps somewhat ironically, the “market” for academic journals has been characterized as such a market. Doh-Shin Jeon & Jean-Charles Rochet, *The Pricing of Academic Journals: A Two-Sided Market Perspective*, 2 AM. ECON. J.: MICROECONOMICS 222 (2010). Many journals provide their articles to the public at no charge, but require authors to pay to submit scholarship to be published in order to induce wider dissemination of the publications. *Id.* at 222-23.

⁴⁷ Indeed, “multi-sided” might be a more suitable description of the payment card industry. See Rochet & Tirole, *Progress Report*, *supra* note 39, at 645 n.1. Benefits are achieved between merchants and cardholders, while card networks intermediate price among merchants, consumers, and issuers.

⁴⁸ See Jean-Charles Rochet & Jean Tirole, *Cooperation Among Competitors: Some Economics of Payment Card Associations*, 33 RAND J. ECON. 549, 551 (2002).

⁴⁹ *Id.*

⁵⁰ See ROBIN A. PRAGER, MARK D. MANUSZAK, ELIZABETH K. KISER, & RON BORZEKOWSKI, FED. RESERVE BD., INTERCHANGE FEES AND PAYMENT CARD NETWORKS: ECONOMICS, INDUSTRY DEVELOPMENTS, AND POLICY ISSUES 15-16 (2009). It is important to note that, in the context of a credit card transaction, cardholders are already incurring a cost to transact in the monthly fees or finance fees the issuer charges. However, in a debit transaction, there are no such costs. In addition, cardholders receive “rebates” from issuers in the form of rewards or “cash back” incentives. Thus, the interchange fee can best be understood as a charge for means of payment, as opposed to any other service.

network must determine the proper level to set the interchange fee in order to attract more participants—i.e., “balance demand.”⁵¹

In addition, the market provides increasing benefits both to cardholders and to merchants as more participate—the more people who use cards, the more merchants will want to accept them, and vice-versa.⁵² Economists refer to this feature of two-sided markets—a phenomenon akin to economies of scale—as a kind of “externality.”⁵³ Externalities are defined as “indirect effects of consumption or production activity.”⁵⁴ More specifically, the idea of shared benefits in two-sided markets is known as a “network externality” or “network effects.”⁵⁵

Another externality that is recognized in a card payment transaction is what is referred to as the “usage externality.”⁵⁶ This references the fact that participants in a card payment transaction do not take account of the other participant’s costs and benefits in taking part in the transaction.⁵⁷ The usage externality and the concept of two-sided markets are both closely related to the concept of multi-product pricing.⁵⁸ However, there is an essential difference in two-side markets. Under multi-product pricing, the recipient of a free or very cheap razor will be cognizant that he is being charged a high price for razor blades,

⁵¹ *Id.* at 15 (internal quotations omitted).

⁵² Evans, *supra* note 43, at 3. Indeed, both merchants and cardholders derive other benefits from electronic card payment transactions besides availability of use, such as a reduction in the handling of cash, security, fraud protection, convenience, etc.

⁵³ *Id.*

⁵⁴ See James M. Buchanan & William Craig Stubblebine, *Externality*, 29 *ECONOMICA* 371, 372 (1962) (describing an externality as “an external effect” that occurs when “the utility of an individual . . . is dependent upon the ‘activities’ . . . that are exclusively under his own control or authority, but also upon the single activity . . . , which is . . . under the control of a second individual.”).

⁵⁵ See PRAGER ET AL., *supra* note 50, at 16. The existence of positive network effects, while not proven, does extend beyond the theoretical. An empirical study has shown a positive correlation between cardholder’s usage of payment cards and acceptance of such cards by merchants. Rysman, *supra* note 40, at 2-3. This correlation is suggestive of a positive feedback loop, which is evidence of positive network effects. *Id.*

⁵⁶ Rysman, *supra* note 40, at 2-3. Two-sided markets often exhibit another sort of externality, “membership externalities.” Rochet & Tirole, *Progress Report*, *supra* note 39, at 646. In the context of card payments, this sort of externality is only relevant to costs like membership fees that are incurred by a cardholder, as in the case of American Express. *Id.* at 647. However, this Article’s focus is primarily on the function of interchange, causing membership externalities to less relevant.

⁵⁷ *Id.*

⁵⁸ See Rochet & Tirole, *Progress Report*, *supra* note 39, at 646.

whereas in a two-side market, one market participant cannot and does not internalize the cost to the other side of the market.⁵⁹ In the context of payments systems, a cardholder does not internalize the cost to the merchant of processing the transactions using a card versus cash.

Interchange fees, in theory, are designed to account for both of these externalities.⁶⁰ By imposing a transfer payment in the form of an interchange fee, card networks strengthen the network and provide increasing utility to all participants, enhancing network effects.⁶¹ And by forcing a transfer, card networks enable the transaction to even occur by providing an otherwise absent incentive for issuers and acquirers to process the transaction.⁶²

Another important concept in two-sided markets is “multi-homing.” Multi-homing is a scenario where a market participant uses multiple networks.⁶³ For example, in the videogame industry, a developer multi-homes by producing a game for two consoles—e.g., for both PlayStation and X-Box—and a consumer multi-homes by owning multiple gaming consoles.⁶⁴ In the context of card networks, an issuer multi-homes by issuing cards on multiple networks, and consumers and merchants multi-home by accepting or using cards on multiple networks.⁶⁵ When one side of a two-sided market multi-homes and the other does not, it can lead to intense competition on the multi-homing side and little to no competition on the side that does not.⁶⁶

C. Important Network Operating Rules

In order to regulate transactions, the card networks maintain voluminous operating regulations that are binding on the network’s participants.⁶⁷ In the case of Visa and MasterCard, these agreements are

⁵⁹ *See id.*

⁶⁰ *See PRAGER ET AL.*, *supra* note 50, at 16-17. For a rebuttal of this assertion, see *supra* Part II.D.

⁶¹ *See PRAGER ET AL.*, *supra* note 50, at 16-17.

⁶² *See id.*

⁶³ Rysman, *supra* note 40, at 9.

⁶⁴ *See Rochet & Tirole, Progress Report*, *supra* note 39, at 659.

⁶⁵ Rysman, *supra* note 40, at 6.

⁶⁶ *See Rochet & Tirole, Progress Report*, *supra* note 39, at 660.

⁶⁷ *Visa International Operating Regulations*, VISA INC. (Apr. 15, 2013), <http://usa.visa.com/download/merchants/visa-international-operating-regulations-main.pdf>; *MasterCard Rules*, MASTERCARD INC. (Dec. 12, 2012), http://www.mastercard.com/us/merchant/pdf/BM-Entire_Manual_public.pdf; *American*

made with member organizations such as issuers and acquirers, who then impose any relevant provisions on merchants and cardholders.⁶⁸ In the case of American Express and Discover, the operating regulations govern issuers and merchants.⁶⁹

There are two important provisions that have historically been maintained in these agreements that have a tremendous effect on the way merchants accept card payments and, arguably, the way the industry competes.⁷⁰ The first provision is known as the “honor-all-cards” rule. This rule requires that merchants who accept a type of card from a card network must accept all types of that card connected with that card network.⁷¹ Thus, a merchant who accepts a Visa credit card must accept all types of Visa credit cards and cannot reject any given Visa credit card on the basis of its issuer or a higher interchange fee.⁷² This rule prevents merchants from accepting only those cards offered by a card network that carry relatively lower interchange fees.⁷³

The card networks and their supporters argue that this rule is necessary to avoid reducing the level of positive network effects, as without it, some cardholders might be denied when making a purchase.⁷⁴

Express Merchant Reference Guide – U.S., AM. EXPRESS CO. (Apr. 2013), https://www260.americanexpress.com/merchant/singlevoice/singlevoiceflash/USEng/pdf/files/MerchantPolicyPDFs/US_%20RefGuide.pdf.

⁶⁸ See VISA INC., *supra* note 67, at 33; MASTERCARD INC., *supra* note 67, at §§ 1.1-1.2, 1.5.5. Prior to 2009, these regulations were not even made available to merchants. PRAGER ET AL., *supra* note 50, at 13 n.25.

⁶⁹ See AM. EXPRESS CO., *supra* note 67, at 4. Discover’s Merchant Operating Regulations and Acquirer Operating Regulations are not available to the general public but instead only to member organizations.

⁷⁰ Not all of the four major card networks implement both or any of the procedures discussed.

⁷¹ PRAGER ET AL., *supra* note 50, at 13. This rule is promulgated explicitly by Visa and MasterCard. VISA INC., *supra* note 67, at 395; MASTERCARD INC., *supra* note 67, at § 5.8.1. American Express’s anti-steering provisions arguably achieve the same result. See AM. EXPRESS CO., *supra* note 67, at 14 (“Merchants must not . . . indicate or imply that they prefer . . . any Other Payment Products.”).

⁷² VISA INC., *supra* note 67, at 395. The honor-all-cards rule, as implemented by Visa and MasterCard, previously required that a merchant who accepted the card network’s credit cards also accept the card network’s debit cards. In 2003, Visa and MasterCard, as part of the settlement of an antitrust action brought by a class of merchants, agreed to revise their honor-all-cards rules to not apply across debit and credit classes of cards. See discussion *infra* III.B.1.

⁷³ See PRAGER ET AL., *supra* note 50, at 14.

⁷⁴ David S. Evans & Michael Noel, *Defining Antitrust Markets When Firms Operate Two-Sided Platforms*, 2005 COLUMBIA BUSINESS LAW REVIEW 667, 684 (2005); see also Levitin, *supra* note 1, at 1366.

