REPAIRING THE FAILED DEBIT CARD MARKET:

LESSONS FROM AN HISTORICALLY INTERVENTIONIST FEDERAL RESERVE AND THE RECENT *VISA CHECK/MASTERMONEY ANTITRUST LITIGATION*

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INTRODUCTION

The United States debit card market, which evolved in a competitive environment toward a system of universal at-par clearance from 1977 to 1991, was assaulted by a bank cartel with the goal of retarding the growth of this market and eliminating at-par clearance. The *Visa Check/MasterMoney Antitrust Litigation* revealed that Visa, and later MasterCard, employed a panoply of anticompetitive measures, including tying arrangements, group boycotts and price-fixing, to raise the price of debit card services and eliminate at-par clearance of point-of-sale debit card transactions.

This paper describes the damage which resulted from the anticompetitive actions of these companies and the limited extent to which the June 2003 settlement in *Visa Check* has been able to repair this damage, concluding with a call to the Federal Reserve to mandate or move the debit card market back toward the at-par clearance system which prevailed before the Visa/MasterCard assault and the resulting market failure.

Section I describes the chaotic environment for check clearance which existed in the United States prior to the 1913 establishment of the Federal Reserve. We go on to explain the Federal Reserve's rationale and the aggressive measures it used, which led to at-par clearance of virtually all U.S. checks by the middle of the century.

Section II describes the debit card market and its evolution toward at-par clearance beginning in the late 1970s and continuing through the early 1990s. Using the unsealed record of the *Visa Check/MasterMoney Antitrust Litigation*, we ex-

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plain how Visa assaulted the competitively-evolved at-par clearance system for debit transactions in order to engraft a credit card-style interchange pricing structure on the debit card market and to protect the Visa/MasterCard dominance in the credit card market. We explain how these efforts largely succeeded, destroying the at-par model for debit card transaction clearance.

In Section III, we explain why the Federal Reserve has the authority and responsibility to steer the trade-restrained and failed debit card market back toward a system of at-par clearance.

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In the United States, most checks have cleared at-par since the 1920s. Before at-par checking, the U.S. check system was riddled with inefficiency. Rather than route checks along the quickest and most direct course to the issuing bank for settlement, depositing banks would send their checks through a long, complicated, and haphazard network of "correspondent banks" to avoid paying check-clearing fees. Congress created the Federal Reserve System (the "Federal Reserve" or "Fed") in part to remedy this dysfunctional system. By serving as a central clearinghouse through which participating member banks could exchange checks at-par, the Federal Reserve brought efficiency and stability to the U.S. payments system.

The Federal Reserve fulfilled its mandate to make at-par checking available to its membership, and forged ahead like a "mighty battleship"[1] to establish a system of universal at-par checking under which every U.S. check clears at-par, regardless of the issuing or depositing bank. The Federal Reserve's at-par checking system has become an unassailable right for all who trade checks in commerce, and has expanded to accommodate the evolution of checks from paper-based to electronic, with checks converted to electronic transactions also clearing at-par.

While the Federal Reserve has aggressively fulfilled its congressional mandate to rationalize the U.S. payments system through the oversight and regulation of checks, it has neglected its analogous responsibility to regulate point-of-sale

1. *See infra* note 29.

("POS") debit, as the shift from checks to debit has commenced and accelerated. The Federal Reserve has done virtually nothing in this area despite: (1) the near-identity in function of the two payment forms (a POS debit transaction is simply a plastic check); (2) the inefficiencies that have plagued the U.S. debit system for the past fifteen years; (3) the fact that these inefficiencies have been as severe, if not more severe, than those that plagued the U.S. check system prior to the Federal Reserve's creation; (4) the deliberate destruction by Visa and MasterCard (the "Associations" or "Visa/MasterCard") of the at-par debit system that once existed; and (5) its broad mandate under the Federal Reserve Act and the Electronic Funds Transfer Act to ensure efficiency, competition, and consumer choice in U.S. payment systems.

The Federal Reserve must correct the failure in the U.S. debit card market, reverse the anticompetitive campaign the Associations have conducted to suppress PIN debit and raise overall debit pricing, restore the at-par model out of which debit was born and thrived for roughly a decade, and reassert itself in the U.S. payments system to ensure efficiency, competition, and choice with respect to the fastest-growing form of payment. It is time for the Federal Reserve to eliminate a central ingredient of the failure of the U.S. debit card market: interchange.

I. THE FEDERAL RESERVE'S REGULATION OF AT-PAR CHECKING

A. *History of Paper Checks*

Checks have been around for centuries. Some attribute their invention to the Romans.[2] Others point to Holland where, in the 16th century, international shippers and traders deposited their cash with a trusted cashier for a fee and depositor's note rather than risk storing it at home. These cashiers also agreed to collect and cancel debts on depositors' written orders. In 17th Century England, people began depositing cash with goldsmiths in exchange for written promises to pay the holder of the promissory paper.[3]

2. H.D. McLeod, *Theory and Practice of Banking*, *in* WALTER EARL SPAHR, THE CLEARING AND COLLECTION OF CHECKS, 9 (1926), [hereinafter "SPAHR"].

3. *See* SPAHR, *supra* note 2, at 9-18.

Checks appeared in the New World in the late 17th century. Boston businessmen short on cash mortgaged land and other property to set up a fund from which they could write checks.[4] During this time, the principal forms of payment were currency and gold.[5] However, checks surpassed currency in popularity in the 1850s, as deposit banking grew increasingly common,[6] and by the 1870s became the most popular form of payment for customers of national and state-chartered banks.[7]

A check is a written order to a bank by a depositor to pay the amount specified on the check from funds the customer has on deposit. The common law provided that payment for the check had to be in full (at-par) only if the check was physically presented to the bank from which it was drawn (the issuing bank).[8] Checks presented by out-of-town banks through the mail were subject to an "exchange charge." This fee was designed to cover the expense purportedly incurred by the issuing bank for transporting coin or bank notes to the depositing bank (the acquiring bank), and was ultimately charged to the merchant or individual cashing the check as an exchange charge (interchange).[9] These charges meant that checks

4. This fund, called *The Fund at Boston in New England*, was established in 1681 to offset a shortage of cash for trade. Contributors to the fund received a credit based on the value of what they contributed, against which they could draw checks. SPAHR, *supra* note 2, at 38.

5. Theodore E. Allison, *The Federal Reserve's Role in the Payments Mechanism and its Communication Plans*, FED. RES. BANK OF RICHMOND ECON. REV., Mar./Apr. 1982, at 21.

6. R. Alton Gilbert (1998), *Did the Fed's Founding Improve the Efficiency of the U.S. Payments System?* FED. RES. BANK OF ST. LOUIS REV., May/June 1998, at 121-22, [hereinafter "Gilbert"].

7. *Id.* at 122.

8. John A. James, *Commentary*, FED. RES. BANK OF ST. LOUIS REV., May/June 1998, at 143; SPAHR, *supra* note 2, at 103. Early on, representatives from local banks would gather at clearing houses to exchange checks drawn on each others' accounts and settle the net differences among themselves. *See* FED. RES. BANK N.Y., THE STORY OF CHECKS AND ELECTRONIC PAYMENTS 6 (2001). Today, automated clearing houses operated either by private entities or Federal Reserve banks perform this function. *Checking out the Check*, FED. DEPOSIT INS. CORP. CONSUMER NEWS, Fall 1995, at 3.

9. SPAHR, *supra* note 2, at 112-13:

> It has been contended that where charges were levied in depositors of out-of-town checks the expense seemed to fall on the merchants and business men whose accounts with their customers were settled

drawn from banks in one city or state lost value when cashed at a bank in another city or state.

As the U.S. economy grew and more people began to engage in travel and business outside their local communities, exchange charges, or interchange, became more prevalent. This was due in large part to the legal restrictions on interstate banking which made physical presentment of out-of-town checks difficult.[10] In order to avoid these charges, banks developed a system of "correspondent banking" relationships, which were bilateral agreements between banks to interchange each other's checks at-par.[11]

Under this system, acquiring banks would send out-of-town checks to their correspondent banks rather than by the most direct route to the issuing bank. The correspondent banks would in turn send the checks to *their* correspondent banks for physical presentment to the issuing bank. This circuitous and lengthy check-routing system evolved to avoid the payment of exchange charges. Checks would routinely travel several times the distance between the issuing bank and the acquiring bank. These trips often covered thousands of

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> with such checks. It is admitted that they could reimburse themselves by charging more for their goods and services, or refuse to receive such checks. But it seems clear that competition prevented them from trying to shift the burden to their customers. There is a rather general agreement that the cost is not often shifted backwards to the drawer of the check.

See also Howard Preston, *The Federal Reserve Banks' System of Par Collections*, 28 J. POL. ECON. 565 (1920); Gilbert, *supra* note 6, at 123.

10. Apart from the brief appearances of the federally-chartered First and Second Banks, nearly all banks were barred from operating branches across state lines in the 19th Century. Moreover, most state-chartered banks were restricted to operating only one branch in the state. David C. Wheelock, *Commentary*, FED. RES. BANK OF ST. LOUIS REV., July/Aug. 2003, 85(4), at 129, n.2.

11. In correspondent banking arrangements, banks settled their accounts by a combination of ledger records and periodic shipments of coin/banknotes in order to balance out any differences. Hal S. Scott, *The Risk Fixers*, 91 HARV. L. REV. 737, 741 (1978). Such relationships typically involved two banks that either agreed to exchange each other's checks at-par, or to set up accounts with each other into which the check proceeds were directly deposited. *See* George B. Vest, *The Par Collection System of the Federal Reserve Banks*, 26 FED. RES. BULL. 89, 90 (Feb. 1940), [hereinafter "Vest"]; Gilbert, *supra* note 6, at 124; Howard Preston, *The Federal Reserve Banks' System of Par Collections*, 28 J. POL. ECON. 565, 567 (1920).

miles, taking a week or more before final settlement and collection.[12]

While correspondent banking helped alleviate the burden of exchange charges for acquiring banks, it was inefficient and increased the overall cost of the U.S. checking system. Moreover, the indirect routing of checks increased the risk of nonpayment. By the time a check was ultimately settled (a week or more after it was presented), the customer might no longer have sufficient funds in the account.[13] It also led to unnecessary duplication in check handling. As the number of banks that touched a transaction increased, so did the risk of error (not to mention the need for additional clerks, postal charges and bookkeeping).[14] This process also entailed analyzing the complicated maze of banking relationships, with their varied processing terms and conditions, before launching the check on its tortuous journey to attempted settlement.[15]

B. *The Federal Reserve's Establishment of At-Par Checking*

Congress passed the Federal Reserve Act ("FRA") in 1913.[16] The FRA established the Federal Reserve, comprised of the Federal Reserve Board of Governors ("Reserve Board"), and the twelve Federal Reserve Banks ("Reserve Banks"),[17] to bring stability to the financial system of the United States.[18]

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12. In one oft-cited example, a check drawn from a Sag Harbor, New York bank that was deposited roughly 100 miles away in a Hoboken, New Jersey bank traveled ten days, and more than 1,200 miles through eight cities, before finally returning to Sag Harbor for collection. SPAHR, *supra* note 2, at 106. In an even more extreme example, a check deposited in a Birmingham, Alabama bank that was issued from a bank only four miles away in North Birmingham was routed on a 2,250 mile, seven-day journey through Jacksonville and Philadelphia before returning to North Birmingham for collection. *Id.* at 107.

13. Paul M. Connolly & Robert W. Eisenmenger, *The Role of the Federal Reserve in the Payments System*, 45 FED. RES. BANK OF BOSTON CONF. 131, 133 (Oct. 2000).

14. SPAHR, *supra* note 2, at 108; Vest, *supra* note 11, at 90.

15. Gilbert, *supra* note 6, at 123-25.

16. Federal Reserve Act of 1913, 12 U.S.C. § 251 (2000).

17. The Reserve Banks are located in Kansas City, Boston, New York, Philadelphia, Cleveland, Richmond, Atlanta, Chicago, St. Louis, Minneapolis, Dallas and San Francisco.

18. Prior to the Fed's formation, the United States had twice attempted to establish a central banking system, and twice failed. The First Bank was chartered in 1791 in the aftermath of the American Revolution and lasted

One of its principal mandates was to ameliorate the inefficiencies that pervaded the U.S. checking system.[19]

Prior to the FRA, common law governed U.S. checking and its dysfunctional system of exchange charges and correspondent banking.[20] The Reserve Board understood its mandate to mend this broken model through the development of a national at-par check clearing system. While the FRA gave the Reserve Banks the authority to act as clearing houses for *member banks*' checks to clear at-par, it did not explicitly provide for *universal* at-par checking. Nevertheless, the Reserve Banks eventually achieved that result.[21]

Initially, participation in the Federal Reserve's at-par check-clearing system was voluntary. The FRA required that checks processed through the Federal Reserve clear, or interchange, at-par.[22] However, Reserve Bank members remained free to avail themselves of other check collection and clearance systems under which they could impose exchange charges. Participating members agreed to the at-par exchange

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for 20 years until its charter expired, and was not renewed. The Second Bank was chartered in 1816 and also only lasted for 20 years. The primary reason for these failed attempts at central banking was that opponents – agrarians, conservatives and most notably Thomas Jefferson and Andrew Jackson – saw a strong central government as incompatible with political independence and challenged the system on constitutional grounds. *See e.g.*, William J. McDonough, *An Independent Central Bank in a Democratic Country: The Federal Reserve Experience*, FED. RES. BANK OF NEW YORK Q. REV. (Spring 1994) at 1.

19. The Federal Reserve was also designed to reduce the incidence and severity of financial panics like those that occurred in the latter part of the 19th and early 20th centuries. Steven A. Ramirez, *Depoliticizing Financial Regulation*, 41 WM. & MARY L. REV. 503, 531 (2000); DONALD R. WELLS, THE FEDERAL RESERVE SYSTEM 14-16 (2004); Ellis W. Tallman & Jon R. Moen, *Lessons from the Panic of 1907,* 75 FED. RES. BANK OF ATLANTA ECON. REV., May/June 1990, at 2-13.

20. Edward L. Rubin, *Uniformity, Regulation and the Federalization of State Law: Some Lessons from the Payment System*, 49 OHIO ST. L.J. 1251, 1253 (1989).

