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Priceless? The Competitive Costs of Credit Card Merchant Restraints

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CREDIT CARD MERCHANT RESTRAINTS**

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ADAM J. LEVITIN

Credit card transactions cost American merchants six times as much as cash transactions. Why, then, do consumers pay the same price for purchases, regardless of the means of payment?

The answer lies in a set of credit card network rules known as merchant restraints. Merchant restraints forbid merchants from surcharging for credit and discounting for non-cash payments, while the framing effect, a well-documented cognitive bias, makes discounting for cash ineffective. Merchant restraints thus prevent merchants from pricing according to consumers' payment method and from signaling to consumers the costs of different payment methods. Accordingly, consumers never internalize the costs of their choice of payment system.

This article argues that credit card merchant restraints lead to an overconsumption of credit cards as a transacting device and distort competition within the credit card industry and among payment systems in general. The article contends that merchant restraints are antitrust violations and demonstrates that the economic justifications for merchant restraints are unfounded. Rather than being a response to an industrial organization problem inherent in networked industries and necessary for the existence of credit card networks, merchant restraint rules are the response to a no-longer extant legal problem and have outlasted any justifiable purpose. Thus, the article proposes regulatory, legislative, or judicial intervention to ban merchant restraint rules.

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I. Introduction: Transaction Costs: What a Transaction Costs

For nearly a decade, MasterCard has run a successful ad campaign that touts the benefits of its cards as “Priceless.”¹ But this is hardly the case. Merchants see the price tag for payment systems, and credit cards are expensive as payment systems go. On average, credit card transactions cost American merchants *six* times as much as cash transactions and twice as much as checks or PIN-based debit cards.²

Table 1. Average Cost per Transaction of Accepting Payment for U.S. Retailers in 2000³

	CREDIT CARDS	OFF-LINE (SIGNATURE) DEBIT CARDS	CHECKS	ON-LINE (PIN) DEBIT CARDS	CASH
Average cost per transaction	\$0.72	\$0.72	\$0.36	\$0.34	\$0.12

While the cost differences between payment systems are often a matter of cents per transaction, they are significant in absolute terms. In 2005, American merchants paid nearly \$50 billion to accept credit and debit cards—more than the total size of the biotech industry, the music industry, the microchip industry, the electronic game industry, Hollywood box office sales, or worldwide venture capital investments.⁴

¹ Seth Stevenson, *Slate's Ad Report Card: The End of "Priceless,"* (NPR radio broadcast, Mar. 16, 2006), at <http://www.npr.org/templates/story/story.php?storyId=5283958>.

² David Humphrey *et al.*, *What does it Cost to Make a Payment?* 2 REV. OF NETWORK ECON., 159, 162-63 (2003). These numbers likely understate the cost discrepancies among payment systems. Credit card costs have risen by 27% since Humphrey's study, while other payment system costs have declined or remained static. *See infra* text accompanying notes 64 - 65.

³ *Id.* These figures include fees paid by merchants to banks, as well as costs such as handling, theft, counterfeit, float, deposit preparation, insurance, armored cars, and labor. For different calculations, *see* Daniel D. Garcia Swartz *et al.*, *The Move Toward a Cashless Society: A Closer Look at Payment Instrument Economics*, 5 REV. NETWORK ECON. 175 (2006) and Daniel D. Garcia Swartz *et al.*, *The Move Toward a Cashless Society: Calculating the Costs and Benefits*, 5 REV. NETWORK ECON. 199 (2006). Unfortunately, both the Humphrey *et al.* study and the Garcia-Swartz *et al.* studies are based on data at least a decade old.

⁴ Aneace Haddad, *The Interchange Industry Is Bigger than . . .*, ANEACE'S BLOG (May 12, 2006), at <http://aneace.blogspot.com/>.

Table 2. Fees Paid to Accept Payment Cards by U.S. Merchants in 2005⁵

PAYMENT CARD BRAND	FEES PAID (bil.)	PURCHASE VOLUME (bil.)	WEIGHTED AVERAGE FEE (% OF SALE PRICE)
MasterCard/Visa Credit Cards	\$25.13	\$1,147.49	2.19%
MasterCard/Visa Off-Line (signature) Debit Cards	\$9.76	\$557.87	1.75%
American Express	\$8.51	\$352.94	2.41%
On-Line (PIN) Debit Cards	\$2.16	\$348.05	0.62%
Private Label Cards	\$1.54	\$140.04	1.10%
Discover	\$1.46	\$82.86	1.76%
TOTAL	\$48.56	\$2,629.25	1.85%

Payment costs—what a transaction costs—are the ultimate transaction cost that one would expect merchants to pass on to consumers. Why, then, do consumers pay the same, regardless of their means of payment?

The answer lies in a set of credit card network rules known as merchant restraints. Merchant restraints are designed to exploit consumers' cognitive bias of reacting differently to mathematically equivalent surcharges and discounts in order to prevent merchants from pricing according to payment system costs. Credit card network rules are incorporated by reference in merchants' contracts with their banks. These rules restrict merchants' options as to what type of payment systems they can accept and how they can price them, and force merchants to bundle the pricing of payment services with the underlying goods and services being sold.

This article argues that merchant restraints are antitrust violations that distort competition within the credit card industry and between payment systems in general. The article examines how merchant restraints have created a barrier to entry for new, more efficient payment systems and shows how credit card networks have chosen to forgo inter-brand price competition in order to gain an advantage over competing payment systems. The article argues that the economic justifications for merchant restraints are unfounded and that the historical context of merchant restraints' development shows that they are the result of a no-longer extant legal problem, rather than an economic necessity for maintaining a credit card network. In light of the lack of an

⁵ NILSON REPORT, Issue 862 (Aug. 2006), at 11.

economic justification for merchant restraints and their competitive costs, the article suggests that there is a market failure in the payment systems market that requires legal, regulatory, or legislative intervention.

* * * * *

This article proceeds in five sections. The first section reviews the structure and economics of credit card networks, which are the essential framework for understanding the card networks' merchant restraints. The second section examines the history of credit card merchant restraints and the functional distinction between rules prohibiting cash discounts and rules prohibiting credit surcharges caused by the cognitive bias known as the framing effect.

The third section of the article considers the major justification for merchant restraints: the need to account for network effects—the phenomenon of a decrease (or increase) in a network's size resulting in a decrease (or increase) in the network's value for remaining network participants. The article argues that while the network effect concern may make sense for an immature network product given the high costs of entry for a new payment system, the network effect concern is inapplicable in the context of established networks competing with other established networks. Moreover, the article contends that the history of merchant restraints shows that no-surcharge rules, the most important merchant restraint, are as much a response to a legal problem, rather than to an industrial organization problem, and that the economic the economic justifications for merchant restraints are *ex-post facto* rationalizations that should be given little credence.

The fourth section of the article is an antitrust analysis of merchant restraints. It shows how they constitute a variety of antitrust violations and how they restrict competition within the credit card industry by shifting the basis of competition from price, an easily commoditizable factor, to bundled rewards programs that are harder to commoditize. The article argues that merchant restraints increase credit card prices *and* usage. It demonstrates a market failure among payment systems because credit card networks leverage their market power by forgoing price-based competition with each other in order to negate other payment systems' price advantage.

The article concludes with a review of international action on merchant restraints and urges regulatory or judicial intervention to ban merchant restraints in light of their anticompetitive costs and lack of a sound positive economic justification.

II. The Structure and Economics of Credit Card Networks

A. Network Structure

The payments industry is a vital part of the American banking system. It accounts for about 40% of banks' revenues.⁶ The payments industry is increasingly dominated by credit and debit cards.⁷ The percentage of dollar volume of goods and services purchased using payment cards has risen from 6% in 1984,⁸ the first year when such statistics were compiled, to 38% in 2005.⁹ In 2004, payment card purchases exceeded the number of paper checks written for the first time,¹⁰ and comprised 47% of all noncash purchases.¹¹ Payment cards are predicted to account for almost half of the number and amount of all sales by 2010.¹² (See Chart 1, below.)

⁶ Steve Bills, *Threat Seen to Banks' Revenue from Payments*, AM. BANKER, May 25, 2006, at 12.

⁷ See Chart 1, *infra*.

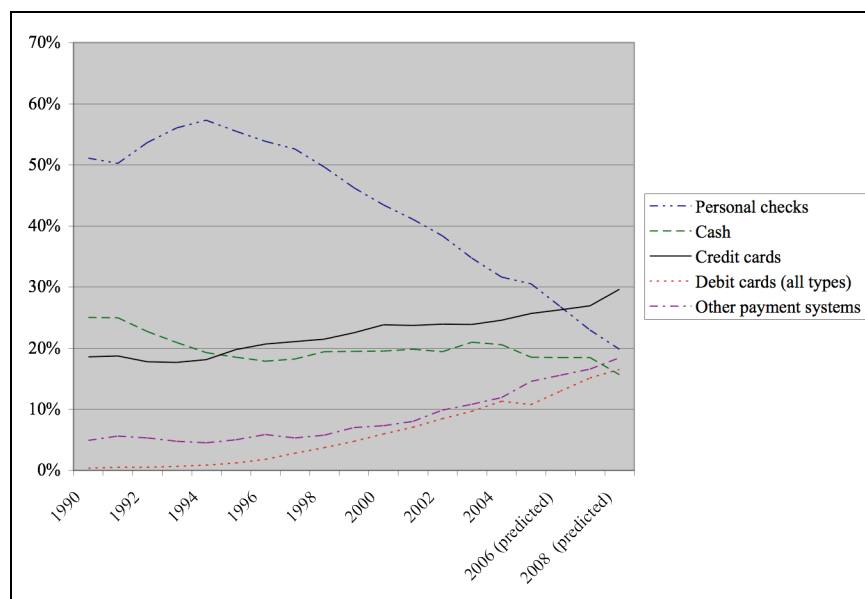
⁸ DAVID S. EVANS & RICHARD L. SCHMALENSEE, *PAYING WITH PLASTIC: THE DIGITAL REVOLUTION IN BUYING AND BORROWING* 25 (1999).

⁹ NILSON REPORT, Issue 847 (Dec. 2005), at 6.

¹⁰ See *Electronic Payments Surpass Paper Checks*, USA TODAY, Dec. 6, 2004. Credit cards alone had already surpassed checks as the most common payment method at point-of-sale. See Sujit Chakravorti & Alpa Shah, *A Study of Interrelated Bilateral Transactions in Credit Card Networks*, 2 FED. RES. BANK OF CHI. EMERGING PAYMENTS OCCASIONAL PAPER SERIES 1 (2001).

¹¹ FED. RES. SYS., *THE 2004 FEDERAL RESERVE PAYMENTS REPORT: ANALYSIS OF NONCASH PAYMENTS TRENDS IN THE UNITED STATES: 2000-2003* 3, 7-9 (2004), available at <http://www.frb services.org/Retail/pdf/2004PaymentResearchReport.pdf>.

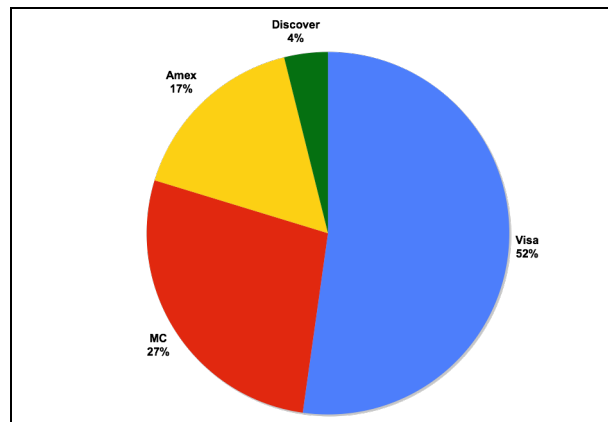
¹² *Id.*

Chart 1. U.S. Payment Systems Market Share by Dollar Volume¹³

Most payment cards in the United States are run on bank-controlled networks: MasterCard, Visa, American Express, and Discover. In 2005, Visa had a 52.12% market share of U.S. combined consumer and commercial payment card purchase volume, followed by MasterCard with 27.47%, American Express with 16.52%, and Discover with 3.89%.¹⁴ (See chart 2, below.)

¹³ NILSON REPORT, Issues 847 (Dec. 2005), 823 (Dec. 2004), 799 (Nov. 2003), 777 (Dec. 2002), 761 (Apr. 2002), 753 (Dec. 2001), 730 (Dec. 2000).

¹⁴ NILSON REPORT, Issue 863, at 1 (August, 2006).

