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Payment Systems Advisory ■

JANUARY 17, 2014

D.C. Circuit Hears Oral Argument in *NACS v. Board*[1]

The Court of Appeals for the D.C. Circuit heard oral argument today in the appeal filed by the Board of Governors of the Federal Reserve System (the "**Board**") of the D.C. District Court's decision in *NACS v. Board of Governors of the Federal Reserve System* ("***NACS v. Board***"),[2] the 2011 challenge filed by a group of merchant trade associations and individual merchants (the "**Merchants**") to the interchange fee limitations and network exclusivity requirements set forth in Regulation II, Debit Card Interchange Fees and Routing ("**Regulation II**").[3] This alert summarizes developments in the case to date, as well as today's oral argument before the circuit court.

NACS v. Board challenges two decisions made by the Board in promulgating Regulation II. First, in setting interchange-fee limitations, the Board determined that the Durbin Amendment[4] permitted the Board to consider not only incremental costs incurred by an issuer with respect to authorization, clearance, or settlement of a particular electronic debit transaction (referred to as "incremental ACS costs"), but also certain fixed costs that the Board found to be specific to a particular transaction. Second, the Board determined that the Durbin Amendment's mandate to prohibit issuers and payment card networks from restricting the number of networks on which a debit card transaction may be processed could be satisfied by requiring enablement of at least two unaffiliated networks on a debit card, regardless of the authentication type (i.e., one PIN network and one signature network).

In a memorandum opinion issued on July 31, 2013, the district court held that each of those decisions violated the plain language of the Durbin Amendment. Holding that the Board "completely misunderstood" the intent of Congress in developing the interchange-fee limitations and network exclusivity prohibitions, the district court declared its intent to vacate the challenged provisions of Regulation II.[5] The Board appealed the district court decision to the D.C. Circuit on

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1 This advisory supplements our advisory regarding the district court's memorandum opinion, available at http://www.alston.com/advisories/NACS-v-Board/, our subsequent updates regarding the August 14 (http://www.alston.com/advisories/update-DC-district-court/) and August 21 (http://www.alston.com/advisories/federal-reserve-appeal-regulation/) status conferences and associated briefing, and our advisory regarding the D.C. Circuit's grant of expedited review (http://www.alston.com/advisories/regulation-II-Review/).

2 *NACS v. Bd. of Governors of the Fed'l Res. Sys.*, No. 11-02075, Mem. Op. Jul. 31, 2013 (D.D.C. 2013) (the "**District Court Opinion**").

3 12 C.F.R. part 235.

4 15 U.S.C. § 1693 *et seq*.

5 District Court Opinion at 55.

August 28, 2013, and on September 19, 2013, filed a joint motion with the Merchants requesting that the circuit court expedite review of that appeal. The circuit court granted the motion, and oral argument in the appeal was held today.

A. The lower court's decision

The district court decided *NACS v. Board* as a "*Chevron* step one" case. In *Chevron, U.S.A., Inc. v. Natural Resources Defense Council*,[6] the Supreme Court provided that a court that is reviewing agency action under the Administrative Procedure Act must first determine if the statutory text clearly expresses the intent of Congress. If so, the agency has no latitude in its rulemaking beyond executing that express intent. This is "*Chevron* step one." However, if the court finds that the intent of Congress with respect to a particular issue is not clearly expressed by the statute, the agency's interpretation of the statutory directive will be upheld unless it is arbitrary, capricious or contrary to law ("*Chevron* step two"). The district court found that the Durbin Amendment clearly and unambiguously directs the Board to consider only incremental ACS costs in setting the interchange-fee limitation. The district court likewise found that the Durbin Amendment clearly requires the Board to ensure that at least two unaffiliated networks are available to process each transaction, viewed after the authentication method has been chosen (i.e., two PIN or two signature networks). Therefore, the district court held, the statute provided no interpretive leeway for the Board, and as a result, the Board exceeded its authority in promulgating the challenged provisions of Regulation II.