21. While Section 16 permits member banks to charge for actual expenses incurred from collecting and remitting funds, it gives the Reserve Board the power to fix the charges imposed by Reserve Banks and member banks for check collection and clearing services. Federal Reserve Act of 1913, 12 U.S.C. § 360 (2000).

22. Section 16 of the FRA provides that "[e]very Federal reserve bank shall receive on deposit at-par from member banks or from Federal reserve banks checks and drafts drawn upon any of its depositors . . ." Federal Reserve Act of 1913, 12 U.S.C. § 360 (2000).

of checks that cleared through the Federal Reserve, even if they were presented by mail. The Federal Reserve refused to process checks submitted by non-participating banks, and checks drawn from accounts held at non-participating member banks could not be cleared through the Federal Reserve, even if the acquiring bank was a participating member.

Because only a quarter of the Reserve Bank members chose to participate, the Reserve Board concluded that a voluntary program would not achieve the goal of universal at-par check clearance.[23] So in 1916, the Reserve Board made participation in the at-par system mandatory for member banks.[24] Under the mandatory program, any member was free to submit a check drawn from an account held at any other member bank for at-par clearance through the Federal Reserve. Congress also amended the FRA to authorize the Federal Reserve to process member checks drawn on nonmember banks.[25] In 1917, Congress further amended the FRA to authorize the Federal Reserve to permit nonmember banks to fully participate in the at-par system.[26]

When the Reserve Banks presented checks for remittance to nonmember banks, those that agreed to remit at-par were placed on the Federal Reserve's at-par lists. Banks would consult these lists before determining how to route deposited checks for collection.

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23. Gilbert, *supra* note 6, at 131; SPAHR, *supra* note 2, at 173.

24. Regulation J, Series of 1916, which went into effect in July 1916. SPAHR, *supra* note 2, at 176.

25. Charles S. Tippets, *The Par Remittance Controversy*, 14 AM. ECON. REV. 629, 633 (1924). *See also* SPAHR, *supra* note 2, at 196 ("The natural inference flowing from this amendment was that the Federal reserve banks were not only to accept checks on non-member banks from their member banks and other Federal reserve banks, but were to exercise the power necessary to collect them").

26. This amendment, sponsored by Senator Thomas Hardwick (D - Georgia), in its original form would have effectively permitted non-par exchange of checks through the Federal Reserve. President Wilson heavily criticized the original amendment as "most unfortunate and as almost destructive of the function of the Federal Reserve banks as a clearing house for member banks." The amendment was subsequently modified to exclude Federal Reserve banks. Jeffrey M. Lacker, Jeffrey D. Walker & John A Weinberg, *The Fed's Entry Into Check Clearing Reconsidered*, ECON. Q. (Spring 1999), at 10; Vest, *supra* note 11.

With respect to those banks that refused at-par clearance (typically rural banks that relied on exchange charges as a source of revenue), the Reserve Banks took aggressive measures to force it upon them. They did this by accumulating checks drawn on these recalcitrant banks and then sending local agents to physically present the checks all at once.[27] This practice exposed these banks to potential insolvency if they lacked sufficient funds to pay all the checks simultaneously presented on the Reserve Bank's behalf, and therefore removed the ability of most of these banks to impose exchange charges.[28] The Reserve Banks then placed these unwilling participants on the at-par lists without consent. As one Federal Reserve employee described it, "[T]he Federal Reserve System was like a mighty battleship coming up as it were from a smooth sea, and all banks that did not affiliate with it could not stand its swells and must get in its wake for safety . . ."[29]

The Reserve Banks' conduct prompted a sharp rise in the number of banks comprising the at-par list, jumping from roughly 10,000 banks in 1918 to more than 19,000 in 1920.[30] A number of non-par banks challenged the Federal Reserve's practices on statutory and constitutional grounds. In two key 1923 decisions, the United States Supreme Court upheld the validity of the Fed's hardball practices.[31]

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27. These agents were typically representatives of local member banks or couriers such as American Express. Farmers' & Merchs' Bank of Catlettsburg v. Fed. Res. Bank of Cleveland, 286 F. 610, 612 (E.D. Ky. 1922).

28. Some states, in direct response to this practice, enacted legislation which permitted their banks to impose exchange charges even on checks that were physically presented. For example, Mississippi passed a law in March 1920 "with the express purpose of preventing the Federal Reserve banks from collecting at-par, checks drawn on banks located in that state." Similar laws were passed in Louisiana, South Dakota, Alabama, North Carolina, Tennessee and Florida. SPAHR, *supra* note 2, at 251-52.

29. *Id.* Typically, the Reserve Banks would resort to this over-the-counter assault of non-par banks as a last resort. They would send letters requesting that the banks join the at-par system; failing that, they would send representatives to the banks to try to persuade them. If that failed, they would threaten to send local agents to present checks in bulk. *See also id.* at 249-50.

30. Jeffrey M. Lacker, Jeffrey D. Walker & John A Weinberg, *The Fed's Entry Into Check Clearing Reconsidered*, ECON. Q. (Spring 1999), at 11.

31. Am. Bank & Trust Co. v. Fed. Res. Bank of Atlanta, 262 U.S. 643 (1923); Farmers' & Merchs' Bank of Monroe v. Fed. Res. Bank of Richmond, 262 U.S. 649 (1923).

While the Supreme Court did not interfere with the Federal Reserve's mission to implement a universal at-par check system, it found that Congress had not given the Fed such a mandate:

> Congress did not in terms confer upon the Federal Reserve Board or the federal reserve banks a duty to establish universal par clearance and collection of checks; and there is nothing in the original act or in any amendment from which such duty to compel its adoption may be inferred.[32]

Moreover, it cautioned the Federal Reserve to employ only "reasonable" measures in its effort to implement universal at-par checking.[33]

Following these decisions, the Reserve Board directed the Reserve Banks to cease their efforts to force non-par banks into the at-par system and to simply refuse to process checks drawn on non-par banks. While the number of non-par banks momentarily increased (from roughly 1,700 to 4,000),[34] this figure ultimately dwindled to virtually zero as more and more banks joined the Federal Reserve. Even though both member and nonmember banks remained free to use private check-clearing arrangements, participation in the Federal Reserve grew because of the tremendous efficiencies it afforded.[35]

In 1965, following the passage of legislation mandating at-par checking in several states, the Reserve Board recommended that Congress adopt "legislation that would require all insured banks to pay at 'par' all checks drawn upon them – that is, without deduction of an exchange charge."[36] Although

32. *Farmers' & Merchs' Bank*, 262 U.S. at 664.

33. *Am. Bank & Trust Co.,* 262 U.S. at 648.

34. Jeffrey M. Lacker, Jeffrey D. Walker & John A Weinberg, *The Fed's Entry Into Check Clearing Reconsidered*, ECON. Q. (Spring 1999), at 11.

35. Gilbert, *supra* note 6, at 135. Ed Stevens, Senior Consultant and Economist of the Federal Reserve Bank of Cleveland, noted that the remaining non-par banks survived only because they were not operating in competitive markets. ED STEVENS, NON-PAR BANKING: COMPETITION AND MONOPOLY IN MARKETS FOR PAYMENTS SERVICES 19 (Fed. Res. Bank of Cleveland, Working Paper No. 9817, 1998), *available at* http://www.clevelandfed.org/research/workpaper/1998/Wp9817.pdf.

36. *Nonpar Banking: Near the End of an Era?* FED. RES. BANK OF MINNEAPOLIS MONTHLY REVIEW, May 1966, at 3, 8; *see also id.* at 8 ("The expense incurred by that bank in performing this service should be borne by the bank's

no legislation was enacted, the Federal Reserve ultimately achieved its goal of having virtually all banks participate in at-par checking. This at-par system covers all forms of checking, whether processed in paper form or through the electronic check conversion technology that many merchants are beginning to employ.[37]

As a result of the Federal Reserve's at-par campaign and the resulting efficiencies, check usage in the United States has surpassed that of any other nation.[38] Americans, *per capita*, write 15 times as many checks as most Europeans.[39] Despite the recent growth of electronic payments, checks still account for the largest share of non-cash purchases in the U.S. In 2003, Americans wrote roughly 37 billion checks, accounting for roughly 45 percent of all non-cash purchases.[40] Unfortunately, the continued popularity of checks in the United States is also a by-product of the dysfunctional U.S. POS debit system, fostered by the Federal Reserve's curious abdication of its authority and responsibility.

II. THE FAILURE OF THE U.S. DEBIT CARD MARKET

A. *The Birth of U.S. Debit*

1. *The Two Forms of Debit*

A POS debit transaction, like a paper check transaction, is used to make retail purchases by debiting funds from the con-

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customer – the depositor who drew the check – rather than by the payee or endorsee").

37. In 2002, the National Automated Clearing House Association ("NACHA"), which was formed in the mid-1970s by several regional clearing houses, attempted to impose a fee structure on ACH transactions that, from the merchants' perspective, resembled interchange fees. Jennifer A. Kingson, *NACHA Idea Worries Retailers*, AM. BANKER (N.Y.), Apr. 22, 2002, at 18. This effort was successfully challenged by merchants.

38. James N. Duprey & Clarence W. Nelson, *A Visible Hand: The Fed's Involvement in the Check Payments System*, FED. RES. BANK OF MINNEAPOLIS Q. REV., Spring 1986, at 18-29.

39. Betty Joyce Nash, *The Fed Continues to Process a Hefty Share of Checks, Despite Overall Declining Volumes*, 7 FED. RES. BANK OF RICHMOND REGION FOCUS, Winter 2003, at 1.

40. FED. RES. SYS., THE 2004 FEDERAL RESERVE PAYMENTS STUDY: ANALYSIS OF NONCASH PAYMENTS TRENDS IN THE UNITED STATES 2000-2003, at 3-4, (2004); Nash, *supra* note 39, at 1.

sumer's demand deposit or other asset account ("DDA"). Unlike credit card and travel and entertainment ("charge") card transactions, debit transactions offer neither revolving credit nor a grace-period before payment is due. A debit transaction, like a paper check transaction, involves the immediate withdrawal of funds from the DDA when the transaction is presented for settlement.

There are two principal types of POS debit transactions used by consumers in the United States: "off-line" signature-based debit ("signature debit") and "on-line" PIN-based debit ("PIN debit"). While both forms of debit are processed electronically, there are significant differences in how they are processed. Signature debit transactions are processed over the Visa and MasterCard credit card network in two separate electronic messages – one for authorization and one for settlement. They are verified with the cardholder's signature in face-to-face transactions. However, signature debit has no signature verification in telephone, mail order, or Internet purchases. In those venues, merchants employ alternative authentication methods such as Address Verification Service ("AVS"), Cardholder Verification Value ("CVV" or "CVV2"), Card Verification Code ("CVC"), or Card Identification Number ("CID" or "4DBC").

PIN debit transactions are routed and processed over the ATM networks operated by electronic funds transfer ("EFT") networks such as PULSE, STAR, NYCE, AFFN and SHAZAM (the "Regional Networks" or "Regionals"),[41] and by the respective Visa and MasterCard PIN debit networks, Interlink and Maestro. They are processed (both authorized and settled) in a single electronic message. PIN debit transactions are verified by the cardholder through the cardholder's use of a personal identification number (PIN).

PIN debit transactions are much safer, faster, cheaper, and more efficient than signature debit transactions. There is little risk of fraud associated with PIN verification, and no risk of insufficient funds for payment. Authorization and settle-

41. The EFT networks have traditionally been referred to as Regional Networks because they typically originated as associations of banks that were limited to particular regions of the country. Today, consolidation and expansion (as well as expansion of the roster of bank and merchant participants) have nationalized most of these networks.

ment occur simultaneously. Consequently, the fraud rates associated with PIN debit transactions in the United States have historically been extremely low, approaching zero.

On the other hand, the fraud rates associated with signature debit transactions are significantly higher, comparable to credit card fraud rates. One reason for the relatively high signature debit fraud rate is the inadequacy of signature as a verification mechanism. The typical store clerk is not trained to meaningfully compare the signature on the sales receipt with the signature on the back of the card. Signature verification is attempted in less than ten percent of face-to-face POS debit transactions,[42] and as noted above, is totally absent from telephone, mail order, and Internet sales transactions. Moreover, since signature debit transactions involve a delayed settlement (anywhere from two to five days after the transaction is authorized), there is a risk that the account will not have sufficient funds to cover the purchase when settlement is attempted.

For these reasons, among others, the federal and state governments limit access to most, if not all, of their electronic benefits transfer ("EBT") programs to PIN debit transactions.[43] The insecurity of signature debit also precludes the "cash-back" option available to consumers using PIN debit. At one time, Visa considered implementing a cash-back option with signature debit but decided against it when its risk experts

42. *See e.g.,* Pl.'s Summ. J. Ex. 493, *In re Visa Check/MasterMoney Antitrust Litig.* 192 F.R.D. 68 (E.D.N.Y. 2000) (No. 96-CV-5238) [hereinafter *In re Visa Check* Summ. J Ex.]. All references herein to exhibits (or portions of exhibits) submitted by plaintiffs in support of their motion for summary judgment in *In re Visa Check*, are to those that have been unsealed by court order or are otherwise publicly available.

