



Payment Systems Advisory ■

MARCH 21, 2014

D.C. Circuit Court Upholds Regulation II

Grant of Summary Judgment by the District Court Reversed; Classification of Transaction-Monitoring Costs Remanded to Board for Further Proceedings¹

In an opinion released today,² the Court of Appeals for the D.C. Circuit reversed the D.C. District Court's grant of summary judgment in *NACS v. Board of Governors of the Federal Reserve System* ("*NACS v. Board*"),³ the 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 by the Board of Governors of the Federal Reserve System (the "**Board**") in Regulation II, Debit Card Interchange Fees and Routing ("**Regulation II**").⁴ The Court of Appeals upheld Regulation II as currently drafted, finding that the Board had reasonably interpreted the Durbin Amendment's⁵ mandates, but the court remanded one "minor" issue to the Board for further explanation—the treatment of transaction monitoring costs.⁶

In *NACS v. Board*, the Merchants challenged two key components of the Board's Regulation II rulemaking to implement the Durbin Amendment, alleging that both components were unreasonable interpretations of the statute. First, the Merchants challenged the Board's determination, in setting the interchange-fee limitation, that the Durbin Amendment 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

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, our advisory regarding the D.C. Circuit's grant of expedited review (<http://www.alston.com/advisories/regulation-II-Review/>), and our advisory regarding the oral arguments held before the D.C. Circuit on January 17, 2014 (<http://www.alston.com/publications/Oral-Argument-NACSVBoard/>).

² *NACS v. Bd. of Governors of the Fed'l Res. Sys.*, No. 13-5270 (D.C. Cir. Mar. 21, 2014) (hereinafter, the "*Circuit Court Opinion*").

³ *NACS v. Bd. of Governors of the Fed'l Res. Sys.*, 958 F. Supp. 2d 85 (D.D.C. 2013) (hereinafter, the "*District Court Opinion*").

⁴ 12 C.F.R. Part 235.

⁵ Electronic Fund Transfer Act, 15 U.S.C. § 1693 *et seq.*

⁶ *Id.* at 3.

(referred to as “incremental ACS costs”), but also certain fixed costs that the Board found to be specific to a particular debit card transaction. Second, the Merchants challenged the Board’s determination 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 any two unaffiliated networks on a debit card, regardless of the authentication method supported by the networks (i.e., the requirement would be satisfied by enabling one signature network and one unaffiliated PIN network).

In a memorandum opinion issued on July 31, 2013, the district court agreed with the Merchants, holding that the Board “completely misunderstood” the intent of Congress in the Board’s implementation of the interchange-fee limitation and network exclusivity prohibition through Regulation II.⁷ In today’s opinion, the court of appeals disagreed with the district court on both counts. “Applying traditional tools of statutory interpretation,” the appellate court wrote, “we hold that the Board’s rules generally rest on reasonable constructions of the statute[.]”⁸

The court devoted the majority of its opinion to Regulation II’s treatment of incremental ACS costs. In contrast to the district court, the court of appeals found that the Board acted reasonably in determining that the Durbin Amendment permitted the Board to consider certain fixed costs in establishing a reasonable and proportional interchange-fee limitation. With respect to three of the four specific categories of fixed costs that the Board included in setting the interchange fee limitation (“fixed” ACS costs, network processing fees and fraud losses), the court of appeals found that the Board had clearly demonstrated that it acted reasonably in including such costs.⁹

With respect to the fourth cost category (transactions-monitoring costs), the court of appeals found that the Board could have reasonably determined that it was permitted to consider such costs as costs “specific to a particular...transaction,”¹⁰ but that the Board had failed to “cogently explain” its decision to do so.¹¹ Consequently, the court of appeals remanded this issue to the Board in order to permit the Board to provide a legally adequate explanation for its decision to include transaction monitoring costs (which account for 1.2 cents of the 21-cent fixed component of the interchange fee limitation established by the Board under Regulation II).¹² Finding that the Board might be able “readily to cure [this] defect in its explanation of [its] decision” and that vacatur would have a significant disruptive effect on the marketplace, the court of appeals permitted Regulation II to remain in full effect during the Board’s proceedings to address the deficiency.¹³

⁷ *District Court Opinion* at 114.

⁸ *Circuit Court Opinion* at 3.

⁹ *Id.* at 26–30.

¹⁰ *Id.* at 31.

¹¹ *Id.* at 32 (internal citation omitted).

¹² Bd. of Governors of the Fed’l Res. Sys., *2009 Interchange Revenue, Covered Issuer Cost, and Covered Issuer and Merchant Fraud Loss Related to Debit Card Transactions* (June 2011), available at http://www.federalreserve.gov/paymentsystems/files/debitfees_costs.pdf; Supplementary Information for Regulation II, at 76 Fed. Reg. 43394, 43433–43434.

¹³ *Id.* (internal citation omitted).

The court of appeals opinion allots only five of its 38 pages to the Merchants' challenge to Regulation II's formulation of the prohibition on network exclusivity. At the outset, the court stated that the Merchants "have a steep hill to climb" in supporting their arguments, stating that the Board's rule "seems to comply perfectly with Congress's command."¹⁴ The court of appeals found that the issues raised by the Merchants as evidence of the inadequacy of the network exclusivity prohibition were not the result of actions taken by networks or issuers: "merchants, not issuers or networks, limit their own options when they refuse to accept PIN debit, and cardholders, not issuers or networks, limit [M]erchants' options when given the ability to choose how to process transactions."¹⁵ As a result, the court wrote, "far from summiting the steep hill, the [M]erchants have barely left basecamp."¹⁶ Finding the Board's interpretation of the Durbin Amendment's prohibition on network exclusivity to be reasonable, the court of appeals fully upheld Regulation II's treatment of the network exclusivity prohibition.

The Merchants may petition the court of appeals to rehear the case en banc, or may seek appeal to the U.S. Supreme Court. The Board may also seek appeal or en banc rehearing of the circuit court's remand regarding transactions-monitoring costs. Rehearing en banc by the court of appeals and Supreme Court appeal, however, are not as of right, and any such petition or request for appeal by either party may be denied. As of today, neither the Merchants nor the Board have stated whether they plan to seek rehearing or to pursue further appeal.

¹⁴ *Id.* at 35.

¹⁵ *Id.* at 38.

¹⁶ *Id.*

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