STATEMENT OF W. STEPHEN CANNON *
ON BEHALF OF
THE MERCHANTS PAYMENTS COALITION, INC.

BEFORE THE
UNITED STATES SENATE COMMITTEE ON THE JUDICIARY

HEARING ON
CREDIT CARD INTERCHANGE RATES: ANTITRUST ISSUES?
JULY 19, 2006

I. INTRODUCTION

Chairman Specter and Members of the Committee, I am honored to appear before you today on behalf of the Merchants Payments Coalition (the MPC). The MPC is a group of 19 trade associations[1] representing retailers, restaurants, supermarkets, drug stores, convenience stores, gasoline stations, theater owners, on-line merchants and other businesses that accept debit and credit cards. MPC is fighting for a more competitive and transparent card system that works better for consumers and merchants alike. The coalition's member associations collectively represent about 2.7 million locations and 50 million employees. These merchant associations account for more than 60 percent of the non-automotive card based transaction volume in the United States

The MPC welcomes the Committee's attention to one of the most significant issues ever to face the merchant community. To answer the question posed by the title of today's hearing, there are indeed crucial antitrust issues raised by interchange fees and we would respectfully suggest this Committee is an appropriate place for them to be addressed.

By way of background, I was privileged to serve as Chief Antitrust Counsel to this Committee during the 97th and 98th Congresses (1981-1984). In addition, I have also been fortunate to serve as both a trial attorney and later, as Deputy Assistant Attorney General for Policy and Legislation in the Antitrust Division of the Department of Justice. Further, as General Counsel of Circuit City Stores, Inc. from 1994 to 2005, I had numerous opportunities to see the impact of interchange issues, and I can understand the plight in which merchants and consumers throughout this country find themselves today.

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[1] MPC's members include the Food Marketing Institute, National Association of Convenience Stores, National Grocers Association, National Retail Federation, National Association of Chain Drug Stores, American Petroleum Institute, Retail Industry Leaders Association, Petroleum Marketers Association of America, Society of Independent Gasoline Marketers of America, National Council of Chain Restaurants, National Association of College Stores, National Association of Truck Stop Operators, International Association of Airport Duty Free Stores, National Association of Theatre Owners, American Beverage Licensees, Bowling Proprietors Association of America, National Association of Shell Marketers, Interactive Travel Services Association, and the National Restaurant Association.

Mr. Chairman, the collective setting of interchange fees represent on-going antitrust violations by the two leading payment card associations—Visa and MasterCard—antitrust violations that costs merchants and their customers—that is, America's consumers—tens of billions of dollars annually. These fees, hidden from consumers, are in addition to the late fees, over-limit fees, and other card fees with which consumers are only too familiar. The purpose of my testimony today is to analyze the competition issues surrounding interchange fees and suggest a range of remedies that the Committee could consider as appropriate solutions to this problem.

My testimony today focuses on three basic topics: The first is the nature of interchange fees and the harm they cause to American merchants and consumers. The second is to explain why interchange fees violate the antitrust laws and why the card associations' justifications are insufficient to overcome this illegality. Last, I focus on the variety of solutions that can address interchange fees in a manner that is in consumers' interest—solutions based on principles of free markets and open competition.

II. WHAT ARE INTERCHANGE FEES AND HOW DO THEY HARM CONSUMERS?

A. Interchange fees represent a nearly $30 billion "sales tax" on merchants—and their customers—collectively set by Visa and MasterCard members.

Mr. Chairman, for far too long American consumers have had to bear the burden of unnecessary and excessive fees charged to merchants by the bank-owned card systems, MasterCard and Visa, organizations that have been held by the courts to have market power in the payment systems marketplace. These fees, called interchange fees, have been set by the collective action of MasterCard and Visa member banks (which include most banks in the United States) and imposed on merchants by the banks to which merchants submit credit card transactions for payment. Merchants must then treat the interchange fee expense as a higher cost-of-doing-business.

When a consumer buys an item with a Visa or MasterCard credit or debit card, the merchant does not receive full face value from the bank to which it submits the charge. The difference between the face value of the customer's purchase and the amount the merchant actually receives is called the "merchant discount," the vast majority of which is the interchange that is paid by the merchant to the bank that issued the customer's card. The average consumer has no idea that this fee is imposed every time they make purchases with their Visa or MasterCard cards. In this way, interchange acts as a hidden sales tax on U.S. commerce, raising both merchant costs and ultimately the price of goods and services sold to consumers.

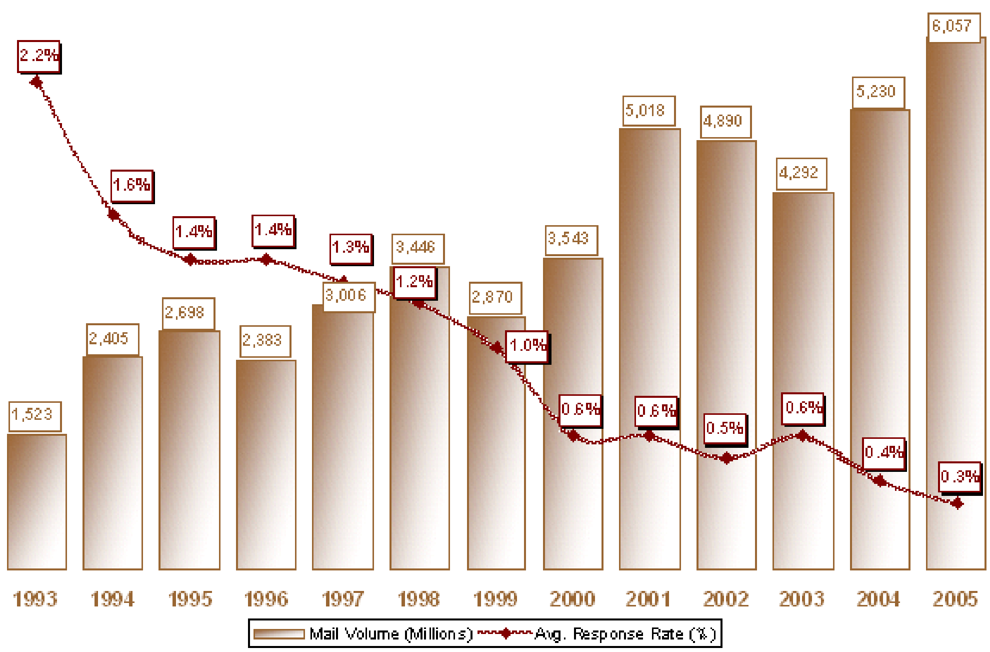
The perverse effects of the current interchange fee system are of growing concern because electronic payments, especially card payments, are an increasing percentage of consumer transactions, replacing checks and cash. For example, the

Federal Reserve reports that, by 2003, the number of electronic payments exceeded the number of check payments for the first time in U. S. history.[2] This event is significant, because checks are cleared at "par" (paid by banks at their face value) and the cost of the checking system is borne by the banking system, with Federal Reserve pricing rules limiting check clearing costs to the cost of processing checks. On the other hand, because card-based payments are credited to a merchant's account only at a discount, merchants not only must pay for costs of the card transaction processing system—but also make a significant contribution to the cost of marketing and issuing cards, themselves.