Chart 2. U.S. Payment Card Brand Market Share by Volume, 2005¹⁵

Visa is a joint venture owned by its member banks, as was MasterCard, until its spring 2006 IPO, which resulted in a complex ownership structure combining public, charitable foundation, and bank ownership.¹⁶ Before MasterCard's IPO, MasterCard and Visa had a 95% overlap in membership.¹⁷

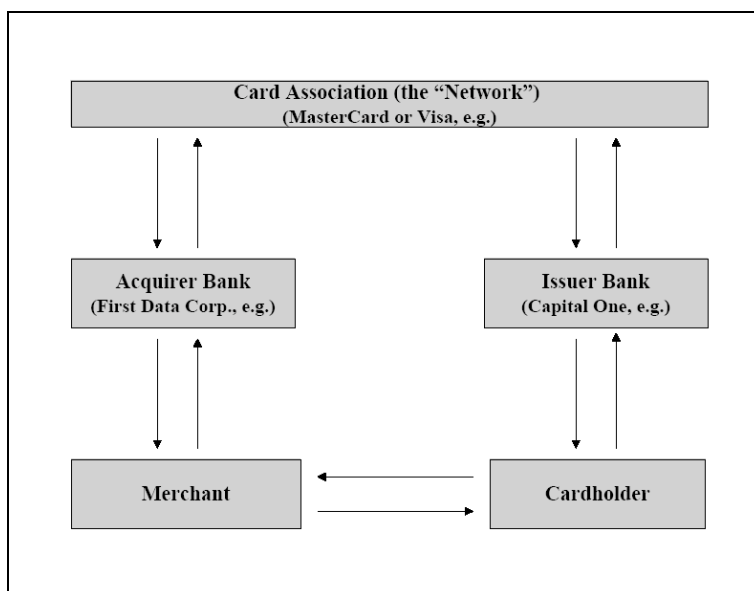
MasterCard's and Visa's networks consist of three parties that link the transaction between the consumer and the merchant. (See Figure 1, below.) First, there are the banks that issue the cards and have the consumer relationship. These are called the issuer banks. Second, there are the banks where the merchants maintain their accounts. These are called the acquirer banks because they functionally purchase the merchant's account receivable created by the consumer's card transactions with the merchant. Intermediating between issuers and acquirers is the network association, which performs authorization, clearing, and settlement (ACS) services. MasterCard and Visa have traditionally been dominated by the large issuers; voting within the joint ventures was in proportion to their sales volumes.¹⁸

¹⁵ *Id.*

¹⁶ See Adam J. Levitin, *Payment Wars: The Merchant-Bank Struggle for Control of Payment Systems*, 12 STAN. J. L. BUS. & FIN. ____ (2007), for an analysis of the antitrust and business factors behind the unusual form of MasterCard's new ownership structure.

¹⁷ *In re Visa Check/MasterMoney Antitrust Litig.*, 280 F.3d 124, 129 (2d Cir. 2001). Visa has also announced that it plans an IPO in 2007. Eric Dash & Michael J. de la Merced, *Visa Plans an Initial Public Offering as Soon as Next Year*, N.Y. TIMES, Oct. 12, 2006, at C2.

¹⁸ NILSON REPORT, Issue 845 (Nov. 2005) at 8.

Figure 1. Parties to MasterCard and Visa Networks

American Express and Discover are owned by individual financial institutions. Historically, these institutions performed all the functions of the issuer, acquirer, and network itself. Recently, these networks began to allow other banks to issue cards with their brands, although they continue to serve as acquirer and ACS network.¹⁹ In all networks there is often an additional party, the merchant service provider, which links the merchant and the acquirer. Acquirers frequently outsource all but the financing element of their operations to merchant service providers.²⁰

B. The Costs of Credit Card Transactions

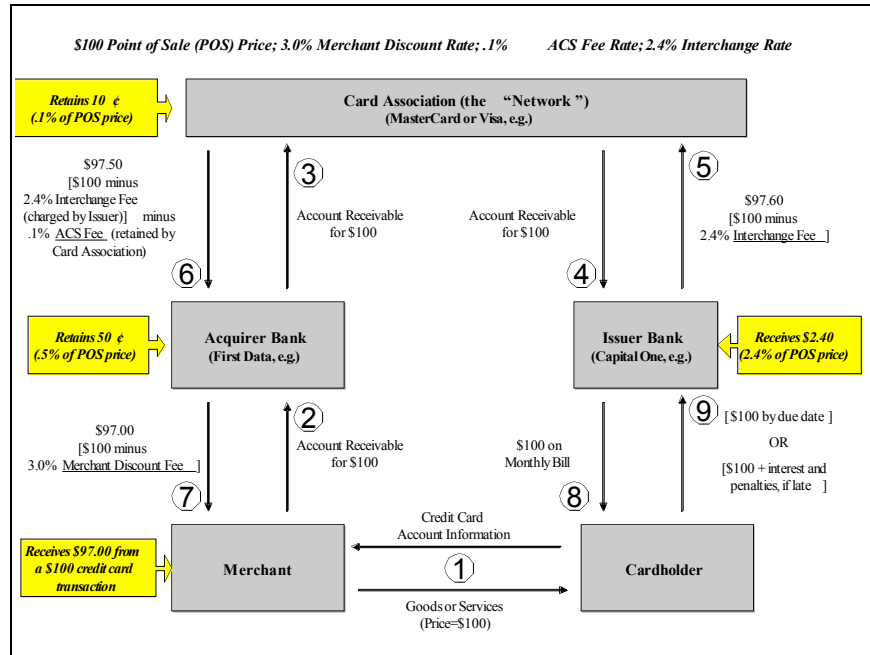
A payment card transaction has several cost components. (See Figure 2, below, for an illustration.) When a consumer makes a purchase with a card, the merchant's account at the acquiring bank is credited with the purchase amount, less an amount known as the merchant discount fee. The merchant discount fee typically consists of both a flat rate amount, ranging from a few cents to a dollar, and a percentage amount.

¹⁹ See *infra* text accompanying note 63.

²⁰ Ramon P. DeGennaro, *Merchant Acquirers and Payment Card Processors: A Look Inside the Black Box*, 91 FED. RES. BANK OF ATLANTA ECON. REV. 27, 31 (2006), available at http://www.frbatlanta.org/filelegacydocs/erq106_degennaro.pdf.

The total merchant discount fee usually amounts to 1% - 2.7%,²¹ but tends to be higher, in the range of 3% - 4% for non-U.S. merchants and for mail-order, Internet, or telephone-order merchants.²² Rates can even be as high as 15% for merchants who present a particularly high risk because of low transaction volume, limited credit history, or the nature of their business.²³

Figure 2. Economics of MasterCard and Visa Transactions



Of the merchant discount fee, part is retained by the acquirer bank, and part is remitted to the network association. The network association keeps a small part of this remittance to cover the costs of

²¹ *What's at Stake in the Interchange Wars*, THE GREEN SHEET, Nov. 28, 2005, at 70.

²² *Merchant Account Rates*, MERCHANT SEEK, at http://www.merchantseek.com/merchant_accounts_rates.htm.

²³ PSW, Inc., *Merchant Services Agreement*, available at <http://www.pswbilling.com/contractno-ccAS-all.pdf>, at 4. High risk account categories include travel merchant accounts, adult merchant accounts, pharmacy merchant accounts, telemarketing merchant accounts, Internet merchant accounts, and on-line gambling.

Guardian Financial Services, Inc., *Why Is a Merchant Account Considered High Risk*, at http://www.guardianfinance.com/high_risk_merchant_account.htm;

Adult Card Processing.com, *High Risk Merchant Accounts*, at <https://secure.gowebbs.net/adultcardprocessing/index.html>.

clearing the transaction²⁴ and remits most of it, in turn, to the issuing bank. The remittance to the issuer is called the interchange fee, although this term is often misapplied to all the fees involved in the network, including the merchant discount fee. The purpose of the interchange fee is to cover the costs of ACS, funds during the interest free (float) period, fraud, chargebacks (*i.e.*, returns, which involve reverse ACS), and particularly rewards programs, which account for 45% of interchange fees.²⁵ Processing only accounts for 13% of interchange costs.²⁶

Interchange rates are set annually or semi-annually by the network. For Visa (and MasterCard before spring 2006), this means that the member banks, through their representatives on the association's board, agree on a rate schedule. American Express and Discover set the interchange rate themselves; their third-party issuers operate as franchises of the American Express and Discover brands, rather than as joint venturers.

Interchange rates are classified by the merchants' business type and by the level of bundled rewards on the consumer's card. Interchange rates typically include both a flat fee of 5¢ - 25¢ and a fee of 1% - 3% of the total transaction amount. The average credit card interchange rate in the U.S. was 1.56% in May 2005.²⁷ Yet, because the interchange fee is an arrangement between the acquirer and the issuer, merchants have no ability to negotiate on the interchange rate or on the network rules, discussed in the following section, that insulate the interchange rate from market discipline. They can only negotiate on the merchant discount fee.²⁸

²⁴ MasterCard's ACS costs appear to be around 13¢/transaction. Dennis W. Carlton & Alan S. Frankel, *Transaction Costs, Externalities and "Two-Sided" Payment Markets*, 2005 COLUM. BUS. L. REV. 617, 633 (2005).

²⁵ Amy Dawson & Carl Hugener, A New Business Model for Card Payments, White Paper, Diamond Mgmt. & Tech. Consultants (Oct. 19, 2006) at 9, available at <http://www.diamondconsultants.com/PublicSite/ideas/perspectives/downloads/INSIGHT%20-%20New%20Card%20Business%20Model.pdf>.

²⁶ *Id.*

²⁷ *What's at Stake in the Interchange Wars*, *supra* note 21, at 70. By comparison the average interchange rate in 2007 for off-line (signature) debit cards was 1.11% and for on-line (PIN) debit, it was .46%. Pulse EFT Association, Press Release, *New Comprehensive PULSE Debit Industry Study Reveals Continued Growth in Debit Card Market*, Feb. 28, 2007, at http://home.businesswire.com/portal/site/google/index.jsp?ndmViewId=news_view&newsId=20070228005200&newsLang=en

²⁸ Nonetheless, interchange fees are scheduled according to merchants' business profiles. This belies the card networks' claim that merchants are indirect purchasers of the interchange service. If merchants were solely purchasing acquirer

The interchange fee sets the floor for the merchant discount fee. The merchant discount fee is always the interchange fee plus an additional percentage taken by the acquirer bank. Although the acquiring market is extremely concentrated,²⁹ it is highly competitive on price.³⁰ It is a low-margin, high-volume business, and acquirers have high turnover rates in their portfolios.³¹ Acquirers have little room in which to set their prices, because the interchange rate floor is the major component of their costs. There is increasingly little room for variation in the merchant discount fee based on the individual merchant's profile because the spread that acquirers charge has declined sharply in the last decade.³² Therefore, merchant discount fees are increasingly a function of the card associations' interchange rates.

Interchange rates vary not on networks' costs, but on the merchant's type and the level of bundled rewards points attached to a particular payment card.³³ The merchant discount fee will vary based on the merchant's risk profile and the acquirers' profit component. Thus, interchange rates are lower in stable, high volume, but low-margin industries like groceries, but extremely high for riskier, fraud prone businesses like small volume, adult Internet sites.

C. Merchant Restraints

Merchants who accept payment cards agree in their contracts with their acquirer banks to be bound by the card associations' rules, which are only available to merchants in abridged form.³⁴ The bankcard

services, the risk posed by the merchant should rest solely on the acquirer, and there would be no reason for it to be accounted for in interchange fees.

²⁹ See Levitin, *Payment Wars*, *supra* note 16, at ____.

³⁰ Howard H. Chang, Payment Card Industry Primer, 2 PAYMENT CARD ECON. REV. 30, 46 (2004).

³¹ *Id.*

³² DAVID S. EVANS & RICHARD L. SCHMALENSEE, PAYING WITH PLASTIC: THE DIGITAL REVOLUTION IN BUYING AND BORROWING 261-62 (2d ed., 2005).

³³ DeGennaro, *supra* note 20, at 37 (2006). Major factors in a merchant's risk profile are its past volume of transactions, fraud rate, chargeback rate, and industry. *What's at Stake*, *supra* note 21, at 70; *New Interchange Rate Highlights*, THE GREEN SHEET, Mar. 27, 2006, at 56-63.

³⁴ *Credit Card Interchange Rates: Antitrust Concerns? Hearing Before the Senate Comm. on the Judiciary*, 109th Cong. (July 19, 2006) (testimony of Bill Douglass, CEO of Douglass Distributing), at http://judiciary.senate.gov/testimony.cfm?id=1999&wit_id=5590. An abbreviated version of MasterCard's rules are available on-line. Visa has only made an abbreviated version of its merchant rules available on-line as of September 1, 2006, to merchants who sign a non-disclosure agreement. *Visa to disclose regs, with strings attached*, THE GREEN SHEET, Issue 06:08:02, 57 (Aug. 14, 2006).

associations employ a number of rules known as merchant restraints to increase card usage at the expense of other payment systems and to limit price competition within the credit card industry in order to maintain higher interchange rates. Three particular categories of interconnected rules are the core of merchant restraints.

First, and most important, are no-surcharge and non-differentiation rules. No-surcharge rules forbid merchants to impose a surcharge for the use of credit or debit cards. Merchants are also prohibited from charging different prices for particular types of cards within a brand (non-differentiation rules),³⁵ and as a catchall, merchants are forbidden from discriminating against the card association's cards in any way.³⁶ Merchants may not pass on the marginal cost of a consumer's choice of payment system to that consumer.³⁷ Thus,

³⁵ MASTERCARD INT'L, MERCHANT RULES MANUAL, BYLAW 3.11 (April 2006), at 2-4, available at http://www.mastercard.com/us/wce/PDF/12999_MERC-Entire_Manual.pdf.

