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Payment Systems Advisory ■

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Merchants Seek Supreme Court Review of Federal Reserve Board Regulation II's Interchange-Fee Limitation

Merchants Assert D.C. Circuit Applied Incorrect Standard in Reviewing District Court Decision; Challenge to Network Exclusivity Prohibition Abandoned

On Monday, August 18, 2014, a group of trade associations and individual merchants ("merchants") filed a petition for *writ of certiorari* in the U.S. Supreme Court seeking review of the decision of the Court of Appeals for the D.C. Circuit in *NACS v. Board of Governors of the Federal Reserve System*.[1] *NACS v. Board*, originally filed by the merchants in the D.C. District Court in late 2011, challenges the network exclusivity prohibition and interchange-fee limitation established by the Board of Governors of the Federal Reserve (the "Board") in Regulation II, Debit Card Interchange Fees and Routing. The District Court's initial decision in favor of the merchants was overturned by the Court of Appeals earlier this year. Pointing to the critical significance of Regulation II to retailers, issuers and card networks, the merchants now urge the Supreme Court to grant *certiorari* and to finally determine whether the interchange-fee limitation established by the Board in Regulation II contravenes the intent of Congress as expressed in the Durbin Amendment.[2]

Significantly, the petition shows the merchants have abandoned their challenge to the network exclusivity prohibition established by the Board in Regulation II. Rather, the merchants are now focusing only on the question of whether the Board's consideration of costs other than per-transaction incremental costs in setting the interchange-fee cap violates the plain language of the Durbin Amendment.

Regulation II's Interchange-Fee Limitation

The Durbin Amendment requires interchange fees charged or received by issuers in conjunction with debit card transactions to be "reasonable and proportional" to the costs the issuer incurs in connection with such transactions.[3] The Durbin Amendment instructs the Board to issue rules to establish standards

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1 *NACS v. Board*, 746 F.3d 474 (D.C. Cir. 2014).

2 Electronic Fund Transfer Act, 15 U.S.C. § 16930-2, "Reasonable fees and rules for payment card transactions."

3 15 U.S.C. § 1693o-2(a)(3)(A).

for assessing whether an interchange fee meets this standard. In so doing, the Durbin Amendment directs the Board to 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"[4] ("incremental ACS costs") and prohibits the Board from considering "other costs incurred by an issuer which are not specific to a particular electronic debit transaction."[5]

In developing the interchange-fee limitation set forth in Regulation II, the Board interpreted the Durbin Amendment to require the consideration of incremental ACS costs, prohibit consideration of costs not specific to particular debit card transactions and permit consideration of other costs that, while not incremental ACS costs, are "specific to a particular electronic debit transaction" (the "third category costs"). 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 interchange-fee limitation established by the Board in Regulation II accounted not only for incremental ACS costs, but also for the following third category costs: (i) certain fixed costs of authorization, clearing and settlement ("fixed ACS costs"), (ii) transaction monitoring costs, (iii) fraud losses and (iv) network fees. After conducting a rulemaking proceeding (which included a survey and analysis of issuer costs as well as review of more than 10,000 public comments on the initial proposed Regulation II), the Board set the interchange-fee limitation at 21 cents per transaction, plus five basis points of transaction value.[6]

The Lower Court Proceedings

The merchants initially challenged both the interchange-fee limitation and Regulation II's prohibition on network exclusivity in an action filed in the District Court in late 2011. First, the merchants argued that the Board erred in concluding that the Durbin Amendment permitted the Board to consider costs other than incremental ACS costs in setting the interchange-fee limitation. Second, the merchants challenged the Board's determination that the Durbin Amendment's prohibition on network exclusivity could be satisfied by requiring enablement of any two unaffiliated networks on a debit card, regardless of the authentication methods supported by the networks (e.g., enablement of one signature network and one unaffiliated PIN network).[7]

In an opinion issued on July 31, 2013, the District Court agreed with the merchants. 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*.[8] In "*Chevron* step one," the court must determine if the statutory text, together with relevant legislative history, clearly and unambiguously

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4 15 U.S.C. § 1693o-2(a)(4)(B)(i).