B. The appellate briefing

The Board's appellate briefing focuses on arguing that *NACS v. Board* was improperly decided as a *Chevron* step one case.[7] In contrast to the district court and the Merchants, the Board argues that the Durbin Amendment does not deliver clear marching orders with respect to the interchange-fee limitation and the network exclusivity prohibition, but rather provides overarching direction and vests in the Board the discretion to determine how that direction should be implemented. Specifically with respect to the interchange-fee limitation, the Board argues that the district court and the Merchants erred by focusing solely on the statute's indication of specific costs that must and must not be included in the Board's analysis. Rather, the Board argues that consideration of the enumerated cost categories is merely an aspect of the Board's obligation to comply with the statutory requirement to establish limitations that are "reasonable and proportional" to issuer costs.[8] With respect to the network exclusivity prohibition, the Board argues that the statutory language can be interpreted to support the Board's determination that multiple networks must be enabled on each debit card, not that multiple networks must be available for each method of authentication supported by a merchant at the point of sale. Ultimately, the Board concludes, with respect to both the interchange-fee limitation and the network exclusivity prohibition, the text of the Durbin Amendment is sufficiently ambiguous that the district court should have treated *NACS v. Board* as a *Chevron* step two case, and accorded deference to the Board's reasonable interpretation of the statutory requirements.

The Merchants' brief, conversely, focuses on shoring up the district court's determination that *NACS v. Board* was properly decided at *Chevron* step one.[9] Where the Board sees discretion, the Merchants argue, the Durbin Amendment intended to direct a specific outcome with respect to both interchange fees and network exclusivity. The Merchants,

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6 467 U.S. 837 (1984).

7 *See* Brief for Defendant-Appellant Board of Governors of the Federal Reserve System (filed 10/21/2013); Reply Brief for Defendant-Appellant Board of Governors of the Federal Reserve System (filed 12/04/2013).

8 15 USC 1693o-2(a)(2).

9 *See* Brief of Appellees (filed 11/20/2013).

like the district court, assert that the statute inarguably divides issuer costs into two categories—required and excluded—and that the text cannot be read to imply a third category of costs that the Board may (but is not required) to include in its analysis. The Merchants argue that the Durbin Amendment is likewise clear with respect to network exclusivity, requiring that multiple networks be available to route a transaction even after the authentication method for the transaction has been determined (whether by the customer at the point of sale, or by virtue of the fact that the merchant supports only one authentication method). In light of the clearly expressed intent of Congress, the Merchants argue, the district court properly found that the Board was not entitled to deference and that Regulation II's interchange-fee limitation and network exclusivity prohibition should be vacated.

Amicus briefs were filed by four parties. A group of financial services trade associations (the "**Bank amici**") filed a brief in support of reversal of the district court decision.[10] A retail trade association and a group of quick-service restaurants (the "**Merchant amici**") filed briefs in support of the Merchants, as did Senator Durbin.[11] The Bank amici, who generally concurred with the Board's analysis, also argued that upholding the Merchants' interpretation of the statute would result in interchange-fee limitations so low as to be confiscatory, and therefore constitutionally problematic. The Merchant amici focused on providing factual information regarding the economic impact on merchants of interchange fees (both pre- and post-Regulation II). Senator Durbin's brief focused on arguing that the Merchants correctly interpreted congressional intent with respect to the interchange-fee limitation and the network exclusivity prohibition.

C. Oral argument before the circuit court

Oral argument was heard by Judges Tatel, Edwards and Williams. The Board, the Merchants and the Bank amici each participated in the oral argument.[12] Two key themes emerged from today's argument: First, the circuit court focused most of its attention on the interchange-fee limitation, directing the parties away from any lengthy discussion about the network exclusivity prohibition. Second, the court appeared to view the case as a *Chevron* step two case—indeed, Judge Edwards advised the Merchants' counsel to focus on *Chevron* step two arguments, stating that the Merchants were "not going to win on *Chevron* step one."