The key to understanding the anti-consumer nature of the card systems' rules is the fact that the higher Visa and MasterCard set the interchange fees, the more money that will flow to their member banks. This pool of funds is available to subsidize marketing efforts, such as reward points or airline miles, by which card issuers promote customers' use of their credit cards. The fees also support the mass mailings of card solicitations—over 6 billion in 2005—with a mere 0.3 percent response rate, as set out in the following chart.

Figure 1

Credit Card Mail Solicitations and Response Rate



Source: Synovate, April 27, 2006.

[2]"Federal Reserve Studies Confirm Electronic Payments Exceeded Check Payments for the First Time," (Press Release, December 6, 2004); E. Klee, *Families' Use of Payment Mechanisms During a Decade of Change in the U.S. Payments System*, at 1 (Federal Reserve, February 2006).

This system is anticompetitive in several ways. First, these fees have been fixed by banks that compete to issue payment cards to consumers or to sign up merchants to accept Visa and MasterCard cards. No matter which Visa or MasterCard member bank issued the card that is used to make a purchase or which Visa or MasterCard member bank signed up the merchant making the sale, the same uniform fixed interchange rates apply. This system also cements Visa's and MasterCard's substantial individual and joint market power. The higher the interchange fees charged by Visa or MasterCard, the more attractive that card system becomes to banks compared to other card systems.[3] Thus, the member banks have every incentive collectively to ensure that the card system sets high interchange fees.

Because these collectively-set interchange fees are passed on to merchants by banks that process the merchants' card transactions, the merchants inevitably must take this cost into account when pricing the goods or services they sell. As a result, even consumers who pay by cash or check subsidize card-issuing banks' marketing efforts.

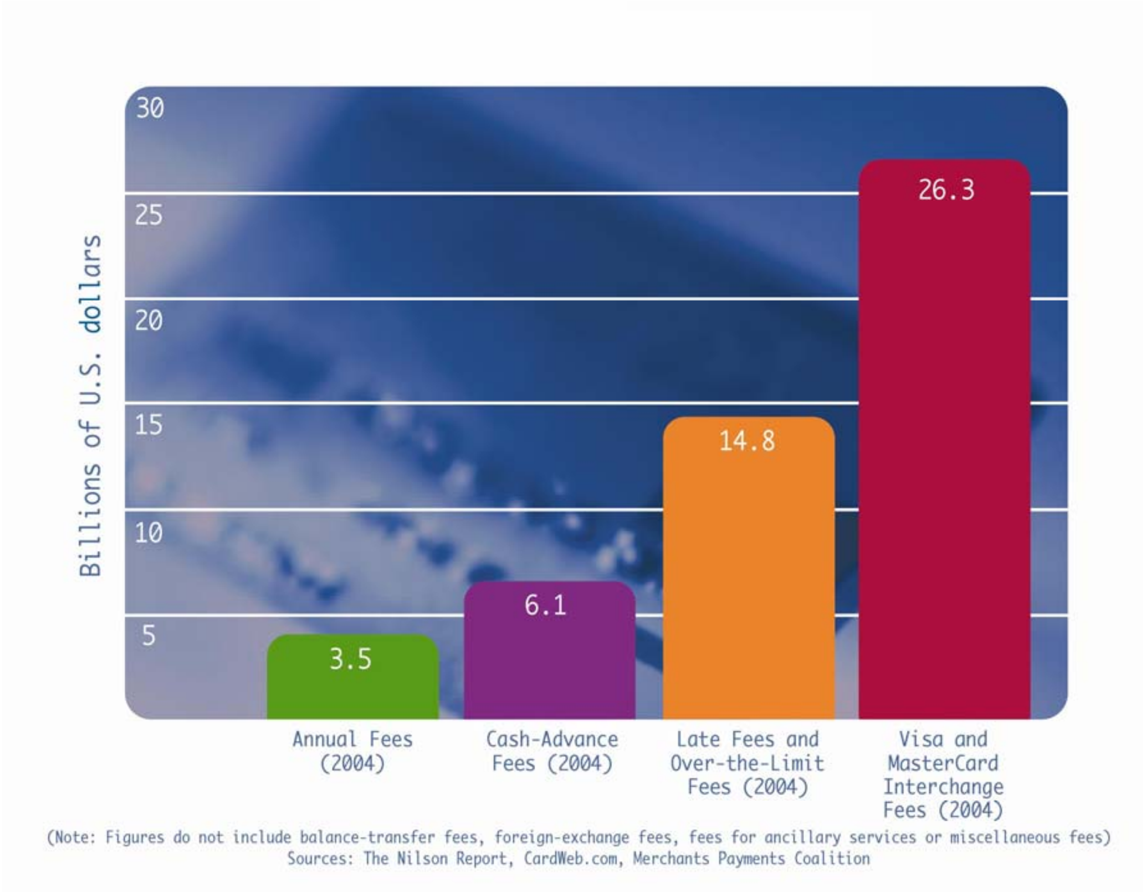
This "sales tax" on ordinary consumers to support users of cards with points, miles, cash-back features, and "concierge" services is a substantial burden on the cost of goods and services that Americans buy. Indeed, merchants are forced to pay higher interchange fees for premium rewards cards, marketed to affluent consumers, such as Visa's Signature Card and MasterCard's World Card to subsidize the higher level of benefits associated with those cards. These activities are, of course, the way in which a card association's card issuers compete *among themselves* for cardholders. The resulting burden on U.S. merchants and their customers is substantial: Visa and MasterCard interchange fees totaled $26.3 billion in 2004, and are expected to increase significantly.[4] These fees dwarf the more visible card fees, as set out in Figure 2.