This argument, when made today, belies the history of such rules. Honor-all-card rules arose in the 1960s, as Visa and MasterCard were developing as networks, in order to counter merchant reticence in accepting a card from a bank of which it had never heard. At the time, banking regulations barred the existence of major national retail bank chains.⁷⁵ However, when a consumer attempts to use a card but is denied, that cardholder's consumer welfare is undeniably harmed.⁷⁶

The second major feature of card network operating agreements relates to a family of similar rules, including "no-surcharge rules" and "no-discounting rules," which can collectively be referred to as no-steering rules or non-discrimination rules.⁷⁷ These rules consist of prohibitions imposed by card networks that prevent merchants from steering customers away from high-cost forms of payment to lower-cost forms of payment, either through the use of surcharges or discounts on the price of goods.⁷⁸ While merchants have been able to offer discounts to consumers for paying in cash since 1981 under the Cash Discount Act,⁷⁹ such discounting is uncommon.⁸⁰

Similar to honor-all-cards rules, no-steering rules are justified primarily on their contributions to positive network externalities. Because consumers are more price elastic⁸¹ in their demand for electronic payment cards (consumers have alternatives in cash and checks) and merchants' demand is highly inelastic (merchants must accept credit and debit cards or lose some sales), if consumers must incur surcharges for the cost of the interchange fee, as opposed to

⁷⁵ Levitin, *supra* note 1, at 1367-68.

⁷⁶ The credit card industry seems to be straining to maintain non-standardized products. *See supra* Part II.D.2. The honor-all-cards rule, by forcing acceptance of high-end rewards cards, helps to keep credit cards from becoming commodities. *Id.*

⁷⁷ Under a settlement with the DOJ, Visa and MasterCard can no longer enforce no-discounting rules in the United States. *See discussion infra* Part III.B.1. However, American Express has chosen to litigate the same suit with the DOJ in order to preserve its anti-steering provisions. *See AM. EXPRESS CO.*, *supra* note 67, at 14.

⁷⁸ *See PRAGER ET AL.*, *supra* note 50, at 14; Levitin, *supra* note 1, at 1369.

⁷⁹ 15 U.S.C. § 1666f(a) (2006).

⁸⁰ *See Levitin, supra* note 1, at 1350 (recognizing that cash discounting is "rare" and "largely confined to the retail gasoline industry") (citation omitted). One reason why merchants do not offer and consumers do not demand cash discounts might be because cash is not part of the same product market as debit cards or credit cards. For example, consumers use debit cards so they do not have to use cash, and they use credit cards to gain access to credit.

⁸¹ Price elasticity of demand is a measure of responsiveness of the quantity of a good or service demanded to changes in price. *See Levitin, supra* note 1, at 1366.

merchants, consumers will not use cards and the beneficial network effects will be lost.⁸² In addition, the requirement of multiple price schedules might lead to less card transactions and thus less network effects.⁸³ Another offered rationale is that no-surcharge rules prevent cash-paying customers from free riding off of the legitimacy that card networks signal to consumers about merchants who accept their cards.⁸⁴

D. Critical Review of Interchange System

The structure and character of payment card transactions—interchange, merchant restraints, and their effect on the industry—have been the subject of much criticism. Criticism of the industry can be best understood in two modes: (1) criticism of the overall structure of the industry and its potential for abuse⁸⁵ and (2) criticism of specific operating rules as promulgated by the card networks that arguably deter competition.⁸⁶ Although the use of these two modes can be helpful in comprehending two spheres of criticism, they cannot be understood entirely independent of each other, as the existence of one may be necessary for the other. In other words, the presence of potentially anticompetitive operating rules may be sustaining a potentially exploitive system,⁸⁷ or the structure of the payment industry might allow for networks to enforce harmful rules.⁸⁸ The payment-card industry can also be criticized for the relative concentration within the industry and the potential for both an exercise of market power and conscious or

⁸² See *id.*

⁸³ See Richard A. Epstein, *The Regulation of Interchange Fees: Australian Fine-Tuning Gone Awry*, 2005 COLUM. BUS. L. REV. 551, 583-84 (2005).

⁸⁴ *Id.* This rationale is of specious merit. Most almost all businesses now accept credit or debit cards, belying any claim of a merchant's quality from its acceptance of credit cards. See Levitin, *supra* note 1, at 1363-64 n.134.

⁸⁵ See, e.g., Matthew L. Cantor & Jeffrey L. Shinder, *Feedback: Interchange Amendment is Pro-, Not Anti-, Consumer*, AM. BANKER (May 24, 2010), available at <http://www.americanbanker.com/news/interchange-1019685-1.html> (describing interchange system as a hidden tax on consumers resulting from the market power of the card networks).

⁸⁶ See, e.g., Levitin, *supra* note 1 (advocating for the proscription of merchant restraints as a restraint on trade in violation of antitrust laws).

⁸⁷ If not for honor-all-cards rules, rewards cards might not exist. See Adam Levitin, *Priceless? The Social Costs of Credit Card Merchant Restraints*, 45 HARV. J. ON LEGIS. 1, 11 (2008).

⁸⁸ For example, the fact that the card networks unilaterally set common interchange fees for all issuers perpetuates the honor-all-cards rule. PRAGER ET AL., *supra* note 50, at 19. If issuers could determine their own interchange rates, they would demand very high rates, and merchants would not accept cards at all. *Id.* at 19-20.

unconscious parallelism in the setting of interchange by the largest networks (i.e. MasterCard and Visa).⁸⁹

1. Criticisms of Overall Structure of Interchange

A critique of the overall industry structure begins with an overview of some of the criticisms emanating from the economic community. Theoretical economic analysis has identified certain problems with the current system of interchange and its determination by the card networks. While not all economists agree in their methods or their conclusions, a number of common themes are exhibited by the available scholarship.⁹⁰ For one, economists recognize that prevailing conditions in the industry will tend to lead to inefficient interchange fees.⁹¹ That means that current market conditions, such as merchants' strong incentives to accept cards, will lead to interchange fees that are higher than the overall benefits received by consumers and merchants.⁹² One factor that could contribute to such a result would be the intense competition among networks to attract issuers, as any rise in fees related to this competition is wholly unrelated to the externality-reduction function of interchange.⁹³ Further, profit maximizing card networks, cognizant of the two-sided nature of their market, will not tend to effect interchange fees that maximize the utility of all participants.⁹⁴

Indeed, economists' "theoretical models" seem to be grounded in reality—the card networks exercise overwhelming market power over merchants. For one, as previously mentioned, merchants' demand for card payment services is extremely inelastic. Electronic payments represent over 75% percent of all noncash payments.⁹⁵ In addition, as early as 2005, card payments were estimated to constitute over half of all the payments made to the retail sector in the United States.⁹⁶ With card payments representing such a large portion of all payments, the

⁸⁹ While this concentration is relevant to many of the anticompetitive features of structure of the industry, criticisms of this concentration—as they relate to market power and parallelism—is beyond the scope of this Article.

⁹⁰ See PRAGER ET AL., *supra* note 50, at 21-22.

⁹¹ *Id.* An efficient interchange fee occurs when the net costs amongst all of the parties involved in the transaction do not exceed the net benefits. *Id.* at 18.

⁹² See *id.* at 21-22.

⁹³ *Id.* at 21 n.38.

⁹⁴ *Id.* at 21.

⁹⁵ FED SURVEY, *supra* note 1, at 19.

⁹⁶ PRAGER ET AL., *supra* note 50, at 25.

vast majority of merchants—those who sell non-unique goods—are guaranteed to lose business if they were to stop accepting cards.

Merchants have expressed these exact concerns. Merchants offer an alternative characterization of the market to that of the card networks', which depicts a "balance of incentives" and a benevolent transfer of interchange to preserve network effects.⁹⁷ Merchants assert that the card networks have extreme market power over the merchant side of the two-sided market.⁹⁸ Because there is substantial competition on the issuer side of the market and little competition on the merchant side, card networks must cater to the issuer side of the market. This reality makes it virtually inevitable that card networks will impose supracompetitive interchange fees on merchants.⁹⁹ Where card networks characterize their actions as a balancing of incentives, merchants characterize these same market conditions as market power.¹⁰⁰

As merchants have asserted, competition on the issuer side of the two-sided market is indeed intense. One encouragement of this competition stems from an antitrust suit brought by the United States Department of Justice ("DOJ") against Visa and MasterCard, *United States v. Visa U.S.A., Inc.*¹⁰¹ As a result of this suit, the two card networks in 2003 were required to eliminate exclusionary rules in their agreements with issuers that precluded those member banks from also issuing American Express and Discover cards.¹⁰² This action, while initiated with the intent of injecting additional competition into the payment card industry by preventing Visa and MasterCard from excluding their relatively smaller competitors, has only led to higher interchange rates due to increased competition on the issuer side of the market, i.e., networks competing for issuers.¹⁰³ In addition, because American Express generally charges higher interchange rates, after the decision, Visa and MasterCard were compelled to raise their

⁹⁷ See generally VISA, INC., INTERCHANGE: WHAT IT IS, HOW IT WORKS, available at <http://usa.visa.com/download/merchants/interchange-brochure.pdf>.

⁹⁸ Steven C. Salop et al., *supra* note 16, at 1.

⁹⁹ See *id.* at 1-2.

¹⁰⁰ Compare *id.* at 14, and VISA, INC., *supra* note 97, at 3. The irony of this comparison is that card network's "merchant inelasticity" is virtually synonymous with merchant's "card network market power"—card networks derive their market power from merchant's inelastic demand for card services.