³⁶ MASTERCARD INT'L, MERCHANT RULES MANUAL, BYLAW 6.5.1; 9.12.1 (April 2006), at 2-15, 2-22 available at http://www.mastercard.com/us/wce/PDF/12999_MERC-Entire_Manual.pdf; DISCOVER NETWORK, DISCOVER NETWORK MERCHANT OPERATING RULES, RULE 3.7 (revised Oct. 2004), available at http://www.discoverbiz.com/common/images/operat_reg.pdf at 4.

³⁷ MASTERCARD INT'L, MERCHANT RULES MANUAL, BYLAW 9.12.2 (April 2006), at 2-22, available at http://www.mastercard.com/us/wce/PDF/12999_MERC-Entire_Manual.pdf; ("A merchant must not directly or indirectly require any MasterCard cardholder to pay a surcharge or any part of any merchant discount or any contemporaneous finance charge in connection with a MasterCard card transaction. A merchant may provide a discount to its customers for cash payments. A merchant is permitted to charge a fee (such as a bona fide commission, postage, expedited service or convenience fees, and the like) if the fee is imposed on all like transactions regardless of the form of payment used. A surcharge is any fee charged in connection with a MasterCard transaction that is not charged if another payment method is used."); MAESTRO GLOBAL RULES 7.2.1 (Mar. 2004) ("Unless permitted by local laws or regulations, Acquirers must ensure that their Merchants do not require Cardholders to pay a surcharge or any part of any Merchant discount, or any contemporaneous finance charge in connection with a Transaction. A Merchant may provide a discount fee to its customers for cash payments."); VISA, RULES OF VISA MERCHANTS 10 (2005), available at http://usa.visa.com/download/business/accepting_visa/ops_risk_management/rules_for_visa_merchants.pdf?it=r4l%2Fbusiness%2Faccepting_visa%2Fops_risk_management%2Findex.html | Rules for Visa Merchants

American Express has a piggy-back no-surcharge rule that requires that its card be treated like a MasterCard or Visa. The absence of an explicit no-surcharge rule appears to stem from a legal settlement. See *infra* text accompanying note 72. AMERICAN EXPRESS, TERMS AND CONDITIONS FOR AMERICAN EXPRESS CARD ACCEPTANCE (revised Jan. 2001) ("You agree to treat Cardmembers wishing to use the Card the same as you would treat all other customers seeking to use other charge, credit, debit or smart cards or similar cards, services or payment products. You agree not to impose any special

consumers are not forced to internalize the full costs of their choice of payment system. Instead, at point-of-sale, all payment systems, as well as all card brands and all card types within card brands, have the same costs to consumers. Therefore, consumers choose among payment systems without factoring in point-of-sale costs.

Second, merchants are required to take all credit cards bearing the card association's brand (honor-all-cards rule).³⁸ They are also required to accept cards at all their locations (all-outlets rule), regardless of different business models (e.g., Internet store, main-line retail, discount outlet).³⁹ Honor-all-cards rules and all-outlets rule prevent merchants from picking and choosing what sort of cards they want to accept. Card acceptance is an all-or-none proposition.

This is a problem for merchants because different types of cards even of the same brand have different costs to merchants. Credit cards have higher costs than debit cards, and among credit cards, the higher the level of rewards points on a card, the higher the cost in interchange fees

restrictions or conditions on the use or acceptance of the Card that are not imposed equally on the use or acceptance of other cards.”).

DISCOVER NETWORK, DISCOVER NETWORK MERCHANT OPERATING RULES, RULE 3.1 (revised Oct. 2004), available at http://www.discoverbiz.com/common/images/operat_reg.pdf at 4. (“Unless otherwise agreed upon by us in writing, you may not impose any surcharge, levy or fee of any kind for any transaction where a Cardmember desires to use a Card for any purchase of goods or services.”). Discover has agreed to drop its no-surcharge rule as part of a settlement in merchant-initiated lawsuits. NILSON REPORT, Issue 851, at 6 (Feb. 2006). It appears, though, that Discover has only dropped its no-surcharge rule in name only, as it has agreed to allow merchants to surcharge, only if they surcharge for other brands of cards. *Id.* Thus, Discover has only changed its no-surcharge rule from a direct one to one like American Express's that piggy-backs on those of MasterCard and Visa.

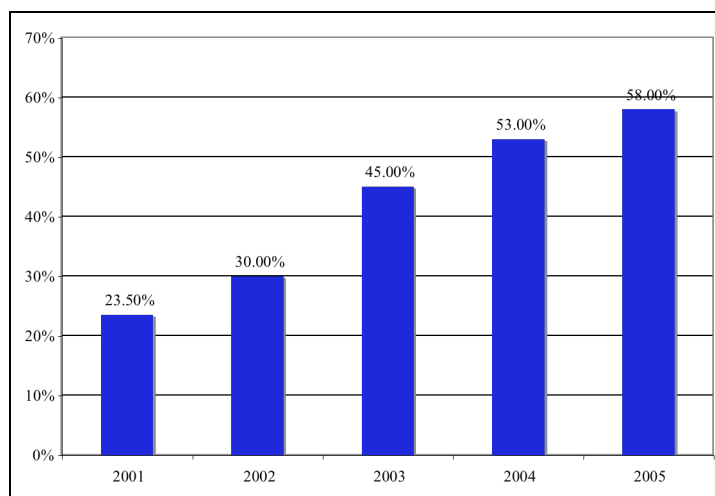
³⁸ MASTERCARD INT'L, MERCHANT RULES MANUAL, BYLAW 9.11.1 (April 2006), at 2-21, available at http://www.mastercard.com/us/wce/PDF/12999_MERC-Entire_Manual.pdf. In the United States, MasterCard and Visa apply the honor-all-cards rule to credit cards and debit cards separately as the result of a settlement with Wal-Mart, Sears, and other retailers in 2003. MASTERCARD INT'L, MERCHANT RULES MANUAL, BYLAW 17.C.2 (April 2006), at 2-31, available at http://www.mastercard.com/us/wce/PDF/12999_MERC-Entire_Manual.pdf. A merchant may choose to honor all credit cards of the brand, all debit cards of the brand or both. MASTERCARD INT'L, MERCHANT RULES MANUAL, BYLAW 17.C.3.a (April 2006), at 2-32, available at http://www.mastercard.com/us/wce/PDF/12999_MERC-Entire_Manual.pdf. Merchants may not choose to honor only low-interchange rate cards within the brand.

³⁹ MASTERCARD INT'L, MERCHANT RULES MANUAL, BYLAW 6.5.1, 9.11.1 (April 2006), at 2-15, available at http://www.mastercard.com/us/wce/PDF/12999_MERC-Entire_Manual.pdf; DISCOVER NETWORK, DISCOVER NETWORK MERCHANT OPERATING RULES, RULE 13.3 (revised Oct. 2004), available at http://www.discoverbiz.com/common/images/operat_reg.pdf at 28. Query whether a merchant could skirt all-outlet rules by using subsidiaries and affiliates.

for merchants. Indeed, some card issuers account for the cost of rewards programs in their financials as reductions in interchange income.⁴⁰

As rewards cards have risen from less than 25% of new card offers in 2001 to nearly 60% in 2005,⁴¹ and the level of rewards offered on cards has risen to as much as 5% cash back on certain purchases, merchants find themselves performing more and more of their transactions on costlier cards. Two-thirds of all cardholders now have a reward card, up from half in 2002.⁴²

Chart 3. Rewards Cards as Percentage of New Credit Cards Offered⁴³



Rewards cards also make up a disproportionate amount of credit card spending. Eighty percent of credit card transactions in 2005 were made on rewards cards.⁴⁴ (See Chart 4, below.) Because rewards programs are a major component of interchange costs, as rewards programs have grown, so too have interchange fees and hence merchant discount fees.

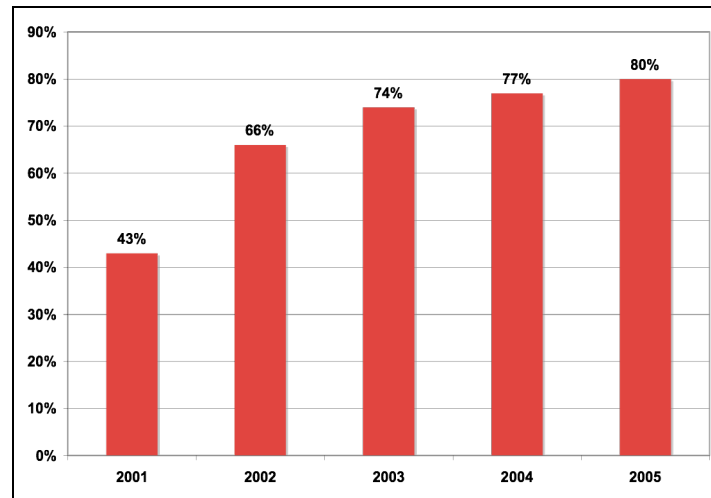
⁴⁰ E.g., Capital One 2005 Annual Report 28, 68; Discover Bank 2005 Annual Report 12; MBNA 2004 Annual Report 42.

⁴¹ Binyamin Appelbaum, *Credit-card rewards rise as more offers hit America's mailboxes*, THE CHARLOTTE OBSERVER, June 5, 2006; CARDTRAK, *Card Debt* (April, 2004), <http://www.cardweb.com/cardtrak/pastissues/april2004.html>.

⁴² Damon Darlin, *Gift Horses To Consider: Credit Cards That Reward*, N.Y. TIMES, Dec. 31, 2005, at C1.

⁴³ Binyamin Appelbaum, *Credit-card rewards rise as more offers hit America's mailboxes*, THE CHARLOTTE OBSERVER, June 5, 2006; CARDTRAK, *Card Debt* (April, 2004), <http://www.cardweb.com/cardtrak/pastissues/april2004.html>.

⁴⁴ *Rewarding Volume*, 171 AM. BANKER 11 (Dec. 14, 2006).

Chart 4. Percentage of Credit Card Transactions on Rewards Cards⁴⁵

Rewards cards divide into regular and premium rewards rates.⁴⁶ For example, Visa Signature cards, which carry the highest level of rewards and are available only to affluent consumers, comprise only 3.5% of all Visa cards, but account for 22.2% of all Visa purchases.⁴⁷ Thus the annual average purchases are \$5,200 on a regular Visa card, but \$26,100 on a rewards card.⁴⁸ The 2006 interchange rate for Visa Signature cards at restaurants is 2.30% + \$.10, whereas the rate for a traditional Visa card is 1.54% + \$.10. The restaurant interchange rate for a traditional MasterCard is 1.15% + \$.05—half of the rate of the Visa Signature card.⁴⁹

Assuming that the merchant discount rate on these transactions is proportional, or roughly so, what has the merchant gained by paying his acquirer the marginal cost of a Visa Signature card transaction? The merchant has not enabled a transaction that could not have otherwise occurred because of the consumer's liquidity constraints. By accepting

⁴⁵ *Rewarding Volume*, 171 AM. BANKER 11 (Dec. 14, 2006).

⁴⁶ See, e.g., *Visa 2006 interchange rates*, THE GREEN SHEET, Issue 06:03:02, 58 (Mar. 27, 2006).

⁴⁷ Elizabeth Olson, *Holding Liev Schrieber's Tony Award? Priceless*, N.Y. TIMES, Aug. 13, 2006, at BU7.

⁴⁸ Darlin, *supra* note 42, at C1.

⁴⁹ THE GREEN SHEET, *Visa 2006 Interchange Rates*, Issue 06:03:02 (Mar. 27, 2006), at 58.

the traditional MasterCard or Visa card, the merchant already enabled purchases from liquidity constrained consumers.

There is no marginal benefit to the merchant from accepting premium cards. He has merely funded the affluent Visa Signature card consumer's first class upgrade or cash rebate. The consumer who purchases on the Signature card has functionally received a discount not available to other consumers.

Rewards are driving the increase in rewards card usage, which comes at the expense of both non-credit card payment systems and non-rewards credit cards. Consumers with a rewards credit card use credit cards more often than those without rewards credits cards.⁵⁰ They also tend to use their rewards credit card more exclusively.⁵¹ But if they also have a rewards debit card, they will use the rewards debit more often than those who only have credit card rewards.⁵² This suggests that rewards are generating card usage. Moreover, it appears that rewards are replacing not only non-card transactions, but non-reward card transactions.⁵³ Thus, rewards programs fuel an expensive cycle of increased card usage funded by merchants who receive no marginal benefit from the rewards cards.

Honor-all-cards, all-outlets, and non-differentiation rules require merchants who want to accept credit cards in order to enable spending by cash-constrained consumers to also take premium credit cards used by affluent consumers who are seeking frequent flier miles. Even if these rules did not exist, card design blurs the distinction between more and less expensive cards, making it difficult for merchants to screen out pricier cards before entering a transaction.

Third, merchants are forbidden from imposing either a minimum or maximum charge amount,⁵⁴ although this rule is widely flouted in regard to minimums. No-minimum/no-maximum amount rules prevent

⁵⁰ Andrew Ching & Fumiko Hayashi, *Payment Card Rewards Programs and Consumer Payment Choice*, Fed. Res. Bank of Kansas City Working Paper 06-02, July 18, 2006, at 4. [N.B. need permission to cite draft.]