[3] Until October 2004, when the Final Judgment in *U.S. v. Visa/MasterCard* went into effect, Visa and MasterCard member banks were effectively precluded from participating in other systems, such as Discover and American Express, by exclusionary rules passed by Visa and MasterCard. These rules – Visa bylaw 2.10(e) and MasterCard's Competitive Programs Policy – were rescinded in accordance with the Final Judgment in *U.S. v. Visa/MasterCard*.

[4] See Food Marketing Institute, "Hidden Credit Card Fees" (2005).

Figure 2

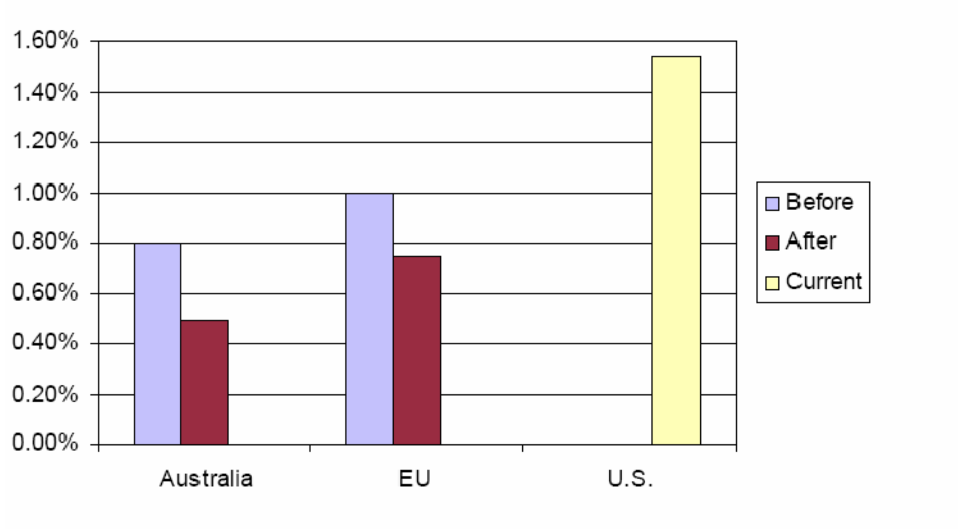
Total Card Fees By Type (2004)



Tellingly, in other nations that have put an end to this price-fixing scheme by Visa and MasterCard, merchants pay lower interchange fees. Moreover, given the size of the U.S. economy, one would expect the MasterCard and Visa systems in the U.S. to have scale and scope economies that would permit the card associations to serve American merchants and consumers at a lower price than in other countries. This is not the case. As demonstrated by the following chart, U.S. merchants and consumers are subject to significantly higher interchange fees than in other countries.[5]

[5] From F. Hayashi, Federal Reserve Bank of Kansas City, "A Puzzle of Card Payment Pricing: Why are Merchants Still Accepting Card Payments?" *Review of Network Economics*, at 145 (March 2006) ("In the United States, interchange fees for both credit and debit card transactions are among the highest in the world. Moreover, they have been increasing rapidly for the past several years.").

Figure 3
Credit card interchange rates in selected countries



Notes: "Before"= before the rate was forced to be lowered, "After"=after the rate was lowered; "Current" = as of November, 2004. The rates in Australia and the United States are the average of Visa and MasterCard rates. In the EU, the European Commission made its decision on the Visa rate for cross-border transactions only. The 'before' rate is not publicly available, but the rate was estimated at about 1 percent.

Sources: Reserve Bank of Australia, Visa Europe, MasterCard International, and American Banker.

B. The costs of card-associations' price-fixing efforts are hidden from consumers.

The card associations make every effort to ensure that card holders remain unaware of the interchange fee costs their usage of cards imposes. First, card association rules require merchants to advertise the price that a card user would pay as the primary advertised price. Second, card association rules prevent merchants from using different prices to reflect the different levels of interchange fees associated with different types or brands of payment cards.[6]

As noted, the heart of the problem is that many card holders want to use cards because they are *paid* to use them through reward points and other enticements subsidized by the interchange fee, even though their card use imposes a burden on merchants and all of their customers. A recent study by the Kansas City Federal Reserve Bank concludes that merchants realistically cannot refuse to accept Visa and MasterCard payment cards, regardless of interchange fee costs.[7]

[6] Interchange fees vary by brand association, type of card (debit or credit), and benefit level. In particular, Visa's "Signature" brand and MasterCard's "World" brand, as well as "business" cards, usually incur a higher interchange fee than standard Visa or MasterCard transactions. The card associations' rules nominally permitting "cash" discounts actually prohibit the use of discounts that reflect differences in fees for debit cards compared to credit cards, or among the various brands and types of each card.

[7] F. Hayashi, "A Puzzle of Card Payment Pricing: Why are Merchants Still Accepting Card Payments?" *Review of Network Economics*, at 172 (March 2006) (footnote omitted).

Indeed, the Federal Reserve Board informed Congress in a 2004 report on disclosure of fees for the use of debit cards, "Because these interchange fees are generally unknown to consumers, most people still remain unaware of the effects of their choices on merchants' costs or card issuers' revenues."[8] The result of Visa and MasterCard interchange fees thus is to distort choices consumers make regarding their payment methods because of the lack of a linkage between the costs card usage imposes on merchants (and the consumer) and the price signals perceived by the card user. Consequently, card holders may choose a payment method that is the most expensive to merchants and consumers, while they may perceive its use as "free," or even having a positive value through the collection of points or miles.

In sum, the combination of interchange fees and card system rules limiting retail pricing flexibility distorts the price signals regarding the use of cards and thus the nature of competition between payment systems. The higher cost to merchants for customer use of payment cards flows through into higher prices for the customers of those merchants. Interchange fees thus become a cost borne by *all* consumers whether they use cards or not.