¹⁰¹ *United States v. Visa U.S.A., Inc.*, 344 F.3d 229, 234 (2d Cir. 2003).

¹⁰² See *id.* at 234.

¹⁰³ See PRAGER ET AL., *supra* note 50, at 35.

interchange rates to the level charged by American Express to compete for issuers.¹⁰⁴ Further, with interest rates declining significantly over the last three decades, thus lowering issuer revenue from finance charges to consumers, issuers have likely demanded higher interchange rates to make up for the difference.¹⁰⁵

From a consumer standpoint, the structure of interchange fees and the card networks is a source of much cause for concern. Although merchants are charged an interchange fee up front on every transaction that is processed, that charge is inevitably incorporated into each individual merchant's cost calculation, similar to overhead or cost of goods sold.¹⁰⁶ If a merchant is in a competitive market, the merchant will have to raise its prices to maintain the same profit margin it would have without a transaction fee. This phenomenon is known as a pass-through and is evidenced by pass-through rates.¹⁰⁷ In the case of sales tax, economists have found there is a pass-through rate of one hundred percent or greater.¹⁰⁸ Therefore, there is a strong inference that the interchange fee is essentially passed on to the unassuming consumer. Indeed, merchants estimated that the average household paid \$427 towards interchange in 2008.¹⁰⁹

Concerns for the consumer can be linked to the economic theories that underlie interchange supporters' best arguments. One of the essential themes supporting two-sided markets and a transfer payment

¹⁰⁴ Levitin, *supra* note 1, at 1341.

¹⁰⁵ See *Historical Prime Rate*, JPMORGAN CHASE & CO., <http://www.jpmorganchase.com/corporate/About-JPMC/historical-prime-rate.htm> (last visited June 8, 2013); see also BANK OF AMERICA, 2010 ANNUAL REPORT 44 (2010) (showing that income from interest was roughly seventy percent of all payment card income).

¹⁰⁶ See *Credit Card Fees*, NACS ONLINE, <http://www.nacsonline.com/NACS/RESOURCES/CREDITCARDFEES/Pages/default.aspx> (last visited Feb. 27, 2012) (acknowledging that retail members consider credit card fees to be an operating expense).

¹⁰⁷ Pass-through rates are determined by looking at prices both before and after the incidence of a tax or other extra charge. See Timothy Besley & Harvey S. Rosen, *Sales Tax and Price: An Empirical Analysis* 21 (Nat'l Bureau of Econ. Research, Working Paper No. 6667, 1998).

¹⁰⁸ See Kai Konrad, Florian Morath & Wieland Müller, *Taxation and Market Power* (CESifo, Working Paper No. 2880, 2009). This result, in the case of sales tax, is even more likely, according to empirical evidence, in the case of commodities. Besley, *supra* note 107, at 26-27. As card payment services can be identified as commodities, see discussion *infra* Part II.D.2, the incidence of this pass-through is even more likely.

¹⁰⁹ Jessica Dickler, *Hidden Credit Card Fees Are Costing You*, CNNMONEY (July 31, 2008, 5:20 PM), http://money.cnn.com/2008/07/28/news/credit_card_interchange/.

in the form of an interchange fee is the characterization of interchange as a cure for the usage externality.¹¹⁰ Usage externality, defined as the problem of transaction participants' inability to internalize the costs of the other participants, can supposedly be solved by the use of an interchange fee under this view.¹¹¹ Proponents of interchange assert that merchants and consumers gain benefits and therefore pay for them in interchange.¹¹² By charging the merchant for the transaction, consumers are more likely to use their card to pay, a transaction that results in greater net benefits for the two parties.¹¹³ However, in the multi-sided market of payment systems,¹¹⁴ issuers are compensated to participate, merchants pay the up-front costs, and consumers pay for the transaction in higher prices without ever knowing it. Interchange, which is supposed to correct the usage externality by charging merchants, simply passes costs back on to consumers—only this time, without consumers being aware of it. Therefore, an essential deficiency in the transfer payment of the card payment industry is the lack of information exchange. Because consumers are completely unaware that they are funding the transaction, they cannot internalize interchange.

A major component in the economically inefficient card payment world of transactions is the prevalence of credit cards that encourage cardholders to accumulate “rewards.” Citi wants you to earn “Extra Cash from Citi.”¹¹⁵ Bank of America pushes “Power Rewards.”¹¹⁶ Almost all issuers have cards that let you earn frequent flier miles, travel rewards, or cash back.¹¹⁷ These rewards programs are funded by interchange.¹¹⁸ In fact, forty-four percent of interchange revenue is

¹¹⁰ See *supra* Part II.B.

¹¹¹ See *id.*

¹¹² See PRAGER ET AL., *supra* note 50, at 7.

¹¹³ Marianne Verdier, *Interchange Fees in Payment Card Systems: A Survey of the Literature*, 25 J. OF ECON. SURVEY 273, 276 (2011).

¹¹⁴ See Rochet & Tirole, *Progress Report*, *supra* note 39, at 645 n.1

¹¹⁵ *Citi Introduces Extra Cash – New Rewards Program*, PAYMENTS NEWS (May 29, 2008, 7:40 AM), <http://www.paymentsnews.com/2008/05/citi-introduces.html>.

¹¹⁶ *Power Rewards*, BANK OF AMERICA, <https://www.managerewardsonline.bankofamerica.com/RWDapp/home?mc=PWRRWD> (last visited June 8, 2013).

¹¹⁷ See *Rewards Cards by Bankrate*, BANKRATE.COM, <http://www.bankrate.com/funnel/credit-cards/credit-card-results.aspx?classificationuid=8&childcategoryid=117&childcategory=Rewards%20Cards> (last visited June 8, 2013).

¹¹⁸ Dawson, *supra* note 6, at 9.

devoted solely to funding these programs.¹¹⁹ And interchange fees can vary based on whether a card offers extravagant rewards.¹²⁰ Thus, interchange fees are paid directly by merchants—indirectly by consumers—and then cycled back around to consumers through rebates and rewards.¹²¹ However, since only forty-four percent is being used to fund rewards, consumers are not even seeing half of what they pay towards interchange through artificially high prices.¹²² These rewards programs induce consumers to use cards to pay for goods, as opposed to cash or check, even though they might not need to. This means that merchants will incur an interchange fee, even though the merchant may not be seeing any additional benefit from the use of a card versus cash (i.e., increased sales from consumer's ability to purchase on credit).¹²³

Another related criticism of the interchange system is that it subsidizes consumers who pay with rewards cards at the expense of other consumers. Because credit and debit card usage results in higher prices of goods, those consumers who pay for goods and services in cash, check, or other low cost forms of payment (even a no-rewards credit card) subsidize the rewards program of the consumer who decides to pay using a more generous rewards card.¹²⁴ The concept can best be understood in the context of cards that offer a certain percentage cash back on purchases, e.g., five percent.¹²⁵ The consumer paying with the rewards card will receive a five percent discount on his purchase, while the cash consumer gets no reward and still pays the artificially inflated price.¹²⁶ Notably, this subsidy is regressive in that it disproportionately hurts the poor in favor of the affluent because lower income consumers are much more likely to pay in cash while higher income consumers predominantly use cards with extravagant rewards programs.¹²⁷

¹¹⁹ *Id.*

¹²⁰ See Levitin, *supra* note 1, at 1348.

¹²¹ Frankel & Shampine, *supra* note 32, at 634.

¹²² See DAWSON & HUGENER, *supra* note 6, at 9.

¹²³ See Levitin, *supra* note 1, at 1347.

¹²⁴ See Levitin, *supra* note 87, at 3.

¹²⁵ See Levitin, *supra* note 1, at 1349.

¹²⁶ *Id.*

¹²⁷ Levitin, *supra* note 87, at 3.

2. Criticisms of Operating Rules

There are two operating rules advanced by the card networks that have been the subject of much criticism: (1) the honor-all-cards rule and (2) non-discrimination rules.¹²⁸ These two rules have been criticized primarily on antitrust grounds, as they can be characterized, respectively, as illegal tying and an anticompetitive vertical restraint.¹²⁹ Critics of these rules assert that their elimination could result in an infusion of competition into the card payment industry, which could remedy the current problems with interchange and issuer market power.¹³⁰

Honor-all-cards rules restrain merchants from making independent decisions about what kinds of payment cards they wish to accept. Because merchants must accept all types of a network's cards if they want to accept any, honor-all-cards rules force merchants to accept cards that have much higher interchange fees than they would otherwise accept.¹³¹ In the absence of such a rule, merchants could simply refuse to accept premium cards that carry extensive rewards paired with a high interchange fee.¹³²

The honor-all-cards rule also allows issuers to sustain the existence of such premium cards. If merchants could refuse to accept high cost cards, they could exert economic pressure on issuers and cause banks to issue less rewards cards or stop issuing such cards altogether.¹³³ Such pressure might result in the elimination of the most extravagant rewards cards, and if not, the elimination of the honor-all-cards rule would at least allow market forces to adjust high-rewards cards' acceptance to a competitive level—that is, such cards would be accepted only where consumers demanded their acceptance.¹³⁴

¹²⁸ See *supra* Part II.C.

¹²⁹ Levitin, *supra* note 1, at 1399-1404.

¹³⁰ See generally *id.* (claiming merchant restraints, including both honor-all-card rules and no-differentiation rules, distort competition); Steven Semeraro, *The Antitrust Economics of (and Law) of Surcharging Credit Card Transactions*, 14 STAN. J.L. BUS. & FIN. 343, 346 (2009).