⁵¹ *Id.*

⁵² *Id.*

⁵³ *Id.*

⁵⁴ MASTERCARD INT'L, MERCHANT RULES MANUAL, BYLAW 9.12.3 (April 2006), at 2-22, available at http://www.mastercard.com/us/wce/PDF/12999_MERC-Entire_Manual.pdf; VISA, RULES OF VISA MERCHANTS 10 (2005), available at http://usa.visa.com/download/business/accepting_visa/ops_risk_management/rules_for_visa_merchants.pdf?it=r4%2Fbusiness%2Faccepting_visa%2Fops_risk_management%2Findex.html Rules for Visa Merchants; DISCOVER NETWORK, DISCOVER NETWORK MERCHANT OPERATING RULES, RULE 3.6 (revised Oct. 2004), available at http://www.discoverbiz.com/common/images/operat_reg.pdf at 4.

merchants from steering transactions on which card payments are particularly costly to non-card payment systems. Small transactions are less profitable for merchants when paid on a bank payment card because interchange fee schedules typically include a flat fee as well as a percentage fee for every transaction. On a small transaction, the flat fee amount can consume a significant amount of a merchant's profit margin.

For large transactions, the flat fee portion of the interchange fee is not important, but merchants are less keen on surrendering a percentage cut to the banks on large transactions than on small ones because of the total amount involved. The merchant receives the same essential service of fund transmission from its acquirer on a \$50 payment as on a \$5,000 payment, but the merchant will pay 100 times as much for the \$5,000 transaction. In contrast, cash, checks, automated clearing house (ACH) transactions, and most PIN debit transactions, cost a flat amount to accept.⁵⁵ Thus, a merchant will pay approximately 5¢ to accept either a \$50 ACH transaction or a \$5,000 ACH transaction. For payment systems other than credit cards (and off-line debit cards that use credit card ACS networks), the marginal cost increase based on the number or size of transactions is minimal.

The net effects of the card associations' rules are: (1) to force merchants to charge the same price for goods or services, regardless of a consumer's payment method; (2) to prevent merchants from steering consumers to cheaper payment options; and (3) to increase the number of credit card transactions and thus interchange and ultimately interest income for issuers.

Merchant restraints prevent consumers from accounting for the cost of payment systems when deciding which one to use. Instead, consumers decide based solely on factors such as convenience, bundled rewards, image, and float. These factors tend to favor credit card transactions over other payment systems. Higher purchase volume increases the issuer's income on the front-end in terms of interchange fees and on the back-end in terms of more interest, late fees, and penalties.

D. The Importance of Interchange

Interchange is the economic engine of credit card networks. Historically, it accounts for nearly three-quarters of American Express's

⁵⁵ Terri Bradford, *Payment Types at the Point of Sale: Merchant Considerations*, PAYMENT SYSTEMS RESEARCH BRIEFING, FED. RES. BANK OF KANSAS CITY (Dec. 2004), at 2, at <http://www.kansascityfed.org/PUBLICAT/PSR/Briefings/PSR-BriefingDec04.pdf>. PIN debit transaction fees are not flat rate, but they are capped at 45 cents, which makes them flat rate for most transactions. *Id.*

revenue⁵⁶ and almost one-quarter of Discover's.⁵⁷ (See Table 3, below.) For MasterCard and Visa issuers, interchange accounts for only 19% of revenue,⁵⁸ but it is still the key to the entire enterprise, as this article will show, because interchange combines with the card networks' merchant restraint rules to increase the number and volume of card transactions, thus increasing not only interchange revenue, but also interest revenue and late fees.

Table 3. Revenue Source of Credit Card Issuers⁵⁹

	MasterCard & Visa	Discover	American Express
Interchange or Merchant Discount Fees	19%	23%	72%
Interest	65%	77%	16%
Other Fees (Late Fees, Annuals Fees, etc.)	16%	0%	12%
<i>Global Average Weighted Interchange Rate</i>	<i>1.80%</i>	<i>1.76%</i>	<i>2.57%</i>

Interchange income has become increasingly important to the card industry in recent years. Low bank prime loan interest rates have led consumers to shift their borrowing from high interest rate (but unsecured) credit cards to low interest rate secured debt, such as home equity loans and home equity lines of credit. Many consumers have used their home equity borrowing to pay off credit card balances.⁶⁰ Consumers continue to use credit cards, but the ratio of purchase amount to balances carried (the "turn rate") has increased 9% since 2002.⁶¹

⁵⁶ American Express 2005 Annual Report, at 62. Amex is less dependent on interest than other issuers because a sizeable part of its portfolio are charge cards, which must be paid in full each month, unlike credit cards.

⁵⁷ Discover Network 2005 Annual Report.

⁵⁸ *What's at Stake*, *supra* note 21, at 70.

⁵⁹ American Express 2005 Annual Report; Discover Network 2005 Annual Report; NILSON REPORT, Issue 862 (Aug. 2006), at 11; Jeffrey Green, *Exclusive 2006 Bank Card Profitability Study and Annual Report*, CARDS & PAYMENTS, May 2006, at 32. American Express figures are calculated based on discount, interest, and annual fees and exclude travel fees and other miscellaneous fee income. Discover interest figure also includes revenue from sale and servicing of securitized accounts.

⁶⁰ Kenneth A. Posner, *Clash of Titans: Retailers, Card Issuers, and Interchange*, Keynote Address, FMI 2006 Retail Electronic Payments Conference (Feb. 1, 2006), available at http://www.fmi.org/elect_pay_sys/2006Conference/Posner.pdf, at 15.

⁶¹ Lee Manfred, *The Kansas City Fed Conference: Another Skirmish in the Interchange Controversy*, FIRST ANNAPOLIS NAVIGATOR, May 2005, at 2.

As interest income has become a less reliable source of revenue for credit card issuers, interchange income has become increasingly important. From 2002 to 2004, interchange revenue rose from 18% to 23% of total industry net revenue before credit losses (uncollectible loans).⁶² Slowed growth in interest income has placed pressure on card issuers to increase their interchange income. Card issuers have responded by issuing more premium cards that carry higher interchange rates, and in some cases, reducing their rewards programs.

Additionally, competition between networks for issuers has pushed up interchange rates. In 2003, the United States Court of Appeals for the Second Circuit ruled that MasterCard and Visa could not prevent their member banks from issuing American Express cards too.⁶³ The end of so-called “dual exclusivity” meant that American Express and Discover could compete with MasterCard and Visa for issuers. American Express has higher interchange rates, which has made American Express card issuance very attractive for issuers.

Third-party American Express issuers determine who is eligible for their cards; American Express, which traditionally required greater credit-worthiness than other brands, does not impose eligibility requirements on cards issued by third-parties. Therefore third-party issuers are able to transfer their existing MasterCard/Visa consumer portfolios to American Express. Because the portfolios contain the same consumers as before, the issuers’ interest revenue remains the same. But by issuing American Express cards, the issuers’ increase their net revenue because they make greater interchange revenue. To compete with American Express for issuers, MasterCard and Visa have had to raise their own interchange rates.

Thus, interchange fee levels have risen, as well as the percentage of premium cards on the higher end of the interchange scale and the absolute number and percentage of transaction made on payment cards. Average interchange rates increased 7% from 2002 to 2005.⁶⁴ Merchants’ cost of accepting payment cards has increased by 27% over the same time period,⁶⁵ however, because of the increased number of payment card transactions and the increased percentage of those transactions made on rewards cards and on premium rewards cards with increasingly generous rewards programs. In fact, for many merchants,

⁶² *Id.*

⁶³ *United States v. Visa U.S.A., Inc.* 2001 U.S. Dist. LEXIS 20222 (S.D.N.Y. Nov. 26, 2001), *aff’d* 344 F.3d 229 (2d Cir. 2003), *cert. denied sub nomine* Visa U.S.A., Inc. v. *United States* 543 U.S. 811 (2004).

⁶⁴ Manfred, *supra* note 61, at 2.

⁶⁵ *Id.*

payment card acceptance has become the fastest growing cost of doing business.⁶⁶ Moreover, payment cards are starting to penetrate areas of the economy previously dominated by checks and cash: micropayments, health care, rent, tax and utility bills. This has placed increased financial pressure on merchants because of their restricted ability to use pricing to influence consumers' choice of payment system.

Responding to slowed interest rate growth and American Express competition for issuers, MasterCard and Visa have raised their average interchange rate approximately 7% since 2002.⁶⁷ The general increase in interchange rates, as well as issuers' shift to higher interchange cards, be they premium rewards cards or American Express cards, has exacerbated merchants' rising cost of accepting payments.

While the costs of payment card acceptance have been rising, the benefits of card acceptance have remained static or declined. When credit cards first became widely available a quarter-century ago, they provided merchants a significant boon by enabling greater spending by masses of credit-constrained consumers. Now, however, credit card growth is fueled by affluent, non-credit-constrained consumers, seeking rewards points and frequent flier miles, rather than by credit-constrained consumers, seeking the benefits of paying later for goods and services received now.⁶⁸ As a result, the marginal net benefit of card acceptance is declining, and at some point it may even become negative.⁶⁹ As the costs of accepting credit cards rise and the marginal benefits decline, it is decreasingly profitable for merchants to accept credit cards, and merchants have become increasingly discontent with bank-controlled payment systems.⁷⁰

III. The Bottle Half-Full & the Bottle Half-Empty: of Surcharges & Discounts

No-surcharge rules are the centerpiece of merchant restraints. In their absence, honor-all-card rules, all-outlets rules, non-differentiation, and no-minimum/no-maximum rules would be far less effective. No-surcharge rules do not prohibit cash discounts, even though a cash

⁶⁶ *Financial Services Issues: A Consumer's Perspective, Hearing Before the House Committee on Financial Institutions, Subcommittee on Financial Institutions and Consumer Credit*, 108th Cong., 108-111, 115 (Sept. 15, 2004) (written testimony of Food Marketing Institute), at <http://financialservices.house.gov/media/pdf/108-111.pdf> at 115.

⁶⁷ Manfred, *supra* note 61, at 2.

⁶⁸ Posner, *supra* note 60, at 5-6.

⁶⁹ *Id.* at 4.

⁷⁰ See Levitin, *supra* note 16; Adam J. Levitin, *The Merchant-Bank Struggle for Control of Payment Systems*, 17 J. FIN. TRANSFORMATION 73 (2006).

discount is mathematically equivalent to a credit surcharge. This was not always the case. Credit card networks originally prohibited cash discounts as well. The history of no-surcharge and no-discount rules illuminates a critical economic distinction between the mathematically equivalent actions—consumers react much stronger to credit surcharges than to cash discounts due to a well-documented cognitive bias known as the framing effect. The history of no-surcharge and no-discount rules shows that these merchant restraints existed to deal with a specific legal problem that is no longer extant, rather than being economic *sine qua non* for the creation and viability of payment card networks.

This distinction is crucial because for certain antitrust causes of action, courts are required to balance the anticompetitive effects of a business's behavior with the pro-competitive effects. The existence of payment card networks increases competition for payment services, and if merchant restraints are necessary for the existence of the payment card networks, then they have a pro-competitive effect that must be balanced against their anti-competitive effects. As this article argues, however, merchant restraints are not necessary for the existence of a payment card network and therefore lack any pro-competitive effect.

A. The History of Merchant Restraints

After their introduction in early 1950s, credit cards represented a miniscule percentage of the total number or dollar volume of consumer transactions in the first few decades. Accordingly, there was only minimal federal or state regulation of the credit card industry other than state usury restrictions.⁷¹ Instead, credit cards were governed by two tiers of private agreements—those between the card network and acquirer and issuer banks, and those between the acquirer banks and merchants on the one side and between the issuer banks and cardholders on the other. The latter tier of agreements incorporated the credit card networks' operating rules by reference. These rules included no-surcharge rules and no-discount rules, which combined to prohibit merchants from charging a consumer a different price for a purchase with one of the network's credit cards than for another payment method.

Consumer advocacy groups saw no-surcharge/no-discount rules as negatively affecting cash consumers, and, in February 1974, the

⁷¹ State usury laws were largely eviscerated by the Supreme Court's decision in *Marquette National Bank of Minneapolis v. First of Omaha Service Corp.*, 439 U.S. 299, 309 (1978), which held that the applicable interest rate for a national bank is that of the state in which it is located, as determined by its certificate of organization. *Marquette* started a race to the bottom, with most national banks moving their credit card operations to states like Delaware or South Dakota with no or minimal usury laws.

Consumers Union sued American Express and Bank AmeriCard (Visa's predecessor) on the grounds that their no-surcharge/no-discount rules were restraints on trade constituting an antitrust violation. American Express settled the suit two months later by agreeing to rescind its no-discount rule and allow merchants to offer cash discounts.⁷² The Consumers Union reportedly reached subsequent settlements with other card networks.⁷³ Merchants, however, were unable to take advantage of the settlement because of the disclosure requirements at the heart⁷⁴ of a major piece of pro-consumer legislation, the 1968 Truth in Lending Act (TILA).⁷⁵

TILA required lenders, including credit card issuers, to disclose the cost of credit *ex ante* through two uniform components: the "finance charge" and the "annual percentage rate" (APR). TILA deemed any difference between the price of a cash transaction and a credit transaction, whether by cash discount or credit surcharge, to be part of the cost of credit, which had to be included in mandatory *ex ante* disclosures. TILA's disclosure obligation is on card issuers, but merchants determine pricing on a good-by-good or service-by-service basis.

