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COMPETITION COMMITTEE**

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**Working Party No. 2 on Competition and Regulation**

**ROUNDTABLE ON COMPETITION AND EFFICIENT USAGE OF PAYMENT CARDS**

**-- United States --**

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1. Payment cards are ubiquitous in the United States. Last year, U.S. card issuers mailed an estimated 3 billion credit card solicitations.<sup>1</sup> As the number of cards and transaction volume have grown, so have interchange fees in most payment categories.<sup>2</sup> And so have the legal challenges to the card associations' conduct. In the United States, there are numerous antitrust challenges to the Visa and MasterCard bank card associations, with merchants now challenging the associations' interchange fees and various association rules. A similar challenge to Visa's interchange fees failed in the early 1980s. But the merchants in the pending litigation argue that changes in the industry and the legal landscape have eroded the persuasiveness of that ruling. Meanwhile, debit cards have experienced explosive growth in the U.S. And Visa has garnered a significant share of debit payment card volume as a result of issuing agreements it entered with many of the largest banks in which those banks dedicate significant debit volume to Visa. The one constant in this industry is change.

## 1. The Payment Card Industry in The U.S.

2. There are four different types of general purpose payment cards in the United States: (1) credit cards; (2) charge cards;<sup>3</sup> (3) Signature debit cards (also called off-line debit cards); and (4) PIN debit cards (also called on-line debit cards). While U.S. consumers can pay for goods and services using cash or checks, they are increasingly using payment cards for these purposes. By 2001, 76% of U.S. households held at least one general purpose credit card, and usage of such cards accounted for almost 20% of U.S. personal consumption expenditures.<sup>4</sup> Today, almost 700 million general purpose credit cards are now in circulation in the U.S.<sup>5</sup>

3. An even more recent phenomenon is the explosive growth of debit cards in the United States. The Federal Reserve recently reported that consumer use of debit cards surpassed general purpose credit card use for the first time in 2003, and it estimated that the number of debit transactions would grow by 20% from 2003 to 2004.<sup>6</sup> There are two types of debit cards in the United States: PIN and Signature. Most U.S. checking account holders are issued a debit card that can access their account, both for cash withdrawals at ATM machines and for consumer payments at the point of sale. At the point of sale, the debit card can typically access the cardholder's account through one or more PIN debit networks and

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<sup>1</sup> Laura Leist, *Paper: Attack the Stack, Emerge Victor*, SEATTLE POST-INTELLIGENCER, Apr. 15, 2006, at 4.

<sup>2</sup> Interchange fees are set by the associations' board of directors, which are comprised primarily of the banks that issue cards to card holders ("issuing banks"). These fees are paid, indirectly, to the issuing banks by merchants who accept the cards as a means of payment. The fees vary by, *inter alia*, merchant category and type of payment card.

<sup>3</sup> General purpose charge cards, such as the American Express "green card," are accepted by a variety of merchants and require the card holder to pay the full statement amount upon receipt of the statement, thus extending credit to a card holder for only about a month. General purpose credit cards, such as a Visa or MasterCard bank card, allow the card holder to pay only a small portion of the total amount charged on the card during the statement period, and thus allow a card holder to access extended credit for a prolonged period of time. Together, credit and charge cards are sometimes referred to as "general purpose cards." Because general purpose cards are accepted by a variety of unrelated merchants, they are fundamentally different from proprietary merchant cards that are only accepted at a single merchant's store locations.

<sup>4</sup> Tom Brown & Lacey Plache, *Paying With Plastic: Maybe Not So Crazy*, 73 U. CHI. L. REV. 63 (2006).

<sup>5</sup> Robin Sidel, "Credit-card issuers' problem: people are paying bills" THE WALL STREET JOURNAL, May 25, 2006.

<sup>6</sup> BD. OF GOVERNORS OF THE FED. RESERVE SYS., REPORT TO THE CONGRESS ON THE DISCLOSURE OF POINT-OF-SALE DEBIT FEES (2004) [hereinafter FED REPORT], *available at* <http://www.federalreserve.gov/boarddocs/rptcongress/posdebit2004.pdf>. *See also* Michael Jalili, *Debit Use May Top Cash and Checks This Year*, AMERICAN BANKER, May 25, 2006, at 5 (MasterCard executive indicating debit volume may exceed cash and check volume in 2006).