¹³¹ U.S. GOV'T ACCOUNTABILITY OFFICE, *supra* note 3, at 39.

¹³² *Id.* at 58.

¹³³ Levitin, *supra* note 87, at 23.

¹³⁴ See *id.*

The card networks defend the honor-all-cards rule primarily on the basis that its elimination would reduce consumer welfare and correspondingly hurt the positive network effects externality.¹³⁵ This concern is partially allayed by the fact that many consumers carry more than one type of card.¹³⁶ This is an instance of multi-homing.¹³⁷ Further, if there was no honor-all-cards rule, the variety of cards issued would likely consolidate to a generic low rewards card, and merchants would either accept a network's cards, or not, assuaging any concerns over merchants accepting some networks' cards and refusing others.¹³⁸

The honor-all-cards rule, as promulgated by the major card networks, has been significantly altered through an antitrust lawsuit. In 2003, a suit instituted by a class of merchants culminated in the largest antitrust settlement in U.S. history.¹³⁹ In addition to over \$3 billion in monetary damages, Visa and MasterCard both agreed to adjust their honor-all-card rules so that debit products would no longer be tied to all other products—namely credit products.¹⁴⁰ The merchants brought both section 1 and section 2 claims under the Sherman Act, alleging that the honor-all-cards rule, as it stood, constituted per se illegal tying of unrelated products. The merchants argued that “Visa, separately and together with MasterCard, [was] attempting to monopolize and conspiring to monopolize the debit card services market” through the tying of debit and credit products.¹⁴¹ Both Visa and MasterCard settled on the eve of trial.¹⁴²

This litigation uncovered a fairly devious scheme as effectuated by both Visa and MasterCard. As stated by the lead counsel of the merchant-certified class, both Visa and MasterCard utilized the honor-all-cards rule and its market power in the credit card market to force merchants to accept the fraud-prone signature debit cards, accompanied by “credit card-style interchange rates,” while simultaneously

¹³⁵ See *supra* part II.C.

¹³⁶ Levitin, *supra* note 87, at 23.

¹³⁷ See *supra* part II.B.

¹³⁸ Levitin, *supra* note 87, at 24.

¹³⁹ *In re Visa Check/MasterMoney Antitrust Litig.*, 297 F.Supp.2d 503, 508 (E.D.N.Y. 2003), *aff'd sub nom* 396 F.3d 96 (2d Cir. 2005), *cert. denied sub nom* 125 S. Ct. 2277 (2005).

¹⁴⁰ *Id.*

¹⁴¹ *In re Visa Check/MasterMoney Antitrust Litig.*, 2003 WL 1712568 (E.D.N.Y. Apr. 1, 2003), at *2, *6.

¹⁴² *In re Visa Check/MasterMoney Antitrust Litig.*, 297 F.Supp.2d at 508.

suppressing the more efficient and secure PIN debit product.¹⁴³ Indeed, following modification of the honor-all-cards rule as agreed to in the settlement, interchange rates on signature debit products reversed the trend of continuously rising interchange rates, with rates instead dropping significantly and entering more in line with the interchange rates of PIN products, presumably to remain competitive with those products.¹⁴⁴

Perhaps even more detrimental to competition are what are known as non-discrimination rules.¹⁴⁵ These rules, as originally promulgated,¹⁴⁶ barred merchants from pricing purchases made with a network's card differently than an alternative form of payment, such as a different card on the same network or a competitor-network's card.¹⁴⁷ Further, merchants are prohibited from adding additional transaction costs onto the purchase price of goods—that is, including an extra surcharge to encourage consumers to use certain forms of payment.¹⁴⁸ These rules essentially forbid a merchant from expressing a preference for a certain form of payment, either expressly or through price.¹⁴⁹ In addition, because merchants cannot inform the purchaser, consumers make purchases without any awareness as to the cost of the transaction.¹⁵⁰ As a result, it prevents card networks from competing at the point of sale on price, as any other type of product would.¹⁵¹

¹⁴³ Lloyd Constantine, Jeffery I. Shinder & Kerin E. Coughlin, *In re Visa Check/MasterMoney Antitrust Litigation: A Study of Market Failure in a Two-Sided Market*, 2005 COLUM. BUS. L. REV. 599, 605-10 (2005).

¹⁴⁴ See DAWSON & HUGENER, *supra* note 6, at 5 (see exhibit 3).

¹⁴⁵ For the purposes of this section, “non-discrimination rules” will cover the entire family of rules associated with price differences based on type of transaction, including surcharging, discounts, in-kind discounts, and steering. See background *infra* part II.C.

¹⁴⁶ Visa's and MasterCard's no-discrimination rules have been modified by way of government antitrust action; however, because American Express's rule remains intact, the underlying concerns related to such rules is still present. See *infra* Part III.B.1.

¹⁴⁷ See, e.g., Final Judgment as to Defendants MasterCard Int'l Inc. and Visa Inc., *United States v. Am. Express Co.*, 2011 U.S. Dist. LEXIS 87560 (E.D.N.Y. July 20, 2011), at *15-16 (providing language of Visa's no-discrimination rule prior to July of 2011).

¹⁴⁸ See, e.g., Visa Inc., *supra* note 67, at 482.

¹⁴⁹ Tracey Kitzman, *A Response: U.S. v. American Express, et al.—Making Everything Out of Something*, LYDIAN JOURNAL 2 (February 2011), available at <http://pymnts.com/journal-bak/201/a-response-u-s-v-american-express-et-al-making-everything-out-of-something-2/>.

¹⁵⁰ *Id.* at 3.

¹⁵¹ See *id.*

This kind of restriction can be cast in the language of two-sided market economic theory. As discussed, when a two-sided market participant subscribes to multiple platforms or networks, it is called multi-homing.¹⁵² When one side of the market multi-homes and the other side does not, the side that does will be much more competitive than the other and thus will exercise market power.¹⁵³ Empirical evidence shows this is precisely the case in payment card transactions. While no study is needed to show that issuers multi-home (i.e., issue cards on more than one network), empirical evidence shows that consumers typically carry more than one network's card and they predominantly use only one—i.e., “single-home.”¹⁵⁴

Non-discrimination rules represent a tremendous hurdle to the prevalence of consumer multi-homing. Consumers hold multiple networks' cards but are not using them; if merchants were free to offer price differences at the point of sale, even if very small, consumers might react.¹⁵⁵ If consumers were to successfully multi-home, they might exert significant price pressure on card networks, leading to a competitive reduction of interchange fees and a more measured balance of power between the two sides of the market.

Non-discrimination rules also prevent another form of competition that is less scrutinized. By forbidding merchants from discriminating on price based on the form of payment, these rules not only prevent card networks from competing, but also prevent merchants from competing on how they price these forms of payment.¹⁵⁶ In other words, eliminating non-discrimination rules would not only infuse competition among card networks, but it would lead to increased competition among merchants in how they price different forms of payment.¹⁵⁷

All of these criticisms, concerning both the overall structure of the interchange system and restrictive operating rules, suggest a resistance on the part of card networks to commoditize their card payment product.¹⁵⁸ Commoditization refers to a process whereby a product

¹⁵² See *supra* Part II.B.

¹⁵³ *Id.*

¹⁵⁴ Rysman, *supra* note 40, at 9-10.

¹⁵⁵ See Rysman, *supra* note 40, at 22 (“[M]any consumers maintain the ability to switch networks on short notice by keeping cards from multiple networks.”).

¹⁵⁶ Kitzman, *supra* note 149, at 2-3.

¹⁵⁷ See *id.*

¹⁵⁸ See Levitin, *supra* note 1, at 1360-63.

becomes undifferentiated and homogenous.¹⁵⁹ Industries featuring such products feature low profit margins and stiff competition.¹⁶⁰ The card payment industry features products that are essentially commodities—cards offer access to a checking account or a line of credit.¹⁶¹ However, issuers compete on factors like low introductory rates, balance transfer rates, and rewards—perks that are hard for consumers to quantify but maintain large back-end sources of revenue from interchange, which funds this product differentiation.¹⁶² To be fair, any rational business will fight the forces of commoditization and take efforts to differentiate its product by competing on brand image and other intangibles that may not confer any real value to consumers. However, when companies avoid commoditization, with the result being increased costs for all products across the board, are the business justifications overwhelmed by concerns for consumer welfare?

II. Potential Solutions

In the United States, intervention into the card payment industry has taken two very different, alternative forms: direct regulation of debit card interchange fees and antitrust lawsuits attacking restrictive operating rules. The Durbin Amendment, which establishes cost-based price ceilings on what card networks can charge merchants to process a debit transaction, takes the more extreme route in the form of regulatory price caps.¹⁶³ Alternatively, antitrust lawsuits from both the DOJ and private plaintiffs occupy a more free-market approach to intervention by eliminating certain anticompetitive behavior and utilizing competition-based motivations.¹⁶⁴ These two very different instances of intervention

¹⁵⁹ *Commoditize*, MERRIAM-WEBSTER DICTIONARY, <http://www.merriam-webster.com/dictionary/commoditize>.

¹⁶⁰ Levitin, *supra* note 1, at 1360.

¹⁶¹ *Id.*

¹⁶² *See id.* at 1360-61.

¹⁶³ *See* PRAGER ET AL., *supra* note 50, at 46 (“The most extreme form of . . . regulatory intervention would involve a regulator directly setting interchange fees . . .”).