Two-tiered pricing made adequate TILA disclosures impossible for card issuers because credit card networks could not calculate and disclose *ex ante* what the APR would be for every single good or service.⁷⁶ Moreover, TILA regulations required the conversion of surcharges and discounts into an APR based on the assumption that the surcharge or discount was for a 30-day extension of credit. This meant that a 5% surcharge would increase the APR by an immense 60%, which would scare potential credit consumers and, at least before 1978, violate

⁷² Edmund W. Kitch, *The Framing Hypothesis: Is It Supported by Credit Card Issuer Opposition to a Surcharge on a Cash Price?*, 6 J.L. ECON. & ORG. 217, 220 (1991). See also Gerald P. O'Driscoll, Jr., *The American Express Case: Public Good or Monopoly?* 19 J. L. & ECON., 163-75 (1976); *Discounts for Cash?* TIME (Apr. 29, 1974); *Suit for Consumers Says Credit Cards Hurt Cash Buyers*, N.Y. TIMES, (Feb. 21, 1974) at 29.

⁷³ Kitch, *supra* note 72, at 220 n.2.

⁷⁴ See, e.g., *Mourning v. Family Publ'ns Serv., Inc.*, 411 U.S. 356 (1973).

⁷⁵ Pub. L. No. 90-321 (1968), *codified at* 15 U.S.C. §§ 1601 *et seq.* (2004).

⁷⁶ S. REP. NO. 97-23, at 1 (1981).

state usury ceilings.⁷⁷ No-surcharge rules, the centerpiece merchant restraint, were devised to avoid legal and marketing problems.⁷⁸

Not content with antitrust settlements alone, consumer groups pressed Congress to amend TILA to allow for cash discounts.⁷⁹ Given the antitrust settlements with the Consumers Union, credit card networks had little incentive to fight to keep their no-discount rules. After it appeared that some kind of bill would pass, though, the credit card lobby turned its attention toward preserving their no-surcharge rules.⁸⁰ The result was that Congress amended TILA in 1974 to permit cash discounts, but of no more than five percent, subject to proper disclosure by the merchant.⁸¹ Congress also instructed the Federal Reserve Board (FRB) to draft TILA disclosure regulations.⁸²

While working on the regulations, the FRB was unsure if Congress intended the five percent discount limitation to apply to surcharges too, given their mathematic equivalence.⁸³ Congress responded in 1976 by specifically prohibiting credit surcharges for three years.⁸⁴ Congress also exempted discounts from state usury and disclosure rules.⁸⁵ The legislative history contains no explanation for the decision to ban surcharges but permit limited discounts.

⁷⁷ Kitch, *supra* note 72, at 221; S. REP. NO. 97-23, at 1 (1981); Carl D. Lobell & Joseph W. Gelb, *The Cash Discount Act*, N.Y.L.J., Dec. 31, 1981, at 3 (usury ceiling concerns); *see* discussion *supra* note 71 regarding changes in the applicability of state usury laws.

⁷⁸ Stephen Darley Annand, Note, *Price Fixing and Tying Arrangements Between Credit Card Issuers and Retailers*, 28 WASH. & LEE L. REV. 371, 374-75 (1971).

⁷⁹ Kitch, *supra* note 72, at 224.

⁸⁰ *See* Richard Thaler, *Toward a Positive Theory of Consumer Choice*, 1 J. ECON. BEHAV. & ORG. 39 (1980).

⁸¹ Fair Credit Billing Act of 1974, Pub. L. No. 93-495, § 306, 88 Stat. 1515 (1975).

⁸² *Id.*

⁸³ 61 FED. RES. BULL. 638 (1975) (statement by Jeffrey M. Bucher, Member, Board of Governors of the Federal Reserve System, before the Subcommittee on Consumer Affairs of the Committee on Banking, Housing, and Urban Affairs, U.S. Senate, Oct. 9, 1975); *see also* S. REP. NO. 97-23, at 2 (1981); *see also* Kitch, *supra* note 72, at 225.

⁸⁴ Pub. L. No. 94-222, §3(c)(1), 90 Stat. 197 (1976).

⁸⁵ *Id.*; S. REP. NO. 97-23, at 2 (1981). The surcharge prohibition had a sunset provision, which was renewed twice, *see* Financial Institutions Regulatory and Interest Rate Control Act of 1978 (FIRIRCA), Pub. L. 95-630, § 1501, 92 Stat. 364 (1978) (two-year extension) and Cash Discount Act, Pub. L. No. 97-25, § 201, 95 Stat. 144 (1981) (three-year extension), before the prohibition lapsed in 1984. *See* Cash Discount Act, Pub. L. No. 97-25, § 201, 95 Stat. 144 (1981) (sunset on February 27, 1984).

Congress renewed the surcharge ban in 1978 for an additional three years but let the ban lapse in 1981.⁸⁶ Several months later, and “only after considerable debate and the addition . . . of a requirement that a study be prepared by the Federal Reserve Board,”⁸⁷ Congress passed the compromise Cash Discount Act, which eliminated the five percent limit on cash discounts⁸⁸ but reinstated the surcharge ban for a further three years.⁸⁹ The surcharge ban lapsed in 1984 and has not been renewed.

Today, federal law no longer bans credit surcharges but continues to prohibit state and private restrictions on cash discounts.⁹⁰ Additionally, twelve states prohibit some or all credit surcharges.⁹¹ More

⁸⁶ The ban lapsed on Feb. 27, 1981. It was renewed as of July 27, 1981. *See supra* note 85.

⁸⁷ BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM, CREDIT CARDS IN THE U.S. ECONOMY: THEIR IMPACT ON COSTS, PRICES, AND RETAIL SALES, A STUDY BY THE BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM SUBMITTED TO THE COMMITTEE OF BANKING, HOUSING, AND URBAN AFFAIRS OF THE UNITED STATES SENATE AND THE COMMITTEE ON BANKING, FINANCE, AND URBAN AFFAIRS OF THE UNITED STATES HOUSE OF REPRESENTATIVES PURSUANT TO SECTION 202 OF THE CASH DISCOUNT ACT OF 1981, at 4 (1983).

⁸⁸ Cash Discount Act, Pub. L. No. 97-25, § 102, 95 Stat. 144 (1981).

⁸⁹ *Id.* § 201 (extending the surcharge ban for three years).

⁹⁰ 15 U.S.C. § 1666(f) (2004).

⁹¹ Ten states forbid surcharging outright. CAL. CIV. CODE § 1748.1(a) (Deering 2004); COLO. REV. STAT. § 5-2-212(1) (2004); CONN. GEN. STAT. § 42-133ff(a) (2003); FLA. STAT. § 501.0117 (2004); KAN. STAT. ANN. § 16a-2-403 (2003); MASS. GEN. LAWS ch. 140D, § 28A; ME. REV. STAT. ANN. tit. 9, § 8-103.1.E, § 8-303.2 (2003); N.Y. GEN. BUS. LAW § 518 (2004); OKLA. STAT. tit. 14A, § 2-417 (2004); TEX. FIN. CODE ANN. § 339.001 (2004). In addition, Minnesota permits a surcharge, but limits it to 5%, MINN. STAT. § 325G.051 (2003); New Hampshire bans surcharges specifically for travel agencies, N.H. REV. STAT. ANN. 358-N-2 (2006); and Kentucky’s Attorney General has opined that restaurants may not reduce the amount of tips remitted to employees by the amount of the discount rate if the tips are placed on credit cards. KY. AG LEXIS 79, OAG 87-7 (Jan. 21 1987).

Six states specifically allow sellers to offer discounts. *See* CAL. CIV. CODE § 1748.1(a) (Deering 2004); COLO. REV. STAT. § 5-2-212(2) (2004); CONN. GEN. STAT. § 42-133ff(c) (2003); FLA. STAT. § 501.0117 (2004); ME. REV. STAT. ANN. tit. 9, § 8-103.1.E.; MD. CODE ANN., COM. LAW § 12-509. California, Maine, and Washington also duplicate federal provisions banning card companies from restricting discounts. *See* CAL. CIV. CODE § 1748 (Deering 2004); ME. REV. STAT. ANN. tit. 9, § 8-103.1.E, § 8-303.1 (2003); WASH. REV. CODE § 19.52.130 (2004).

It is unclear whether state surcharge restrictions can constitutionally apply to interstate credit card transactions. Many of the states that restrict credit surcharges have also made exceptions for government agencies (*see* FLA. STAT. § 215.322 (2004); 1987 Tex. A.G. LEXIS 105 (July 15, 1987)), public utilities (*see* 2003 ME. P.U.C. LEXIS 455 (Nov. 4, 2003), *but see* 2000 CONN. P.U.C. LEXIS 363 (Nov. 22, 2000) (Connecticut anti-surcharge statute applies to public utilities)), and donations or membership dues to

importantly, Congress left the credit card networks' no-surcharge rules and other merchant restraints untouched.

B. Doublespeak? The Cash Discount Act as Consumer Protection

The Senate Committee Report on the Cash Discount Act portrayed the Act as a pro-consumer action,⁹² but this is suspect. Major consumer groups, such as the Consumer Federation of America and the Consumers Union, opposed the Cash Discount Act's continuation of the surcharge ban.⁹³ Moreover, the Committee's logic, as expressed in the Report, makes little sense from a pro-consumer standpoint. Although the Committee recognized that "discounts for cash and surcharges on credit cards may be mathematically the same," it argued that "their practical effect and the impact they may have on consumers is very different."⁹⁴ The Report claimed that two-tiered pricing is deceptive because the sticker price is not always the price paid.⁹⁵ Allowing cash discounts, the Report argued, would add some price flexibility into the system while guaranteeing that the sticker price would be the highest price possible:

[P]ermitting unlimited cash discounts and prohibiting surcharges allows the competitive free market to operate.

religious organizations (*see* 1996 TEX. A.G. LEXIS 21 (Feb. 29, 1996)), as well as limiting the restriction to sales of goods (*see* 1987 TEX. A.G. LEXIS 105 (July 15, 1987)).

Five other states, which do not prohibit surcharges have specifically authorized various governmental and quasi-state actors to charge credit surcharges. *See* ALA. CODE § 41-1-60(e) (2004) (state and local governments may impose a credit surcharge); ALA. CODE § 11-47-25(h) (2004) (municipalities may impose a credit surcharge); GA. CODE ANN. § 50-1-6(e) (2004) (state and local government units may impose a credit surcharge); NEB. REV. STAT. §81-118.01(6) (2004) (state agencies may impose a surcharge of no more than cost of credit transaction); N.C. GEN. STAT. § 159-32.1 (2004) (local governments, public hospitals, public authorities may impose a credit surcharge); WYO. STAT. ANN. §§ 40-14-209(b)(v); 40-14-212 (Michie 2006) (cash discount of up to 5% permitted).

⁹² S. REP. NO. 97-23, at 3-4 (1981).

⁹³ *Id.* at 10, 16 (1981). The surcharge ban was also opposed by several government agencies, including the Federal Reserve Board, the Federal Trade Commission, the Office of Comptroller of the Currency, the Federal Home Loan Bank Board, and the Credit Union Administration. *See id.*; *see also* 70 FED. RES. BULL. 102 (1984) (statement of Nancy H. Teeters, Member, Board of Governors of the Federal Reserve System, before Subcommittee on Consumer Affairs of the Committee on Banking, Housing, and Urban Affairs, U.S. Senate, Feb. 7, 1984). The Federal Reserve Board has been consistent in its questioning of the surcharge restriction. *See, e.g.*, 67 FED. RES. BULL. 235 (1981) (statement of Nancy H. Teeters, Member, Board of Governors of the Federal Reserve System, before Subcommittee on Consumer Affairs of the Committee on Banking, Housing, and Urban Affairs, U.S. Senate, Feb. 18, 1981).

⁹⁴ S. REP. NO. 97-23, at 3-4 (1981).

⁹⁵ *Id.* at 4.

Merchants can utilize two-tier pricing systems and thereby price cash purchases lower than credit purchases, if they choose to do so.

But they cannot implement two-tier pricing systems which deceive or mislead the consumer. By permitting only cash discounts, the Committee intends to assure that consumers will be seeing at least the highest possible price they will have to pay when they see a tagged or posted price. In other words, consumers cannot be lured into an establishment on the basis of “low, rock-bottom price” only to find at the cash register that the price will be higher if a credit card is used.⁹⁶

Two-tiered pricing, either through discounts or surcharges, makes it more difficult for consumers to compare prices, unless merchandise is routinely tagged with both prices and sales quotes are given for both cash and credit. Yet, there is no reason to think that a comparison of maximum prices (allowing discounts, but not surcharges) is any better than a comparison of minimum prices (allowing surcharges, but not discounts).

