



Payment Systems Advisory ■

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D.C. District Court to Vacate Key Provisions of Regulation II

In a memorandum opinion released July 31, 2013, in *NACS v. Board*,¹ the D.C. District Court held that the Board of Governors of the Federal Reserve System (the “Board”) “clearly disregarded” the intent of Congress in developing the interchange fee limitations and network exclusivity requirements set forth in Regulation II, Debit Card Interchange Fees and Routing (“Regulation II”).² The plaintiffs (a group of merchant trade associations and two individual merchants), asserted that the Board exceeded its statutory authority by (i) considering costs other than those expressly stated in the Durbin Amendment³ when setting the interchange fee limitation applicable to certain debit transactions and (ii) determining that an issuer may comply with the Durbin Amendment’s network diversity requirements by enabling a single PIN debit network and a single signature debit network on its debit cards. In a strongly worded opinion, the court agreed with the plaintiffs’ contentions, granted the plaintiffs’ motion for summary judgment and declared its intent to vacate the challenged sections of Regulation II and remand to the Board for new rulemaking.

Background

Regulation II was issued by the Board on June 29, 2011, and implements the provisions of the Durbin Amendment, including the interchange fee limitation and the network exclusivity prohibition. Regulation II caps the interchange fee permitted to be received or charged by an issuer in connection with an electronic debit transaction at 21 cents per transaction, plus five basis points.⁴ Regulation II also requires that issuers ensure that each of their debit cards is enabled for participation in at least two unaffiliated networks (which can be satisfied by enabling one signature debit network and one PIN debit network on each debit card).⁵ The interchange fee limitation is inapplicable to issuers with assets of less than \$10 billion; however, all debit card issuers are subject to the network exclusivity prohibition.⁶

¹ *NACS v. Bd. of Governors of the Fed’l Res. Sys.*, No. 11-02075, Mem. Op. Jul. 31, 2013.

² 12 C.F.R. part 235.

³ 15 U.S.C. § 1693 *et seq.*

⁴ 12 C.F.R. § 235.3(b).

⁵ 12 C.F.R. § 235.7(a)(2).

⁶ 12 C.F.R. § 235.5(a).

The Court's Opinion

In reviewing challenges to agency regulations under the Administrative Procedure Act, courts apply the two-step analysis outlined by the Supreme Court in *Chevron, U.S.A., Inc. v. Natural Resources Defense Council*.⁷ The court must first determine if the statutory text, together with relevant legislative history, clearly and unambiguously expresses the intent of Congress with respect to the question at issue. If the congressional intent is clear, then the agency has no latitude in its rulemaking beyond executing Congress's express intent. If the court finds, however, that the intent of Congress is ambiguous or unclear, or that the statute is silent with respect to an issue in question, then the agency may clarify the ambiguity or issue through its rulemaking and the agency's interpretation of the statute will be upheld unless it is arbitrary, capricious or contrary to law.

Court Disagrees with Board's Interpretation of the Durbin Amendment's Interchange Fee Limitation

The Durbin Amendment requires interchange fees charged or received by issuers in conjunction with debit transactions to be "reasonable and proportional" to the costs the issuer incurs associated with the transaction.⁸ The Durbin Amendment instructs the Board to issue rules to establish standards for assessing whether an interchange fee meets this standard and, in so doing, consider the "incremental cost incurred by an issuer for the role of the issuer in the authorization, clearance or settlement of a particular electronic debit transaction"⁹ (referred to herein as "incremental ACS costs"). The Durbin Amendment prohibits the Board from considering "other costs incurred by an issuer which are not specific to a particular electronic debit transaction" in promulgating its interchange rules.¹⁰

In developing the interchange fee limitation set forth in Regulation II, the Board interpreted the Durbin Amendment as requiring the consideration of incremental ACS costs and permitting consideration of any other costs, so long as those costs were "specific to a particular electronic debit transaction." By the Board's reasoning, Congress only prohibited the Board from considering issuer costs that are "not specific to a particular electronic debit transaction" in its rulemaking. As a result, the Board accounted not only for incremental ACS costs, but also for fixed processing costs, transaction monitoring costs, fraud losses, and network fees in arriving at the interchange fee limitation set forth in Regulation II. The court, however, rejected this interpretation. Rather, it construed the Durbin Amendment as dividing all issuer debit transaction costs into two groups: incremental ACS costs (which the Board was required to consider) and all other costs (which the Board was prohibited from considering). The court held that the statutory text, together with related legislative history, clearly and unambiguously expressed Congress's intent that the Board consider only incremental ACS costs in establishing the interchange fee limitation. Therefore, the court found that by considering other costs in developing the interchange fee limitation, the Board acted without statutory authority and in contravention of clear congressional intent.

Court Disagrees with Board's Interpretation of the Durbin Amendment's Prohibition on Network Exclusivity

With respect to the prohibition on network exclusivity, the court determined that the Durbin Amendment clearly expressed Congress's intent that at least two unaffiliated networks be available for routing each electronic debit transaction. According to the court, this clear intent could only be accomplished by requiring the presence on each

⁷ 467 U.S. 837 (1984).