through the Visa and/or MasterCard networks. The networks over which a debit transaction can be routed are designated by trademarks (called “bugs” or “flags”) that appear on the card. Signature debit card transactions are authenticated by the consumer signing the transaction receipt, allowing the cashier to compare the signature on the receipt to the signature on the debit card. Signature debit transactions are routed over the Visa or MasterCard credit card payment networks, and thus almost all merchants that accept their credit cards also accept their Signature debit products.<sup>7</sup> Accordingly, U.S. consumers can use a Signature debit card virtually “everywhere [they] want to be.” In contrast, PIN debit transactions are authenticated through the consumer typing a Personal Identification Number into a merchant terminal. In order to accept a PIN debit card, a merchant must install a PIN pad terminal that allows customers to enter their PIN number. Although PIN acceptance has grown, it has not achieved anywhere near the same level of acceptance as Visa’s and MasterCard’s Signature debit products.

4. There are a number of parties and fees involved in each payment card transaction. To analyze the relative costs/benefits of various means of payment, we can focus on three parties: the cardholder, the issuing bank, and the merchant.<sup>8</sup> Most payment card networks charge both the merchant acquirer and the issuing bank a “switch” fee for the network switching services provided by the network and set an “interchange” fee.<sup>9</sup> For a PIN debit transaction, the interchange fee is typically at least four to five times as large as the switch fee, and the Signature interchange fee can be significantly larger than the PIN interchange fee.<sup>10</sup> The disparity is even larger between PIN debit and general purpose card interchange fees.

5. From the cardholder’s perspective, there is virtually no difference in cost between the three main payment card options. An exception to this general rule, however, is that some banks charge their customers a fee for each PIN debit point of sale transaction. Cardholders may also derive significant benefits, such as airline miles or other rewards points, if they choose to conduct a transaction using their credit card or, in some instances, their Signature debit card.

6. From the issuing bank’s perspective, as a general matter, the amount of revenue generated by a cardholder’s choice of payment card for a transaction, from most to least, is: credit, Signature debit, and PIN debit. Credit card transactions generate the most revenue for issuers for two reasons. First, the interchange fee is higher for credit than it is for debit. Second, the cardholder frequently chooses to pay less than the full amount due, leading the cardholder to pay the issuer interest payments at relatively high

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<sup>7</sup> Since the settlement of the *Wal-Mart* class action litigation, merchants that accept Visa and MasterCard credit cards are no longer required to accept their Signature debit cards, but nearly all have chosen to accept both.

<sup>8</sup> Merchant acquiring banks are also involved in transactions conducted over the bank card associations’ payment card networks. Merchant acquiring banks are members of the associations; they sign up merchants to accept bank cards as payment.

<sup>9</sup> Merchants pay their merchant acquiring bank a “merchant discount fee” which is comprised, *inter alia*, of an interchange fee, a switch fee, and a fee paid to the merchant acquiring bank. For debit transactions, the associations assert the interchange fee is payment for access to the cardholder’s demand deposit account. For credit card transactions, the associations have asserted that the interchange fee reimburses issuers their costs, including significant costs related to fraud. Some of the economic literature indicates the credit card interchange fee is necessary to strike a balance in the two-sided market between issuing and acquiring to provide an incentive for issuers to issue the cards.

<sup>10</sup> Plaintiffs’ Pretrial Brief at 4, *United States et al. v. First Data Corp. and Concord EFS, Inc.*, 2003 WL 23194271 (D.D.C. Dec. 10, 2003) (No. 1:03CV02169), available at <http://www.usdoj.gov/atr/cases/f201800/201804.htm>.

rates. Signature debit transactions generally generate the next highest level of revenue for issuers because they typically have higher interchange fees than PIN debit transactions.<sup>11</sup>

7. From the merchants' perspective, as one might expect, the relative costs to merchants run in the opposite direction, with credit being the most costly and PIN debit the least expensive payment card.<sup>12</sup> Credit is most expensive because the interchange fees merchants pay for credit transactions are higher than the interchange fees for Signature debit or PIN debit. Merchants, however, are unable to directly charge their customers the payment network transactional costs, and thus encourage consumers to use the least costly payment cards, because the payment card networks have enacted "no surcharge rules" prohibiting them from doing so.<sup>13</sup> Merchants have taken some steps to encourage users to enter a PIN rather than using the Signature debit function, but the effectiveness of these steering efforts is debatable. Nonetheless, merchants feel compelled to accept all means of payment, because: (1) there is a relatively low marginal cost to merchants to accept additional payment cards; and (2) U.S. retail markets in the are generally competitive and merchants do not want to potentially lose a sale because they do not accept the customer's preferred means of payment – especially when the merchant's local competitors accept the cardholder's preferred payment card.