III. THE SETTING OF INTERCHANGE FEES BY CARD ASSOCIATION MEMBERS (OR THEIR AGENTS) IS UNLAWFUL.

A. The setting of interchange fees constitutes horizontal price fixing.

In the landmark Department of Justice case against Visa and MasterCard, the Court of Appeals for the Second Circuit found that when Visa and MasterCard pass rules, their actions are the actions of "consortiums of competitors" (banks) that compete to issue cards or to sign up merchants to accept Visa or MasterCard cards.[9] That rationale would equally apply to the associations' fixing of interchange by Visa and MasterCard. As discussed above, interchange fees are fees imposed on merchants (and consumers) by Visa and MasterCard members (who are competitors).[10] The collective setting of interchange fees (by or on behalf of their member banks) by the card associations effectively cartelizes the setting of interchange fees by removing any incentive for card issuing banks

[8] Board of Governors of the Federal Reserve System, *Report to the Congress on the Disclosure of Point-of-Sale Debit Fees*, at 14 (November 2004).
[9] *United States v. Visa U.S.A., Inc.*, 344 F. 3d 229, 242 (2d Cir. 2003)
[10] Interchange fee proponents may argue that the interchange fee is not a "price" charge by issuing banks to acquiring banks but a "transfer payment" between the two sides of the transaction, since interchange fees do not compensate issuing banks for any specific services provided. As interchange fees are virtually always treated as a pass through charged to merchants by acquiring banks, interchange fees are, in truth, a price fixed by a cartel of competing issuers that is paid by merchants on every Visa and MasterCard transaction in the United States.

individually to lower interchange fees in response to requests from merchants and acquiring banks.[11]

Moreover, in conjunction with the associations' related rules restricting merchants' pricing flexibility and cost disclosure, merchants are unable to charge cardholders a differentiated price based on differences in interchange fees. As a result, the associations have the incentive and ability to exercise this pricing power on behalf of their members to charge a supra-competitive price to the merchant, precisely the "evil" at which the Sherman Act's pricing-fixing prohibition was directed. Indeed, from the earliest days of antitrust, courts have recognized that cartel rate-setting is inherently anticompetitive regardless of the claimed "reasonableness" of the prices a cartel might set.[12]

B. MasterCard's IPO does not end the illegality of its interchange fee mechanism.

MasterCard's recent reorganization is a change in form, not substance: collective price-fixing continues. The antitrust laws recognize a hub-and-spoke form of conspiracy in which a central agent manages a cartel even if the conspirators do not expressly agree with each other to go along with the "hub's" plan.[13] The case is strongest where there is an agreement among members along the "rim" to utilize the hub.[14] This is precisely the case with the MasterCard reorganization.

Under the reorganization, MasterCard International undertook an initial public offering that sold a significant share of equity and voting rights to the public.[15] Nevertheless, as MasterCard's filings with the Securities and Exchange Commission make clear, post-reorganization, the fundamental structure of the MasterCard system would remain, particularly the interchange fee system, which was explained in some detail.[16] That the overall business approach of MasterCard would remain intact is unsurprising, because, as MasterCard readily admits, a key motivator for the reorganization was that: "[W]e have faced heightened regulatory scrutiny and legal challenges in recent years. … We believe our new structure will place our business in a stronger position as we will be better able to defend ourselves against legal and regulatory challenges involving our ownership and governance."[17] That is, MasterCard implicitly assumed it could escape from

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[11] In a decision in the recently-settled *Visa USA v. First Data Corp.* litigation, a district court ruled that Visa was not a "single entity" and its actions could be considered to be the result of collective action by its members. 2006 WL 516662 (N.D. Cal., March 2, 2006).

[12] E.g., *United States v. Trenton Potteries Co.,* 273 U.S. 392, 397 (1927) ("The power to fix prices, whether reasonably exercised or not, involves the power to control the market and to fix arbitrary and unreasonable prices. The reasonable price fixed today may through economic and business changes become the unreasonable price of tomorrow.")

[13] See, e.g., *Toys "R" Us v. FTC,* 221 F.3d 928, 932 (Seventh Circuit, 2000).

[14] See, e.g., *Spectators' Communication Network v. Colonial Country Club,* 253 F. 3d 215 (Fifth Circuit, 2001).

[15] See, "Is MasterCard Stock Priceless?" *Wall Street Journal Online* (July 12, 2006).

[16] See MasterCard Incorporated, SEC Form S-1, Amendment No. 8, p. 76 (May 23, 2006).

[17] *Ibid.,* at 72-73.

future antitrust liability for its existing business practices because a separate, "independent" board would continue to serve as cartel manager for the members, without the need for members, themselves, to agree on specific interchange fee levels.

Such a legal sleight-of-hand is simply unavailing. First, by agreeing to the reorganization, based on the representation that existing agreements, including the interchange fee mechanism, would continue, the members have agreed to use the services of MasterCard, Inc. as manager of their existing interchange fee cartel arrangement. Second, when the MasterCard members agreed to designate MasterCard, Inc., as the ongoing manager of the MasterCard system, they had every reason to believe that its board would operate in their collective best interest as cartel agent: the member banks would remain significant MasterCard shareholders with a collective 44 percent equity interest (plus a 10 percent equity and 18 percent voting interest in a "MasterCard Foundation," with restrictions on the aggregate accumulation of stock by outside parties), they would appoint members to the board with certain voting rights, and they would remain MasterCard's only customers—and MasterCard is dependent on their customer-members' goodwill toward MasterCard.[18]

As MasterCard put it, "We are, and will continue to be, significantly dependent on our relationships with our issuers and acquirers [member banks]…."[19] Indeed, the five largest MasterCard member banks provided 34 percent of MasterCard Inc.'s revenue as of early 2006.[20] And, of course, a consideration for those large issuers remaining in the MasterCard system could be the level of interchange fees paid to them in comparison with, for example, Visa. Thus, even an "independent" MasterCard board could be expected to assume the best interests of all MasterCard shareholders would result from setting interchange fees at levels that are in the collective best interest of issuing banks, particularly MasterCard's dominant issuers. And, as the saying goes the proof of the pudding is in the eating: Since the IPO, MasterCard's interchange rates and rules have not changed one bit. The price fixing continues unabated.

C. Interchange fees are unlawful, anticompetitive restraints.

1. Visa and MasterCard's price fixing are not "ancillary restraints."

Visa and MasterCard may argue that the so-called "ancillary restraints" doctrine saves them from liability for their price fixing. As explained below, this technical argument does not offer Visa and MasterCard a defense to their illegal conduct.

[18] *Ibid.*, at 6-7, 30.
[19] *Ibid.*, at 21.
[20] *Ibid.*, at 20.

Under the "ancillary restraints" doctrine established by cases such as *BMI,*[21] an agreement that is adopted by competitors as part of a joint venture arrangement may be evaluated under the Sherman Act's "rule of reason," rather than being condemned as *per se* unlawful. In turn, the agreement can survive a rule of reason analysis "if it is no greater than reasonably necessary to achieve a legitimate commercial objective (i.e., has a procompetitive purpose), has no substantial anticompetitive impact, and is no broader than necessary to accomplish its pro-competitive goals."[22] Clearly that is not the case here.

The card associations may argue that the Supreme Court's recent decision in *Texaco Inc. v. Dagher*, 126 S.Ct. 1276 (2006) should be interpreted to mean that competitors need merely form a simple joint venture to have free rein to engage in otherwise illegal collusive activity such as price fixing, even if such price fixing is unrelated to any pro-competitive justification for the joint venture.[23] Such an interpretation, however, would contravene well-settled law.