43. During the 1980s, the federal and state governments developed the EBT system, providing government financial aid recipients a means by which they could access benefits electronically with a debit card. 1 DONALD I. BAKER & ROLAND E. BRANDEL, THE LAW OF ELECTRONIC FUND TRANSFER SYSTEMS ¶¶ 1.03[3], 5.06[1] (Update Feb. 2005). In 1996, the EBT Council of NACHA adopted standardized rules for government EBT programs, including requirements for issuance and management of PINs for cards. *Id.* at ¶5.06[1]; *see also* QUEST OPERATING RULES §§ 1.16, 2.1 (2005), http://ebt.nacha.org/docs/1.5_July_ 2005.pdf; David B. Humphrey, *The Economics of Electronic Benefit Transfer Payments*, FED. RES. BANK OF RICHMOND ECON. Q., Spring 1996, 77, at 80-81, *available at* 1996 WLNR 2541080 ("Using a personal identification number, or PIN, the recipient withdraws cash through an ATM and/or debits his EBT account using a debit card").

concluded that such a program would result in "huge [fraud] losses" and was a "disaster waiting to happen."[44]

2. *The Origins of PIN and Signature Debit*

Visa and MasterCard introduced signature debit in the United States in the late 1970s. The Associations' signature debit card programs were an extension of their credit card programs, using the same system of electronic interconnections among banks, processors and merchants. Missing, however, was the network infrastructure for electronically connecting to consumers' DDAs. This infrastructure had already been established by the Regional Networks. Because these Regional Network ATM programs were directly linked to cardholders' DDAs, banks were able to add POS capability to their existing ATM card base by simply interconnecting their ATM network with participating merchants. In many cases, merchants had already deployed ATMs in their stores.[45]

This pre-existing network infrastructure, coupled with PIN debit's superiority in safety, speed and cost, initially made PIN debit the preferred debit product for banks. This preference prevailed despite the credit card-style interchange fee pricing which Visa and MasterCard engrafted onto signature debit. The Associations' interchange fees for signature debit were a percentage of the transaction price and were identical to their credit card rates. PIN debit pricing, by contrast, either cleared at-par or involved negative (below-par) interchange. Negative interchange on a cents-per-transaction basis was paid to a merchant for each PIN debit transaction to give merchants an incentive to install PIN pads. Negative PIN debit interchange mirrored the model employed by the Regional Network ATM programs.[46] As discussed in more detail below, PIN debit would have remained and thrived in an at-

44. *In re Visa Check* Summ. J Ex. 393, *supra* note 42, at 36573; *In re Visa Check* Summ. J. Ex, 394, *supra* note 42, at 39905.

45. FUMIKO HAYASHI, ET AL., FED. RES. BANK OF KAN. CITY, A GUIDE TO THE ATM AND DEBIT CARD INDUSTRY, 13-14 (2003), *available at* http://www.kc.frb.org/FRFS/ATMpaper.pdf. [hereinafter *A Guide to the ATM and Debit Card Industry*]

46. ATM interchange fee is paid by the issuing bank to the owner of the acquiring ATM as payment for dispensing cash to the issuing bank's depositor. *Id.* at 5

par environment but for the Associations' successful efforts to suppress PIN debit and overturn the at-par model.

Banks did not need interchange to cover the cost of PIN debit functionality because ATM cards were already issued to the vast majority of their depositors. By the time the Associations began their campaign to destroy the at-par pricing model of PIN debit, the banks had already issued roughly 130 million ATM/PIN debit cards.[47] Banks offered PIN debit not merely as another access mechanism for their depositors, but also to avoid the substantial costs of processing the check transactions that PIN debit replaced. PIN debit attracted and retained depositors and promoted higher account balances. Giving depositors PIN debit access to their accounts deepened the banks' relationships with their customers, enabling them to cross-sell other bank services.

Initially, positive interchange was not part of the revenue model for PIN debit. This was not only because it was unnecessary to recover costs, but also because high interchange fees suppressed usage, which in turn reduced conversion from the costly paper checking banks sought to eliminate. The economic perversity of an issuing bank charging, say, 50 cents to a store for accepting the bank's PIN debit transaction when that transaction would replace an at-par check costing the bank $1 to process, was apparent to everyone. However, this economic perversity began to prevail once Visa, and later MasterCard, put their full force behind converting debit transactions and the checking system to their credit card fee model.

Initially, while the Regional Networks worked with banks to promote the growth of debit, Visa and MasterCard did little to advance their signature debit programs. By the early 1990s, roughly 15 years after PIN and signature debit simultaneously launched, PIN debit accounted for more than 60 percent of all debit transactions.[48] PIN debit was growing at an annual rate of more than 40 percent and was poised to grow even faster.[49] There was widespread industry expectation that PIN debit

47. HSN Consultants, THE NILSON REPORT, June 1993 at 6-7.

48. In 1993, PIN and signature debit accounted for 61.3% and 38.7% respectively, of total debit transactions in the United States. HSN Consultants, THE NILSON REPORT, Jan. 1994 at 1; HSN Consultants, THE NILSON REPORT, Apr. 1994 at 6-7.

49. *In re Visa Check* Summ. J. Ex. 294, *supra* note 42, at 24983.

would not only continue to dominate signature debit, but that PIN's superiority would eliminate signature altogether. Consistent with this widely-held view, a June 1990 presentation to the Visa board by Arthur Andersen predicted the ultimate "demise" of signature debit if PIN debit was "uncontained."[50] Andersen, Visa's long-time advisor, also predicted that, if "uncontained," PIN debit would maintain its at-par interchange structure.[51]

B. *The Associations' Assault on the Regional PIN Debit Networks and At-Par Interchange*

In 1990, forewarned by Andersen and industry consensus that at-par PIN debit would prevail in a free market, Visa decided to suppress PIN debit and its at-par model. Visa was not only concerned that a mature at-par PIN debit system would eliminate its signature debit card program, but that it would erode the profitability of Visa and MasterCard's credit card programs. Andersen projected annual reductions in the Associations' credit card revenues in the range of $701 million to $3.5 billion in 1990 dollars, but expressed most confidence in an annual reduction of $813 million.[52]

By the early 1990s, hundreds of local ATM/Debit networks had consolidated into fifty or so larger so-called Regional ATM/Debit networks – a trend which, had it continued, would have resulted in super-regional and, eventually, national networks. These networks had everything necessary to eventually enter the credit card market and compete with Visa/MasterCard. The ATM/Debit networks had thousands of issuing banks, well over 100 million cardholders, and state-of-the-art

50. *In re Visa Check* Summ. J. Ex. 299, *supra* note 42, at 1018613. *See also In re Visa Check* Summ. J. Ex. 548, *supra* note 42, at MCI-0328073 ("there is virtual consensus that on-line [PIN debit] products will ultimately dominate the U.S. POS debit marketplace"); *In re Visa Check* Summ. J. Ex. 179, *supra* note 42, at MCIA-071142 ("[w]e believe on-line debit will be far larger than off-line debit").

51. *In re Visa Check* Summ. J. Ex. 299, *supra* note 42 at 1018611.

52. *Id.*; *see also In re Visa Check* Summ. J. Ex. 302, *supra* note 42, at 5 ("[T]here is a clear danger that Visa Debit and Credit transactions will be preempted by the lower regional mark. This is . . . a strong threat to Visa interchange income"); *In re Visa Check* Summ. J. Ex. 738, *supra* note 42, at 96 (expressing concern that regional network at-par pricing could put downward pressure on credit pricing).

network infrastructures. They had a happy and growing roster of merchant customers which included most supermarkets and warehouse clubs that did not yet accept Visa or MasterCard credit (or debit) cards. PIN debit also threatened to cannibalize the use of credit cards for pure convenience, *i.e.*, use by the significant portion of cardholders who want to "pay now," but also enjoy the convenience of paying with plastic.

Finally, at-par PIN debit threatened credit card revenues because merchants preferred the guaranteed payment and the efficiency of electronic transactions delivered by PIN debit over discounted credit card payments replete with fraud, signature verification, and myriad other rules and penalties.

To counter the economic force of PIN debit's challenge, the Associations engaged in a frontal attack on PIN debit and the Regional Networks that offered the product. While the Associations took a free ride on the debit infrastructure that the Regional Networks had built, they simultaneously attacked these networks and their at-par pricing model with a dizzying array of predatory and anti-consumer tactics. The assault began in the 1980s as the Regional debit programs began to register double and triple-digit annual growth rates.

Visa acquired PLUS and MasterCard bought CIRRUS[53] to prevent these two national ATM networks from emulating the Regionals and extending their networks into national POS debit systems. In 1987, Visa and MasterCard merged their nascent PIN debit operations under the ENTREE Network joint venture. The Attorneys General from a group of 14 states, led by New York, sued under the Sherman and Clayton Antitrust Acts, alleging that ENTREE constituted an illegal merger and an attempt to monopolize the debit card market.[54] The States alleged that ENTREE was a preemptive gambit designed to retard the growth of the Regional debit networks and the progress of PIN debit.[55] After mounting a token defense of EN-

53. Visa acquired the PLUS ATM network in 1982 and MasterCard purchased CIRRUS in 1988. *A Guide to the ATM and Debit Card Industry*, *supra* note 45, at 13-14.

54. *In re Visa Check* Summ. J. Ex. 685, *supra* note 42, at 1-2 (First Am. Compl. in *New York v. Visa U.S.A., Inc.*, CV-89-5043 (S.D.N.Y. filed Apr. 6, 1990) (No. 89-5043) [hereinafter ENTREE compl.]).

55. *Id.,* ¶ 36.

TREE, Visa/MasterCard surrendered to the States and abandoned the network in 1990.[56]

Visa/MasterCard's ENTREE collaboration had included an explicit price-fixing agreement.[57] It later came to light that the formation of ENTREE also involved an agreement that Visa would not allow its internationally successful "*Electron*" online debit program to operate in the United States, in return for MasterCard agreeing to eliminate the "*MasterCard II*" debit identifier from ATM/Debit cards.[58] This was Visa/MasterCard's first step in a massive campaign to deceive merchants into thinking that the debit cards they received were credit cards. This campaign confused millions of consumers as well.

After the States terminated ENTREE, Visa and MasterCard shifted tactics. Visa bought Interlink[59] (by far the largest Regional debit network, accounting for more than 60% of all PIN debit), and immediately began to destroy it. In October 1991, five days after acquiring Interlink, Visa changed its pricing structure from at-par clearance to a positive interchange rate equal to 45 cents on a $100 purchase.[60] Meanwhile, MasterCard enticed a group of credulous Regional Networks to form "*Maestro*," with the promise that MasterCard would emphasize PIN debit and virtually abandon signature debit.[61]

Four months after Visa abandoned at-par clearance for PIN debit, MasterCard followed, pricing Maestro at the then outrageous $.095 interchange rate.[62] Although MasterCard promised its Regional partners that it would promote PIN debit and vigorously partner in a national network, six years later MasterCard measured Maestro's share of the debit card market at zero.[63] But MasterCard was too modest; Maestro's actual market share was .00006 percent.[64]

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56. *See e.g.,* Cheryl Wetzstein, *Debit Plan Not in the Cards for Credit's Top Players*, THE WASHINGTON TIMES, May 9, 1990 at C1.

57. *See* ENTREE compl., *supra* note 54, ¶ 40(d).

58. *See, e.g., In re Visa Check* Summ. J. Exs. 100, 101, *supra* note 42.

59. *See, e.g., Done Deal: Visa U.S.A.*, CARDFAX, Oct. 17, 1991.

60. *See, e.g.,* Yvette D. Kantrow, *Visa Launches Interlink With Aggressive Pricing*, AM. BANKER, Oct. 25, 1991.

61. *See e.g., All Systems Go: National On-Line Debit POS is Fast Becoming a Reality*, CARDFAX, Oct. 3, 1991 (announcing upcoming launch of Maestro).

62. *See e.g.,* Matt Barthel, *Card Rivals Firming up Plans for Debit Networks*, AM. BANKER, Feb. 24, 1992.

63. *In re Visa Check* Summ. J. Ex.. 688, *supra* note 42, at 1157.

64. *Id.* at 1155.

In the early 1990s, Visa and MasterCard used the Regional debit networks to sponsor thousands of banks into the Associations for the issuance of signature debit. This was only part of the free ride that Visa/MasterCard took on the backs of their Regional "partners."

1. *The Associations' Free Ride on PIN Debit*

Prior to 1990, the Regional Networks leveraged their burgeoning ATM programs to reach the POS and educated both consumers and banks on the benefits associated with POS debit. PIN debit blossomed because of the promotional efforts of the Regional Networks. Throughout this period, PIN debit pricing cleared at-par or paid merchants negative interchange.[65]

Awakening to the strategic importance of debit, Visa and MasterCard renewed their efforts to promote their foundering signature debit programs using the infrastructure established by the Regional Networks. Visa and MasterCard used the Regional Networks to sell the Associations' signature debit programs to the banks,[66] and cobranded the Regional Networks' pre-existing ATM/PIN debit card base of more than 130 million cards with Visa or MasterCard logos.[67] A July 2001 report prepared by industry consultant Benton International described this process:

> Signature Debit leveraged the existence of the ATM card base . . . and the on-line infrastructure developed to accept PIN-Debit . . . All of these elements were brought to market through the efforts of the then "regional" EFT networks. This contribution of the Network infrastructure to the success of Signature Debit has not been widely recognized, perhaps

65. *In re Visa Check* Summ. J. Ex. 311, *supra* note 42, at 0582088. The single exception was the BankMate network, which charged merchants a fee of only two basis points.

66. *In re Visa Check* Summ. J. Ex. 398, *supra* note 42, at 0507852; *In re Visa Check* Summ. J. Ex. 399, *supra* note 42, at 1292097; *In re Visa Check* Summ. J. Ex. 400, *supra* note 42, at 180.

67. HSN Consultants, THE NILSON REPORT, June 1993 at 6-7; *In re Visa Check* Summ. J. Ex. 398, *supra* note 42, at 1292097.

because it was not granted willingly, but was competitively taken.[68]

2. *The "Honor All Cards" Tying Arrangements*

With the infrastructure for signature debit in place, the acquisitions of PLUS, CIRRUS and Interlink complete, and the ENTREE joint venture terminated, Visa and MasterCard renewed their assault on PIN debit. The linchpins of the Associations' attack on PIN debit were their identical Honor All Cards ("HAC") tying arrangements. Under these tying arrangements, any merchant that accepted Visa/MasterCard credit cards was forced to accept Visa/MasterCard signature debit card transactions, regardless of their price, quality, or the terms under which they were offered. With market power leveraged from the credit card market to the debit card market, the Associations charged merchants supra-competitive prices for signature debit. The debit rates were identical to their credit card interchange rates.

In 1996, Visa/MasterCard signature debit interchange rates were 10 to 20 times the rates charged for PIN debit offered by the Regional Networks despite the fact that the pricing gap between PIN and signature debit had actually narrowed. When Visa bought Interlink and MasterCard launched Maestro in 1991, signature debit was infinitely more expensive than PIN debit (when measured as a percentage), because PIN debit cleared at-par or paid merchants to accept it.