Consumers deal with such price differentials on a regular basis, such as when deciding in which jurisdiction to shop, based on state and local sales taxes, which are not reflected on merchandise tags. A consumer living near the border of a state with a sales tax and a state without a sales tax is aware that purchasing the same items in the sales tax state will be more expensive, even if the sticker price is the same. A credit surcharge could be applied in the same manner as sales tax, as percentage added on to a bill at the register, with signs posted detailing the surcharge applicable to different card types. It would not take much for consumers to learn that the same item would be more expensive when purchased with a credit card and to then conduct a personal cost-benefit analysis for which payment system to use.

Any real consumer protection concerns could easily be addressed by the FRB and Federal Trade Commission through mandating pricing disclosure guidelines so consumers would know the relevant surcharge before payment.⁹⁷ Moreover, the market itself would serve to discipline

⁹⁶ *Id.*

⁹⁷ *Id.* at 11-12 (1981) (letter from FTC Chairman Michael Pertschuk to Senator William Proxmire). *Cf.* Council Directive 98/6, art. 3, 1998 O.J. (L 80) 27, 28 (directing member states adopt regulations requiring merchants to indicate both selling price and unit price for all covered products).

sharp dealing by merchants. Although a merchant could use two-tiered pricing to lure in customers, consumers could walk away if abused, so merchants who use bait-and-switch pricing might well lose customers. And, given that a merchant who charges a credit surcharge *is* offering this advertised price, although only for cash payments, there is nothing *per se* deceptive. Only convenience and cash flow impede a consumer from paying in cash instead of credit, and these are poor policy grounds for protecting surcharges restrictions.

Given that *disclosure*, and not usury rates or price restraints, was at the heart of TILA,⁹⁸ if a merchant gives fair notice that all credit purchases will be surcharged at a specified rate, has not TILA's goal been met? And if so, how exactly has the customer been harmed?

C. The Framing Bias

There is a well-established body of psychological and economic literature on cognitive biases⁹⁹—the manner in which the typical human mind will routinely misjudge a situation—and there is a growing body of legal work that incorporates the insights from this literature,¹⁰⁰ including in the area of payment systems.¹⁰¹ Among the cognitive biases that have been identified is what is known as a “framing effect” or “framing bias”. As Jon D. Hanson and Douglas A. Kysar have explained, “the frame within which information is presented can significantly alter one’s perception of that information, especially when one can perceive the

⁹⁸ See *supra* note 74.

⁹⁹ See, e.g., Daniel Kahneman & Amos Tversky, *Prospect Theory: An Analysis of Decision Under Risk*, 47 *ECONOMETRICA* 263 (1979); Amos Tversky & Daniel Kahneman, *The Framing of Decisions and the Psychology of Choice*, 211 *SCI.* 453 (1981); Amos Tversky & Daniel Kahneman, *Rational Choice and the Framing of Decisions*, 59 *J. BUS.* 251 (1986).

¹⁰⁰ See, e.g., Oren Bar-Gill, *Seduction by Plastic*, 98 *NW. U. L. REV.* 1373 (2004); Jon D. Hanson & Douglas A. Kysar, *Taking Behavioralism Seriously: Some Evidence of Market Manipulation*, 112 *HARV. L. REV.* 1420 (1999); Richard A. Posner, *Rational Choice, Behavioral Economics, and the Law*, 50 *STAN. L. REV.* 1551 (1998); Christine Jolls, Cass R. Sunstein & Richard Thaler, *A Behavioral Approach to Law and Economics*, 50 *STAN. L. REV.* 1472 (1998); Jennifer Arlen, Comment, *The Future of Behavioral Economic Analysis of Law*, 51 *VAND. L. REV.* 1765, 1768-69 (1998); Samuel Issacharoff, *Can There Be a Behavioral Law and Economics?*, 51 *VAND. L. REV.* 1729 (1998).

¹⁰¹ E.g., Bar-Gill, *supra* note 100 (identifying a systemic tendency of consumers to overestimate their ability to repay their credit card bills in full and on time.); Adam J. Levitin, *The Antitrust Super Bowl: America’s Payment Systems, No-Surcharge Rules, and Hidden Costs of Credit*, 3 *BERKELEY BUS. L.J.* 265, pin (2005) (discussing framing biases); RONALD J. MANN, *CHARGING AHEAD: GROWTH AND REGULATION OF PAYMENT CARD NETWORKS AROUND THE WORLD* (2006).

information as a gain or a loss.”¹⁰² The classic example of a framing bias is the glass “half full” or “half empty.” There is the same amount of liquid in glass, but it is perceived differently depending on how it is presented. The difference in perception is crucial because consumers do not have equivalent reactions to gains and loss.

Surcharges and discounts are different frames for presenting the same price information—a price difference between two things. There is no mathematic difference between a surcharge and a discount. A merchant can achieve the same price differentiation either way, simply by altering which of two price points is set as the baseline.

Consumers react differently to surcharges and discounts, as the language of pricing frames the information conveyed to the consumer. It is well-documented that people have stronger reactions to losses and penalties than to gains.¹⁰³ Thus, in a survey of Dutch consumers’ opinions on credit card surcharges (perceived losses) and cash discounts (perceived gains), 48% of consumers had a negative reaction to surcharges, and an additional 26% had a strongly negative reaction.¹⁰⁴ Only 19% had positive reactions to cash discounts, and a mere 3% had a strong positive reaction to cash discounts.¹⁰⁵ Attitudes were substantially more negative towards surcharges than towards discounts, in spite of the economic equivalence. Accordingly, although the credit card industry has never embraced cash discounts, it has preferred them to credit surcharges, because consumers perceive a discount as a gain, but a surcharge as a penalty and will prefer to use another payment system rather than be penalized for using credit. There are powerful differences in consumer perception of surcharges and discounts, however.

Although the Senate Banking Committee recognized the mathematic equivalence of cash discounts and credit surcharges,¹⁰⁶ it displayed the framing bias in its concern for the credit consumer penalized with a surcharge. The Committee had no problem with a cash consumer receiving a “bargain.” The Committee was concerned that credit consumers might fall victim to bait-and-switch pricing via surcharges. This concern seems misplaced. Comparing price *minimums*,

¹⁰² Hanson and Kysar, *supra* note 100, at 1441.

¹⁰³ Framing biases first received widespread attention from the work of Amos Tversky and Daniel Kahneman. *See supra* note 99.

¹⁰⁴ ITM RESEARCH, THE ABOLITION OF THE NO-DISCRIMINATION RULE, REPORT FOR THE EUROPEAN COMMISSION DIRECTORATE GENERAL COMPETITION 12 (2000), available at <http://europa.eu.int/comm/competition/anti-trust/cases/29373/studies/netherlands/report.pdf>.

¹⁰⁵ *Id.*

¹⁰⁶ S. REP. NO. 97-23, at 3-4.

not maximums, is the more effective way for consumers to gauge the price of a payment system.¹⁰⁷ Most people are better at addition than at subtraction,¹⁰⁸ in part because of addition's commutative property, so it is better to have a baseline onto which surcharges can be added than a baseline from which they can be subtracted.

When consumers compare price minimums, they perceive the cost of the underlying good itself plus the baseline cost using *any* method of payment. Surcharges then alert the consumer to the extra cost of different payment systems. A cash discount does not have the full signaling effect of a credit surcharge, which illustrates to the consumer the marginal cost of using credit. Indeed, the Chairman of the Federal Trade Commission, writing in opposition to the surcharge ban, recognized that surcharges, not discounts, drive home the true marginal cost of a credit transaction to the consumer:

In theory, a discount and a surcharge are equivalent concepts, but one is hidden in the cash price and the other is not. From a practical standpoint the surcharge seems easier to implement and more likely to ensure that the price credit card users pay reflect the cost of accepting credit cards.¹⁰⁹

Because of the framing effect, surcharges are far more effective than discounts at signaling to consumers the relative costs of a payment system, so it would take a larger non-credit discount to have the same effect on consumer behavior as a smaller credit surcharge.

D. Why Don't Merchants Discount for Less Expensive Payment Systems?

Although a surcharge has a greater affect on consumer behavior than a discount, no-surcharge rules and cognitive biases do not fully explain the rarity of discounts for cheaper payment systems. Why do merchants so rarely offer discounts to encourage the use of less expensive payment systems?

There are many factors contributing to the rarity of discounts: First, some merchants have idiosyncratic costs from cash. Cash handling, management, and accounting is particularly complicated for large merchants. Second, many merchants simply do not know they are

¹⁰⁷ See Bar-Gill, *supra* note 100, at 1381.

¹⁰⁸ See Gary B. Nallan *et al.*, *Adult Humans Perform Better on Addition Than Deletion Problems*, 44 PSYCHOL. REC. 489-99 (1994).

¹⁰⁹ S. REP. NO. 97-23, at 11-12 (1981) (letter from FTC Chairman Michael Pertschuk to Senator William Proxmire).

allowed to discount.¹¹⁰ Third, larger, more sophisticated merchants often have lower merchant discount rates and less incentive to care about payment costs.¹¹¹ They also have more payment cost minimization options such as co-branding or private label credit card arrangements.¹¹²

Fourth, discounts are less likely to influence consumer behavior for both small and large transactions. For small transactions, the absolute size of the discount is too small for consumers to care, while for large transactions, the discount is offset for consumers by the convenience and safety of credit cards.¹¹³ In many transactions, discounting may have only a negligible effect on consumer behavior, and in light of its costs may not be worthwhile for merchants.

Fifth, merchants' ability to discount is limited by the spread between the credit price and the cost of the merchandise to the merchant. If the merchant discounts by more than that spread, the merchant will lose money on the transaction. Merchants might need to increase the credit price to create a sufficient spread to offer a discount that both affects consumer behavior and is profitable.

This poses a dilemma for the merchant. If the merchant raises his baseline (credit) price in order to offer a sufficient non-credit discount to influence consumer behavior, his advertised sticker price—the credit price—will be higher than that of non-discounting creditors, and this will put him at a competitive disadvantage because he may lose both casual comparison customers and customers who can only make credit purchases.¹¹⁴

The most important factor, however, behind the paucity of discounting is that within the legally permitted parameters, discounting is inefficient for many merchants. Public and private law limits merchants' ability to discount. Discounting is only an option for cash. The Cash Discount Act only allows for a cash discount, not a debit or check discount.¹¹⁵ Non-differentiation rules prevent merchants from discounting for certain credit card brands or cards within a brand.

¹¹⁰ See Levitin, *The Antitrust Super Bowl*, *supra* note 101, at 310.

¹¹¹ See Levitin, *Payment Wars*, *supra* note 16, at ____.

¹¹² *Id.* at ____.

¹¹³ Of course, the issues of transaction size apply to surcharges as well. Credit card rebates escape this logic because they aggregate small transactions and are already the preferred payment method for large transactions.

¹¹⁴ This limitation is specific to discounts and does not apply to surcharges.

¹¹⁵ When the Cash Discount Act was first enacted in 1976, there were only three payment options available for consumers: cash, check, or credit. The Cash Discount Act was silent as to checks. It could be argued that checks and debit are roughly equivalent to cash, so the Cash Discount Act should apply to those payment systems to, but there is no authority on the issue.

Although cash is the cheapest payment system for merchants to accept, merchants generally do not want to encourage cash payments.¹¹⁶ Plastic payments (credit and debit) offer merchants a variety of benefits that paper payments (cash and checks) do not. Thus, for most merchants, the *net* cost of cash is higher than that of plastic.

Plastic payments have a number of benefits such as easier accounting and cash management. Plastic's biggest benefit for merchants, though, is that consumers spend significantly more when purchasing with plastic than with paper.¹¹⁷ Consumer price elasticity depends on payment method. Relative to paper, plastic increases consumers' willingness to pay for goods and services and to make purchases they otherwise would not.¹¹⁸

Merchants want to receive the benefits of greater consumer spending induced by plastic, and merchants are willing to pay a price for it. Although cash is cheaper on average for merchants, the net benefits of cash acceptance are lower than those of debit or credit acceptance for most merchants because of the increased spending that goes with plastic.

The right provided by the Cash Discount Act, then, is of little use to most merchants, who want to *encourage* the use of plastic, rather than the use of cash. Merchants do not want to differentiate between cash and credit prices; they want to differentiate between rewards cards and non-rewards cards and between credit cards and debit cards to encourage the use of payment systems with the lowest net costs.¹¹⁹ Merchants already try to do this in marginal ways, such as offering free shipping or monogramming on goods purchased using a co-branded credit card (such as an L.L. Bean Visa) on which the merchant is charged a lower

¹¹⁶ When merchants encourage cash use, tax evasion becomes a significant concern.

¹¹⁷ See Adam J. Levitin, *Priceless: The Social Costs of Credit Card Merchant Restraints*, Georgetown Law and Economics Research Paper No. 973970, Georgetown Public Law Research Paper No. 973970. (2007). The difference in consumer price elasticity among credit and debit products has not been explored, but it seems safe to assume that consumers might spend more with credit than with debit products because they are not constrained by the amount of funds in the debit account when using a credit card.

