Client Alert

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D.C. District Court Finds Fed Interchange Rules Are Invalid

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On July 31, 2013, the U.S. District Court for the District of Columbia ("District Court") issued a sharply worded Memorandum Opinion in the merchant litigation with the Federal Reserve Board ("Board") regarding the Board's Regulation II—*NACS, et al. v. Board of Governors of the Federal Reserve System* ("Opinion"). United States District Judge Richard Leon held that two critical aspects of Regulation II—the debit interchange fee and network exclusivity provisions—are contrary to the language and purpose of the underlying statute, section 920 of the Electronic Fund Transfer Act, commonly known as the "Durbin Amendment."

The Durbin Amendment was added to the Dodd-Frank Act on the Senate floor shortly before the Act was enacted in to law. After passage, there were efforts to enact legislation to make the Durbin Amendment less onerous, particularly for smaller banks, but these efforts were unsuccessful.

The Durbin Amendment directed the Board to write rules to implement the statute. After initially proposing rules that would reduce debit interchange fees, which at that time averaged around 38¢ per transaction, to 12¢ per transaction or less, the Board ultimately adopted a fee structure that started at 21¢ per transaction and increased with transaction value and a fraud adjustment. In addition, in implementing the statute's network exclusivity requirements, the Board required that a debit card be enabled with at least two unaffiliated payment card networks, and not two networks per authorization method (*i.e.*, PIN v. signature) that it initially had considered. Shortly after Regulation II became effective, merchant groups that had supported the Durbin Amendment challenged in the District Court the Board's implementation of the amendment as inconsistent with the language of the Amendment.

The District Court sided with the merchants relying on its view of the statutory language and on statements made by Senator Richard Durbin (D-IL) to conclude that the statute was clear and that *Chevron* deference for the Board's interpretation of the statute was not required. After finding that Regulation II's interchange fee provisions and network exclusivity provisions are inconsistent with the statute, the District Court concluded that the proper remedy is to remand to the Board with instructions to vacate the rule's debit interchange fee limitation (12 C.F.R. § 235.3(b)) and network exclusivity rule (12 C.F.R. § 235.7(a)(2)). But, the District Court stayed the vacatur to "provide the Board an opportunity to replace the invalid portions of" Regulation II. The Opinion also states that "an appropriate order" from the District Court will be forthcoming.

ALLOWABLE COSTS IN SETTING THE DEBIT INTERCHANGE FEE STANDARD

The District Court found that the statutory language of the Durbin Amendment evidenced intent by Congress to bifurcate the costs associated with debit interchange fees into only two groups: (1) incremental costs that are

incurred by an issuer for its role in the authorization, clearance, and settlement ("ACS") of a debit transaction; and (2) and "other costs" incurred by the issuer that are not specific to the transaction.[1] On this basis, the District Court concluded that "[t]he plain text of the Durbin Amendment thus precludes the Board from considering in the interchange fee standard any costs, other than variable [ACS costs] incurred by the issuer in processing each debit transaction."[2] The Court also found that fraud-related costs should not have been used by Board in establishing the debit interchange fee standard and that such costs should be recoverable only as part of the fraud prevention adjustment to the standard.[3] In the District Court's view, a permissible interchange fee cannot include an issuer's: (1) fixed ACS costs; (2) transaction monitoring costs; (3) fraud losses; and (4) network processing fees.[4] The effect of this standard is not completely clear, but it could result in a fee structure that more closely resembles the structure in the Board's original proposal or, perhaps, an even lower fee structure.

NETWORK EXCLUSIVITY

The District Court also held that merchants should be given a choice to route debit transactions between multiple unaffiliated networks "not only for each card, but for each transaction," regardless of authorization method.[5] Specifically, the Court stated that the plain language of the Durbin Amendment "supports the conclusion that Congress intended for each transaction to be [able to be] routed over at least two competing networks for each authorization method" enabled on a debit card (*i.e.*, two signature networks and/or two PIN networks, as opposed to one signature network and one PIN network).[6] In justifying this conclusion, the Opinion cites to a number of statements in the *Congressional Record* by Senator Durbin, as well as comments submitted by Professor Adam Levitin on the Board's proposed rules on Regulation II.[7] The Court seems to take the view that a merchant is entitled to a choice of networks after the transaction is authorized, rather than a choice of networks when the card is presented for authorization.

EFFECT OF THE RULING

The District Court's ruling was largely unanticipated. For a rate-making provision, the Durbin Amendment used unique language that made reference to existing bodies of law on rate-making difficult to apply. Further, the markedly different interpretations of the language of the Durbin Amendment by the Board and the District Court suggest the type of ambiguity that *Chevron* deference was designed to address. At this point, the Board has not stated whether it intends to appeal the decision.

If the Board does not appeal, or the ruling otherwise stands, the Board will have to craft new standards to replace the vacated provisions of Regulation II. In this regard, it is important to recognize what the court did not strike down. The ruling leaves intact the concept of a general interchange fee cap that applies to all issuers, instead of

[1] Opinion at 29 (citing 12 U.S.C. §§ 1693o-2(a)(4)(B)(i), (ii)).

[2] Opinion at 33 through 37.

[3] Opinion at 36.

[4] Opinion at 41.

[5] Opinion at 47.

[6] Opinion at 49.

[7] *Id.*

an issuer-by-issuer determination based on individual issuer costs. Further, the Opinion does not address a number of important issues in the Board's Regulation II rulemaking and does not address all aspects of rule itself. For example, the Opinion does not address all of the factors on which the Board based its debit interchange fee standard (*e.g.*, that the Board used issuer costs at the 80th percentile to calculate the standard), nor does the Opinion address the Board's implementation of the fraud prevention adjustment.

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