The pricing gap between signature and PIN debit distorted the banks' debit issuance and promotion incentives. After favoring PIN debit through the early 1990s, U.S. banks did an about-face, and aggressively pushed signature debit and suppressed PIN debit. In doing this, they also suppressed the overall growth of debit and slowed the conversion from paper checks.

Visa/MasterCard banks moved PIN debit marks to the back of their cards and stopped promoting PIN debit's supe-

68. *NYCE Point-of-Sale Debit: A White Paper* (Benton International), July 2001 [hereinafter *NYCE White Paper*]. *See also id.* at 3 ("The contribution of the early Regional EFT in building the infrastructure that Signature Debit was able to exploit has not been adequately recognized. A successful POS program needs both a large card base and acceptance base. Signature debit leveraged the successes of the regional networks in both of these areas").

rior features. They penalized their cardholders for making PIN debit transactions. They adopted rewards programs such as air miles, cash rebates and prize sweepstakes for which only signature debit transactions qualified, and PIN debit was excluded and ridiculed (*e.g.*, "Skip the PIN, Sign and Win!").[69] Banks sent cardholders materials instructing them to always sign for their debit purchases or press the "Credit" button at the merchant terminal. One major bank went so far as to affix a "DO NOT INPUT YOUR PIN" sticker on the face of the millions of debit cards it issued.[70] John Fennell, an executive of New York Community Bank, explained the $1.50 charge assessed by his bank for each PIN debit transaction: "We are trying to encourage people to use debit cards the way they are supposed to be used, not with a PIN . . . We want everybody to use them as credit cards."[71]

The perverse incentives created by the tying arrangements forced the Regional Networks to respond by raising their prices. The pressure to raise their interchange fees was exacerbated by Visa's use of its Interlink and Visa Check Card II PIN debit products as a lever to elevate PIN debit pricing. Over the past decade, PIN debit pricing has increased by more than 2,000 percent! The combination of suppressed transaction flow and heavy price hikes significantly reduced the incentives for merchants to install PIN pads. The end result was higher prices, lower debit volumes, more paper checks, more fees from bounced checks, and the dominance of an inferior debit product.

3. *Additional Anticompetitive Acts*

Visa and MasterCard also engaged in numerous additional acts to facilitate, reinforce, and exacerbate the anticompetitive effects of their tying arrangements.

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69. Commerce Bank Skip the Pin, http://www.commercebank.com/skipthepin/index.html (last visited on Apr. 18, 2002).

70. Card face of Cincinnati-based Fifth-Third Bancorp debit card with MasterCard logo.

71. Heike Wipperfurth, *Banks Sock NYers with Debit Fees: More Institutions Quietly Charge for PIN-based Buys; No End in Sight,* CRAIN'S N.Y.BUS., May 20, 2002, at 3.

a. Anti-Steering Acts

Visa and MasterCard supplemented the tying arrangements, which prevented merchants from just saying "No thank you" to signature debit, with additional rules that prevented merchants from urging their customers to avoid signature debit transactions and instead use the PIN debit feature available with virtually every ATM/Debit card issued in the United States.

MasterCard's rule was explicit: "Merchants may not engage in acceptance practices or procedures that discriminate against, or discourage the use of, MasterCard cards in favor of any other card brand . . ."[72] Visa's rule stated that "[t]he Merchant shall promptly honor all valid Visa cards when properly presented as payment . . ."[73] Visa and MasterCard consistently enforced these rules to prohibit merchants from steering their customers to the use of PIN debit.[74] They also reinforced these rules with others which prohibited merchants from surcharging Visa/MasterCard transactions.[75] Because the rules deprived merchants of the ability to refuse the transactions or surcharge them, all consumers (rather than just those who used signature debit) paid for the supra-competitive fees.

Further, Visa and MasterCard disguised their debit cards both visually and electronically so that merchants could not

72. *In re Visa Check* Summ. J. Ex. 609, *supra* note 42, at 011527, 011543.

73. *In re Visa Check* Summ. J. Ex. 608, *supra* note 42, at 011465-66. In July 1998, after these rules became an issue in the lawsuit, Visa amended its rule to explicitly allow merchants to attempt to steer. *In re Visa Check* Summ. J. Ex. 633, *supra* note 42, at 865.

74. *In re Visa Check* Summ. J. Ex. 624, *supra* note 42, at 171 (Visa rules violation letter based on merchant that "prompted customer to enter in his pin number"); *In re Visa Check* Summ. J. Ex. 612, *supra* note 42, at 846 ("spoke with merchant and explained they cannot suggest other means of payment"); *In re Visa Check* Summ. J. Ex. 613, *supra* note 42, at 644 ("Types of Discrimination . . . Cardholder Presents a Mastercard Card – Clerk asks for a different card before transaction").

75. *In re Visa Check* Summ. J. Ex. 946, *supra* note 42 (Visa Operating Regulation 5.2.E (1998) ("A merchant must not . . . Add any surcharge to Transactions.")); *In re Visa Check* Summ. J. Ex. 609, *supra* note 42 (MasterCard Rule 9.04(14) (1999) ("The merchant shall not directly or indirectly require any MasterCard cardholder to pay a surcharge")).

distinguish them from Visa and MasterCard credit cards.[76] Visa ignored the unanimous recommendation of its branding experts that its credit and debit cards should be clearly distinguished to avoid customer confusion and to promote maximum debit usage.[77]

Even the handful of very large merchants who were strong enough to violate the anti-steering rules and had the technical sophistication to electronically distinguish some Visa/MasterCard debit transactions from credit transactions were not able to steer consumers to PIN debit. They faced obstacles such as pervasive and effective signature debit rewards, PIN debit penalties, and bank-generated consumer steering materials.[78] The few merchants that tried to steer risked significant consumer backlash from customers directed to a form of payment which their banks penalized them for using.

b. Interlink

When Visa acquired Interlink in 1991, it accounted for roughly 60 percent of all PIN debit transactions in the United States. Visa used Interlink to contain the growth of PIN debit, raise PIN debit pricing, and drive banks away from the Re-

76. *See e.g., In re Visa Check* Summ. J. Ex. 588, *supra* note 42, at 361-62, 365; *In re Visa Check* Summ. J. Ex. 575, *supra* note 42, at 177-82; *In re Visa Check* Summ. J. Ex. 576, *supra* note 42, at 213. To prevent merchants from electronically identifying signature debit cards through their Bank Identification Numbers ("BINs"), the Associations prohibited merchants from obtaining the BIN information and mixed the numbers for both credit and debit cards so the information would otherwise be useless. *See e.g., In re Visa Check* Summ. J. Ex. 600, *supra* note 42, at 973; *In re Visa Check* Summ. J. Ex. 601, *supra* note 42, at 743; *In re Visa Check* Summ. J. Ex. 604, *supra* note 42, at 53-54.

77. *In re Visa Check* Summ. J. Ex. 103, *supra* note 42, at 155 ("It was unanimous that, if Visa Debit is intended to be the flagship product and to produce sales commensurate with the potential market size, it *must* be somehow separated from Visa Credit and given a 'personality' of its own").

78. Dove Consulting, *Debit Issuer Survey: Cardholder Fees & Industry Outlook*, 1, 7, 24 (Aug. 2, 2002) *available at* http://www.pulse-eft.com,/documents/pdf/Debit_Survey_Document.pdf (survey of 50 banks finding that 26% had PIN debit penalty fees and 56% had signature debit only promotions); *id.* at 1, 19 (showing penalty fee of 50 cents reduced PIN debit usage by 40%); New York Public Interest Research Group, *ATM: Always Taking Money From Consumers*, Apr. 9, 2002, *available at* http://www.nypirg.org;consumer/atm/2003/toc.html (New York Public Interest Research Group survey finding that 57% of banks surveyed charged PIN debit penalty fees).

gional Networks. A May 1991 draft of its "Debit Strategy Proposal" set forth Visa's plan:

> The challenge to Visa, therefore, is to properly define the Interlink product . . . as a secondary product to fill a niche left unfilled by Visa Debit. If Interlink is not properly defined, it has the potential of emerging as a primary product, creating a threat to the Visa brand and income derived from the Visa brand. The Visa Board is concerned about this threat and has received assurances by management that the secondary product, Interlink, will be "controlled."[79]

Visa relegated Interlink to merchants who already accepted PIN debit. Visa reduced, and eventually eliminated, all promotional funding for Interlink.[80] The same week that Visa eliminated promotional funding for Interlink, MasterCard eliminated all U.S. promotional activities for its PIN debit program, Maestro.[81] Visa encouraged its members to issue signature debit cards to as many of their DDA customers as possible, consigning Interlink to low-income customers. Visa required members to obtain written consent before issuing a debit card with both Visa and Interlink logos.[82]

In 1996, the Director of Interlink acknowledged that Interlink "has been left to languish."[83] Within eight years, Interlink's 60 percent share of PIN debit plummeted to less than 10 percent,[84] as Visa used the network as a lever to force PIN debit pricing to rise. In 1991, Visa fixed Interlink interchange at 45 cents per $100 ticket, in a market where the entire PIN debit industry was at or below par. Over the next decade, Visa and its banks fixed several price increases for Interlink in-

79. *In re Visa Check* Summ. J. Ex. 304, *supra* note 42.

80. *In re Visa Check* Summ. J. Ex. 341, *supra* note 42 (E-mail dated August 15, 1997 from Visa's Director of Interlink, indicating that Visa "dropped [Interlink] advertising to '0' from $600,000").

81. *In re Visa Check* Summ. J. Ex. 692, *supra* note 42, at 548 (MasterCard memorandum dated August 15, 1997, stating "U.S. region indicated they have removed all support for Maestro from their budget"). At this time, however, MasterCard continued to vigorously promote Maestro to other parts of the world.

82. *In re Visa Check* Summ. J. Ex. 338, *supra* note 42.

83. *In re Visa Check* Summ. J. Ex. 342, *supra* note 42.

84. HSN Consultants, THE NILSON REPORT, Mar. 2000, at 7.

terchange.[85] Each increase forced the Regional Networks to respond with dramatic increases, lest they be dropped by the banks.

A May 1991 Visa document concisely projected the special role that Interlink would play in its plan:

> Visa must put forth forceful efforts to reduce the overall acceptance of these regional POS networks. In doing so, regional network ownership may be convinced to eliminate the regional ATM/POS mark from the POS environment and to replace the regional POS mark with Interlink thereby eliminating the problem.[86]

Visa also used its dual-function signature/PIN debit-capable Visa Check Card II product, introduced in 1998, to further force an increase in PIN debit pricing. While issuance of the card was minimal, and has all but disappeared today, the exorbitant interchange fee associated with the card led to significant price increases by the Regional Networks. As one Visa strategy document made clear, this is exactly what Visa planned: "Pricing to protect 'the floor.' Defending value of

85. As the district court in *In re Visa Check* noted in its class certification order, Interlink did implement one price decrease in April 1997, when Visa capped interchange at 12 cents. *In re Visa Check/MasterMoney Antitrust Litig.,*, 192 F.R.D. 68, 75 (E.D.N.Y. 2000). Contrary to Visa/MasterCard's expert's assertion, this price decrease caused an increase in Interlink's overall output, both in terms of transaction volume and merchant acceptance. *Id.* ("After this move, the number of Interlink transactions and merchants accepting the card *rose,* the opposite of what Schmalensee's model would have predicted").

86. *In re Visa Check* Summ. J. Ex. 304, *supra* note 42, at 642-43. *See also In re Visa Check* Summ. J. Ex. 743, at 608039 ("Support implementation of a Direct Debit POS Product by accepting 'Z' [Interlink] as the POS mark and migrating members to 'Z' [Interlink] and Visa [off-line] Debit, in place of regional POS marks . . . ") (*emphasis omitted*). *See also In re Visa Check* Summ. J. Ex. 409, *supra* note 42, at 1290874 ("One of the goals of the mainstreaming debit initiative is to issue Visa Check Cards and Interlink cards without the regional marks"); *In re Visa Check* Summ. J. Ex. 373, *supra* note 42, at 319308 ("Overview of Visa Debit Strategy . . . Desired End Game . . . Members drop regional marks from their Visa cards"); *In re Visa Check* Summ. J. Ex. 375, *supra* note 42, at 1295316 ("REGIONAL NETWORK STRATEGY . . . Incent processors to eliminate regional marks from their financial institution cards and replace with Interlink/Plus logos"); *In re Visa Check* Summ. J. Ex. 377, *supra* note 42, at 292975 ("RESTRICT DEPLOYMENT OF PIN PADS UNTIL REGIONALS ARE GONE").

on-line transaction . . . Even if product is never successful, 'you have earned your spurs' (regional networks will increase cost)."[87] These PIN debit price increases diminished merchants' incentives to install PIN pads.[88]

c. Bank Payoffs

In addition to the high fixed interchange the Associations forced upon merchants by the tying arrangements, Visa paid banks to stop issuing debit cards over the Regional Networks. In 1996, Visa and Andersen devised the *Deposit Access 2001 Mainstreaming Debit Strategy*, which called for Visa to meet with its top "5-6" signature debit card issuers and convince them to drop all Regional Network PIN debit marks from their debit cards.[89]

Bank of America was at the center of this effort. Visa believed that if it could persuade Bank of America and other large debit card issuers to drop the Regional Networks, it would create a "domino" or "snowball" effect, causing other Visa debit members to follow.[90]

In 1997, Visa commissioned Andersen Consulting to prepare a financial analysis for Bank of America, explaining why the bank should drop its Regional Network debit memberships. Visa utilized Andersen's work as a "portable analysis" for use with other banks allegedly competing with Bank of America.[91]

87. *In re Visa Check* Summ. J. Ex. 452, *supra* note 42, at 1625777.

88. *See, e.g.,* Richard Mitchell, *Bridging the Debit Gap*, CREDIT CARD MGMT., Feb. 2005, at 30, 32 ("steadily rising PIN-based interchange is softening the incentive to install PIN pads among merchants interested in lowering their debit acceptance costs"); *NYCE White Paper*, *supra* note 69, at 18 (PIN debit will likely grow "unless inhibited by the upward pricing trends").

89. *See In re Visa Check* Summ. J. Ex. 365, *supra* note 42 (*Deposit Access 2001 Visa U.S.A. Strategy Working Papers*, prepared by Andersen Consulting).