¹¹⁸ See *id.*

¹¹⁹ Robin Sidel, *Cash Back: As Card Fees Climb, Merchant Push PINs—They Battle Banks Over Debit Checkouts; Paying for a Signature*, WALL ST. J., Jan. 16, 2007 at A1; See *PIN-Debit Is Second Only To Cash In Wal-Mart Stores*, CARD FORUM (May 26, 2005), <http://www.cardforum.com/article.html?id=200505311NJAMQ3O&from=home&fmse=atmdn>.

merchant discount fee in exchange for providing the issuer with consumer data.¹²⁰

Merchant restraints prevent this, however. Merchants do not have an option of discounting for the payment systems they want to encourage, such as on-line debit or no-rewards credit cards. Instead, because of merchant restraints, if merchants want to accept credit cards, they must accept *all* credit cards of a brand. Merchants are unable to avoid funding credit card rewards programs from which they derive no benefit. Merchants absorb some of this cost themselves, but they pass the rest on to *all* consumers, not just those receiving the rewards, in the form of higher prices, creating a highly regressive, *sub-rosa* cross-subsidization.¹²¹ And as rewards programs become more common, the cost of payments increases for merchants.

A similar situation existed among debit cards before 2003. MasterCard and Visa originally issued only credit cards and off-line debit cards (called the Visa Check Card and MasterMoney, respectively). Off-line debit cards require a consumer signature at point of sale. Off-line debit ACS is performed using credit card networks. Off-line debit is far more expensive for merchants than on-line debit cards, which uses a PIN rather than a signature for authorization and which use electronic fund transfer (EFT) or regional ATM networks for ACS.¹²² Off-line debit cards are processed over credit card networks. On-line debit cards are processed using regional ATM or electronic fund transfer (EFT) networks. Often the same physical card can access both an off-line and an on-line debit network.¹²³

MasterCard and Visa's honor-all-cards rules required merchants who took their credit cards to take their off-line debit cards. Many merchants, however, did not want to take the more expensive off-line debit cards, when they received the same benefits at lower price from on-line debit transactions. A class of merchants, led by Wal-Mart and Sears brought suit over the honor-all-cards rules in 1996. MasterCard and Visa

¹²⁰ See Levitin, *Payment Wars*, *supra* note 16 at __ regarding co-branding arrangements.

¹²¹ Levitin, *Priceless? The Social Costs of Credit Card Merchant Restraints*, working paper, *supra* note 117

¹²² Julia S. Cheney, *Supply- and Demand-Side Developments Influencing Growth in the Debit Market*, Fed. Res. Bank of Phila. Payment Cards Center Discussion Paper, Oct. 2006, at 5. PIN debit cards are also more secure than signature debit cards.

¹²³ When a consumer uses a debit card and selects the "credit" function at the register, the transaction is actually an off-line debit transaction, not a credit transaction. EVANS & RICHARD, *PAYING WITH PLASTIC* (2d ed.), *supra* note 32, at 210.

settled the suit in 2003 for \$3.05 billion,¹²⁴ the largest private antitrust settlement in history, and the temporary rescission of MasterCard and Visa's honor-all-cards rules as applied to debit cards.

E. Rewards Programs as a Form of Discounting by Card Issuers

The behavior of issuer banks provides an informative point of comparison for both discounting and surcharging. Issuer banks essentially offer a discount for using credit cards in the form of their rewards programs. This is best seen with rewards programs that offer cashback rebates, typically at what is advertised as rates of \$1 to \$5 for every \$100 spent. This would seem to show that discounting is effective. The framing bias does not mean that discounting is ineffective, however, only that it is less effective than surcharging and a proportionally larger discount is needed to achieve the same result in consumer behavior as a surcharge.

It can be difficult for a merchant to profitably offer a sufficiently large discount to affect consumer behavior without raising baseline prices. Card issuers have no such problem because the advertised discount—which is what affects consumer behavior—is greater than the actual economic discount—which affects card issuers. Rewards rebates are not enjoyed at point of sale, but after a delay, which reduces their value. Rewards programs are often structured to keep consumers from cashing in their rewards for as long as possible, and many consumers never utilize their rewards.¹²⁵ Thus the delayed rewards rebates need to be discounted for present value. Rebate programs are also typically capped with a maximum annual rebate amount that will reduce their real size even further for high spending consumers. So, while a card issuer can advertise a 5% cashback rebate to affect consumer behavior, the issuer may only be paying out 1% overall. And as competing rebate programs among cards show, consumers are very sensitive to the perceived differences in price among payment systems.

Card issuers also have an upside potential to discounting that merchants do not. To the extent that a merchant shifts consumer consumption from credit cards to cash, the merchant is only limiting his costs, not increasing revenue, and there is a maximum amount of costs that can be limited. When a credit card issuer offers a rebate, the costs of the rebate are borne by increased interchange fees (and are even

¹²⁴ See *In re Visa Check/MasterMoney Antitrust Litig.*, 297 F. Supp. 2d 503 (E.D.N.Y. 2003), *affirmed*, *Wal-Mart Stores, Inc. v. Visa U.S.A. Inc.*, 396 F.3d 96 (2d Cir. 2005).

¹²⁵ *GMAC: Many Rewards Aren't Used*, 171 AM. BANKER 7, Dec. 11, 2006. (41% of reward cardholders rarely or never claim their rewards.)

accounted for as such). More importantly, the issuer's revenue increases beyond costs because increased card usage leads to increased interest revenue. There is no maximum amount by which the issuer's revenue is capped, unlike the merchant's limitations on costs. Credit card networks are able to discount through rebates for the very reasons that it is hard for merchants to do so.

F. ATM Surcharging

Tellingly, banks themselves surcharge in a related context: automated teller machine (ATM) networks. ATM networks consist of a consumer, an issuer bank that issues the ATM card, an operator bank that operates the ATM, and the network association that provides ACS services. ATM networks have interchange fees that the operator pays to the issuer.¹²⁶ When the operator and issuer are the same, that is the consumer uses his own bank's ATM machine, there is no interchange fee.

Many banks that serve as credit card issuers also serve as ATM operators. Operator banks are in an equivalent position to the merchant at point-of-sale on a credit card transaction. ATMs networks originally had no-surcharge rules, have not since 1996 in response to state legislation banning the ATM no-surcharge rules.¹²⁷ As a result, most ATM operators impose flat rate, per transaction surcharges of \$1 - \$3 to cover the costs of interchange. Over 98% of banks owning ATMs surcharge.¹²⁸ Thus, when the banks themselves are in the position of merchants, they surcharge to cover transaction costs.

ATM surcharging has not limited the growth of ATM networks. To the contrary as David Balto has noted, "under surcharging, the amount of ATM deployment has been breathtaking,"¹²⁹ particularly at "remote, low volume locations."¹³⁰ Indeed, the number of ATMs tripled

¹²⁶ David A. Balto, *ATM Surcharges: Panacea or Pandora's Box?* 12 REV. BANKING & FIN. SERVS. 169 (1996).

¹²⁷ David A. Balto, *Regulatory, Competitive, and Antitrust Challenges of ATM Surcharges*, 70 BNA BANKING REP. 82-83 (1998) (detailing history of state laws banning ATM no-surcharge rules). State attempts to ban ATM surcharges have been struck down on preemption grounds. *See, e.g.,* Metrobank, N.A. v. Foster, 193 F. Supp. 2d 1156, 1162 (S.D. Iowa 2002).

¹²⁸ Greg McBride, *Bankrate's Fall '06 Checking Study: Fees Rise Again*, Bankrate.com, at http://www.bankrate.com/brm/news/chk/chkstudy/2006_fall_checking_study_main.asp?caret=2#2

¹²⁹ David A. Balto, *The Problem of Interchange Fees: Costs Without Benefits?* 2000 EUR. COMMUNITY L. REV. 221 (2000).

¹³⁰ Balto, *Regulatory, Competitive, and Antitrust Challenges*, *supra* note 127, at 83.

in the five years following the ATM networks' rescission of their no-surcharge rules.¹³¹ Banks are willing to deploy more ATMs because they know that they will not face an externality from use of the ATM by other banks' customers.

The effect of bank surcharging for ATMs shows that consumers will shy away from payment systems for which they have to pay an explicit point-of-sale cost. Many consumers have shifted their cash withdrawal transactions from ATMs to PIN-debit cashback because of ATM surcharges.¹³² Thus, in the five years following the rescission of ATM network no-surcharge rules, the number of transactions per ATM declined about 45 percent.¹³³ In the ATM context, surcharging has resulted in larger ATM networks, which provide consumers with easier access to their bank accounts. It has also resulted in consumers shifting their transactions to methods without point-of-sale costs.

The average ATM withdrawal is for \$67,¹³⁴ and the average ATM surcharge is \$1.64.¹³⁵ Thus, the average ATM surcharge is 2.45% of the transaction. If many consumers switch from ATMs to PIN debit cashback to avoid a 2.44% surcharge, it seems likely that they would do also switch consumption from credit cards to other means to avoid a surcharge of 2.41% (average American Express merchant fee) or 2.19% (average MasterCard/Visa merchant fee).¹³⁶ From the ATM example, it is reasonable to extrapolate that if merchants could surcharge for credit cards, more merchants would accept credit cards, but consumers would make a larger percentage of their transactions on cheaper payment systems unless credit card costs declined.

G. Would Merchants Surcharge If They Could?

All this raises the question of whether merchants would surcharge if they could. Existing merchant behavior in the United States tells us that at least some merchants will surcharge. Merchants are

¹³¹ Gautam Gowrisankaran & John Krainer, *The Welfare Consequences of ATM Surcharges: Evidence from a Structural Entry Model*, Fed. Res. Bank of S.F. Working Paper 2005-01, at 2.

¹³² Cheney, *supra* note 122, at 10.

¹³³ Gowrisankaran & Krainer, *supra* note 131, at 2. Gowrisankaran & Krainer find that ATM surcharge bans increases consumer welfare and lowers producer welfare by similar amounts. Accordingly, there is no change in total welfare between regimes in which ATM surcharges are allowed and those in which they are not. *Id.* at 37. Their model, however, does not account for consumer ability to receive surcharge free cashback via PIN-debit as an alternative to paying ATM surcharges.

¹³⁴ See Crown ATM Network, at <http://www.crownatm.com/profitability.htm>.

¹³⁵ McBride, *supra* note 128.

¹³⁶ See Table 2, *supra*.

willing to switch acquirers to get prices mere hundredths of a percentage point better.¹³⁷ If surcharging would have an impact hundreds of times larger, it stands to reason that merchants would surcharge.

Some merchants already surcharge for debit cards. Some on-line (PIN-based) debit card networks do not have no-surcharge rules. Accordingly, ARCO gasoline stations do not accept credit cards or off-line debit cards, but they accept PIN-based debit cards on networks that allow surcharges. ARCO surcharges 45¢ per transaction on debit cards.¹³⁸ Likewise, many Sacramento area fast food restaurants surcharge for debit.¹³⁹

Examples from Western Europe and Australia also tell us that some merchants will surcharge. Since merchant discount fees in Western Europe and Australia are significantly lower than in the United States, there is less incentive for merchants to surcharge. Nonetheless, ten percent of Dutch merchants surcharge for credit,¹⁴⁰ and in Australia, 11% of merchants now surcharge.¹⁴¹ In Denmark, nearly a fifth of merchants surcharge for debit cards.¹⁴² It seems that merchants will surcharge either when there is little competition within the merchant's industry or when an industry leader sets the pace and surcharging becomes standard practice.

Ultimately, though, whether merchants would actually surcharge is irrelevant. The ability to surcharge would give merchants negotiating leverage to gain lower fees, so there would be no need to surcharge. The level and frequency of surcharging would vary according to the market and would subject the interchange rate to market discipline.

¹³⁷ EVANS & RICHARD, *PAYING WITH PLASTIC* (2d ed.), *supra* note 32, at 261.

¹³⁸ Herb Weisbaum, *How to avoid getting socked with extra fees: Nothing is as simple as it seems when it comes to debit cards, credit cards*, Consumerman, MSNBC (July 17, 2006), at <http://www.msnbc.msn.com/id/13905579/>.

¹³⁹ *Id.*

¹⁴⁰ Levitin, *The Antitrust Super Bowl*, *supra* note 101, at 310.

¹⁴¹ InfoChoice, *Credit Card Surcharging More Common* (Sept. 4, 2006), at <http://www.infochoice.com.au/banking/news/creditcards/06/09/article15501.asp>; East & Partners, Ltd., Press Release, *Almost one half of Australian merchants set to surcharge*, (August 1, 2005), available at <http://www.east.com.au/bankingnews.asp?id=1314>. Nearly half of all Australian merchants surveyed plan to institute surcharges within six months of the survey date. *Id.*

¹⁴² David Evans & Richard Schmalensee, *The Economics of Interchange Fees and Their Regulation: An Overview*, INTERCHANGE FEES IN CREDIT AND DEBIT CARD INDUSTRIES: WHAT ROLE FOR PUBLIC AUTHORITIES? PROCEEDINGS OF THE 2005 FEDERAL RESERVE BANK OF KANSAS CITY CONFERENCE, 93 at <http://www.kansascityfed.org/PUBLICAT/PSR/Proceedings/2005/Evans-Schmalensee.pdf>.