For example, as noted in the *NCAA* case[24] cited approvingly in *Dagher*, "joint ventures have no immunity from the antitrust laws…." 468 U.S. at 113. Simply "labeling an arrangement a 'joint venture' will not protect what is merely a device to raise price or restrict output." U.S. Dept. of Justice, *Competitor Collaboration Guidelines* at § 3.2 ("Agreements Challenged as Per Se Illegal"). "The fact that there is common ownership or control of the contracting corporations does not liberate them from the impact of the antitrust laws." *Timken Roller Bearing Co. v. United States*, 341 U.S. 593, 598 (1951) (condemning restraints that went "far beyond" the legitimate, pro-competitive purpose of the joint venture and "provided for control of the manufacture and sale" in a manner that "avoid[ed] all competition either among themselves or with others" *Id.* at 597, 598). The *Timken* Court further held that it did not find any "support in reason or authority for the proposition that agreements between legally separate persons and companies to suppress competition among themselves and others can be justified by labeling the project a 'joint venture.' Perhaps every agreement and combination to restrain trade could be so labeled." *Id*. at 598. The Supreme Court's analysis twenty years later in *Catalano Inc. v. Target Sales, Inc.*, 446 U.S. 643 (1980) – also cited approvingly in *Dagher* – reinforces this point. In condemning an agreement among wholesalers to eliminate short-term credit on beer purchases, the Supreme Court observed that "[i]t has long been settled that an agreement to fix prices is unlawful per se" and "the machinery employed by a combination for price-fixing is immaterial." *Id*. at 647.

Moreover, interchange fees are *not* fees charged by a joint venture for products or services sold by the joint venture. Rather, they are fees that association members

[21] *Broadcast Music, Inc. v. Columbia Broadcasting Co.,* 441 U.S. 1 (1979).
[22] As summarized in *National Bancard Corp. (NaBANCO) v. Visa USA*, 779 F. 2d 592, 601 (Eleventh Circuit, 1986).
[23] Visa USA was a party to an amicus brief filed in the Supreme Court on this case.
[24] *National Collegiate Athletic Association v. Board of Regents of Univ. of Okla.*, 468 U.S. 85 (1984).

have agreed that *each bank* that issues cards would charge to the banks that process merchant transactions. As MasterCard's recent SEC filings clearly state:

> Generally, interchange fees are collected from acquirers [merchants' banks] and passed to [card] issuers to reimburse the issuers for a portion of the costs incurred by them in providing services which benefit all participants in the system, including acquirers and merchants. … We administer the collection and remittance of MIFs [multilateral interchange fees] through the settlement process; however, we generally do not earn revenues from them. As noted above, MIFs are a significant component of the costs that merchants pay to accept payment cards and are subject to regulatory or legal challenges in a number of jurisdictions.[25]

Thus, reliance on precedents applicable to the setting of a joint venture's own prices is irrelevant to an ancillary restraints analysis of interchange fees.

Indeed, in recent years, various antitrust authorities of America's trading partners have found interchange fee mechanisms to be unlawful restraints under relevant competition laws of their respective jurisdictions. These findings of illegality include:

- Australia, 2000 (by the Australian Competition and Consumer Commission);
- European Commission, 2002 (cross-border transaction by Visa);
- Spain, April 2005 (interchange fees of major card associations) Competition Court of Spain;
- United Kingdom, September 2005, (MasterCard), Office of Fair Trading;[26] and
- European Commission, June 23, 2006 (Statement of Objections to MasterCard based on the preliminary view that its credit and debit card interchange fee mechanisms are unlawful).

At a July 17, 2006 hearing on the payment card industry, the E.C.'s Competition Commissioner stated that collectively set interchange fees amount "to a 'tax' on businesses and consumers," and that if the card industry did not take corrective measures, the E.C. would undertake antitrust enforcement action.[27]

[25] MasterCard Incorporated, SEC Form S-1, Amendment No. 8, p. 76.
[26] This decision was recently "set aside" by the UK Competition Appeals Tribunal, after the OFT sought to withdraw the decision based on "procedural" considerations. The OFT stated that it remains of the view that the MasterCard and Visa interchange fee mechanisms could be unlawful. Press Release, June 20, 2006.
[27] "EU Kroes Urges Credit Card Companies to Revise Practices," Dow Jones Newswire (July 17, 2006).

No similar action has been taken by antitrust authorities in the U.S., perhaps based on the existence of the Eleventh Circuit's 1986 decision in the NaBANCO case[28] a decision from credit cards' "infant industry" days. The NaBANCO court found Visa's interchange fee mechanism to be a reasonable ancillary restraint. Regardless of the validity of this holding at the time it was made, such a finding is no longer supportable.

2. The 20-year-old *NaBANCO* decision is based on factual assumptions no longer relevant to the payment card marketplace.

Visa and MasterCard evolved from regional and local credit card systems during the 1960's and 1970's. Originally paper-based, in the 1980's the credit card networks moved to electronic processing of many transactions. During this start-up period, Visa and MasterCard faced the challenges of creating incentives for banks to issue their respective cards, and also for banks to recruit merchants into accepting those cards by accepting card transactions for processing and payment through those card networks. In this context, Visa claimed it adopted interchange fees to allocate costs and revenues among the banks issuing cards, and those dealing with merchants: "[The interchange fee] serves the function of re-distributing the costs of the VISA service more equitably between the merchant and card-issuer sides*, that is, it is a "transfer payment" of sorts*."[29]

The 1986 NaBANCO decision was based on facts now a quarter of a century old, a time when, "The present VISA business arrangement is relatively young."[30] In NaBANCO , the appeals court upheld a district court's the finding that, applying the rule of reason, the interchange fee was valid "on two separate and independent grounds." First, the district court had determined "that VISA did not possess power in that [all payment devices] market. … Second the court found that [assuming VISA has market power], on balance, the interchange fee is pro-competitive in nature … and reasonably cost related," and was necessary to give banks incentives to issue Visa cards. 779 F. 2d, at 603.

The *NaBANCO* findings are, however, directly undercut: (a) by the Second Circuit's 2003 finding (in *United States v. Visa U.S.A., Inc.*) that Visa and MasterCard now have market power; (b) by rulings that other card association rules defended as "reasonable" have been found to be unlawful; and (c) by the findings of competition authorities that the justifications provided by Visa and MasterCard for the interchange fee are not supported by today's market facts.

a. Federal courts have found Visa and MasterCard to have market power today.