8. As payment cards have increased in popularity among consumers, the card payment networks' structure and conduct have come under increasing scrutiny. Not surprisingly, market participants have sought to garner a greater share of the industry's profits through lawsuits. Most notable among the lawsuits filed in the 1980s was *National Bankcard Corp. v. Visa USA, Inc.*, 779 F.2d 592 (11<sup>th</sup> Cir. 1986) ("*NaBanco*") and *SCFC ILC, Inc. v. Visa U.S.A. Inc.*, 36 F.3d 958 (10<sup>th</sup> Cir. 1994) ("*MountainWest*"). In *NaBanco*, a merchant processor claimed the interchange fee was essentially a price fixing agreement among Visa's issuing members. The court rejected this contention for various reasons, including factual findings that: (1) credit cards were not a relevant product market, but rather were among a group of payment methods that included cash, checks, and debit cards, and thus, Visa did not have market power,<sup>14</sup> and (2) issuers and acquirers were able to (and did) bypass the Visa network by entering into bilateral agreements for the interchange of credit card receivables ("interchange bypass arrangements").<sup>15</sup> After evaluating all of the evidence, the court held that the default interchange fee was an ancillary restraint to

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<sup>11</sup> Plaintiffs' Pretrial Brief at 6, *United States et al. v. First Data Corp. and Concord EFS, Inc.*, 2003 WL 23194271 (D.D.C. Dec. 10, 2003) (No. 1:03CV02169), available at <http://www.usdoj.gov/atr/cases/f201800/201804.htm> ("In 2003, PIN debit was typically 35%-60% less expensive to the merchant than Signature debit."); See generally FED REPORT, *supra* note 5, at 12-13 (fees paid by a merchant on the same transaction, by payment card type).

<sup>12</sup> FED REPORT, *supra* note 5, at 15. Merchants pay a "merchant discount fee" for payment card network services. The merchant discount fee is primarily comprised of the interchange fee, the network switch fee, and the merchant acquiring/processing fee. The overwhelming majority of the merchant discount fee is the interchange fee. The net relative costs to merchants identified in the text will vary to some degree by, *inter alia*, merchant category, payment card type, and whether the merchant has entered a special agreement with the payment network.

<sup>13</sup> The no surcharge rules prohibit merchants from surcharging consumers any additional fee based on use of the payment card. These rules do, however, permit merchants to discount if their consumers use cash or a cash equivalent, such as PIN debit or checks. The U.S. Congress has on several occasions also prohibited merchant surcharging over brief time periods, while allowing merchants to discount for cash payment. Currently, numerous states prohibit merchant surcharging.

<sup>14</sup> *Nat'l Bankcard Corp. v. Visa U.S.A., Inc.*, 596 F. Supp. 1231, 1258 (S.D. Fla. 1984).

<sup>15</sup> *Id.* at 1264.

the association's joint venture that was necessary for Visa's universality of acceptance; and thus was, on balance, procompetitive.<sup>16</sup>

9. In *MountainWest*, Discover claimed that Visa's refusal to allow Discover to issue Visa cards was essentially an agreement among competing issuing banks to restrain a strong competitor. Discover had entered the U.S. payment card market in the early 1980s by creating its own, separate payment card network. Although difficult and slow, the Discover card network slowly gained acceptance, but had not achieved a level of success comparable to Visa and MasterCard. The *MountainWest* court ruled for Visa, finding that Visa's refusal to allow Discover to issue Visa cards preserved network-level competition, i.e., the competition between the Visa payment card network and the Discover payment card network, by preventing Discover from gaining a governing role and significant influence within the Visa joint venture.

10. Visa's victories in these cases are likely at least partially responsible for the relative period of calm through the mid-1990s.

## 2. General Purpose Card Networks: *United States v. Visa U.S.A., Inc.*

11. In 1998, the Justice Department filed an antitrust case against the Visa and MasterCard joint ventures alleging two interrelated, anticompetitive agreements among Visa's and MasterCard's member banks.<sup>17</sup> The associations' bank members (many of which governed both networks through the associations' boards and committees) adopted policies and by-laws to: (1) permit the election or appointment of governors of their associations that had material portions of their card portfolios on both the Visa and MasterCard networks, thereby reducing or eliminating incentives for the two jointly owned systems to compete vigorously against one another (the "dual governance" claim); and (2) prohibit all member banks from issuing American Express or Discover cards, while expressly permitting each member bank to issue cards on the largest two networks -- Visa and MasterCard (the "exclusionary rule" claim).