Counsel for the Board began her argument with the network exclusivity prohibition, but was promptly encouraged by the panel to move along to discussion of the interchange-fee limitation. The panel focused particularly on two questions regarding the interchange-fee limitation: (i) how the Board decided which fixed costs it should include in setting the interchange fee standard and (ii) why the Board elected to separate transaction monitoring costs from fraud prevention costs, given that Congress specifically directed that fraud prevention costs should only be recoverable by issuers that meet certain standards prescribed by the Board. The Board's counsel first argued that the Durbin Amendment's limitations on cost considerations that may be included in setting the interchange-fee standard turn not on whether a cost is incremental or variable, but rather on whether the cost is "specific to a particular electronic debit transaction."[13] Therefore, the Board reasoned, the only costs it is prohibited from considering in setting a reasonable and proportional interchange-fee limitation are those that are not specific to a

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[10] *See* Brief of *Amici Curiae* The Clearing House Association L.L.C. et al. (filed 10/21/2013).

[11] *See* Brief of The Retail Litigation Center, Inc., as *Amicus Curiae* in Support of Plaintiffs-Appellees (filed 11/20/2013); Brief for *Amici Curiae* 7-Eleven, Inc. et al. in Support of Plaintiffs-Appellees and Affirmance (filed 11/20/2013); Brief of *Amicus Curiae* United States Senator Richard J. Durbin in Support of Plaintiffs-Appellees (filed 11/20/2013).

[12] The Merchant amici and Senator Durbin did not participate in oral argument.

[13] *See* 15 U.S.C. § 1693o-2(a)(4)(B)(i).

particular debit transaction. The Board then argued that the fixed costs it included were those that it determined did qualify as specific to a particular transaction. With respect to the panel's second question, the Board stated that it interpreted the Durbin Amendment as permitting transaction-monitoring costs to be allocated to either the costs included in setting the amount of the separate fraud-prevention adjustment payable to qualifying issuers or, given the role of transaction monitoring in the authorization process, to the costs included in the calculation of the interchange-fee limitation.

Counsel for the Bank amici opened his argument by addressing the district court's *Chevron* analysis, contending that there is no reading of the statute that precludes the Board from considering, in setting the interchange fee standard, the four categories of costs at issue in the case—(i) fixed authorization, clearing and settlement costs; (ii) transaction monitoring costs; (iii) fraud losses; and (iv) network processing fees. The panel's questions for the Bank amici focused on similar themes to those addressed in its questioning of the Board's counsel.

Counsel for the Merchants opened by asserting that the plain language of the Durbin Amendment clearly bifurcates all costs into two categories for purposes of the Board's setting of the interchange-fee limit—costs the Board must consider and costs the Board must not consider. Almost immediately, however, Judge Edwards advised the Merchants' counsel that "you're not going to win on *Chevron* step one," encouraging counsel to focus instead on demonstrating why the Board's interpretation of the statutory requirements was not entitled to deference. Merchants' counsel then argued that even if the statutory text is not unambiguous, the Board's interpretation of that text to permit inclusion of the four additional cost categories was unreasonable because those costs are not specific to particular debit transactions. With respect to network exclusivity, the Merchants' counsel stated that, despite the promulgation of Regulation II, networks continue to maintain rules that restrict the networks over which merchants may route debit transactions. On rebuttal, the Board's counsel stated that any such network rules that remain in place violate Regulation II in its current form.

Although it is unknown when the circuit court will issue its opinion, by practice, the D.C. Circuit issues all opinions by the end of the then-current term. The D.C. Circuit's current term ends in late summer. The district court's decision vacating the challenged provisions of Regulation II has been stayed during the pendency of the appeal, meaning that the current Regulation II presently remains in place. In the event that the circuit court upholds, whether in whole or in part, the lower court's decision, the Board must promulgate new regulations consistent with the lower court opinion. If the circuit court reverses the district court's decision, Regulation II most likely will remain intact and new rulemaking will not be required. Although less likely, the circuit court could reverse the district court's decision, but find some portion of current Regulation II to be unreasonable (under *Chevron* step two), in which case, the Board would be required to revise Regulation II consistent with the circuit court's holding.

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