[28] *National Bancard Corp. (NaBANCO) v. Visa USA*, 779 F. 2d 592 (Eleventh Circuit, 1986)..
[29] *National Bancard Corp. (NaBANCO) v. Visa USA*, 596 F. Supp. 1231, 1260-61 (S. D. Fla., 1984, emphasis added).
[30] 596 F. Supp. 1231, 1263 (S. D. Fla., 1984).

The facts relied upon in the *NaBANCO* decision have no relevance to the payment card market place in the 21st century. Most significantly, the payment card industry is not "young," but decidedly mature, with most Americans having a credit card and/or debit card. Indeed, as of 2001, over 72 percent of American households had credit cards.[31]

The Second Circuit held in *United States v. Visa U.S.A., Inc.*, 344 F. 3d 229, 239-40 (2d Cir. 2003) that in today's business environment, Visa and MasterCard have market power in the market for network services for general purpose cards. Following a thirty-four day trial, the *Visa U.S.A.* district court defined this market as the one in which networks such as Visa and MasterCard "provide the infrastructure and mechanisms through which general purpose card transactions are conducted, including the authorization, settlement, and clearance of transactions." *United States v. Visa U.S.A., Inc.*, 163 F.Supp.2d 322, 338 (S.D.N.Y. 2001). The court also noted that "[m]erchant acceptance of a card brand is also defined and controlled at the system level and the merchant discount rate is established, directly or indirectly, by the networks." *Id*. Based upon the facts in the record – that the market is highly concentrated and there are high barriers to entry – the Second Circuit affirmed the trial court, ruling that Visa and MasterCard "jointly and separately, have power within the market for network services" for general purpose cards. 344 F. 3d at 239.

In addition, in an antitrust case brought in 1997 by merchants who claimed that Visa and MasterCard acted in violation of the antitrust laws by making merchants who accepted an association's credit cards also accept its debit cards, the district court held that "Visa possesses appreciable economic power" in the credit card services market. *In re Visa Check/Mastermoney Antitrust Litigation*, 2003 WL 1712568 at *3 (E.D.N.Y. April 1, 2003). The court noted that the "evidence establishes conclusively that merchants have not switched to other payment devices despite significant increases in the interchange fees on the defendants' credit cards." *Id*. ("there is no cross-elasticity of demand at the merchant level between the defendants' products and all other forms of payment"). In fact, the court pointed out, Visa itself had "adopted this market definition, excluding all forms of payment except credit and charge cards" in a previous case. *Id*.[32] Finding that Visa's share of the general purpose credit and charge market had ranged from 41 percent to 47 percent during 1991-98 and that Visa's share of the credit card market alone was nearly 60 percent, the court held that Visa "easily qualifie[d] as [having] 'appreciable economic power' for purposes of the per se rule." *Id*. at *4 (citation omitted).

[31] U.S. Census Bureau, *Statistical Abstract 2006*, Table 1176.
[32] Citing *SCFC ILC, Inc. v. Visa U.S.A., Inc.*, 36 F.3d 958, 966 (10th Cir. 1994) ("Visa stipulated 'the relevant market is the general purpose card market in the United States'").

b. Key Visa and MasterCard rules recently have been found to have failed "rule of reason" analyses.

Visa and MasterCard are no strangers to adverse outcomes in antitrust litigation challenging their rules under an ancillary restraint form of analysis. For example, in its recent case, the Justice Department successfully challenged Visa's and MasterCard's "so-called 'exclusionary' or 'exclusivity' rules, which prohibited members of their networks from issuing Amex and Discover cards." *Visa U.S.A.*, 344 F. 3d at 237. The Second Circuit affirmed the lower court's holding that Visa and MasterCard engaged in an antitrust violation by using these exclusionary rules to "effectively foreclose[] [Amex and Discover] from the business of issuing cards through banks." *Id.* "Since [Visa's and MasterCard's] exclusionary rules undeniably reduce output and harm consumer welfare, and defendants have offered no persuasive procompetitive justification for them, these rules constitute agreements that unreasonably restrain interstate commerce in violation of Section 1 of the Sherman Act." *Visa U.S.A., Inc.*, 163 F.Supp.2d at 406.

In addition to being found to have violated the antitrust laws in the government case, Visa and MasterCard also agreed to an unprecedented settlement of the antitrust claims brought by merchants in the *In re Visa Check* case. There, a class of approximately 5 million merchants (including Wal-Mart, Sears, Circuit City, the Limited, and Safeway) sued Visa and MasterCard for alleged violations of Sections 1 and 2 of the Sherman Act:

First, plaintiffs claimed that the defendants' 'Honor All Cards' policy, which forced merchants who accepted Visa and MasterCard credit cards to accept Visa and MasterCard debit cards, was an illegal 'tying arrangement' that violated Section 1 of the Sherman Act. Second, plaintiffs alleged that defendants used their Honor All Cards policy in conjunction with other anti-competitive conduct to monopolize the debit card market, in violation of Section 2 of the Sherman Act. *Wal-Mart Stores, Inc., v. Visa U.S.A., Inc.*, 396 F. 3d 96, 100-01 (2d Cir. 2005).

Rather than face trial on these claims, Visa and MasterCard entered into the largest settlement in antitrust history. In fact, the court noted that it was "the largest settlement ever approved by a federal court." *In re Visa Check/Mastermoney Antitrust Litigation*, 297 F. Supp. 2d 503, 511 (E.D.N.Y. 2003) (citation and internal quotation marks omitted). Specifically, the cash portion of the settlement had a present value of $3.383 billion, and the court valued the significant injunctive relief at "$25 to $87 billion or more." *Id*. at 509, 511-12.