12. The Justice Department alleged, and the trial court found, there were two relevant product markets: (1) a general purpose card market, and (2) a general purpose payment card network services market. The general purpose card market consists of all credit and charge cards used by consumers to purchase goods at unrelated retail merchants. The Government proved the general purpose card market through the defendants' and their members' documents, economic testimony, and merchant testimony that they would continue to accept general purpose cards even if the cost to accept those cards were to rise significantly. In contrast to the card market, the general purpose card *network services* market is the bundle of goods and services that allow banks to issue general purpose cards to consumers and that allow merchants to accept general purpose cards as a method of payment by consumers. The court found that Visa USA and MasterCard International had market power in the U.S. general purpose card network services market.

13. The Government alleged that the dual governance agreements restrained competition by reducing the level of competition between the two leading networks, Visa and MasterCard, which jointly controlled over 75% of the general purpose payment card network services market. The overlapping governance of the two associations allowed member banks to restrain Visa's and MasterCard's proposed advertising and "share-stealing" innovations. The Government introduced evidence at trial that Visa and MasterCard each considered attacking the other in their advertising, but were prevented from doing so by their governing member banks. The Government also submitted evidence that Visa and MasterCard each refrained from introducing innovative products (for example, a chip "smart" card, and a premium card targeted at an

<sup>16</sup> *NaBanco*, 779 F.2d at 605

<sup>17</sup> *United States v. Visa U.S.A., Inc.*, 163 F. Supp.2d 322 (S.D.N.Y. 2001), *aff'd*, 344 F.3d 229 (2d Cir. 2003), *cert. denied*, 543 U.S. 811 (2004).

affluent demographic) because of member-governors' concerns that the innovation might adversely affect the other association.

14. In its second count, the Justice Department alleged that the exclusionary rules restrained competition among general purpose card networks by limiting the areas of competition among the defendants' members through an agreement that they would not compete with respect to the issuance of cards on the American Express and/or Discover networks. The inevitable result had been the weakening of the American Express and Discover networks by denying them access to the assistance of card issuing banks, thereby: (1) limiting output of cards on those competitive networks; (2) restraining output of products that combine the unique features of the Amex and/or Discover networks with the particular skills of the numerous issuers; and (3) preventing those networks from issuing a competitive debit product (since the member banks have exclusive access to most Americans' checking accounts). The Government also introduced evidence demonstrating that, in regions of the world where the exclusionary rules did not exist, Visa and MasterCard responded to American Express' competitive overtures to member banks by enhancing their network products and services.

15. Visa and MasterCard argued that dual governance did not have any significant anticompetitive effect, that any such effect was the result of dual issuance, and that any effects would be ameliorated by Visa's recently-enacted by-laws mandating that the portfolio of all banks sitting on Visa USA's Board of Directors consist of at least 75% Visa cards. The card associations' primary defense to the Government's exclusionary rule claim was that their chosen organizational structure entitled their "loyalty/cohesion" rules to special deference as ancillary to the joint venture. Because the exclusionary rules were ancillary to the joint venture, the trial court examined the conduct under a rule of reason analysis. Based, in part, on each association's respective exclusionary rule exception for its largest network competitor (the other association), the trial court rejected the defendants' loyalty/cohesion rationale for the rules.

16. The trial court held that the exclusionary rules were unreasonably anticompetitive, but that the Government failed to demonstrate that dual governance (as opposed to dual issuance of credit cards by member banks) was the continuing cause of any restraint on competition.

### 3. Debit Card Networks

17. Electronic funds transfer ("EFT") networks were widely introduced in the United States during the late 1970s, when bank consortiums formed numerous regional networks to enable their customers to withdraw money at Automated Teller Machines ("ATMs") owned by other banks within a geographic region of the country. EFT networks began routing point of sale PIN debit transactions on a small scale in the early 1980s.<sup>18</sup> To accept PIN debit cards, merchants need to install PIN pad terminals that allow customers to enter their PIN number. Consequently, it was not until the 1990s that EFT networks were widely used for point of sale PIN debit transactions in the United States. As the use of PIN debit grew, networks began to consolidate, resulting in fewer networks with wider geographic coverage. By 2003, there were three nationwide PIN debit networks (Interlink, owned by Visa; Maestro, owned by MasterCard; and STAR, owned by Concord), two large regional networks (NYCE and PULSE), and a few smaller, regional networks.<sup>19</sup>

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<sup>18</sup> Some EFT networks, such as the STAR network, switch/route both ATM transactions and PIN point of sale debit transactions; others, such as Visa's Interlink, only switch point of sale PIN debit transactions.