5 *Id*. at (4)(B)(ii).

6 12 C.F.R. § 235.3(b).

7 Because the merchants have abandoned their challenge to the Board's implementation of the network exclusivity provision, this advisory does not address the treatment of that issue by the District Court and Court of Appeals. Detailed discussion and analysis regarding the merchants' arguments regarding network exclusivity, as well as the lower court opinions, is available in our prior advisories, which are referenced below.

8 467 U.S. 837 (1984).

expresses the intent of Congress concerning 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. However, if the court finds that the intent of Congress concerning a particular issue is not clearly expressed by the statute, the agency has discretion to interpret the statute through rulemaking, and 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 decided *NACS v. Board* as a *Chevron* step one case, holding that the statutory text, together with related legislative history, clearly and unambiguously expressed Congress's intent (i) that the Board consider only incremental ACS costs in establishing the interchange-fee limitation and (ii) that each debit card must be enabled on at least two unaffiliated networks for each method of transaction authentication supported by any network enabled on the card. The District Court declared its intent to vacate both the interchange-fee limitation and the network exclusivity prohibition.

In an opinion released in March 2014, the Court of Appeals reversed the District Court and upheld both the interchange-fee limitation and the network exclusivity prohibition as promulgated by the Board. The Court of Appeals held that the District Court erred in deciding *NACS v. Board* as a *Chevron* step one case. Rather, the Court of Appeals found the statutory text ambiguous and the District Court should have conducted a *Chevron* step two analysis of the Board's interpretation of the Durbin Amendment. The Court of Appeals then held that, under such an analysis, the Board reasonably determined that the statute permitted the consideration of third category costs in establishing the interchange-fee limitation and that the network exclusivity prohibition could be satisfied by the enablement of at least two unaffiliated networks on a given card, regardless of the methods of authentication supported by such networks.

Having found that the Board's interpretation of congressional intent concerning the interchange-fee limitation was reasonable, the Court of Appeals then turned to the question of whether the Board acted reasonably in selecting the types of costs included in the third category costs. The Court of Appeals noted that the decision whether issuers or merchants should bear a given cost required policy determinations that the Board was uniquely positioned to make. Drawing an analogy to agency ratemaking proceedings, the Court of Appeals stated that agencies are afforded special deference when making such policy determinations. The Court of Appeals upheld the Board's decision to include three of the four third category costs in setting the interchange-fee limitation but held that the Board failed to provide adequate explanation for its decision to include transaction monitoring costs in the third category costs rather than in the fraud-prevention adjustment. Under the Administrative Procedure Act, agency policy determinations made through the notice-and-comment rulemaking process must be upheld unless found to be arbitrary and capricious.[9] A key element in determining whether an agency's action is arbitrary and capricious is whether the agency record adequately reflects the agency's justification for its decision.[10] Therefore, the Court of Appeals remanded to the Board for further explanation the narrow issue of how it decided to allocate transaction monitoring costs to the third category costs.

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[9] 5 U.S.C. § 706(2)(A)

[10] *Motor Veh. Manuf. Ass'n v. State Farm Mut. Auto. Ins. Co.*, 463 U.S. 29, 43 (1983).

The Merchants' Petition

In the petition, the merchants assert that the Court of Appeals "committed a significant legal error" in upholding the interchange-fee limitation established by the Board in Regulation II.[11] In prohibiting the Board from considering costs "not specific to a particular debit transaction," the merchants argue, the Durbin Amendment "unambiguously forbids recovering fixed costs."[12] As a result, the merchants claim, the Board's decision to consider issuer costs other than per-transaction, incremental costs in setting the interchange-fee limitation directly contravened Congress's intent.