¹⁶⁴ *See id.* at 43-46, 49. Some have suggested that the unilateral determination of interchange fees by the card networks is an antitrust violation and should be eliminated. *Id.* at 46. If this feature were eliminated, merchants and issuers would need to engage in one-on-one negotiation of interchange fees. This would not only result in large transaction costs, but issuers would likely demand much higher interchange fees, resulting in the likely demise of payment systems altogether. *See id.* Because such a change would result in the demise of payment systems, it would most likely not survive as an antitrust claim of price fixing due to pro-competitive justifications and is thus not discussed further in this Article. *See* Broadcast

provide an excellent vantage for which to compare and contrast alternative forms of regulation.

Prior to taking an in-depth look at the parameters and goals of these two different regulatory regimes, it is worth taking a moment to examine the critical differences between credit cards and debit cards and how those differences can impact the method of intervention. As an initial matter, the two products provide substantially different benefits to consumers. For one, debit cards are simply a form of access to a bank account.¹⁶⁵ Alternatively, credit cards give consumers access to credit.¹⁶⁶ Based on this reality, in at least some cases, when a consumer uses a credit card instead of a debit card, that consumer makes a purchase that she otherwise might not have made.¹⁶⁷ As a result, courts have considered the two products to be distinct and to occupy separate product markets for the purpose of antitrust law.¹⁶⁸ Therefore, the distinction between credit and debit cards is an important difference to keep in mind when selecting a suitable form of regulation, as merchants have less to gain from a debit product.

Another critical difference relates to the consumer's choice in picking a network. When a consumer maintains a debit card, the consumer's bank typically issues the card. Therefore, the consumer does not have any choice at all in what network its card is processed on.¹⁶⁹ Conversely, consumers are more likely to make a conscious choice

Music, Inc. v. Columbia Broadcasting Sys., Inc., 441 U.S. 1, 19-20 (1979). Indeed, the Southern District of Florida found that a centrally determined interchange fee was pro-competitive and essential to the functioning of Visa's system. *National Bancard Corp. v. Visa U.S.A., Inc.*, 596 F.Supp 1231, 1259-61 (S.D. Fla. 1984) (finding that a unilaterally determined interchange fee "eliminates the costly uncertainty and prohibitive time and expense of 'price negotiations at the time of exchange' between the thousands of VISA members") (internal quotation omitted), *aff'd*, 779 F.2d 592 (11th Cir. 1986).

¹⁶⁵ *Visa Debit/Check Card*, VISA, INC., <http://usa.visa.com/personal/cards/debit/index.html> (last visited June 8, 2013).

¹⁶⁶ *FRB: Consumers Guide to Credit Card*, BD. OF GOVERNORS OF THE FED. RESERVE SYS., <http://www.federalreserve.gov/creditcard/> (last visited June 8, 2013). Charge cards provide benefits similar to a credit card, as their user can access funds otherwise not available. See *What is a charge card?*, AM. EXPRESS CO., http://www.americanexpress.com/ireland/personal_cards/american_express_what_is_charge_card.shtml (last visited June 8, 2013).

¹⁶⁷ U.S. GOV'T ACCOUNTABILITY OFFICE, *supra* note 3, at 29.

¹⁶⁸ *In re Visa Check/MasterMoney Antitrust Litig.*, 2003 WL 1712568 (E.D.N.Y. Apr. 1, 2003), at *2-3, *6-7 (2003) (holding that debit and credit products are distinct for the purposes of a section 1 tying claims and that debit products occupy a distinct submarket for the purposes of section 2 claims of attempted monopolization or conspiracy to monopolize).

¹⁶⁹ Rysman, *supra* note 40, at 4-5.

when deciding which credit card account they wish to enroll in. However, it is unclear whether a consumer will choose their credit card based on the card network rather than the issuer, the interest rate, and what rewards are offered.¹⁷⁰ This “consumer choice” difference is slightly relevant to the concept of multi-homing.

A. *Direct Regulation: Price Ceilings on Interchange*

1. Durbin Amendment

The Dodd-Frank Wall Street Reform and Consumer Protection Act (“the Act”), enacted in response to the “Great Recession” of the late-2000s, was signed into law on July 21, 2010.¹⁷¹ The massive comprehensive enactment embodies the most significant overhaul of financial regulation in the United States since the Great Depression¹⁷² and was designed “[t]o promote the financial stability of the United States by improving accountability and transparency in the financial system, to end ‘too big to fail,’ to protect the American taxpayer by ending bailouts, [and] to protect consumers from abusive financial services practices.”¹⁷³ Only a few of the Act’s provisions were designed to become effective upon the enactment of the law, and its complete enactment requires a cache of regulatory agencies to conduct sixty-seven studies and draw up 243 different rules.¹⁷⁴

Among those provisions requiring some regulatory action is a little-discussed amendment that directly regulates credit and debit card transactions, “SA 3989,” colloquially known as the Durbin Amendment (“the Amendment”).¹⁷⁵ Senator Dick Durbin of Illinois introduced the Amendment on May 12, 2010, which the Senate approved in a 64-33 vote the following day.¹⁷⁶ With the exception of Senator Durbin’s own introduction of the Amendment, there was no floor discussion or debate.¹⁷⁷ As a result, the Amendment, which arguably had no place in

¹⁷⁰ See *id.* at 5-6.

¹⁷¹ Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010).

¹⁷² DAVIS POLK & WARDWELL, SUMMARY OF THE DODD-FRANK WALL STREET REFORM AND CONSUMER PROTECTION ACT, ENACTED INTO LAW ON JULY 21, 2010, at i (2010).

¹⁷³ 124 Stat. 1376 (2010).

¹⁷⁴ DAVIS POLK & WARDWELL, *supra* note 172, at i.

¹⁷⁵ 156 CONG. REC. S3651-52 (2010).

¹⁷⁶ 156 CONG. REC. S3703-05 (2010).

¹⁷⁷ See *id.*

Wall Street reform bill meant to avoid a future Great Recession,¹⁷⁸ passed along with the rest of the Act with little attention.¹⁷⁹

The Amendment modifies the Electronic Fund Transfer Act.¹⁸⁰ The Amendment contains two main provisions: (1) the Amendment provides the Federal Reserve System with rulemaking power to prescribe limitations on interchange fees to ensure that they “be reasonable and proportional to the cost incurred by the issuer,”¹⁸¹ and (2) the Amendment requires that debit cards allow for at least two networks to be available process a given transaction.¹⁸² In addition, the Amendment provides for a number of other small regulations that benefit merchants. The Amendment prohibits card networks from contractually barring merchants from offering discounts or in-kind incentives for using other forms of payment, though the incentives must not discriminate between cards on the basis of issuer or card network.¹⁸³ The Amendment also

¹⁷⁸ Senator Durbin himself recognized that many would regard the Amendment as out of place in the Act. 156 CONG. REC. S3696 (2010) (“A lot of people in Congress . . . have told me this is the wrong bill to talk about [debit fee reform].”).

¹⁷⁹ Nearly a year after the passage of the Amendment and after significant lobbying efforts, Senators Jon Tester (D-Mont.) and Bob Corker (R-Tenn.) offered an amendment to an unrelated act that would delay the implementation of the Durbin Amendment. Alexander Bolton, *Senate Readies for Showdown in K Street Battle Over Rules on Debit-card Fees*, THE HILL (June 8, 2011), available at <http://thehill.com/blogs/floor-action/senate/165379-senate-readies-for-showdown-in-years-biggest-k-street-battle>. However, the so-called Tester-Corker Amendment failed to achieve the sixty votes needed for adoption. Claude R. Marx, *Senate Rejects Interchange Cap Delay*, CREDIT UNION TIMES (June 8, 2011), available at <http://www.cutimes.com/2011/06/08/senate-rejects-interchange-cap-delay>.

¹⁸⁰ Pub. L. No. 111-203 § 1084, 15 U.S.C. § 1693 et. seq. (2006) (“Amendments to the Electronic Fund Transfer Act.”).

¹⁸¹ 15 U.S.C. § 1693o-2(a)(2) (2006). Notably, this provision excludes “small issuers,” that is issuers with assets less than \$10 billion. 15 U.S.C. § 1693o-2(a)(6) (2006). This exemption has witnessed a lot of criticism, mainly due to skepticism as to its effectiveness in protecting small issuers. Silla Brush, *Bernanke Says Fed Uncertain on Small-Bank “Swipe” Fee Exemption*, BLOOMBERG-BUSINESSWEEK (Feb. 17, 2011), available at <http://www.businessweek.com/news/2011-02-17/bernanke-says-fed-uncertain-on-small-bank-swipe-fee-exemption.html>. In fact, the small bank exemption has even led to a constitutional challenge, albeit unsuccessful. See *TCF Nat. Bank v. Bernanke*, 643 F.3d 1158 (8th Cir. 2011) (affirming trial court’s denial of a preliminary injunction on the basis that disparate impact, equal protection claim was unlikely to succeed on the merits). In addition, the interchange fee restrictions exempt government-administered payment programs and reloadable prepaid cards under 15 U.S.C. § 1693o-2(a)(7), and allow the Fed to make an adjustment to whatever cap it sets for fraud prevention costs under 15 U.S.C. § 1693o-2(a)(5).

¹⁸² See Pub. L. 111-203, § 1075, 124 Stat. 1376 at 2068-73 (codified at 15 U.S.C. §§ 1693p, 1693q (2006)).