<sup>19</sup> Although the transaction volume on MasterCard's Maestro is relatively insignificant, it has a nationwide infrastructure. In 1990, several state enforcement agencies blocked Visa and MasterCard from jointly creating a PIN debit network. *The State of New York et al v. Visa U.S.A., Inc.*, 1990-1 Trade Cas. (CCH) ¶ 69016 (S.D.N.Y. 1990). Approximately three years after the decree was entered, on October 24, 1993, Visa purchased the Interlink PIN-debit network.

18. Generally, a transaction can be carried over a particular PIN debit network only if the debit card issued by the customer's bank participates in that network.<sup>20</sup> To provide customers with seamless access to a wide array of merchants, many banks have historically placed the "bug" of more than one PIN debit network on their debit cards. Cards that can access more than one PIN debit network are often referred to as "double-bugged" or "multi-bugged." Some networks have "priority routing" rules that specify which network carries a transaction when a customer uses a multi-bugged card at a merchant that accepts more than one of the networks. For example, as recently as 2003, the NYCE PIN-debit network routing rule allowed the issuing bank to designate the network that carries the transaction, while STAR's network routing rule required most transactions on cards bearing the STAR bug to be routed over the STAR network, regardless of whether there are other bugs on the card.<sup>21</sup>

19. The PIN debit networks' routing rules substantially limit merchants' ability to engage in "least-cost routing," whereby the transaction is routed to the least expensive network whose bug is on the card. There are instances, however, when two networks' routing rules conflict. For example, an issuer of cards double-bugged with STAR and NYCE may designate NYCE as its priority network, while at the same time the STAR rule requires that STAR be designated as the priority network. When routing rules conflict, some merchants (through their merchant processors) route the transaction to the least expensive network.

#### 4. United States v. First Data Corp and Concord EFS

20. First Data (the 65% owner of the NYCE network) and Concord (the owner of the STAR network) executed a merger agreement on April 1, 2003. Under that agreement, First Data would acquire Concord through an all-stock transaction valued at approximately \$7 billion. Approximately seven months later, the United States filed a complaint seeking to block the merger. The parties settled on the eve of trial, when First Data agreed to divest the NYCE network in conjunction with the merger. Shortly thereafter, First Data divested NYCE to Metavante Corporation.

21. The Justice Department's complaint alleged that PIN debit network services were a relevant antitrust product market because merchants would continue to purchase PIN debit network services even if the price of those services were to significantly increase.<sup>22</sup> Generally, PIN debit was significantly less expensive for merchants than any other card payment method. Moreover, the issuing banks would not cause card holders to use other payment methods if the PIN merchant discount fee were substantially increased. Even if there were a 10% increase in the interchange fee paid to PIN debit issuers, issuing banks would not encourage their customers to switch to other payment methods because each PIN debit transaction would still generate less revenue than a Signature debit or credit transaction. Moreover, PIN debit cards have enhanced functionality relative to Signature debit that made cardholder and merchant switching to Signature products unlikely. For example, PIN debit cards offered greater security (and thus

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<sup>20</sup> Some PIN networks have gateway agreements with each other that allow a card "bugged" on one network to function on another.

<sup>21</sup> Plaintiffs' Pretrial Brief at 4-5, *United States et al. v. First Data Corp. and Concord EFS, Inc.*, No. 1:03CV02169, (D.C. Cir. Dec. 10, 2003).

<sup>22</sup> Because the network switch fee is a relatively minor component of the merchant discount fee, if a hypothetical PIN debit network monopolist were to raise the switch fee 10% and leave the interchange fee unchanged, the merchant discount fee would rise significantly less than 10%.

less fraud), faster transaction speed at cashiers, and the ability for consumers to get cash back from the cashier.<sup>23</sup>

22. As evidence of the likelihood of anticompetitive effects the Justice Department noted the highly concentrated nature of the PIN debit network industry. At the time, the three largest PIN debit networks were STAR, NYCE, and Interlink. STAR routed 56 percent of all PIN debit transactions, while Interlink and NYCE accounted for approximately 15% and 10% of the PIN debit market, respectively.<sup>24</sup> Even accounting for contract losses that might have reduced STAR's share, if the transaction were consummated, the combined STAR/NYCE would have been the largest network with at least a 45 percent market share. Together, the combined STAR/NYCE network and Interlink would have formed a near duopoly, accounting for approximately 80 percent of all PIN debit transactions.