90. *See In re Visa Check* Summ. J. Ex. 380, *supra* note 42, at 268-69 (describing the "domino effect" as the belief "that if certain key banks dropped out of a region and created this awareness program, then it made it easy for the next bank and the next bank and the next bank"); *In re Visa Check* Summ. J. Ex. 404, *supra* note 42, at 356622 ("If you can get certain members to join then things should snowball").

91. *See In re Visa Check* Summ. J. Ex. 374, *supra* note 42, at 1412157 ("REGIONAL NETWORK STRATEGY . . . Goal/Objective: To facilitate Members' removal of regional marks from debit cards . . . Visa has hired Andersen Consulting to develop a state-by-state quantitative modeling assessment

In 1998, Visa and Bank of America agreed that the bank would promote only Visa-branded debit products (to the exclusion of the Regional Networks) in exchange for a large sum of money.[92] A year later, Bank of America dropped the Regional Network marks from the debit cards it issued in certain regions,[93] and in 2001, dropped STAR from all of its approximately 18 million debit cards.[94] The timing of Bank of America's action fell exactly along the debit strategy time-line that Visa and Andersen conceived in 1996.

Visa's payments to banks for dropping Regional PIN debit programs have increased in the last several years. Visa, armed with a $200 million fund established by its board,[95] obtained commitments for near or total Visa exclusivity from other banks, including U.S. Bank, Wachovia/First Union, Bank One, Wells Fargo, AM South, South Trust, Commerce Bank, BB&T, National City, PNC, SunTrust, and Synovus.[96] In addition to Bank of America and Nationsbank (now merged), Visa has succeeded in obtaining debit exclusivity from all of the re-

for Bank of America that will help get this bank's agreement to drop its regional marks . . . The outcome of the Bank of America project will be to develop a 'portable analysis' for Visa to use at the other big Member banks that have multi-state, multi-network configurations (*i.e.,* Nations and First Union)"); *see also* SJ Ex. 421 at '076 ("Objective: Incent BankAmerica to eliminate on-line regional marks (STAR) and rely upon Visa family of marks"); SJ Ex. 727 at 900 ("Regional Network Strategy Initiative . . . Bank of America Proposal Interview . . . Opportunity to partner with BAC to execute initiatives to remove regional marks from BAC check cards . . . Model of cooperation which Visa can extend to other regions and Members in execution of regional network strategy").

92. *See* Memorandum of Law in Support of Plaintiffs' Motion for Summary Judgment in *In re Visa Check*, June 7, 2000 (as redacted), at 45-46.

93. *In re Visa Check* Summ. J. Ex. 405, *supra* note 42, at 23-24, 145-46.

94. HSN Consultants, THE NILSON REPORT, Sept. 2001, at 1, 7. Bank of America has since returned to STAR for ATM access and limited POS debit access. However, Bank of America remains committed to Interlink for debit. *In re Visa Check* Summ. J. Ex. 1057, *supra* note 42; *see also* D. Breitkopf, *Star, Rebuilding Customer Base, Looks Overseas*, AM. BANKER, Apr. 2005.

95. *Concord EFS Company Update*, Lehman Brothers Equity Research, Oct. 22, 2002, at 1 ("Visa has just committed about $200 million to induce banks to move to Interlink").

96. *See, e.g.*, *Bank One to Drop Star Network*, CARDLINE, Jan. 23, 2004 (citing Bank of America, Wells Fargo, Wachovia, U.S. Bank, Bank One, SunTrust and unnamed others as having "switched or announced their intentions to switch . . . from Star to Interlink"); *KeyBank Renews Star Agreement, But Synovis Doesn't*, CARDLINE, Apr. 6, 2004.

maining "5-6 key Visa members" it originally targeted: U.S. Bank and First Bank (now merged), Norwest and Wells Fargo (now merged), and Wachovia and First Union (now merged).[97] The dominos are falling and the snowball is rolling downhill, to borrow both of Visa's metaphors.

4. *The Foreclosure of PIN Debit*

Visa and MasterCard's tying arrangements, and their associated anticompetitive conduct, suppressed the growth of PIN debit in the United States. In 1993, when Visa and MasterCard began promoting their signature debit programs, PIN accounted for roughly 60 percent of all debit transactions.[98] By 1998, signature debit accounted for roughly 60 percent of debit transactions.[99]

This market share flip occurred despite the widespread expectation that PIN debit would cause the ultimate "demise" of signature debit.[100] Andersen further predicted that if "uncontained," PIN debit would reach "6 billion transactions annually."[101] When these projections are compared to the actual "contained" evolution of PIN debit, the foreclosure is apparent. Rather than causing the "demise" of signature debit or merely outpacing it, PIN debit still trails signature debit 39.6 percent to 60.4 percent (for transaction volume) and 34.4 percent to 65.6 percent (for dollar volume).[102] Market-wide output has also been suppressed. PIN debit crossed the 6 billion annual transaction mark in 2003, a level that Andersen forecasted fifteen years ago.[103]

In Canada, by comparison, major banks refused to allow access to their depositors' asset accounts with signature

97. *See In re Visa Check* Summ. J. Ex. 330, *supra* note 42, at 325 (identifying the "five or six key banks that represent the majority of the [debit card] business"); *In re Visa Check* Summ. J. Exs. 298, *supra* note 42, at 766-67; *In re Visa Check* Summ. J. Exs. 331, *supra* note 42, at 103 (identifying banks with whom Visa has discussed anti-Regional strategy).

98. *See* HSN Consultants, THE NILSON REPORT, Jan. 1994, at 1; HSN Consultants, THE NILSON REPORT, Apr. 1994, at 6-7.

99. *See* HSN Consultants, THE NILSON REPORT, Mar. 1999, at 6-7; HSN Consultants, THE NILSON REPORT, Apr. 1999, at 6-7.

100. Plaintiff's Motion for Summ. J., *supra* note 51.

101. *Id.*

102. 2003 figures from HSN Consultants, THE NILSON REPORT, Feb. 2004, at 7; HSN Consultants, THE NILSON REPORT, Apr. 2004, at 7.

103. HSN Consultants, THE NILSON REPORT, Apr. 2004, at 7.

debit.[104] PIN debit transactions interchange at-par in Canada, and Visa/MasterCard have neither used tying arrangements nor engaged in related anticompetitive conduct to suppress PIN debit. As a result, PIN debit accounts for virtually 100 percent of Canada's debit transactions. In addition, *per capita* use of PIN debit is three and a half times greater than in the United States and nearly 50 percent greater than overall debit usage in the United States, even though PIN debit was introduced in Canada a decade later.[105]

C. *The Merchants Institute the* Visa Check/MasterMoney Antitrust Litigation

After complaints about Visa and MasterCard to state and federal antitrust agencies and to the Associations themselves, the merchants filed suit on October 25, 1996. Nearly seven years later, the United States District Court for the Eastern District of New York decided most aspects of the case in the merchants' favor on summary judgment. The case was settled on the day trial commenced. Visa and MasterCard eliminated the tying arrangements on January 1, 2004, and provided merchants with monetary compensation valued by the court at $3.383 billion and with injunctive relief valued by the court at $25 to $87 billion.[106]

The lawsuit, led by The Limited, Wal-Mart, Sears, Circuit City, Safeway and three of the country's largest retail trade associations,[107] resulted in a court-certified class of five million U.S. merchants who claimed that the tying arrangements and other anticompetitive conduct violated Sections 1 and 2 of the Sherman Act.

On April 1, 2003, the district court denied all of Visa/MasterCard's motions for summary judgment, and granted the

104. *In re Visa Check* Summ. J. Ex. 669, *supra* note 42 (Redacted Expert Report of Kenneth J. Morrison, Apr. 4, 2000, ¶¶ 14-15).

105. Dove Consulting, Inc., Debit in Canada (Feb. 2004), available at http://www.pulse-eft.com/rpr00010/pdf/debit_in_canada_executive.pdf (last visited Jan. 23, 2006).

106. *In re* Visa Check/MasterMoney Antitrust Litig., 297 F. Supp. 2d 503, 509, 511-12 (E.D.N.Y. 2003).

107. These trade associations include the Food Marketing Institute ("FMI"), the National Retail Federation ("NRF"), and the International Mass Retail Association ("IMRA"), now the Retail Industry Leaders Association ("RILA").

merchants summary judgment on most of their claims.[108] The court found, among other things, that: (i) debit and credit cards are distinct products; (ii) credit and charge card services to merchants constitute a relevant antitrust market; (iii) Visa had market power in that market; (iv) Visa/MasterCard tied their credit card services to their debit card services; (v) debit card services to merchants constitute a distinct and relevant antitrust market; and (vi) the tying arrangements affected a substantial amount of interstate commerce.[109]

On April 30, 2003, the parties settled, with Visa/MasterCard providing substantially greater injunctive relief than the merchants had initially sought, and paying roughly $3.4 billion (many multiples of the merchants' original monetary demand of "hundreds of millions of dollars").[110] The district court and the United States Court of Appeals for the Second Circuit recognized the settlement as "the largest settlement ever approved by a federal court," and "the largest antitrust settlement in history."[111]

The injunctive relief, which the court described as "far more significant" than the record-setting compensatory relief,[112] included the abolition of the tying arrangements, the clear, conspicuous and uniform rebranding of more than 200 million debit cards with unique visual and electronic "debit"

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108. *In re Visa Check,* 297 F. Supp. 2d at 508; *see also In re* Visa Check/MasterMoney Antitrust Litig., No. 96-CV-5238, 2003 WL 1712568 (E.D.N.Y. Apr. 1, 2003).

109. *In re* Visa Check/MasterMoney Antitrust Litig., 2003 WL 1712568. In denying defendants' motions, the Court found that: (i) the merchants' Section 2 allegations of predatory and anticompetitive conduct were "factually-supported;" (ii) the merchants made a "threshold showing" of a dangerous probability that Visa, individually, would achieve monopoly power in the debit card services market; (iii) the merchants presented direct and circumstantial evidence of a conspiracy; and (iv) the merchants "have presented a sufficiently compelling (and factually-supported) theory of damages . . ." *Id.* at 12-14.

110. *In re Visa Check/MasterMoney Antitrust Litig.,* Second Amended Consolidated Class Action Complaint and Jury Demand (the "Operative Complaint"), Master File No. CV-96-5238 (Gleeson, J.) (Mann, M.J.), filed Mar. 17, 1999, ¶¶ 190, 198, 206, 214.

111. *In re* Visa Check/MasterMoney Antitrust Litig., 297 F. Supp. 2d at 508; *aff'd*, 396 F.3d 96, 103, 119 (2d Cir. 2005).

112. *Id.* at 520.

identifiers, and the elimination of numerous anti-steering rules.[113]

D. *The State of the Debit Card Market Today*

The *In re Visa Check* court concluded that the settlement has "produced significant and lasting benefits for America's merchants and consumers."[114] The press, the banking industry, and the antitrust community heralded the settlement as "groundbreaking,"[115] "stunning,"[116] "the stuff of dreams,"[117] "revolutionary,"[118] and "a grand slam for the merchants."[119]

Merchants are now free to reject or steer their customers away from Visa/MasterCard signature debit. Visa and MasterCard must substantially lower their prices in order to compete for merchant acceptance. Numerous large merchants have used their newfound powers to negotiate agreements with the Associations and have extracted price reductions much larger than the published reductions. Signature debit interchange rates will likely continue to decline. On April 1, 2005, Visa instituted additional price reductions of roughly thirteen percent.[120]

Consumers have benefited from the lower merchant pricing and from the distinct debit branding mandated by the settlement, removing a source of significant consumer confusion. Consumers have also benefited from the growing number of merchants that are installing PIN pads to take advantage of their new rights and powers under the settlement. Following the settlement, the number of PIN-capable merchant terminals increased 23.5 percent, from 4.05 million terminals in

113. *Id.* at 508.

114. *Id.* at 524.

115. James J. Daly, *Legal Overload?* CREDIT CARD MGMT., Aug. 2003, at 4.

116. Kara Scannell & John R. Wilke, *Merchants Advance in Card Suit – Judge Sets Pretrial Ruling Against Visa, Mastercard on Many Issues of Fact*, WALL ST. J., Apr. 2, 2003, at C10, *available at* 2003 WL 10167680.

117. Sarah Henderson, *US Swipes Card Sharps*, HERALD SUN (Melbourne), May 28, 2003, at 18.

118. James J. Daly, *Cards Uncorked*, CREDIT CARD MGMT., July 2003, at 4.

119. Robert A. Bennett, *The Retailers' Home Run*, CREDIT CARD MGMT., July 2003, at 24.

120. Lavonne Kuykendall, *Visa Makes Big Changes to its Debit Interchange*, AM. BANKER, Nov. 3, 2004, at 1.

2002 to 5 million terminals at year-end 2003.[121] Included among the merchants that installed (or are in the process of installing) PIN pads are The Limited, Sears, Circuit City, Barnes & Noble, Best Buy, Dollar Stores, and Kenneth Cole.[122] Increased PIN terminalization is particularly beneficial to low-income consumers who generally are not issued signature-capable ATM/Debit cards and whose only access to POS debit is with a PIN.

Despite these "significant and lasting" merchant and consumer benefits, the debit card market is in need of government intervention. Signature debit pricing has dropped significantly, but still reflects two decades of market power abuse and continuing anticompetitive conduct. Some of this conduct, most notably the continuing cartel pricing of signature debit interchange, was not addressed in either *In re Visa Check* or in the United States' separate, later-filed case against Visa/MasterCard.[123] The number of PIN-capable merchants has grown considerably, but it is still artificially low. Competition among Visa, MasterCard, and the Regional Networks has intensified, but does not yet occur on a level playing field. There are numerous lingering effects of the Associations' campaign to suppress and dominate debit, which have become part of the fabric of a market that remains distorted.

Central to the residual problems in the debit card market is the insatiable appetite for interchange that Visa and MasterCard created with their fixed pricing for signature debit. Banks that originally saw debit principally as a tool to save costs and develop customer relationships were indoctrinated to look at debit as a short-term profit center, rather than a check replacement device for access to depositors' DDAs. Along the way, the banks lost sight of the reason they developed PIN debit in the first place.