⁸ 15 U.S.C. § 1693o-2(a)(3)(A).

⁹ 15 U.S.C. § 1693o-2(a)(4)(B)(i).

¹⁰ *Id.* at (4)(B)(ii).

debit card of at least two unaffiliated networks for each method of transaction authorization supported by the card (i.e., for debit cards supporting both signature and PIN methods of transaction authorization, at least two unaffiliated networks enabled on the card would need to support signature-authorized transactions and at least two unaffiliated networks enabled on the card would need to support PIN-authorized transactions). In issuing Regulation II, the Board construed the Durbin Amendment as requiring only that two unaffiliated networks be enabled on each debit card regardless of the transaction authorization methods supported by the card (i.e., for debit cards supporting both signature and PIN methods of authorization, any two unaffiliated networks enabled on the card would satisfy the prohibition on exclusivity, even if one network supported only signature-authorized transactions and the other network supported only PIN-authorized transactions). In essence, the Board concluded that the Durbin Amendment permitted evaluation of network routing options at the initiation of an electronic debit transaction, regardless of the ultimate transaction authorization method.

The court disagreed, holding that Congress intended to ensure that at least two unaffiliated network routing options were available for each debit transaction after accounting for transaction authorization method. In arriving at this conclusion, the court heavily cited floor statements made by Senator Durbin both prior to and after the passage of the Durbin Amendment, as well as to the text of the statute itself. Once again, the court found that the Regulation II failed to pass the first step of the *Chevron* analysis. Having found that Congress spoke clearly and unambiguously with respect to its intended network diversity requirement, the court concluded that the Board exceeded the scope of its authority under the Durbin Amendment by failing to require multiple unaffiliated routing options per authorization method for each debit transaction.

Court Determines to Vacate “Irredeemable” Regulation II Approaches to Interchange Fee Limitation and Network Diversity Requirements

In conclusion, the court stated that the interchange fee limitation and the network exclusivity prohibition were “fundamentally deficient.” The Board, the court wrote, “completely misunderstood the Durbin Amendment’s statutory directive and interpreted the law in ways that were clearly foreclosed by Congress.”¹¹ Describing the regulation as “irredeemable,” the court determined that the only appropriate remedy is to vacate the specific provisions of Regulation II at issue and to remand to the Board for development of regulations that meet the statutory standard.¹²

Recognizing the disruptive effect of its ruling on regulated entities and their commercial relationships, the court stated that it would stay the vacatur of Regulation II in order to permit the Board to develop replacement regulations. The court refrained from issuing a final order, however, in order to permit the parties to provide supplemental briefing on the appropriate duration of the stay. The court noted, however, that it envisioned a stay of “months, not years.”¹³ In addition, the court requested supplemental briefing regarding whether to permit the challenged provisions of Regulation II to remain in effect during the stay, or rather to require the Board to develop an interim rule consistent with the court’s ruling to govern debit card transactions during the new rulemaking process.

¹¹ Mem. Op. at 55.

¹² *Id.* at 55-56 (internal citations omitted).

¹³ Mem. Op. at 56 (internal citations omitted).

Impact of the Decision

Upon issuance of the court's final order, the Board will have the right to appeal the decision to the United States Court of Appeals for the D.C. Circuit. At this time, the Board has not yet stated whether it plans to pursue an appeal. Given that the appeal process can be lengthy, the Board may seek a stay of the court's order during the pendency of that appeal. Whether a stay would be granted is unknown.

In the event that the Board elects not to appeal (or the court's ruling is not stayed during the pendency of an appeal), the short-term impact of the ruling will depend heavily upon the contents of the court's final order. The court has set a follow-up hearing for August 14, 2013, at which the parties will discuss the schedule for briefing regarding the appropriate duration of the stay and the fate of current Regulation II during the stay. The court's order may obligate the Board to issue interim regulations or may allow existing Regulation II to remain in effect until completion of the formal process for issuing replacement regulations. In either case, affected parties will need to closely monitor developments and remain ready to participate in the development of interim rules and/or permanent replacement regulations.

The long-term impact of the court's decision is likewise unclear. The court struck only the specific provisions of Regulation II that govern the interchange fee limitation and the network exclusivity prohibition. The remainder of Regulation II remains intact, including § 235.5 (containing the exemptions for small issuers, government-administered programs, and certain general-use prepaid cards) and § 235.6 (prohibiting circumvention or evasion of interchange fee limitations). However, if the Board is ultimately required to revise both the interchange fee limitation and network exclusivity provisions (the heart of the Regulation II requirements), it may determine that it is necessary to address other provisions of Regulation II through the new rulemaking process. Therefore, even portions of Regulation II that were not at issue in this litigation may ultimately be affected. The Alston & Bird payments team will continue to monitor the situation and will provide updates as appropriate with respect to the litigation and any resulting rulemaking.

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