Earlier this month, Visa settled a complaint by First Data, a processor of Visa transactions, after the court had denied summary judgment motions. Among other alleged antitrust violations, First Data had claimed it was damaged by Visa's rules requiring an honoring of all credit or debit cards, its limitation on point of sale discounts, and its ban on Visa member banks from processing Visa transactions outside the Visa network. As summarized by the court, damages arose from the claim that the aggregate effect of the Visa restrictions "works to maintain a supra-competitive interchange structure by preventing issuing banks from competing over merchant business which might have the overall effect of requiring Visa to lower its interchange fees."[33]

c. Empirical Analyses by Competition and Financial Authorities Have Undercut the Card Associations' Justification for Interchange Fees

On April 12, 2006, the European Commission's Directorates for Competition and Financial Services jointly issued a preliminary report analyzing interchange fees based on a comprehensive analysis of the major card systems' operations *in all 25* European Union countries. Among other conclusions, the report found:

- Profitability in card issuing is high and has been sustained over time. The credit card business is particularly profitable…. High profitability is often correlated with high fees charged to merchants and card holders. The evidence also suggests that even in the absence of an interchange fee, other revenues alone would in many cases generate a healthy profit for issuers. (p. iv)

- The empirical evidence shows that if the interchange fee increases by 1 Euro, only 25 cents are passed on to consumers in lower fees. The result challenges the hypothesis advanced by some industry participants and the economic literature that an increase in interchange fees exactly equals a decrease in cardholder fees. Overall, the inquiry has not confirmed the possible justifications for interchange fees which rely on economic efficiency arguments. (p. vi)

- The Commission's sector inquiry provides indications that interchange fees are not intrinsic to the operation of card payment systems, as several national systems operate without an interchange fee mechanism. The use of interchange fees may, however, serve several purposes. From a competition viewpoint, it would appear <u>important to what extent interchange fees are de facto (also) used as a tool to extract rents from merchants.</u> In this context, some of the preliminary findings in this report, in particular those showing strong country divergences in interchange fees and between merchant segments, may provide indications that the setting of interchange fees could possibly be a matter of market power in some EU Member States. (p. 32, emphasis in original)

Indeed, one European Commission finding directly contradicts the "cost-revenue balancing" justification for interchange fees upheld by the courts in *NaBANCO*:

> [T]hese results [of the EC's empirical analyses] also seem to cast substantial doubt on the justifications for the existence of interchange fees

[33] *Visa USA v. First Data Corp.*, 2006 WL 1310448 (N.D. Cal., May 12, 2006).

> put forward by the payment card systems. For instance, one international network believes that in the absence of … interchange fees paid by acquirers to issuers, issuers would have to recoup all of their costs from cardholders and this would lead to a level of card issuing that is "not optimal" for the system as a whole. This statement seems to be largely refuted by our results. The justification put forward by another international network, which considers that the interchange fee provides for a transfer of revenue between issuers and acquirers to achieve the optimal delivery of services by both acquirers and issuers to merchants and cardholders, is also not supported by our results. … In such a context, the role of interchange fees as a "mechanism to redress the imbalance between issuers' and acquirers' costs and revenues in delivering a payment card service" is not readily understandable. (p. 71)

Similarly, the Australian experience has refuted claims that decreases in interchange fees would undercut the viability of card systems. In fact, after three year's experience with reduced interchange fees, following intervention by the Reserve Bank of Australia, credit card applications are at record highs, along with the use of credit.[34] The reason seems straight forward: with the reduction in interchange fees, credit card issuers have been forced to rely on price competition (on interest rates) rather than solely on rewards points. In addition, consumers in general benefit when merchants pass through their interchange fee savings in their retail prices.[35]

Whether a consumer uses a low-priced, low rewards card, or a higher priced card, with rewards, is a choice that appropriately should be the consumer's to make. Increasing the range of card offerings serves the goals of competition policy. Giving consumers the choice of which approach to take is precisely the outcome that competitive markets—free of cartel pricing restrictions—should make. As the official of the Australian central bank responsible for overseeing interchange fee regulation recently testified to the Australian Parliament, the reduction of interchange fees has resulted in banks focusing on the interest rate-sensitive segment of the consumer marketplace:

> The credit card business was very profitable and the banks were focusing their competitive efforts on giving reward points to card holders. The idea

[34] See, "Big rush for new credit cards," *The Australian* (January 25, 2006) ("[W]ith the explosion in credit card applications, debt levels also swelled."); "Rates Fall on Credit Cards," *The Australian* (February 14, 2006) ("Australians have never had easier access to a credit card with banks undercutting each other in the battle for the consumer dollar.").

[35] Some critics of Australian regulation claim that lower interchange fees have not been fully passed through to consumers in the near term, in part due to the concentrated nature of Australian retailing, e.g., H. Chang, D. Evans, S. Garcia Swartz, *The Effect of Regulatory Intervention in Two-Sided Markets: An Assessment of Interchange-Fee Capping in Australia* (2005) ("Many merchant categories appear to have significant levels of concentration," p. 11). Whatever the validity of the observations concerning the retail pass through of interchange fee reductions in Australia, the highly competitive nature of American retailing would lead to the rapid pass through of lower interchange fees.

> that you would go and compete for credit card customers by lowering an interest rate seemed foreign to many financial institutions. What they wanted to do was attract people by offering a very generous reward scheme. That was where the competition in the credit card industry reflected itself, not on interest rates. But, since we have seen the lower interchange fees come into existence, we have seen the competitive dynamics realign themselves and people are now focusing on that segment of the market, whereas previously that was not the case.[36]

Indeed, MasterCard complained to the Reserve Bank about having its members forced to compete on price:

> MasterCard does not disagree that there is, *at present*, strong competition amongst issuers of credit cards. Such competition has been enhanced by the fact that, at present, issuers have been able to recover eligible costs…. One distinct characteristic of the product offerings in recent times, however, has been the increase in the number of "low cost" credit card offerings. While MasterCard believes that it is beneficial for there to be "low cost" credit card products being offered, it also believes that, with the common benchmark interchange fee, in the future there will be fewer "fully featured" credit card offerings and the competition between issuers will be based on increasingly homogeneous "low cost" credit card offerings.[37]

Thus, the evidence is clearly mounting that the theoretical arguments in favor of any use of interchange fees as a subsidy for card-issuers' costs are factually unsupportable, and cannot serve as a justification for cartel price fixing.

IV. A RANGE OF POSSIBLE REMEDIES EXISTS TO ADDRESS VISA'S AND MASTERCARD'S ILLEGAL PRICE FIXING

A. The antitrust laws provide an appropriate framework for addressing changes from the current interchange fee mechanism.

A determination that the card associations' price fixing is unlawful under the antitrust laws is just the first step: the important public policy issue is the appropriate form of relief against future violations. A range of options is possible in dealing with these antitrust problems, including enhancing competition and increasing transparency in the payment card market.

[36] Testimony of Dr. Philip Lowe, Assistant Governor, Reserve Bank of Australia, Official Committee Hansard, House of Representatives Standing Committee on Economics, Finance, and Public Administration, at 51 (May 16, 2006).
[37] (Letter from Senior Vice President—Australasia, MasterCard International to Head of Payments Policy, Reserve Bank of Australia, August 25, 2005, page 3 (emphasis in original).)