23. The Government alleged the merger would result in higher prices for PIN debit network services to merchants and that merchants, in turn, would pass these higher prices on to consumers by raising the price on all of their goods and services. First, the merger would reduce the merchants' ability to credibly threaten not to accept PIN debit cards on the merged firm's network, thus reducing opportunities for merchants to negotiate lower merchant discount fees.<sup>25</sup> Second, combining STAR and NYCE would eliminate a substantial number of routing conflicts that had existed between them, reducing opportunities for merchants to lower their costs through least-cost routing.

##### **5. In Re: Visa Check/MasterMoney Antitrust Litigation ("Wal-Mart Class Action")**

24. The *Wal-Mart* class action suit involved a challenge by merchants to the "honor all cards" rules imposed by Visa and MasterCard that required merchants to accept Visa and MasterCard Signature debit products if they wanted to accept Visa and MasterCard credit cards. The plaintiffs argued that debit cards were a separate relevant product from credit cards and that the associations' rules constituted unlawful tying.<sup>26</sup> Because Signature debit card acceptance was tied to credit card acceptance, the *Wal-Mart* plaintiffs alleged that Signature debit interchange fees were artificially high and immune from price pressures they would face if merchants could credibly threaten not to accept Signature debit cards.

25. The defendants settled the suit on the eve of trial by agreeing to: (1) pay the merchant class approximately \$3 billion and attorneys' fees and costs in excess of \$300 million; (2) abolish the "honor all cards" rule (as applied to debit and credit card products bearing the Visa or MasterCard "flag"); (3) require

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<sup>23</sup> Plaintiffs' Pretrial Brief at 7, *United States et al. v. First Data Corp. and Concord EFS, Inc.*, 2003 WL 23194271 (D.D.C. Dec. 10, 2003) (No. 1:03CV02169), available at <http://www.usdoj.gov/atr/cases/f201800/201804.htm>. See also FED REPORT, *supra* note 5, at 5-6.

<sup>24</sup> At the time, the fourth-largest network was PULSE, which had an overall market share just slightly below that of NYCE. But PULSE had difficulty competing effectively for large, nationwide bank contracts due to its regional focus and operational structure. Consequently, Pulse's market share had remained essentially flat.

<sup>25</sup> Plaintiffs' Pretrial Brief at 11, *United States et al. v. First Data Corp. and Concord EFS, Inc.*, 2003 WL 23194271 (D.D.C. Dec. 10, 2003) (No. 1:03CV02169), available at <http://www.usdoj.gov/atr/cases/f201800/201804.htm>.

<sup>26</sup> The *Wal-Mart* plaintiffs used the decision in *United States v. Visa* as support for their contention that credit and charge cards were a separate relevant product from debit cards and that Visa and MasterCard, together and separately, had market power in the general purpose card network product market.

their issuing members to clearly label their debit cards as “debit;”<sup>27</sup> and (4) lower their Signature debit rates by approximately 30% from August 1, 2003 to December 31, 2003.<sup>28</sup> The settlement did not prescribe Signature debit rates after January 1, 2004.

## 5.1 *Recent Legal And Industry Developments*

26. The payment card industry continues to evolve. As a result of the remedy in *United States v. Visa*, issuing banks can and do issue cards on the American Express and Discover networks. Merchants and a prominent merchant processor are, separately, asserting new legal challenges to the card associations’ practices. And, perhaps in response to these challenges, the Visa and MasterCard associations are reorganizing.

### 5.1.1 *First Data And Visa Lawsuit*

27. First Data, a large processor for issuers and merchant acquirers, and Visa are preparing to go to trial in a case where First Data alleges that Visa’s recently enacted prohibition on interchange bypass arrangements is unlawful.<sup>29</sup> According to First Data, Visa recently enacted rules that require member banks to route all Visa card transactions over the Visa network. Previously, if the same bank issued the card to the cardholder and acquired the transactions for the merchant, the bank could circumvent the Visa network and route the transaction within its own network in what is typically called an “on us” transaction. Similarly, if a single processor processed transactions for both the issuing bank and the acquiring bank, it could essentially act as an alternative network for a Visa transaction and bypass Visa altogether. Moreover, the processor could offer its “on us” network services on different terms, such as a lower interchange fee. Soon after First Data developed the capability to offer this service to banks on a wide scale basis, Visa U.S.A. filed a complaint against First Data alleging, *inter alia*, trademark infringement and dilution claims. First Data’s counterclaim alleges that Visa is: (1) orchestrating a concerted refusal to deal with First Data; (2) has monopolized or is attempting to monopolize credit and debit card processing markets; and (3) tied debit and credit network services with processing services.<sup>30</sup> The court recently dismissed Visa’s claims and denied Visa’s motion for partial summary judgment.