¹⁸³ Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203,

prohibits card networks from enforcing rules that forbid merchants from requiring a minimum transaction amount on a credit card transaction.¹⁸⁴

The first main provision vests power in the Federal Reserve to regulate interchange fees so they are reasonably related to the costs incurred by issuers in providing such services. Following the enactment of the Act, the Federal Reserve began meeting with industry participants.¹⁸⁵ In September 2010, the agency solicited industry data by distributing surveys to issuers and card networks to determine the costs associated with a typical transaction.¹⁸⁶ Using this information, the agency proposed a set of rules and requested comments on the proposed rules.¹⁸⁷ Those proposed rules, relying on a great deal of information and influence from the networks and issuers, allowed for a maximum interchange fee of \$0.12.¹⁸⁸ The Federal Reserve noted that a cap of \$0.12 would allow a majority of issuers to recoup the non-fixed costs of a transaction,¹⁸⁹ which when averaged across issuers was estimated to be \$0.13.¹⁹⁰ In July 2011, the Fed put forth final rules. Suddenly, the Fed reversed positions and determined the maximum allowable interchange rate to be \$0.21 plus five basis points of the transaction amount—roughly double the original proposed amount.¹⁹¹

§ 920(b)(2), 124 Stat. 1376 (2010). This means that the card networks can no longer bar *all* discounts as was previously the practice, *see supra* Part II.C.; however, discounting between cards from the issuer (i.e., no-frills versus premium rewards) and from different networks (i.e., Visa versus MasterCard) can still be prohibited. Thus, this provision of the Amendment does little to inject competition between card networks or deter inefficient rewards cards.

¹⁸⁴ Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 920(b)(3), 124 Stat. 1376 (2010).

¹⁸⁵ 75 Fed. Reg. 81,722, 81,724 (2010).

¹⁸⁶ *Id.* at 81,724, 81,725.

¹⁸⁷ *Id.* at 81,722.

¹⁸⁸ *Id.* at 81,755.

¹⁸⁹ *Id.* at 81,737.

¹⁹⁰ *Id.*

¹⁹¹ 76 Fed. Reg. 43,394, 43,467 (2011). The Federal Reserve estimated that the typical interchange fee will be \$0.24 on an average transaction of \$38—exactly double the original estimate. Press Release, BD. OF GOVERNORS OF THE FED. RESERVE SYS. (June 29, 2011), *available at* <http://www.federalreserve.gov/newsevents/press/bcreg/20110629a.htm>. The agency, in computing the \$0.21 fixed rate, determined the “per-transaction allowable cost . . . of the issuer at the 80th percentile.” 76 Fed. Reg. at 43,422. Therefore, the Federal Reserve largely determined the appropriate interchange rate by selecting a cost figure at the very high range based on survey results from issuers. *See id.* Nowhere does the agency acknowledge that issuers may have had an interest in bloating the costs they submitted in the survey.

In addition to capping interchange fees, the Amendment's second main provision requires the Fed to make rules that require issuers to enable debit cards to be processed on more than one network—in other words, a rule prohibiting network exclusivity.¹⁹²

2. Critical Review of Direct Regulation

This form of direct regulation of fees constitutes a price cap.¹⁹³ While such forms of regulation will always be decried by some as less preferable to free-market determinations of price,¹⁹⁴ others have recognized price caps as conducive to measured benefits. For one, price caps tend to encourage companies to reduce costs and become more efficient.¹⁹⁵ By setting a ceiling on how much an issuer can earn from interchange, such regulation encourages issuers to improve operations in order to earn additional revenue.¹⁹⁶ Indeed, there is empirical evidence that the telecommunications industry, which has used price caps, experienced efficiency gains through network modernization without any detriment to the financial performance of businesses.¹⁹⁷ Many of the same benefits have also been recognized in regulated electricity markets.¹⁹⁸ Moreover, this form of regulation is simple and cheap from an administrative perspective, as all parties involved—issuers, networks, and regulators—are required to do little to be in compliance.¹⁹⁹

This kind of regulation is likely to shift some of the costs associated with card payment transactions onto consumers and reduce some of the positive network effects associated with two-sided markets.

¹⁹² 76 Fed. Reg. at 43,468. This provision may also have a major impact on how debit transactions are processed and what kind of interchange fee is levied. However, because caps on debit interchange fees will likely have a greater impact and the consequences of a mandating multiple network processing are less certain, this second provision is largely beyond the scope of this Article.

¹⁹³ See Paul L. Joskow, *Incentive Regulation and Its Application to Electricity Networks*, 7 REV. OF NETWORK ECON. 547, 552-53 (2008).

¹⁹⁴ See, e.g., Richard A. Epstein, *The Regulation of Interchange Fees: Australian Fine-Tuning Gone Awry*, 2005 COLUM. BUS. L. REV. 551, 596-97 (2005) (“[D]on’t mess with success.”).

¹⁹⁵ See 75 CFR Part 235, at 81,738.

¹⁹⁶ See *id.*

¹⁹⁷ JAISON R. ABEL, *THE PERFORMANCE OF STATE TELECOMMUNICATIONS INDUSTRY UNDER PRICE-CAP REGULATION: AN ASSESSMENT OF THE EMPIRICAL EVIDENCE*, at iv (2000).

¹⁹⁸ Joskow, *supra* note 193, at 548.

¹⁹⁹ 75 Fed. Reg. at 81,738; PRAGER ET AL., *supra* note 50, at 47.

Because merchant fees will be reduced,²⁰⁰ rewards to consumers will be reduced and costs to consumers will likely increase.²⁰¹ As cards become less attractive, card usage should decline despite the likelihood of increased merchant acceptance.²⁰² Arguably, this regulation does not fully take into account the nature of two-sided markets.²⁰³ And in fact, many have criticized the Amendment for shifting costs to consumers.²⁰⁴

However, these same arguments against price caps—that consumers will bear additional costs and card usage may decline—can be used to argue this sort of restriction on interchange fees is precisely the answer to the problems created by payment cards and two-sided markets. By limiting the amount of interchange that networks can charge merchants, issuers will be forced to charge consumers for the services associated with payment cards if they cannot recoup their costs on the capped interchange fees.²⁰⁵ If the benefits to consumers from debit card transactions outweigh the benefits to merchants, then a higher incidence of cost should fall to consumers. Further, if the cost burden is placed on consumers, issuers will be forced to compete more vigorously because consumers are more price-sensitive. Moreover, at present consumers are already shouldering much of this cost in the form of higher prices, only without realizing it.²⁰⁶

We need not consider these effects on only a theoretical level. Indeed, banks have already attempted to shift costs to consumers. Most infamous is Bank of America's ("BoA") much-touted \$5 per month surcharge for debit card users,²⁰⁷ which BoA dropped after customers responded with overwhelming negative feedback.²⁰⁸ The BoA episode presents an excellent illustration of the principles behind two-sided markets and general features of the payment card industry.

²⁰⁰ Because merchant acquirers are competitive, *see supra* Part II.A., a reduction in interchange should reduce the merchant discount. *See PRAGER ET AL., supra* note 50, at 47.

²⁰¹ PRAGER ET AL., *supra* note 50, at 47.

²⁰² *Id.*

²⁰³ *See generally* Epstein, *supra* note 194.

²⁰⁴ Sen. Bob Corker, *Durbin Amendment Backfires*, Opinion, POLITICO (Oct. 25, 2011, 9:26pm), available at <http://www.politico.com/news/stories/1011/66806.html>.

²⁰⁵ *See PRAGER ET AL., supra* note 50, at 47.

²⁰⁶ *See supra* Part I.D.1.

²⁰⁷ Shanthi Bharatwaj, *Bank of America Slaps \$5 Monthly Fee on Debit*, THE STREET (Sept. 29, 2011), <http://www.cutimes.com/2011/06/08/senate-rejects-interchange-cap-delay>.

²⁰⁸ Dan Fitzpatrick & Robin Sidel, *BoFA Retreats on Debit Fee, Citing Uproar*, WALL ST. J. (Nov. 1, 2011), <http://online.wsj.com/article/SB10001424052970204528204577011813902843218.html>.

Aside from any cost shifting effects stemming from price regulation, the Durbin Amendment may be insufficient to carry out its intended effects. Under current law, card networks may be able to introduce new fees that, at best, offset their lost revenue from the regulation and, at worst, avoid the regulation altogether. Originally, in July 2011, following the Fed's issuance of final rules, Visa announced that it would be restructuring how it charges fees on all payment cards within its network.²⁰⁹ Without revealing the specifics of its intentions, Visa said it would move away from transactions-based fees and opt for a new "participation fee," or a monthly fee charged to acquirers.²¹⁰ Ultimately, the company renamed the fee the Fixed Acquirer Network Fee ("FANF").²¹¹ The amount of the fee would be based on the number and character of the merchants that the acquirer processes.²¹² Presumably, acquirers will pass the fee onto merchants as they have done previously with interchange fees.²¹³ The FANF was touted as an opportunity for merchants to reduce their total swipe fees on a per unit basis. By presenting a fixed cost to merchants, the network is providing an incentive to process additional card transactions.²¹⁴ In reality, however, the fee is simply an additional cost for merchants in addition to the fees that Congress tried to cap. The drafters of the Durbin Amendment partially anticipated such attempts to avoid its regulation of fees, as it prohibited card networks from using its network fee as a rebate to compensate issuers.²¹⁵ However, by implementing a monthly fee, Visa would avoid any such restriction.²¹⁶ Visa has said that DOJ is investigating the antitrust implications of the fee.²¹⁷

²⁰⁹ Joe Rauch, *Visa Rolls Out New Fee Program*, REUTERS (July 27, 2011), <http://www.reuters.com/article/2011/07/28/us-visa-idUSTRE76Q6D020110728>.

²¹⁰ *Id.*

²¹¹ *See Visa to Launch New Acquirer Fee in April that Could Run Up to Big Numbers*, DIGITAL TRANSACTIONS, Feb. 23, 2012, <http://www.digitaltransactions.net/news/story/3439>.