The merchants then argue that, even if the Durbin Amendment is ambiguous and a *Chevron* step two analysis is appropriate, the Board's decision to include costs other than per-transaction, incremental costs in setting the interchange-fee standard does not "fall within the bounds of reasonable interpretation."[13] Although in briefing to the Court of Appeals the merchants directly challenged the Board's reasoning regarding each of the four types of costs the Board included in the third category, the merchants focus on a more basic argument in the petition; namely, that costs other than per-transaction, incremental costs are, by definition, costs not specific to a particular debit transaction. Therefore, the merchants reason, it is clearly unreasonable to interpret the Durbin Amendment as permitting the Board to consider such costs (regardless of whether designated as a fixed ACS cost, transaction monitoring cost, network fee or fraud loss). As a result, the merchants assert, even under the highly deferential standard of *Chevron* step two, the interchange-fee limitation should be overturned.

The merchants argue that the Court of Appeals failed to invalidate the interchange-fee limitation because it reviewed the Board's consideration of fixed costs in setting the interchange-fee limitation not under the *Chevron* standard but rather under a more deferential standard applicable to agency ratemaking. However, the merchants assert, the rulemaking conducted by the Board in promulgating Regulation II was not analogous to an agency ratemaking proceeding; therefore, the Board's reasoning was not entitled to any greater level of deference than an ordinary rulemaking proceeding. Had the Court of Appeals properly applied *Chevron* analysis, the merchants imply, the interchange-fee limitation would have been overturned.

As discussed above, the court reviewed the Board's determination of which costs should be included in the third category not as a question of statutory interpretation subject to *Chevron* review but rather as a policy determination subject to the Administrative Procedure Act's arbitrary and capricious test (and entitled to special deference due to its similarity to ratemaking). The thrust of the merchants' argument appears to be that the Board's decision to consider costs other than per-transaction, incremental costs was invalid under the *Chevron* test (whether evaluated under step one or step two) and, thus, the Court of Appeals should never have considered whether the Board acted arbitrarily and capriciously in determining which costs to consider in setting the interchange-fee limitation and should not have applied a standard of heightened deference in doing so.

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[11] Petition at 17.

[12] *Id.*

[13] Petition at 27 (internal citations omitted).

Impact of the Petition

The merchants have opted not to seek further review of the network exclusivity provision. As a result, the current network exclusivity requirements of Regulation II will remain intact. Issuers may comply with the Durbin Amendment by enabling two unaffiliated networks on each debit card, without regard to the methods of authentication supported by each such network (e.g., by enabling one PIN network and one signature network).

Costs other than incremental ACS costs account for approximately nine cents of the total 21 cent base cap of the interchange-fee limitation.[14] The merchants estimate that about 75 percent of those nine cents is attributable to fixed costs that are not per transaction, incremental costs. Therefore, in the event the Supreme Court grants the merchants' petition and rejects (whether in whole or in part) the Board's reasoning with respect to the inclusion of costs other than per-transaction, incremental costs in setting the interchange-fee limitation, the ultimate impact will likely be a cap that is set somewhere between 12 cents and 21 cents.

Next Steps

The petition will be docketed within the next few days. The Board will have 30 days from docketing to file a response, although the Board also has the option to seek one or more 30-day extensions. Assuming the Board requests a single extension, the justices will likely review the petition and the Board's response in a late November conference. A decision on the petition will likely be issued in early December. If additional extensions of time for the Board to file a reply are granted, that timeline will likely be proportionally extended. In the event the Supreme Court elects to grant *certiorari*, the case should be argued in the spring, and a decision rendered prior to the end of the Court's term in June.

This advisory supplements our previous advisory regarding the District Court's memorandum opinion, our subsequent updates regarding the August 14, 2013 and August 21, 2013 status conferences and associated briefing, our advisory regarding the D.C. Circuit's grant of expedited review, our advisory regarding the oral arguments held before the D.C. Circuit on January 17, 2014, and our prior alert and advisory regarding the D.C. Circuit's opinion.

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[14] While the Board has provided precise statistics relating to some components of the 21cent cap, such as transaction-monitoring costs, that is not the case with the components of the general "processing costs" component, which includes fixed and variable ACS costs, fraud losses and network fees. *See* Bd. of Governors of the Fed's 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. Calculation of the processing-fee component is discussed at pages 8-9 and Tables 4 and 13.

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