### 5.1.2 *Merchant Class Action Litigation*

28. A number of merchants and other industry participants have also filed antitrust claims against Visa and MasterCard. These merchant class actions challenge: (1) the interchange fees on credit and debit cards as a price fixing agreement; (2) various network rules, including the “honor all cards” rule’s requirement that merchants accept more costly premium credit cards if they want to accept ordinary credit cards; and (3) the tying of network processing services and fraud guarantee services to card acceptance. Many of these lawsuits were recently consolidated for pretrial proceedings and transferred to the judge

<sup>27</sup> Previously, a bank issuing ATM/debit cards typically had numerous regional PIN debit network “bugs” on the back of the card and the bank’s name and the Visa “flag” on the front of the card. Thus, the card closely resembled typical Visa/MasterCard credit cards, and there was no indication the card was a “debit” card, as opposed to a credit card.

<sup>28</sup> See Memorandum and Order, *In Re: VisaCheck/MasterMoney Antitrust Litigation*, 297 F. Supp.2d 503 (E.D.N.Y. Dec. 19, 2003), available at [http://www.nyed.uscourts.gov/Decisions\\_of\\_Interest/96cv5238mo122303.pdf](http://www.nyed.uscourts.gov/Decisions_of_Interest/96cv5238mo122303.pdf); see also, The Garden City Group, *History of the Action*, at <http://www.inrevisacheckmastermoneyantitrustlitigation.com/history.php3> (last visited on May 26, 2006) (description of a history of the litigation).

<sup>29</sup> Complaint, *Visa U.S.A., Inc. v. First Data Corp.*, No. C 02-011786 (N.D. Cal. filed April 15, 2002).

<sup>30</sup> Complaint and Defendant’s First Amended Counterclaim, *Visa U.S.A., Inc. v. First Data Corp.*, No. C 02-011786 (N.D. Cal. filed April 15, 2002).

who presided over the Wal-Mart class action.<sup>31</sup> One of the plaintiffs' most significant legal hurdles will be the Eleventh Circuit's holding in the *NaBanco* case that the joint setting of interchange fees by Visa's board of directors did not violate the antitrust laws. There have been a number of changes in the industry since the *NaBanco* decision that the merchant plaintiffs cite as support for their arguments that *NaBanco* is no longer persuasive authority, including Visa's prohibition of interchange bypass arrangements, the Second Circuit's relevant market and market power holdings in *United States v. Visa*, and the fact that Visa's and MasterCard's boards of directors have recently been comprised primarily of issuing bank competitors with fewer representatives of the card acquiring banks.<sup>32</sup> At this early stage of the litigation, plaintiffs have not publicly articulated the "but for" world that would avoid the allegedly unlawful price fixing agreements and still allow for the creation/existence of the general purpose credit card product.

## 5.2 *The Bank Card Associations*

29. Meanwhile, the Visa and MasterCard associations are responding by fundamentally changing their organizational structures to more closely resemble American Express and Discover. The exact contours of their reorganizations are unclear at this point. Visa's board recently approved the immediate appointment of independent directors and a transition plan to ensure that a majority of voting board members are independent directors.<sup>33</sup> But the fiduciary duties that should guide the voting behavior of these board members is unclear. Meanwhile, MasterCard apparently intends to create a structure whereby 49% of the shares are held by the public and 10% of the shares are owned by a charitable foundation.<sup>34</sup> Presumably, the card associations believe their respective reorganizations will help them avoid the antitrust pitfalls inherent in an association of horizontal competitors.