²¹² *Id.*

²¹³ *Id.*

²¹⁴ *Visa's New Participation Fee: Analysts View*, INT'L BUS. TIMES, July 28, 2011, <http://www.ibtimes.com/visas-new-participation-fee-analysts-view-819191>.

²¹⁵ *See* 5 U.S.C. § 1693o-2(a)(8)(B) (2006) (empowering the Federal Reserve Board to regulate fees paid to card networks insofar as necessary to prevent its use as means to compensate issuers and circumvent the regulation).

²¹⁶ In the context of two-sided market theory, such a fee is referred to as a "membership fee," rather than a usage fee.

²¹⁷ Kate Fitzgerald, *Justice Department Probes Visa Acquirer Fee*, ISO & AGENT (May 4, 2012),

In addition, the card networks have expressed that they are not going to comply with the spirit of the regulation. For example, both Visa and MasterCard have intimated that they will charge the highest possible interchange rate that they can on all transactions, even if the interchange fee would have been less under the old regime.²¹⁸ This means that on a small ticket item, which would have incurred a small interchange fee under the old percentage-only fee (e.g., a fee of roughly six cents for a five dollar purchase), the card networks will impose the Fed's maximum fee allowable by law of \$0.21 plus five basis points. This policy will disproportionately hurt merchants who sell large quantities of small ticket items to a large extent.²¹⁹ Businesses that sell only small dollar amount items will feel a massive dent in their profit margins.²²⁰

In response to Visa and MasterCard's expressed intent to charge higher fees on lower priced items combined with the Fed's dilution of their original interchange fee cap of \$0.12, merchants have brought action against the Fed for failing to follow the spirit and intent of the Durbin Amendment.²²¹ The suit brings action against the Fed under the Administrative Procedure Act, alleging that the Fed put forth a rule that "exceeds the statutory authority delegated to [it] by the Durbin Amendment and is an unreasonable interpretation of the statute."²²² At the time of the writing of this Article, summary judgment motions were filed and pending.²²³

Regardless of concerns about avoidance of the Durbin Amendment and the capping of debit card fees, the suitability of price caps in the context of credit cards is up for debate. For one, credit cards involve

http://www.isoandagent.com/news/doj_visa_investigat_saunders_durbin_acquir_fee_debit_justice-3010587-1.html.

²¹⁸ Dakin Campbell & Donal Griffin, *Visa, MasterCard Risk 'Mom and Pop' Ire With Debit-Fee Increase*, BLOOMBERG (Sept. 23, 2011), <http://www.bloomberg.com/news/2011-09-23/visa-mastercard-risk-mom-and-pop-ire-with-debit-fee-increase.html>.

²¹⁹ *Id.*

²²⁰ *See id.*

²²¹ Press Release, National Restaurant Association, *National Restaurant Association Joins Suit Against Federal Reserve for Failure to Follow Congressional Intent on Swipe Fee Reform* (Mar. 8, 2012), available at <http://www.restaurant.org/pressroom/pressrelease/?id=2237>.

²²² Complaint at 3, *NACS v. Bd. of Governors of the Fed. Reserve Sys.*, No. 11-cv-02075 (D.D.C. Nov. 22, 2011), ECF No. 1.

²²³ *See, e.g.,* Motion for Summary Judgment, *NACS v. Bd. of Governors of the Fed. Reserve Sys.*, No. 11-cv-02075, (D.D.C. Mar. 2, 2012), ECF No. 22.

many more price points—membership fees, interest charges, introductory rates, and increased rewards. Because credit cards have so many more opportunities for issuers to generate revenue, any direct regulation of interchange will fall prey to the same issues that are plaguing the Durbin Amendment, only with greater ease. Issuers, instead of relying on the card networks to come up with new sources of revenue to replace inflated interchange fees, can merely fine-tune rates and fees on the consumer side.

B. Competition-Based Intervention

1. Antitrust Lawsuits

Over the last three decades, the card payment industry has been the subject of intensive antitrust scrutiny, both by DOJ and by private plaintiffs, with the brunt of that scrutiny being directed at Visa, MasterCard, and to a lesser extent American Express. The majority of this litigation has focused on potential restraints arising from the card networks' governance structure, interchange fees, and anticompetitive effects arising out of merchant restraints.

Card networks' use of interchange was challenged as early as the mid-1980s. In *National Bancard Corp. v. Visa U.S.A., Inc.*, an acquiring bank brought suit alleging that Visa's unilateral setting of interchange rates was a restraint of trade in violation of section 1 of the Sherman Act.²²⁴ Reviewing the trial court's ruling for Visa, the Eleventh Circuit affirmed, holding that interchange was not a naked restraint of trade and thus not subject to a per se review under Sherman Act jurisprudence.²²⁵ Notably, the court did not disturb the lower court's finding that the relevant product market consisted of all forms of payment—including cash, checks, and ATM cards—and thus Visa did not possess market power at roughly five percent market share.²²⁶ The court held that a centrally determined interchange fee is an ancillary restraint on competition and possessed net pro-competitive justifications: “it [is] necessary to achieve stability and thus ensure the one element vital to the survival of the VISA system—universal acceptance.”²²⁷ As a result,

²²⁴ *Nat'l Bancard Corp. (NaBanco) v. VISA U.S.A., Inc.*, 596 F.Supp 1231, 1236 (S.D. Fla. 1984).

²²⁵ *Nat'l Bancard Corp. v. Visa U.S.A., Inc.*, 779 F.2d 592, 603 (11th Cir. 1986).

²²⁶ *Id.* at 604.

²²⁷ *Id.* at 605.

at an early stage, the payment card networks possessed judicial recognition of pro-competitive justifications for interchange.

Card networks have also become the subject of competition law scrutiny as a result of their corporate structures. In the 1998 case *United States v. Visa U.S.A., Inc.*, the DOJ initiated suit against MasterCard and Visa alleging that their structures, then consisting of joint ventures among their member banks (issuers), resulted in collusion or price fixing in the determination of interchange fees.²²⁸ While the DOJ was unable to show a section 1 violation on the basis of the networks' structure, the presence of such scrutiny likely played a role in the two card networks ultimately altering their structure and going public.²²⁹ By going public and instituting a board of non-interested directors to set interchange, the two networks will now likely impede any allegation of collective price determination.²³⁰

The contractual restraints that card networks have placed on merchants have also been the subject of antitrust scrutiny. Private plaintiffs, consisting of both a class of merchants and individual merchants, instituted a suit in 1999 attacking the card networks' policy of tying credit products together with signature debit products through the honor-all-cards rules.²³¹ On the eve of trial, the card networks, perhaps sensing a poor likelihood of success,²³² settled with the plaintiffs for \$3.4 billion, the largest antitrust settlement in history.²³³ In addition

²²⁸ Complaint at 2, *United States v. VISA U.S.A. Inc.*, 1998 WL 34256236 (S.D.N.Y. Oct. 7, 1998). In addition to the DOJ's assertion of collusion on price, the suit also asserted section 1 Sherman Act violations on the basis that card networks' operating agreements prevented issuers from also issuing cards with American Express and Discover. *Id.* The elimination of these rules by the court likely led to an increase in interchange fees and additional competition on the issuer side of the market. *See supra* Part III.

²²⁹ *See Levitin, supra* note 1. Following the DOJ's action, Discover instituted its own private suit under the same set of facts, which, after the Southern District collaterally estopped the defendants from disputing the findings of the previous suit, resulted in a large monetary settlement to the tune of \$2.75 million. *Discover Fin. Serv. v. Visa U.S.A., Inc.*, 598 F.Supp.2d 394, 401 (S.D.N.Y. 2008); Stipulation & Order of Dismissal, *Discover Fin. Serv.*, 598 F.Supp. 2d 394 (No. 98-cv-07076).

²³⁰ *See Levitin, supra* note 1.

²³¹ Second Amended Complaint, *In re Visa Check/MasterMoney Antitrust Litig.*, 1999 WL 34848247 (E.D.N.Y. May 26, 1999).

²³² Some commentators have indicated that the mere prospect of a potential judgment of the size in question being awarded to the class, along with the trebling provision of the Clayton Act, prompted the defendants to settle.

²³³ *In re Visa Check/MasterMoney Antitrust Litig.*, 297 F. Supp.2d 503 (E.D.N.Y. 2003), *aff'd sub nom*, *Wal-Mart Stores, Inc. v. Visa U.S.A., Inc.*, 396 F.3d 96, 101 (2d Cir. 2005), *cert. denied sub nom*, 125 S. Ct. 2277 (2005).

to the massive monetary settlement, the card networks agreed to injunctive relief, which barred them from instituting similar honor-all-cards rules that tied credit and debit products together in the future.²³⁴ In contrast to the court's decision in *Bancard*, in this case the court determined that debit cards and credit cards occupied distinct, separate markets and the relevant market did not consist of all forms of payment.²³⁵

No-discrimination rules have also been challenged by both private plaintiffs and the DOJ. In 2006, various private plaintiffs' lawsuits against Visa, MasterCard, and major issuing banks were consolidated in the Eastern District of New York.²³⁶ These suits, in a slew of section 1 and section 2 claims, attack the card networks' old corporate structure, interchange fees generally, non-discrimination rules, and other network rules that bundle processing services. The plaintiffs claim that the card networks used these tactics to inflate interchange fees.²³⁷ As of the writing of this Article, a settlement between the defendants and class had received preliminary approval.²³⁸ However, numerous class members, including large merchants such Starbucks and Wal-Mart and large retail trade associations, have opted out of the settlement contending that the relief provided in the agreement is not sufficient in light of the releases from future litigation provided to the card networks.²³⁹ Primarily, that settlement agreement provides an estimated \$7.25 billion of relief for class plaintiffs in the form of both cash and interchange abatements.²⁴⁰

²³⁴ *Id.* at 508.