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121. HSN Consultants, THE NILSON REPORT, Apr. 2003, at 6; HSN Consultants, THE NILSON REPORT, Apr. 2004, at 7.

122. *See, e.g., Holidays Brighter for Visa's Interlink Than for Rival Star*, ATM & DEBIT CARD NEWS , Jan. 20, 2005, *available at* 2005 WLNR 821519 (citing Barnes & Noble, Dollar Stores, and others); Richard Mitchell, *Bridging the Debit Gap*, CREDIT CARD MGMT., Feb. 1, 2005, *available at* 2005 WLNR 1372026 (citing Circuit City, Kenneth Cole, and others).

123. U. S. v. Visa U.S.A. Inc., 163 F. Supp. 2d 322, *judgment modified*, 183 F. Supp. 2d 613 (S.D.N.Y. 2001), *aff'd*, 344 F.3d 229 (2nd Cir. 2003), *cert. denied*, 125 S.Ct. 45 (2004) [hereinafter *U.S. v. Visa and MasterCard*].

While a competitive market or another successful antitrust challenge might ultimately undercut or eliminate this cartel pricing, the U.S. market is still highly trade-restrained. Signature debit interchange, though significantly lower than prior to the *In re Visa Check* settlement, is still among the highest debit pricing in the world.[124] PIN debit pricing is rapidly rising. PIN debit interchange increases are driven by the continued exercise of market power by Visa/MasterCard. Escalating PIN debit interchange may eliminate the economic rationale for PIN terminalization.[125]

Merchant power, though greater after the settlement, is largely concentrated among bigger merchants who have the power to negotiate with the Associations.[126] The significance of their new choices has been tempered by the substantial "lock-in" of merchants forced to accept signature debit for more than two decades. The Federal Reserve recently recognized both of these constraints:

> With the recent removal of the honor-all-cards rule, merchants now have the option of refusing signature debit as a form of payment . . . However, because consumers are now accustomed to signature debit as a widely accepted method of payment, many merchants would likely be unable to drop signature debit without losing customers. Similarly, the scenario in which many moderate-sized or smaller merchants would find it profitable to drop signature debit seems unlikely.[127]

124. For example, average debit pricing in Canada and the Netherlands is zero; in the United Kingdom it is between 6 cents for domestic PIN debit to 10 cents for Visa/MasterCard PIN debit; and in Australia, average debit pricing is -20 cents for PIN debit and 40 cents for signature debit.

125. *See* Mitchell, *supra* note 88; *see also NYCE White Paper*, *supra* note 88, at 18.

126. For example, Wal-Mart has recently negotiated lower signature debit interchange rates with MasterCard. *See, e.g.,* Morgan Stanley Equity Research, WEEKLY PULSE, June 28, 2004, at 3 ("We would guess, based on commentary from Wal-Mart, that the [MasterCard signature debit] interchange rate is well below 1% and possibly as low as the fees for on-line").

127. Board of Governors of the Federal Reserve System, *Report to the Congress on the Disclosure of Point-of-Sale Debit Fees* (Nov. 2004), *available online at* http://www.federalreserve.gov/boarddocs/rptcongress/posdebit2004.pdf [hereinafter *Report on Disclosure of POS Debit Fees*], at 42-43.

At the same time, Visa is buying near-exclusive debit relationships with many of the major banks in the country. As the number of consumers whose debit cards are Visa/Interlink or MasterCard/Maestro-only grows, the threat that merchants will turn to alternative sources for debit becomes less credible.[128] The *In re Visa Check* settlement has helped, but the market is still failing and suffering from the effects of the Associations' destruction of at-par PIN debit interchange, which had prevailed in a free market.

In the United States' failed debit card market, rapidly expanding output and scale economies produce higher prices, reduced efficiency and diminished quality. This failed market needs the intervention of the Federal Reserve to restore the dynamic of a free market destroyed through documented and adjudicated predation.

III. WHY THE FEDERAL RESERVE SHOULD MANDATE AT-PAR DEBIT

A. *The Federal Reserve's Failure to Regulate Debit*

In contrast to efforts the Federal Reserve undertook to establish and regulate at-par checking, it has done nothing to address the predation-induced failure of the debit card market or the usurpation of its role by the Associations. The Federal Reserve's initial reluctance to exercise authority over debit, despite the fact that debit was replacing checks (a product regulated by the Federal Reserve), may have resulted from a *laissez faire* approach to evolving payment forms. The Fed has traditionally regulated only after a payment market has matured, and only after a determination that the market exhibits signs of failure for an extended period of time. The Federal Reserve's campaign to establish at-par clearance of checks took place after it was clear that the dysfunctional checking system would not repair itself.

When Congress authorized the Federal Reserve to oversee electronic payments under the Electronic Funds Transfer Act (the "EFTA"),[129] it clearly directed that the Federal Reserve

128. The banks with which Visa has recently entered into some form of Visa/Interlink exclusivity arrangements collectively issue roughly 60 million POS debit cards. HSN Consultants, THE NILSON REPORT, Apr. 2004, at 8.

129. 15 U.S.C. § 1693 *et seq.* (1978).

allow the market to develop with minimal regulation.[130] However, Congress was equally clear that the Federal Reserve had broad powers to intervene if the system failed to operate "fairly, efficiently, and with public confidence."[131] The debit card market is neither operating fairly nor efficiently. It has lost the confidence of millions of U.S. merchants, where tens of millions of Americans work and virtually every U.S. consumer shops.

The Federal Reserve has recently acknowledged that it must become more involved in debit. It has begun to take steps to evaluate the U.S. debit card market and examine the principal source of the market's failure: fixed interchange.

In September 2003, the Federal Reserve Bank of Kansas City published findings from a study of the debit card market[132] conducted pursuant to the Federal Reserve's mission of "ensuring the smooth functioning of the payments system,"[133] and prompted by developments in the debit card market that were "fundamentally altering the payments landscape, with important implications for efficiency, safety, and access."[134] These developments included "the sharp growth in point-of-sale debit card transactions, the intense competition between online and offline debit, and new pricing structures and strategies."[135]

Central to the Kansas City Fed's ongoing inquiry is the critical role of interchange: "The interchange fee is one of the key elements that affects not only the future of the online debit industry but also the landscape of the payments system in the future."[136] While reserving judgment on many of the questions surrounding interchange, such as the optimal debit interchange rate, whether there should be any interchange

130. "The Committee agrees that it is desirable to minimize regulation of EFT at this time . . ." Senate Committee on Banking, Housing, and Urban Affairs on Committee Bill (S. 3156) to Provide for Consumer Rights and Safeguards in Electronic Fund Transfer Systems, Senate Report No. 95-915 (May 26, 1978), *available at* S. REP. NO. 95-915 (1978), *reprinted in* 1978 U.S.C.C.A.N. 9403, 9405 [hereinafter Senate Report 95-915].

131. *Id.*

132. *See A Guide to the ATM and Debit Card Industry, supra* note 46.

133. *Id.* at iii.

134. *Id.*

135. *Id.*

136. *Id.* at 82.

fees in debit, and whether the government should regulate such fees, Kansas City recognized the centrality of these interchange questions to the path that the debit card market will take.

The Kansas City Reserve Bank recognized that many of the justifications for interchange in credit card networks simply do not hold in the context of debit, and certainly not PIN debit. Interchange is not needed to compensate issuers for the cost of PIN terminalization because merchants pay for it.[137] Interchange is not needed for the cost of debit processing because debit is significantly cheaper to process than the checks it replaces.[138] Interchange is not needed to provide banks with an incentive to issue debit cards. The cards were already issued as part of their ATM programs.[139] Nor is it needed to compensate issuers for the risk of fraud and charge-offs (at least for PIN debit) because with PIN debit, there is virtually none.[140]

According to the Reserve Bank's report, the only reason for PIN debit interchange, and the reason PIN debit interchange continues to rise, is that it is "necessary for online debit networks to compete with offline debit networks."[141] In other words, as the Reserve Bank conceded, competition in the U.S. debit card market leads to higher, not lower, prices.[142] This perverse "competition" which prevails in the debit card market is evidence of market failure, and is the

137. *A Guide to the ATM and Debit Card Industry, supra* note 46, at 79.

138. *Id.*

139. *Id.* at 79-80 ("In contrast with credit cards, a cardholder base for debit cards was fairly well-established before the explosive growth of debit transactions in the 1990s. Banks were able to exploit the large base of ATM cardholders by simply adding a debit function to ATM cards. Even if the interchange fee was helpful in further expanding the number of debit cardholders, the industry is no longer an infant industry and, hence, that rationale is no longer applicable").

140. *Id.* at 80 ("There is no risk of charge-offs for online debit because the transaction amount is immediately debited from the consumer's account. Fraud risk is much smaller for debit than credit card transactions because of the features of debit card transactions, such as PIN and immediate account settlement").

141. *Id.* at 80.

142. *A Guide to the ATM and Debit Card Industry, supra* note 46, at 83 ("[T]he usual competition-price relationship (that is, more competition lowers the price) does not necessarily hold for interchange fees. Until recently there has been little pressure to contain interchange fees because competi-

principal reason why action by the Federal Reserve is necessary.[143]

The May 2005 Kansas City Federal Reserve Bank conference in Santa Fe, New Mexico, has continued the inquiry into the role interchange plays in the debit card market. The Reserve Bank brought together authorities from payment networks, central banks, academics and lawyers to further its inquiry as to whether there is "a rationale for central bank or other agency involvement in the setting of interchange fees."[144]

Unfortunately, the Reserve Bank failed to include among the speakers a single U.S. merchant. This is curious given the Reserve Bank's recognition that interchange is "[p]aid by merchants to card issuers on a per-transaction basis."[145] Moreover, not a single representative of a Regional PIN debit network was invited to speak, notwithstanding the Reserve Bank's recognition that a major issue to be addressed is the effect that signature debit interchange has had on PIN debit networks. However, numerous representatives of Visa and MasterCard spoke at the conference.

Following the May 2005 Kansas City Fed conference, the Chicago Fed sponsored a conference entitled "Innovations, In-

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tion among offline and online debit networks has tended to raise interchange fees rather than decrease them").

143. The September 2003 Kansas City report was followed in November 2004 by a Reserve Board report to Congress on consumer disclosure of PIN debit penalty fees. *See Report on Disclosure of POS Debit Fees, supra* note 128. The Senate Banking, Housing, and Urban Affairs Committee asked the Reserve Board to prepare the report out of concern that consumers were not being adequately informed of the existence or purpose of these fees. *See* Press Release, Federal Reserve Board Request for Comment on Adequacy of Existing Disclosures on Debit Card Fees, (May 18, 2004), http://www.federalreserve.gov/boarddocs/press/bcreg/2004/20040518/. While the Reserve Board principally focused its analysis on the issue of consumer disclosure, it recognized the importance of understanding and accounting for the incentives the current debit system provides for favoring a form of payment that "from the perspective of the financial system as a whole, is more costly." *Report on Disclosure of POS Debit Fees, supra* note 127, at 42.

144. *A Guide to the ATM and Debit Card Industry*, *supra* note 46, at 91; *see also* INTERNATIONAL PAYMENTS POLICY CONFERENCE, INTERCHANGE FEES IN CREDIT AND DEBIT CARD INDUSTRIES: WHAT ROLE FOR PUBLIC AUTHORITIES? (May 4-6, 2005), http://www.kc.frb.org/FRFS/PSR/2005/05prg.htm [hereinafter Santa Fe Interchange Fee Conference materials].

145. *See* Santa Fe Interchange Fee Conference materials, *supra* note 144.

centives and Regulation: Forces Shaping the Payments Environment," which again examined some of the issues raised in this paper. In another significant development, the New York Fed held a conference in September 2005, titled "Antitrust Activity in Card-Based Payment Systems: Causes and Consequences," which touched directly on the issues addressed here. This flurry of Federal Reserve activity demonstrates the widespread interest and concern about these issues throughout the country.

B. *The Federal Reserve's Authority to Regulate Debit*

The Federal Reserve's authority to regulate debit derives from two sources. Under the EFTA, the Federal Reserve has broad and flexible powers to ensure efficiency, competition, and consumer choice in the debit card market. Under the FRA, the Federal Reserve has similarly broad powers to regulate payment systems. These statutes provide the Federal Reserve with the authority and responsibility to remedy the failure of the U.S. debit card market.

1. *The Federal Reserve's Authority under The EFTA*

Enactment of the EFTA followed from the findings of the National Commission on Electronic Fund Transfers, which Congress established in 1974 to investigate rapidly developing electronic funds transfer systems.[146] In addition to consumer protection issues, Congress created the Commission out of a concern "that without sufficient study[,] electronic funds transfers development could result in distortions to competition . . ."[147]

The Commission studied the efficacy of extending safeguards already available to consumers paying with checks and credit cards to consumers who, in the future, would pay with

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146. *See* S. REP. NO. 95-915 (1978), *reprinted in* 1978 U.S.S.C.A.N. 9403.

147. Senate Committee on Banking, Housing, and Urban Affairs, S. REP. NO. 93-902 (1974) *reprinted in* 1974 U.S.C.C.A.N. 6119, 6133. *See also id.* at 6132 ("The function of this Commission is to conduct a thorough study and investigation of electronic funds transfer systems and to recommend appropriate administrative action and legislation taking into account among other things: The need to preserve competition among the financial institutions and other business enterprises using such a system").

electronic funds transfers.[148] In its October 1977 Final Report to Congress, the Commission stressed the importance of competition and free choice in evolving EFT systems:

> The Commission concludes that the development of EFT within an orderly competitive marketplace would be in the best interest of consumers, providers, and suppliers of EFT systems.[149]
>
> EFT should be a means to expand consumer choice among financial services, not to narrow it . . . [I]t is essential that consumers have the ability to choose among payment alternatives, and that any attempt to restrict such choice should be prohibited to the extent possible.[150]

Congress enacted the EFTA in 1978 "to provide a basic framework establishing the rights, liabilities, and responsibilities of participants in electronic funds transfer systems."[151] It delegated broad authority to the Reserve Board to "prescribe regulations to carry out the purposes" of the statute, and adopted Regulation E pursuant to this authority.[152] Regulation E applies "to any electronic fund transfer that authorizes a financial institution to debit or credit a consumer's account."[153]

148. S. REP. NO. 95-915, at 9404-05; *see also generally*, Truth in Lending Act ("TILA"), § 102, 15 U.S.C. § 1601 (1968); U.C.C. §§ 3, 4 (1977).