With the exception of Australia, our key trading partners have addressed the problem of collectively-set interchange fees as an antitrust/competition policy problem, rather than a problem for banking regulators. A November 2005 study by the Federal Reserve Bank of Kansas City found that, as payment systems migrate from paper to electronics, "central banks are paying increasing attention to credit and debit card industries." However, "specific interchange-fee and other payment competition issues fall under the jurisdiction of competition … authorities. … [I]t is the competition authorities that have taken the lead in evaluating and … bringing about change in credit and debit card markets."[38]

Even in Australia, the key impetus for regulation was the failure of card-issuing banks to reach a settlement with the Australian Competition and Consumer Commission following its finding that the collective fixing of interchange fees was unlawful. As a result, in March 2001, the head of that antitrust agency requested that the Reserve Bank of Australia use its statutory powers to address the interchange fee problem through regulation—and the Reserve Bank did so.

In contrast to our trading partners, such as the European Union and the United Kingdom, the United States has, to date, only approached prices and rules imposed by card joint ventures through piecemeal antitrust litigation. On April 24, 2006, numerous merchants filed a consolidated complaint in a consolidated class action litigation[39] challenging collectively set interchange fees. If there is a merits ruling in favor of the plaintiffs, or a settlement, the court in that case would, of course, have to address appropriate prospective remedies.

B. A range of relief alternatives is available.

A broad range of remedy options exist in an antitrust context. We take no position on these options now but air them simply as illustrative examples. Antitrust remedies may include:

1. Simply holding the collective setting of interchange fees to be unlawful price fixing and leave it to the card associations and their members to comply with this prohibitory order.

2. Establishing "safe harbors" in a consent decree (before or after a finding of liability) between the parties that would not be considered to be antitrust violations.

3. Permitting collective negotiation between merchants (or classes) of merchants and a card system's issuing banks, regarding interchange fees, since it is the merchants (and their customers) who pay the cost of

[38] S. Weiner and J. Wright, *Interchange Fees in Various Countries: Developments and Determinants*, 24-25 (2005).
[39] *In Re Payment Card Interchange Fee and Merchant-Discount Antitrust Litigation,* First Consolidated Amended Class Action Complaint, No. 1:05-md-1720-JG-JGO (Eastern District, NY, April 24, 2006).

interchange fees. This Committee has experience in enacting a statutory framework where there is a need to reach agreement but the sides have multiple parties and unequal bargaining power.

4. Leaving it up to a federal judge to design a remedial scheme for the industry.

Other alternatives are possible, of course, and should be explored.

A regulatory solution is also possible. Australia has a well-developed regulatory mechanism, adopted after the card associations there failed to reach an agreement with that country's competition authority under Australian antitrust laws. As discussed above, these rules have both lowered interchange fees to merchants and their customers, and encouraged Australian card issuers to compete on the basis of lower interest rates rather than through greater rewards.

C. The benefits of a congressional solution: lessons from the AT&T divestiture.

During the 1970's and early 1980's, Congress wrestled with the "Bell System problem." That is, AT&T was vertically integrated into (a) regulated monopoly local telephone service and (b) competitive or potentially competitive long distance services and equipment manufacture and sale. It thus had the incentive and ability to monopolize those competitive markets. Many in the industry, as well as at the Justice Department, believed it had unlawfully acted on those incentives. Congress attempted a range of legislative solutions, but by the end of 1981, none had been enacted. Meanwhile, in 1974, the Justice Department had filed suit against the Bell System, alleging multiple violations of Sherman Act section 2's monopolization prohibitions.

As counsel to this Committee beginning in 1981, I had the opportunity to work with the Committee's members in developing amendments to deal with AT&T. While that legislation did pass the Senate, it never made it through the House. Rather, on January 8, 1982, AT&T and Justice filed a consent decree (as a modification of the final judgment entered in 1956 in an 1949 case against Western Electric) that essentially divested AT&T's Bell company local service operations, prevented the Bell companies from entering into competitive markets, and requiring the Bell companies to provide "equal access" to AT&T's long distance competitors.

As a result of the divestiture decree and its amendments, Judge Harold Greene had a major influence over the course of America's telecommunications industry from 1982 until the decree was repealed by express provisions of the Telecommunications Act of 1996,[40] a period of 14 years.[41] He was often referred

[40] Public Law 104-104, section 601 (February 8, 1996).
[41] Between 1984 and 1996, there were numerous Congressional efforts to end judicial control of national telecommunications. As early as 1986, the "Dole Bill" would simply have lifted the decree out of Judge

to as the "telephone czar" in the press, particularly when he made rulings that changed the shape of the industry, such as whether the Bell companies could provide information services. (He said no and was reversed on appeal.[42])

The key lesson for Congress with respect to the interchange fee debate is that a judicial remedy to unlawful activity at the center of a major services industry may lead to uncertainty and doubt over multiple years. Neither policymakers nor the parties to the litigation may be in ultimate control, as district and appellate judges provide their *controlling* perspectives on the appropriate form of relief. Consequently, the MPC believes it is prudent for Congress to provide a framework for relief with respect to the antitrust issues raised by the card associations' price fixing activities.[43]

D. Visa and MasterCard cannot avoid liability simply by criticizing remedies.

In their various public statements, Visa and MasterCard routinely claim that there is no alternative to collectively-set interchange fees—and if there is no alternative, logically there can be no antitrust liability arising from their use. This is simply not true. Remedial options exist and thus the card associations should choose: on-going and growing antitrust liability, or something else chosen by someone else.

Mr. Chairman, it is beyond dispute that consumers, merchants, and the payment card industry all need each other. In today's world, none could function without the others. In the not too distant future, we would like to think that a well-reasoned solution is possible. In the absence of such a solution, consumers and merchants will continue to press their claims in the courts, here in Congress and, not surprisingly, to anyone who may be able to give them relief from this illegal, pernicious practice. By the same token, the payment card associations will continue to steadfastly deny any wrongdoing and instead tout the benefits of their services to merchants and consumers alike and, of course, seek any shelter from this storm they have had now faced for over a decade.

Speaking on behalf of several million merchants, we sincerely appreciate the Committees' interest here today and stand willing and able to work with you and the Committee on this important public policy issue.

Green's court and placed jurisdiction squarely with Congress and the FCC. See F. Henck and B. Strassburg, *A Slippery Slope,* at 252 (1988).

[42] *United States v. Western Electric Co.*, 900 F. 2d 283, 321 (1990).

[43] This "race" between Congress and the court to solve the "Bell problem" is well documented in Steve Coll's 1986 book, The Deal of the Century. These events from the Bells perspective is also found in Peter Temin, *The Fall of The Bell System* (1987).