²³⁵ *In re Visa Check/MasterMoney Antitrust Litig.*, 2003 WL 1712568, at *3, *7 (E.D.N.Y. Apr. 1, 2003).

²³⁶ *In re Payment Card Interchange Fee and Merch. Disc. Antitrust Litig.*, 562 F.Supp.2d 392, 395 (E.D.N.Y. 2008).

²³⁷ First Consol. Amended Class Action Complaint, *In re Payment Card Interchange Fee and Merch. Disc. Antitrust Litig.*, 562 F. Supp. 2d 392 (E.D.N.Y. 2008).

²³⁸ *See Class Settlement Preliminary Approval Order, In re Payment Card Interchange Fee and Merch. Disc. Antitrust Litig.*, 562 F. Supp. 2d 392 (E.D.N.Y. 2008) ECF No. 1745.

²³⁹ David McLaughlin, *Wal-Mart Among Retailers Quitting Visa, MasterCard Deal*, BLOOMBERG (May 21, 2013 4:58 PM), <http://www.bloomberg.com/news/2013-05-21/wal-mart-among-retailers-opting-out-of-visa-mastercard-deal.html>; Andrew Longstreth, *Opt-outs of \$7.2 Billion Credit Card Fee Settlement Face Risks*, THOMPSON REUTERS (June 10, 2013), [http://newsandinsight.thomsonreuters.com/Legal/News/2013/06_-_June/Opt-outs_of_\\$7_2_bln_credit_card_fee_settlement_face_risks/](http://newsandinsight.thomsonreuters.com/Legal/News/2013/06_-_June/Opt-outs_of_$7_2_bln_credit_card_fee_settlement_face_risks/).

²⁴⁰ Christie Smythe, *Visa, MasterCard \$7.25 Billion Fee Deal Wins Approval*, BLOOMBERG NEWS (Nov. 10, 2012), <http://www.businessweek.com/news/2012-11-09/visa-mastercard-fee-deal-falls-too-short-retailers-claim>. The agreement also removes many non-

In addition, the DOJ has also instituted actions against Visa, MasterCard, and American Express attacking non-discrimination rules.²⁴¹ In July 2011, the two four-party-network defendants, Visa and MasterCard, agreed to the DOJ's proposed judgment, which was filed simultaneously with the DOJ's complaint, and the court approved.²⁴² The agreement provides significant relief through the prohibition of non-discrimination rules.²⁴³ However, American Express has decided to continue with the litigation.²⁴⁴ This is likely due to the fact that American Express will be hurt the most by the elimination of non-discrimination rules. This is because their cards have the highest rewards, and consequently, the highest interchange fees.²⁴⁵ However, Visa and MasterCard's consent to eliminating the non-discrimination rules is only a minor victory until American Express follows suit. This is because, as long as American Express holds out, any merchant that accepts American Express will still be unable to steer customers towards one card over another and inject competition among the networks—that is, elimination of Visa's no-discrimination rules does nothing to affect American Express's no-discrimination rules.²⁴⁶

2. Critical Review of Competition-Based Intervention

Attempts to alter the card industry through antitrust litigation have had varying results. While industry modifications brought through injunctive relief or consent decrees can sound highly effective in the abstract, they can also have unintended consequences, such as in the case of *United States v. Visa U.S.A., Inc.*²⁴⁷ In contrast, the elimination of the honor-all-cards rule, with respect to debit and credit products, has arguably been quite successful—its removal forced interchange on

discrimination rules; however, this relief is coincident with Visa and MasterCard's agreement with the DOJ to remove non-discrimination rules. *See infra* text accompanying notes 240-42.

²⁴¹ Complaint for Equitable Relief for Violation of Section 1 of Sherman Act, *United States v. Am. Express Co.*, No. 10-cv-04496, 2010 WL 5594629 (E.D.N.Y. Dec. 21, 2010), ECF No. 64.

²⁴² *United States v. Am. Express Co.*, No. 10-cv-04496, 2011 WL 2974094 (E.D.N.Y. July 20, 2011), ECF No. 180.

²⁴³ *Id.*

²⁴⁴ At the time of the writing of this Article, the suit was in discovery.

²⁴⁵ *See Levitin, supra* note 1, at 1341.

²⁴⁶ Kitzman, *supra* note 149, at 4-5.

²⁴⁷ *See supra* Part III.B.1.

signature debit products to decline drastically.²⁴⁸

In addition, antitrust actions against card networks have embodied a variety of forms and have the potential to effect a significant number changes to the industry's landscape.²⁴⁹ As a result, it is an effective strategy to focus on one or two. The elimination of non-discrimination rules, which could be eradicated easily, as demonstrated in the DOJ's consent decree with Visa and MasterCard,²⁵⁰ has great potential for infusing competition into the merchant side of the two-sided market. Their elimination will force card networks to compete among consumers on payment choice and enable consumers to exercise "multi-homing power."²⁵¹ Due to the potential that this reform possesses, this Article confines itself to the analysis of the elimination of non-discrimination rules and other similar non-steering provisions.

Regardless of concerns regarding unintended consequences, from a theoretical standpoint, the elimination of merchant restraints, in effecting greater competition amongst card networks, possesses a great deal of merit. Merchants possess little market power towards influencing interchange fees, and consumers—with highly elastic demand—have the potential to have a great deal of influence. Therefore, by eliminating merchant restraints and placing the critical choice among competitors in the hands of consumers, antitrust enforcement has the potential to bring interchange rates in line with what they would be in a competitive market, or at least closer.²⁵²

From a practical standpoint, antitrust methods of altering the industry suffer from a number of criticisms. For one, consumers may not react to surcharges or discounts in some situations. For example, many consumers use credit cards, not because they offer a low cost form of payment, but because they offer the extension of credit, allowing consumers to make purchases they would not otherwise make or permitting them to pay off a large purchase off in increments.²⁵³ Also, even if merchants are permitted to discount, a number of factors might

²⁴⁸ *Id.*

²⁴⁹ See 15 U.S.C. § 16(e) (2006) (Clayton Act allows consent decrees to take any form so long as they are "in the public interest").

²⁵⁰ United States v. Am. Express Co., No. 10-cv-04496, 2011 WL 2974094 (E.D.N.Y. July 20, 2011), ECF No. 180.

²⁵¹ See *supra* Part II.D.2.

²⁵² See *supra* Part II.D.2.

²⁵³ See *supra* Part III.

keep them from doing so. The reluctance to implement a multi-tiered price structure on the basis of cost will certainly be a deterrent. In addition, merchants might have difficulty identifying which cards incur which interchange fees in order to determine what the discount on the price might be.²⁵⁴

A far larger concern lies in the potential retaliatory action card networks might take against those merchants who decide to implement discounting. Many merchants fear the card networks.²⁵⁵ In fact, merchants have already indicated that card networks have used methods of economic coercion to prevent merchants from taking advantage of the availability to discriminate between cards, in the form of the withholding of preferable rates.²⁵⁶ In addition, in the case of small merchants, the card networks might be inclined to withdraw from servicing merchants who decide to discount. Merchants that find themselves the subject of such retaliation will only have the courts as a remedy and bringing antitrust actions can be prohibitively expensive.²⁵⁷ Also, large retailers might prefer to leverage their bargaining power with the card networks to negotiate lower interchange rates for only themselves, rather than utilize discounting to engage competitive forces and lower interchange rates for the entire merchant community.

CONCLUSION

Both antitrust law and direct regulation of interchange fees possess a great deal of potential in effectuating actual improvements to the flawed structure of card payment transactions. However, both methods—at least in practice—have failed to do so in the execution stage. The Durbin Amendment, through its implementation by the Fed,

²⁵⁴ Visa and MasterCard have indicated that they are developing systems that will help merchants to execute this. See Jeffrey I. Shinder, *Latest Anti-Durbin Amendment is Desperate and Absurd*, AM. BANKER (June 20, 2011), available at <http://www.americanbanker.com/bankthink/Durbin-Desperate-Shinder-1039151-1.html>. However, whether this system will result in additional costs or delays remains to be seen. See *id.*

²⁵⁵ See Andrew Martin, *How Visa, Using Card Fees, Dominates a Market*, N.Y. TIMES (Jan. 4, 2010) (highlighting data that showed rising interchange fees, which was provided by a “large retailer, who requested anonymity to preserve its relationship with Visa”).

²⁵⁶ See *In re Payment Card Interchange Fee and Merch. Disc. Antitrust Litig.*, 562 F.Supp.2d 392, 396 (E.D.N.Y. 2008).

²⁵⁷ In addition, those on the enforcement side of antitrust can often find themselves in the difficult position of having to convince a company to pursue such action or assist them in such a pursuit.

2013]

REGULATION OR COMPETITION?

347

has led to watered-down rules with abundant loopholes for the card networks. The elimination of no-discrimination rules through antitrust action—at least at this early stage—has yet to lead to effective intervention; its efficacy depends on the results of pending litigation.

As a result, any future intervention, whether through legislation or court settlement, must be forceful and impermeable. Card networks have proven themselves to be very adept at avoiding regulation. This opportunity for avoidance is largely a byproduct of the inherent characteristics of the card payment industry—revenue generation involves complicated transfer payments between closely associated parties. Therefore, future intervention must contemplate these characteristics and include stronger provisions that punish avoidance.