149. NAT'L COMM'N ON ELEC. FUND TRANSFERS, EFT IN THE UNITED STATES: POLICY RECOMMENDATIONS AND THE PUBLIC INTEREST: THE FINAL REPORT OF THE NAT'L COMM'N ON ELEC. FUND TRANSFERS 17 (1977).

150. *Id.* at 41.

151. 15 U.S.C. § 1693(b) (1999).

152. 15 U.S.C. § 1693b(a) (1999); 12 C.F.R. § 205.1(b) (2005).

153. 12 C.F.R. § 205.3(a) (2005). The term "electronic fund transfer" is defined as "any transfer of funds that is initiated through an electronic terminal, telephone, computer, or magnetic tape for the purpose of ordering, instructing, or authorizing a financial institution to debit or credit an account." 12 C.F.R. § 205.3(b) (2005). The types of transactions covered by this law include POS and ATM transactions, direct deposits, withdrawal of funds, telephone transfers, and debit card transactions, whether or not initiated through an electronic terminal. *Id.* The term "account" is defined as "a demand deposit (checking), savings or other consumer asset account (other than an occasional or incidental credit balance in a credit plan) held directly or indirectly by a financial institution and established primarily for personal, family, or household purposes." 12 C.F.R. § 205.2(b)(1) (2005).

Among the principal protections afforded consumers under Regulation E are (i) restrictions on a bank's issuance of debit cards,[154] (ii) limitations on consumer liability for unauthorized transactions,[155] and (iii) mandatory disclosures regarding the terms and conditions for making electronic transfers.[156]

Beyond the explicitly-defined consumer protection purposes of the Act and Regulation E, the Federal Reserve's power to regulate debit interchange derives from the expansive authority it was granted to do anything necessary and proper to effectuate the broader objectives of the Act:

> Regulations prescribed hereunder may contain such classifications, differentiations, *or other provisions*, and may provide for such adjustments and exceptions for any class of electronic fund transfers, as in the judgment of the Board are *necessary or proper to effectuate the purposes* of this subchapter, to prevent circumvention or evasion thereof, or to facilitate compliance therewith.[157]

Congress believed that allowing the Federal Reserve to employ a broad and flexible regulatory regime was not only "essential to the Act's effectiveness," but was also "necessary for the continuing development of electronic banking services."[158] The Federal Reserve has amended Regulation E

154. 12 C.F.R. § 205.5(b) (2005) (financial institution may distribute a debit card on an unsolicited basis only if the card is not validated, and is accompanied by a clear explanation that the consumer does not need to accept the card, and by certain disclosures regarding the consumer's rights and liabilities associated with the card's use).

155. 12 C.F.R. § 205.6(b)(1) (2005) (if the consumer notifies the financial institution within 2 days after learning of loss or theft of the debit card, the consumer's liability for unauthorized transactions is limited to $50).

156. 12 C.F.R. § 205.7 (b)(5) (2005) (one of the disclosures mandated by this provision is notice of "[a]ny fees imposed by the financial institution for electronic fund transfers").

157. 15 U.S.C. § 1693b(c) (1999) (emphasis added).

158. *See* S. REP. NO. 95-915 (1978), at 19, *reprinted in* 1978 U.S.C.C.A.N. at 9421 ("The [Senate] Committee believes these regulations would be essential to the Bill's overall effectiveness and to provide the flexibility necessary for the continuing development of electronic banking services."); *id.* at 9412 ("The Committee regards regulations as essential to the Act's effectiveness. These regulations will add flexibility to the Act by permitting the Board to modify the Act's requirements to suit the characteristics of individual EFT

when necessary, to address new developments in electronic funds transfers and to expand the Federal Reserve's influence over them.[159]

The Federal Reserve should use these powers to address the distortions that Visa, MasterCard, and their bank cartel have imposed upon the debit card market in their two-decade campaign.[160] But for the fixed and artificially high interchange fees that the Associations have charged for their signature debit transactions, these distortions would not exist, and PIN debit would have continued to develop in a competitive marketplace.

The Associations' predatory campaign in the debit card market over the last two decades, replete with tying arrangements (*In re Visa Check*), group boycotts (*U.S. v. Visa and MasterCard*), and the ongoing interchange price-fixing cartel, has substantially restrained the competitive marketplace which the FRA and the EFTA empower the Federal Reserve to maintain. The Federal Reserve must restore full competition to this marketplace by eliminating the cartel pricing. Indeed, well before the full picture of the Associations' predatory campaign became manifest and the subject of both private and government antitrust litigation, the need to regulate was apparent at the state government level. The 1990 *Entree* case prosecuted by 14 State Attorneys General was the first expression of this awareness.

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services. Moreover, since no one can foresee EFT developments in the future, regulations would keep pace with new services and assure that the Act's basic protections continue to apply"); *id.* at 9411 ("This delegation of authority to the Board is an important aspect of this legislation as it would enable the Board to examine new services on a case-by-case basis and would contribute substantially to the Act's overall effectiveness").

159. *See* 49 Fed. Reg. 2972 (Jan. 13, 1981) (amending Regulation E to exempt overdraft credit plans from the prohibition of conditioning an extension of credit on repayment by preauthorized debit); 49 Fed. Reg. 40794 (Oct. 18, 1984) (amending Regulation E to cover debit card transactions that do not involve an electronic terminal at the time of the transaction); 59 Fed. Reg. 10678 (Mar. 7, 1994) (amending Regulation E to cover EBT programs established by federal, state, or local government agencies).

160. As the Second Circuit observed in *U.S. v. Visa and MasterCard*, "Visa U.S.A. and MasterCard . . . are not single entities; they are consortiums of competitors. They are owned and effectively operated by some 20,000 banks . . ." U.S. v. Visa & MasterCard, 344 F.3d 229, 242 (2nd Cir. 2003).

In the early 1990s, the State of Iowa realized that the Associations were tying debit and credit card services, deceiving merchants about the distinction between debit and credit cards, and collectively fixing debit interchange prices. Iowa inquired as to why the Federal Reserve, which effectively had mandated the at-par interchange of checks, had not acted similarly with respect to the debit card transactions which were replacing paper checks.

In the face of the Federal Reserve's acquiescence (which at the time was explicable as an effort to see how the market would evolve free of regulation), Iowa drafted legislation which would have regulated the debit card market in three important ways. First, the Iowa bill would have prohibited the tying of debit card acceptance to credit card acceptance, which the *In re Visa Check* decree accomplished thirteen years later. Second, it would have required that debit cards be conspicuously labeled as such, to address the intentional confusion created by the Associations' campaign to deceive merchants. The *In re Visa Check* decree also accomplished this objective. Third, it would have mandated at-par interchange of any debit transaction accessing an asset account in the State of Iowa. Dale Dooley, then head of the Iowa Transfer System ("ITS"), now the SHAZAM ATM/Debit network, testified in the *In re Visa Check* case that this proposed legislation was killed by a planeload of lawyers sent in by Visa and MasterCard.

After Visa and MasterCard killed most of the Iowa bill with threatened litigation, a scaled-back version devoid of the anti-tying and conspicuous labeling reforms was enacted by the Iowa legislature. This law, which mandated at-par interchange of debit transactions, was passed on May 29, 1991, with an effective date of July 1, 1994. However, prior to the law's at-par provision taking effect, another wave of threats by Visa/MasterCard caused Iowa to effectively repeal that provision.

Visa/MasterCard demonstrated that their power, which derives from the collective force and action of thousands of banks, is too much for any single state government to withstand. More than a decade later, as the Federal Reserve and its Regional Banks consider the example of Iowa and all that the Associations have done to restrict the debit card market since then, it is clear that the responsibility to act falls squarely on the shoulders of the Fed.

The Federal Reserve must now fulfill its responsibility to foster a debit card market that operates "fairly, efficiently, and with public confidence,"[161] and free of "distortions to competition,"[162] by aggressively acting to foster the at-par interchange of all debit card transactions. Taking a page from its early efforts with at-par checks, the Fed can take aggressive measures to move the market toward at-par interchange, without making it mandatory.

Such action will protect low-income consumers who are not issued signature-capable debit cards and can only use highly-penalized PIN debit for payment. The protection of such low-income consumers from unfair and discriminatory bank practices was a primary focus of the Congress when it enacted the EFTA: "In prescribing [its] regulations, the [Reserve] Board shall . . . prepare an analysis of economic impact which considers . . . the availability of [electronic banking] services to different classes of consumers, particularly low income consumers."[163]

The Federal Reserve's authority to regulate debit interchange derives not only from its powers under the EFTA to protect consumer rights and competition, but also from the very specific directive to "assure that EFT develops in an environment of free choice for the consumer."[164] Consumers

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161. S. REP. NO. 95-915 (1978), *reprinted at* 1978 U.S.C.C.A.N. at 9405.

162. S. REP. NO. 93-902 (1974), *reprinted at* 1974 U.S.C.C.A.N. at 6133.

163. 15 U.S.C. § 1693(b)(a)(2) (1999). *See also* S. REP. NO. 93-902 (1974), *reprinted at* 1974 U.S.C.C.A.N. at 6132 ("The function of this Commission is to conduct a thorough study and investigation of electronic funds transfer systems and to recommend appropriate administrative action and legislation taking into account among other things: . . . [t]he need to prevent unfair and discriminatory practices by any financial institution and other business enterprise using such a system").

164. S. REP. NO. 95-915 (1978), *reprinted at* 1978 U.S.C.C.A.N. at 9409; *id.* at 9418 ("This section contains prohibitions on compulsory use of EFT services which are designed to assure the EFT develops in an atmosphere of free choice for the consumer. First, an extension of credit could not be conditioned on a consumer's repayment by means of preauthorized (automatic) transfers. While a creditor could not offer only loans repayable by EFT, this section would not prohibit a creditor from offering a lower annual percentage rate to consumers who repay by EFT. This lower rate would have to reflect the cost savings of EFT to the creditor, however, and could not be set artificially so as to induce EFT repayment").

could not exercise free choice when they were intentionally misled, as millions were, about the identity and functionality of Visa and MasterCard signature debit.[165] While that confusion has been eliminated, today free choice is still constrained by PIN debit penalty regimes which steer consumers to a less safe and less efficient product. This widespread practice, which flows from the high fixed-price of signature debit, impinges upon the ability of consumers to freely choose the form of debit they want to use.

Action by the Federal Reserve to address this failure, by removing the financial incentives of banks to impose such PIN penalties, is plainly within the Federal Reserve's mandate to protect consumer choice. If the Federal Reserve determines that it is without authority under the EFTA to prescribe these necessary and overdue debit regulations, it should propose appropriate legislation to the Congress. The Board is required to make annual reports to Congress "concerning the administration of its functions under this subchapter, *including such recommendations as the Board deems necessary and appropriate*."[166]

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165. Overwhelming evidence of such confusion was revealed in *In re Visa Check*. For example, an unsealed 1995 MasterCard survey revealed that 72% of the users who were surveyed about the functions of the MasterCard-branded debit card thought it was a credit card. *In re Visa Check* Summ. J. Ex. 776, *supra* note 42, at 135. Even members of the House Committee on Banking and Financial Services have experienced the effects of Visa and MasterCard's campaign of deception. At one meeting of this committee in 1997, the Honorable Thomas M. Barrett (WI) described his confusion: "I was issued a debit card and was carrying it around in my pocket without even realizing it was a debit card. The card, as you can see, looks almost identical to my credit card and was stamped with the same logo, and I actually used this card to make what I thought was a credit card purchase . . . Fortunately, I had enough money in my checking account at that time and was not faced with the unpleasant situation for a Member of Congress of bouncing checks. But the reality is that thousands, if not millions, of Americans are being issued debit cards and are carrying them around without realizing it, and are unaware of their potential liability in the case of theft or loss." *Debit Cards and Unsolicited Loan Checks*, 105th Cong. 16-17 (1997) (statement of Rep. Barrett, Member, House Comm. on Government Reform), *available at* http://commdocs.house.gov/committees/bank/hba4 3660.000/hba43660_0.HTM.

166. 15 U.S.C. § 1693(p)(a) (1999) (emphasis added). The FRA likewise mandates reports on a semi-annual basis from the Board to Congress under Section 2B. 12 U.S.C. § 225b (2005).

2. *The Federal Reserve's Authority under the FRA*

The Federal Reserve's authority to regulate debit interchange also derives from the FRA. Congress enacted the FRA to create a central banking authority with broad powers "to establish a more effective supervision of banking in the United States."[167] The Federal Reserve has recognized that among its core responsibilities under the FRA are the promotion of "the integrity and efficiency" of U.S. payments markets, and the assurance of "competitive fairness" for all participants.[168]

Congress intended the Federal Reserve to play both a regulatory and a participatory role in carrying out these functions.[169] The Federal Reserve was intended to serve as the "institutional anchor" for the U.S. payments system.[170] Historically, it has performed this role through active involvement and oversight of cash, checks, and the ACH system.[171] The Federal Reserve controls the circulation of U.S. currency by setting interest rates and managing the country's monetary reserves and serves as a central clearing house for checks and ACH transactions, through which virtually every U.S. financial institution can interconnect for processing and settlement services.

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167. Introductory Clause, Federal Reserve Act of 1913, 12 U.S.C. § 251 (1999); *see also* BD. OF GOVERNORS OF THE FED. RES. SYS., THE FEDERAL RESERVE SYSTEM PURPOSES AND FUNCTIONS, (8th ed. 1994) [hereinafter *Purposes and Functions*], at 2.

168. William W. Wiles, *The Federal Reserve in the Payments System*, 76 FED. RES. BULL., 293 (1990).

169. Leonard Fernelius & David Fettig, *The Dichotomy Becomes Reality: Ten Years of the Federal Reserve as Regulator and Competitor*, FED. RES. BANK OF MINNEAPOLIS ANN. REP. (1991), *available at* http://minneapolisfed.org/pubs/ar/ar1991.cfm.