30. Visa has also made significant inroads in PIN debit by signing "preferred debit network" issuing agreements with a significant number of banks. These agreements provide bank issuers with incentives to issue debit cards to their account holders that have only one PIN debit network "bug" on the card: Visa's Interlink. The strategy has been successful. In 2003, at the time the First Data/Concord case was filed, Visa's Interlink network had a 15.5% market share among PIN debit networks. Since then, Interlink has garnered about a 35.3% market share.<sup>35</sup> And most of that volume is dedicated to Interlink because the debit card issuers have eliminated other bugs on the cards.<sup>36</sup> Consequently, many merchants feel they must accept the card (because many of their customers' debit cards function *only* on the Interlink network) and they are unable to route the transaction to a less expensive PIN debit network.

31. As a result of the remedy ordered in *United States v. Visa*, there have been some fundamental changes in the payments card industry. The remedy allows banks issuing cards on the Visa and

<sup>31</sup> *In Re Payment Card Interchange Fee and Merchant Discount Antitrust Litigation*, 398 F. Supp.2d 1356 (Jud. Pan. Mult. Lit. 2005).

<sup>32</sup> At the time of *NaBanco*, merchant acquirers were well represented on Visa's board of directors. *NaBanco*, 779 F.2d at 603 ("The board can be, and actually has been, composed of members that handle more merchant accounts than cardholder business, and who therefore represent the solely merchant-signing members' interests because that interest coincides with their own.").

<sup>33</sup> David Breitkopf & H. Michael Jalili, *Visa Plan Advances, But...A Lawsuit Looms; Small Issuers Gain a Seat*, AM. BANKER, May 1, 2006, at 1.

<sup>34</sup> MASTERCARD, INC., 2005 ANNUAL REPORT (FORM 10-K) 4-5 (2006), available at <http://www.sec.gov/Archives/edgar/data/1141391/000119312506056300/d10k.htm>; Wendy Atkins, *Sudden Philanthropy*, THE BANKER, Feb. 6 2006, at 80.

<sup>35</sup> ATM & DEBIT NEWS, September 1, 2005.

<sup>36</sup> *Id.*

MasterCard networks to also issue cards on a competing network. Since the decision became final in 2005, American Express has entered distribution/issuing agreements with several banks in the United States, including Bank of America, MBNA, and Citigroup.<sup>37</sup> In addition, Discover recently acquired the PULSE PIN debit network and announced that banks would be able to offer a Signature debit product on the Discover network.<sup>38</sup> Discover also announced that, in contrast to the other payment networks, it would allow merchants to surcharge transactions conducted with a Discover card.<sup>39</sup>

## 6. Conclusion

32. Although payment cards have become ubiquitous in the United States, there is no significant U.S. regulation of the interchange fee charged by the card networks. The Federal Reserve recently indicated that its regulatory authority in this area is limited,<sup>40</sup> and recent Congressional hearings suggest that Congress will not enact legislation regulating interchange in the near future.<sup>41</sup> The Justice Department neither regulates nor legislates. Rather, the DOJ investigates potential violations of the U.S. antitrust laws and brings enforcement actions when the investigation indicates the law has been broken and a remedy will rectify the resulting harm.

33. The only certainty in this industry is that it will continue to evolve and grow. If there is one message that permeates the Federal Reserve's recent Report to Congress and the various domestic and international challenges to the card associations it is that careful study and consideration should precede any government intervention in this complex and evolving industry.

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<sup>37</sup> *American Express Co.*, HOOVERS IN-DEPTH COMPANY RECORDS, May 10, 2006, available at 2006 WLNR 8000168

<sup>38</sup> Press Release, Discover Card, Merger of Discover Financial Services and Pulse EFT Association Closes Following Pulse Member Approval (Jan. 12, 2005) (available at <http://pressroom.discovercard.com/data/articles/2005/01/12/200501141303580.shtml>).

<sup>39</sup> *Discover to Allow Surcharges; Adds Debit*, 19 CREDIT CARD MGMT. 10 (2006). Given that Discover's merchant discount fee is generally lower than the other general purpose card networks, merchants are unlikely to steer their customers to other, more expensive general purpose credit/charge cards by only surcharging consumers for using their Discover cards.

<sup>40</sup> *Market To Decide; Fed Won't Intercede In Interchange Fee Battle*, CREDIT UNION JOURNAL, No. 10-16, April 24, 2006, at 1.

<sup>41</sup> *Law and Economics of Credit Card Interchange Fees: Hearings Before the Subcomm. of Commerce, Trade, and Consumer Protection of the House Comm. on Energy and Commerce*, 109th Cong. (2006) (Statement of Timothy J. Muris, of counsel, O'Melveny & Myers LLP), available at <http://energycommerce.house.gov/108/Hearings/02152006hearing1774/hearing.htm>.