170. EDWARD J. STEVENS, THE FOUNDERS' INTENTIONS: SOURCES OF THE PAYMENT SERVICES FRANCHISE OF THE FEDERAL RESERVE BANKS 25 (Fed. Res. Bank of Cleveland, Financial Services Research Group,Working Paper No. 03-96, 1996), *available at* http://www.cleavelandfed.org/research/FSRG/index.cfm

171. The Automated Clearing House (ACH) is an electronic funds transfer system developed in the 1970s by the Federal Reserve in cooperation with private entities, through which payments are processed in batches. Payments for insurance premiums, mortgages, and direct deposit payroll are some examples of funds that are transferred through the ACH system. *Purposes and Functions*, *supra* note 167, at 105.

With non-check forms of electronic payments, however, the Federal Reserve has largely remained on the sidelines. While it has engaged in some oversight of consumer protections in the debit and credit arenas, the Federal Reserve has not influenced the flow of *electronic* commerce. With the substantial growth of electronic payments over the past twenty years, the Federal Reserve's direct influence over the U.S. payments system has substantially eroded. That erosion has coincided with the failure of the Federal Reserve to fulfill its mandate to "anchor" the U.S. payments system. This failure has left debit, the fastest-growing payment system, adrift in a sea of inefficiency and market failure.

The FRA provides the Federal Reserve with both the authority and responsibility to reassert itself in the U.S. payments system through more active involvement in the debit card market. When staging the Santa Fe conference, the Kansas City Reserve Bank noted that:

> Virtually all central banks have general oversight responsibility for the payments systems of their respective countries and areas. Explicitly or implicitly, most have a mandate to ensure that payments systems operate safely and efficiently.[172]

This basic responsibility of central banks motivated the Federal Reserve to act "like a mighty battleship" and to drive at-par checking through a recalcitrant banking community. The Federal Reserve must take decisive action again. Without such action, the debit card market will continue to be far from the efficient, competitive, and consumer-oriented payment system Congress created the Federal Reserve to foster.

C. *Regulation of Interchange in Other Nations*

The growth of electronic payments has caused governmental authorities in other nations to regulate debit and/or credit interchange fees, lest the dysfunctional U.S. paradigm prevail in their markets. There is widespread concern abroad that the U.S.-invented debit systems controlled by the U.S. networks, Visa and MasterCard, will privatize their national payment systems as they have in the United States.

172. Santa Fe Interchange Fee Conference materials, *supra* note 144, at 6.

Regulatory intervention has occurred or is underway in the United Kingdom,[173] the European Union, the Netherlands, Denmark, Spain, Mexico,[174] and Australia. The most prominent example of such regulatory involvement in debit interchange is the recent action taken by the Reserve Bank of Australia (the "RBA") to regulate signature debit rates and close the gap in fees between PIN and signature debit.

In a February 2005 decision, the RBA proposed setting (i) a maximum signature debit interchange fee of roughly 15 cents (down from an average fee of roughly 40 cents), and (ii) a maximum PIN debit fee *paid to the merchant* of roughly 5

173. In November 1998, the UK Treasury Department commissioned a study on competition in the UK's banking services industry. The results of this study were published in the March 2000 Cruickshank Report which concluded, among other things, that interchange fees "are substantially higher than can be justified by legitimate cost recovery" and that "in all cases, the process by which these fees are set is extremely opaque to end users and subject to abuse." DON CRUICKSHANK, COMPETITION IN UK BANKING: A REPORT TO THE CHANCELLOR OF THE EXCHEQUER §§ 3.114 (2000). The report recommended that interchange fees undergo substantial reform. *Id.* at § 3.199 ("[I]nterchange fees . . . should be derived through a process that is transparent to final users. Such prices should be based on legitimate costs and should anticipate achievable cost reductions"). As a result of the Cruickshank Report, the UK Office of Fair Trading (OFT) investigated MasterCard and made a preliminary finding in 2003 that its interchange fees violated UK competition laws. THE OFFICE OF FAIR TRADING, OFT634, MASTERCARD INTERCHANGE FEES PRELIMINARY CONCLUSIONS (2003) (U.K.), *available at*: http://www.oft.gov.uk/NR/rdonlyres/9F26CE17-08E2-4680-8F4F-56A24980F8B9/0/oft634.pdf. The OFT released its final report on Sept. 6, 2005. Among its findings, the OFT concluded that the interchange fee effective from 2000 to 2004 violated UK and EC competition laws because it amounted to a price fixing conspiracy and because it resulted in the unjustified recovery of certain extraneous costs incurred by members. Decision of the Office of Fair Trading, No. CA98/05/05, *Investigation of the multilateral interchange fees provided for in the UK domestic rules of MasterCard UK Members Forum Limited (formerly known as MasterCard/Europay UK Limited)* (Sept. 6, 2005), available at http://www.oft.gov.uk/Business/Competition+Act/Decisions/MasterCard.htm (last visited Jan. 23, 2006). That same year, the OFT also launched an investigation into Visa's interchange fee structure because "[t]he OFT has reasonable grounds for suspecting that the agreement between Visa members on multilateral interchange fees appreciably prevents restricts and/or distorts competition . . ." Press Release, The Office of Fair Trading, *OFT Issues Statement of Objections on MasterCard Agreement*, Nov. 10, 2004, *available at:* http://www/oft.gov/uk/news/press+ releases/2004/184-04.htm

174. *See, e.g.,* Santa Fe Interchange Fee Conference materials, *supra* note 145, at 2.

cents (down from an average fee of roughly 20 cents).[175] The combined effect of these proposed changes would reduce the gap between PIN and signature debit fees from 60 cents to a maximum of 20 cents.[176]

Underlying the RBA's recent action were its findings that the current interchange structure results in limited competition, reduced efficiency, and restricted consumer choice in the Australian debit card market.[177] The RBA found that a misalignment in the price and cost of debit drives consumers to signature debit, which is inherently more costly for both consumers and merchants. While PIN is still the more popular form of debit in Australia, the differential in interchange pricing artificially inflates signature debit volume. The RBA is concerned that without intervention, this trend will greatly accelerate, with Australian banks emulating their U.S. counterparts by increasing their efforts to suppress PIN debit.[178] By realigning pricing with inherent costs, the RBA hopes to provide consumers with the freedom to choose the most efficient debit product – those priced consistent with their true cost to the Australian payment system and the Australian economy:

> In effect, the distorted price signals to the cardholder, which have encouraged the use of the more expensive payment options, have come at the ex-

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175. RESERVE BANK OF AUSTRALIA, REFORM OF THE EFTPOS AND VISA DEBIT SYSTEMS IN AUSTRALIA, A CONSULTATION DOCUMENT (Feb. 2005) *available at:* http://www.rba.gov.au/PaymentsSystem/Reforms/Eftpos/ConsultDocFeb2005 [hereinafter REFORM OF THE EFTPOS AND VISA DEBIT SYSTEMS IN AUSTRALIA] The RBA is in the process of reviewing public comments on these proposed changes, together with anticipated submissions on more recent proposed debit card system reforms, and plans to meet in March 2006 to consider all issues raised. Reserve Bank of Australia, Media Release, No. 2005-16, *Reform of Debit Card Systems in Australia* (Dec. 20, 2005) *available at* http://www.rba.gov.au/MediaReleases/2005/mr_05_16_html (last visited Jan. 23, 2006).

176. REFORM OF THE EFTPOS AND VISA DEBIT SYSTEMS IN AUSTRALIA, *supra* note 175.

177. *Id.* at 1-2.

178. *Id.* at 1, 23. The RBA noted that one key factor that has until now inhibited the growth of signature debit in Australia is the uncertainty of the regulatory environment. "The [RBA] is concerned that, when the uncertainty is resolved, unless appropriate measures are put in place, the Visa Debit system will grow at the expense of [PIN debit], not because of its intrinsic strength as a product, but as a result of the higher interchange fees." *Id.* at 23.

> pense of higher merchant costs. In turn, these higher costs flow through into higher prices for goods and services. Accordingly, the [RBA's] opinion is that bringing the relative prices and costs for these payment systems into closer alignment would promote the efficiency of the overall system. Encouraging more efficient payment choices by cardholders should reduce merchants' overall costs, and thus put downward pressure on the overall level of prices for goods and services.[179]

The distorted system of misaligned incentives that exists in the Australian debit card market is similar to that of the U.S. market, but as the RBA noted, the U.S. market is significantly worse and its system is an extreme example of how interchange fees can lead to market failure.[180] In describing the U.S. system, the RBA concluded that "the expensive system has been driving out the cheaper one, even though the two systems provide[ ] essentially the same payment service," and that "[t]he same dynamic, although less dramatic, can be seen in Australia."[181]

This statement by the Australian Federal Reserve is eerily reminiscent of a similar statement made in 1997 by an executive of the MAC ATM/Debit network, one of the Regional Networks that pioneered POS debit in the United States:

> Off-line debit, an inferior and far more costly product, has quickly moved from a minority share of the national general-purpose POS debit card market to dominance over on-line's safer, faster and far less costly service.[182]

The RBA's recent action on debit interchange is designed to correct this market failure, and to restore competition, efficiency and consumer choice to the Australian debit card market.[183] In proposing the current fee changes, the RBA com-

179. *Id.* at 10.

180. *Id.* at 22-23.

181. REFORM OF THE EFTPOS AND VISA DEBIT SYSTEMS IN AUSTRALIA, *supra* note 175, at 22-23.

182. *In re Visa Check* Summ. J. Ex. 1074, *supra* note 42 (shown at Oral Argument on Summary Judgment, Jan. 10, 2005).

183. The RBA's powers, which derive from the Reserve Bank Act 1959 and the Payment Systems (Regulation) Act 1998, authorize the RBA to act in a

mented that setting all debit interchange fees at zero "has considerable appeal."[184] The RBA questioned the need for interchange at all and whether an efficient and competitive market could ever coexist with interchange.[185] However, the agency left that determination for another day, noting that its current proposal "is consistent with an evolutionary, rather than revolutionary, approach to reform."[186]

The U.S. debit card market is in worse shape than Australia's. The restoration of at-par clearance, which had prevailed when the U.S. debit market was unconstrained, is necessary to unleash the curative power of free market forces.

D. *The Pro-Competitive Effects of At-Par Clearance*

Collectively-fixed interchange is now at the core of the market failure in U.S. debit. It has induced collective amnesia, as banks have forgotten the original economic rationale for issuing debit cards – as a replacement for checks. The inferior and far more costly signature debit product has been elevated to a dominant position in the market. Prices and costs are misaligned, causing consumers to pay much more to use the product which is far less costly to the system. Banks virtually ignore the merchant side of the payments equation.

None of this has come about from the natural evolution of U.S. debit in a free and open market. It has resulted from tying, group boycott, price-fixing and related anticompetitive behavior. While some of this conduct has now ceased, substantial merchant lock-in has occurred and the price-fixing persists. This ongoing cartel behavior and the after-effects of the practices addressed in *In re Visa Check* and *U.S. v. Visa and MasterCard* require government intervention.

At-par interchange of debit would lead to greater efficiency, greater use of debit, and a massive reduction in paper checks. Banks would put their resources behind a debit prod-

way that "will best contribute to: (i) controlling risk in the financial system; (ii) promoting the efficiency of the payments system; and (iii) promoting competition in the market for payment services, consistent with the overall stability of the financial system . . ." REFORM OF THE EFTPOS AND VISA DEBIT SYSTEMS IN AUSTRALIA, *supra* note 175, at 8.

184. *Id.* at 30, 32.

185. *Id.* at 19.

186. *Id.* at 31.

uct that all of their customers (not simply the affluent) could use. Merchants would expand the number of outlets where customers could use PIN debit. Consumers would be directed by both sides of the market to use the safer, faster, less costly product and would bounce fewer checks. Signature debit would survive to the extent that banks wanted to issue the product, merchants freely chose to accept it, and unsubsidized cardholders found it useful.

With at-par interchange, debit pricing would be transparent. Banks would no longer hide behind the veil of the merchant discount. Banks would price the product based on real costs, and consumers would be able to make informed and unrestrained choices based upon full information. Without interchange, competition would lead to lower prices and the Associations would have less ability to contract anti-competitively with large debit card issuers for exclusivity.

Interchange is not necessary for debit card issuance. PIN debit thrived and predominated in the U.S. market in an at-par environment. As both the Kansas City Reserve Bank and the Reserve Bank of Australia have noted, none of the traditional justifications for positive interchange, such as reimbursement for terminalization, processing, card issuance, and fraud and charge-off losses, are sound. Interchange is merely a device utilized by the Associations to support a product that likely would have long since crumbled on its own demerits in a free market.

The failures of the U.S. debit card market are at least as severe, if not more severe, than those engendered by the system of exchange charges and correspondent banking that pervaded the U.S. check system before the Federal Reserve's aggressive intervention. It is time for the Federal Reserve to reestablish itself as the institutional anchor of the U.S. payments system to ensure efficiency, competition, and choice in the debit card market.

IV.
Conclusion

The Federal Reserve has the authority and responsibility to restore competition on the merits to the failed U.S. debit market. The decrees in *In re Visa Check* and *U.S. v. Visa and MasterCard* have begun the process of destroying barriers to competition that were erected and exploited by Visa and MasterCard for several decades. However, those decrees do not address the ongoing cartel pricing of interchange. This final barrier can be eliminated in one of two ways: through years of costly litigation, or, more appropriately, as the result of a better remedy – one created by Congress.

One day during one of the many court appearances in the *Visa Check* case, the authors were shocked by a statement made by an esteemed adversary, Larry Popofsky, who represented Visa. Illustrating one of Visa's arguments in defense of the tying arrangements, he told the court that Visa now functions like the Federal Reserve.[187] However, Congress gave that job to the real Federal Reserve. The time has come for the Fed to reassert its stewardship over the U.S. payment system.

187. Statement of M. Laurence Popofsky, Transcript of Conference held before Magistrate Judge Mann in *In re Visa Check*, Dec. 14, 1999, at 53-54 ("What's the product that we are talking about? It is certainly unique. It is akin to a private checking system. It is a four-party set of transactors in order for a single transaction to occur . . . It is interdependent in the economic sense. For every transaction, a consumer must do something, a bank must do something and a merchant must do something, and the association must do something . . . In 1975, banks realized that not only could they offer their customers credit through this remarkable four-party private federal reserve kind of clearing system, if you will, but they could also offer debit").