Credit card network merchant restraint rules and the framing effect prevent merchants from signaling payment costs to consumers. This has major anticompetitive effects because consumers are not factoring in costs when making their consumption choices.¹⁴³ Before turning to those effects, however, it is important to understand the framework for the academic debate on interchange fees and merchant restraints, particularly the standard argument made in favor of merchant restraints and its deficiencies.

IV. The Network Effect Justification for Merchant Restraints

A. The Difference Between the Interchange Debate and the Merchant Restraint Debate

There is only a small body of academic literature on payment system competition issues, most of which has appeared in the last five years. The literature has been written mainly by economists, although legal scholars¹⁴⁴ and practicing attorneys¹⁴⁵ have started to weigh in. The literature largely consists of modeling how various market distortions and imperfections affect the relationship between interchange fee levels that maximize welfare and that maximize profit.¹⁴⁶ Typically, the modeling literature assumes the existence of merchant restraints. At best, merchant restraints are considered in passing. Excluding an earlier article by this author,¹⁴⁷ there are no articles that focus on no-surcharge rules and only one on honor-all-card rules.¹⁴⁸

¹⁴³ This also has significant social effects, an issue considered in the companion article to this. See Levitin, *Priceless: The Social Costs of Credit Card Merchant Restraints*, *supra* note 117.

¹⁴⁴ Levitin, *Payment Wars*, *supra* note 16; MANN, CHARGING AHEAD, *supra* note 101; Levitin, *Merchant-Bank Struggle*, *supra* note 70; Richard A. Epstein, *The Regulation of Interchange Fees: Australian Fine-Tuning Gone Awry*, 2005 COLUM. BUS. L. REV. 551 (2005); Levitin, *The Antitrust Super Bowl*, *supra*, note 101; Timothy J. Muris, *Payment Card Regulation and the (Mis)application of the Economics of Two-Sided Markets*, 2005 COLUM. BUS. L. REV. 515 (2005). See also Kitch, *supra* note 72; O'Driscoll Jr., *supra* note 72; and Annand, *supra* note 78.

¹⁴⁵ Stephen V. Bomse & Scott A. Westrich, *Both Sides Now: Buyer Damage Claims in Antitrust Actions Involving Two-Sided Markets*, 2005 COLUM. BUS. L. REV. 643 (2005); Luc Gyselen, *Multilateral Interchange Fees Under E.U. Antitrust Law: A One-Sided View on a Two-Sided Market*, 2005 COLUM. BUS. L. REV. 703 (2005); Lloyd Constantine, et al., *In re Visa Check/MasterMoney Antitrust Litigation: A Study of Market Failure in a Two-Sided Market*, 2005 COLUM. BUS. L. REV. 599 (2005); Balto, *The Problem of Interchange Fees*, *supra* note 129.

¹⁴⁶ Evans & Schmalensee, *supra* note 142, at 89.

¹⁴⁷ Levitin, *The Antitrust Super Bowl*, *supra* note 101.

¹⁴⁸ See Jean Charles Rochet & Jean Tirole, *Tying in Two-Sided Markets and the Honor All Cards Rule*, Mimeo (Feb. 9, 2006) at <http://idei.fr/doc/by/tirole/2sided.pdf>.

The economics literature on interchange fees is indeterminate. “[E]conomists have only scratched the surface [in understanding] pricing in two-sided markets in general and in the determination of interchange fees in particular.”¹⁴⁹ Interchange economics “literature, in short, is not very useful for either rationalizing or designing a system of interchange fee regulation.”¹⁵⁰ At best, then the theoretical literature merely shows that one can neither assume that “the interchange fee set collectively by an association is greater than, less than, or equal to the socially optimal interchange fee.”¹⁵¹ Thus, as David Evans and Richard Schmalensee have noted, the debate on regulating interchange rates comes down to a question of who bears the burden of proof as to the competitive effects of interchange fees:

Since there is so much uncertainty about the relation between privately and socially optimal interchange fees, the outcome of a policy debate can depend critically on who bears the burden of proof under whatever set of institutions and laws the deliberation takes place. There is no apparent basis in today’s economics—at a theoretical or empirical level—for concluding that it is generally possible to improve social welfare by a noticeable reduction in privately set interchange fees. Thus, if antitrust or other regulators had to show that such intervention would improve welfare, they could not do so. . . . By the same token, there is no basis in economics for concluding that the privately set interchange fee is just right. Thus, if card associations had to bear the burden of proof—for example, to obtain a comfort or clearance letter from authorities for engaging in presumptively illegal coordinated behavior—it would be difficult for them to demonstrate that they set socially optimal fees.¹⁵²

While the socially optimal interchange rate is unclear, merchant restraints present a distinct issue. Even if the burden of proof regarding interchange rates were on opponents of the current system, in light of the uncertainty of the socially optimal interchange rate, it does not follow

¹⁴⁹ Evans & Schmalensee, *supra* note 142, at 104.

¹⁵⁰ *Id.* at 94.

¹⁵¹ *Id.* at 104.

¹⁵² *Id.* at 76-77.

that the burden of proof for merchant restraints should also be on the challengers. This is because merchant restraints go to the question of market discipline on the interchange rate, not whether there should be an interchange rate, what its socially optimal level is, or even who should set it.

The academic literature on credit card networks has focused on the related issues of need for an interchange fee and what the socially optimal interchange level is. The payment system competition policy debate, in contrast, has emphasized the question of who should determine the interchange rate—the credit card networks or government regulators, or the market. The merchant restraint issue goes to this later question because the existence of merchant restraints prevents the free market from regulating the interchange rate.

In a sense, then, the merchant restraint issue is not about who should set the interchange rate, but what should determine the rate level (including the possibility of a zero or negative interchange rate). The simple answer is that it should respond to the invisible hand of the market. Merchant restraints prevent this. Indeed, the existence of interchange itself should not be a problem, so long as the rate is subject to market discipline. The presence of merchant restraints ensures that this cannot happen. Not only do merchant restraints restrict price-based competition, but they come on top of already high barriers to entry for would-be payment system competitors. Removing merchant restraints, then, would be a free market middle ground between rates set by regulators and rates set by powerful players with market power.

B. The Network Effect Justification

Two considerations have shaped the interchange literature. First is that credit cards are a network industry. Networked industries exhibit what is known as a “network effect.”¹⁵³ The “network effect” means that the value of the network product depends on the number of users of the product. Put another way, the value of a network for its participants depends on its size.¹⁵⁴ Although theoretical network economics lacks consensus regarding the relationship between the size

¹⁵³ See William H. Page & John E. Lopatka, *Network Externalities*, *ENCYCLOPEDIA OF L. & ECON.* 952, 956 (1999) (discussing the lack of agreement on definitions of “network effect” and “network externality”).

¹⁵⁴ Robert E. Litan & Alex J. Pollock, “The Future of Charge Card Networks,” Working Paper 06-03, Feb. 2006 (Joint Center, AEI-Brookings Joint Center for Regulatory Studies), at 5.

and the value of a network,¹⁵⁵ it is recognized that the bigger the network, the more valuable it is to be a part of it, and that there is a positive externality (a positive “network externality”) to network users when a new user joins the network.

For example, a single fax machine is of no use because it cannot be used to communicate with anyone else. The more fax machines there are, the more valuable it is to have a fax machine, and a reduction in the number of fax machines will reduce the value of the fax network. The network effect means that the utility of the network for a user increases when the size of the network increases, and the utility of the network for a user decreases when the size of the network decreases. Thus an “impact event” that affects the size of a network also affects the networks’ value for its users. Moreover, networks are not sustainable unless they maintain a sufficient size.

The second factor complicating interchange rate structure analysis is that payment systems are “two-sided” networks, that is, they have two distinct types of customers—cardholders and merchants—whose interactions are brokered by the network.¹⁵⁶ Other examples of two-sided networks are action houses and dating services. The costs of entry into the consumer payment systems market are extremely high because payment systems involve expensive ACS and security technology, have high regulatory costs (especially for bank-run systems), have costs for funds if the system offers any float, and need flawless initial nationwide deployment. The two-sided nature of payment networks raises the already substantial barriers to entry into the industry for new systems.

Two-sided networks have a chicken-and-egg problem. The network needs to recruit a sufficient number of both types of customers to be viable, as the value of the network to each type of customer depends on the quantity of the other type of customer in the network. This is best illustrated by heterosexual dating services, which are only valuable to men if they have a sufficient number of women customers

¹⁵⁵ See Bob Briscoe, Andrew Odlyzko, and Benjamin Tilly, *Metcalf’s Law is Wrong*, IEEE SPECTRUM, July 2006, at <http://www.spectrum.ieee.org/jul06/4109>. The traditional position is expressed in Metcalfe’s law, which holds that a network’s value is proportional to the square of the number of parties in the network. More recent work, however, has argued that the value of the network actually increases at a lesser rate, such as $n \log(n)$.

¹⁵⁶ But see Carlton & Frankel, *supra* note 24, at 626 (arguing that the concept of “two-sided” markets is insufficiently defined and that most markets can be described as “two-sided” because consumers benefit from the supply created in response to the demand of other consumers).

and vice-versa. Similarly, merchants will not accept a card unless consumers demand to use the card, and consumers will not carry a card unless merchants accept it. Discover and American Express have suffered from this problem for years.¹⁵⁷

The standard justification for merchant restraints is that they help two-sided networks overcome the chicken-and-egg problem.¹⁵⁸ Two-sided networks attempt to maximize their size and hence value to participants by allocating costs to the different types of customers according to their different price elasticities. Thus, dating services will frequently charge men a different rate than women.

For payment systems, this sort of cost allocation is complicated by the constant financial transactions *between* the two types of

¹⁵⁷ Discover and American Express are only accepted by 65% of merchants, as compared to 83% for MasterCard and Visa. Assoc. of Fin. Professionals, *AFP 2005 Interchange Survey: Report of Survey Results* (Oct. 2005), at 3.

¹⁵⁸ Two other justifications for merchant restraints have been offered. Both are unconvincing. First, in Hearings before the House Subcommittee on Special Small Business Problems of the Select Committee on Small Business in 1970, Kenneth V. Larkin, senior vice president of marketing of the Bank of America explained the no-surcharge and no-discount rules were warranted because:

our policy is that our discount rate more than offsets or is more than offset by [merchants'] cost of carrying receivables. We do not want them dumping that discount rate on the cardholder and say, "That is to pay the cost of my discount to the bank," because it just was not true. The cost of the discount to the bank was offset by his diminished collection costs, nonrecourse in the matter of receivables and so forth. That is really why we did it.

H.R. REP. NO. 91-1500, 91st Cong., 2d Sess. 108 (1970). Larkin's statement glosses over the difference between gross costs and costs net of benefit. Instead, it shows that card networks are aware that if merchants could surcharge, their products would face an uphill marketing struggle.

Richard Epstein has presented an additional justification for surcharging: that it is needed to prevent cash-only consumers from free-riding on credit cards' signaling of merchant reputability. Epstein, *supra* note 144, at 583-84. Epstein is concerned that cash-only consumers will capture some of the reputational signaling value conveyed by the display of credit card logos at merchants. According to Epstein, these logos inform consumer of "the scope and reliability of the business' full range of operations." *Id.*

Epstein's argument is a red herring and is disconnected from the realities of modern payment systems. It takes very little for a merchant to accept credit cards—a bank account and telephone or Internet access are the basic requirements. Card networks *want* merchants to accept their cards. When fly-by-night Internet companies and corner delis accept credit cards (and the networks make their logos freely downloadable over the Internet), the idea that credit card logos impart significant reputational signaling value is preposterous. Compared to the signaling imparted by a merchant's operative lease, the reputational signaling of credit card acceptance is minimal at best. Epstein's free-riding scenario is an unconvincing justification for no-surcharge rules.

customers, which provide the customers with the opportunity to reallocate the costs among themselves. This can lead to a less than optimal cost allocation balance that would reduce the size and hence value of the network for its remaining participants. For example, assume that a credit card network would achieve its maximum size when 70% of costs are allocated to merchants and 30% are allocated to cardholders. The network can easily allocate these costs when there are merchant restraints. As Joshua Peirez, MasterCard Group Executive of Global Public Policy has said, “When setting interchange rates, we are looking at maximizing the output of the MasterCard system.”¹⁵⁹

Absent merchant restraints, however, merchants are in a position to pass along part of their share of the costs to consumers. Thus cost allocation might end up at 50/50, which would decrease the size and hence the value of the network to all of its participants. If merchants could surcharge, they would be able to recalibrate the network’s careful cost allocation in a way that might cause a negative network effect. Thus, the standard justification of merchant restraints is that they allow the network associations to maintain control over cost allocation between consumers and merchants.

Finally, no-surcharge rules can be seen as a countermeasure to the free-riding problem that comes from the path-dependent nature of payment systems. Payment systems are path-dependence. Off-line (signature-based) debit card networks simply piggyback on existing credit card infrastructure. Thus, newer payment systems free-ride on the innovation of earlier systems. No-surcharge rules counter newcomers’ free-riding and let the trailblazer recoup the fruits of its innovation.

C. Problems with the Network Effects Justification

There are four problems with this justification of merchant restraints. The first is that the history of no-surcharge rules, discussed above, indicates that they were as much a solution to a legal problem as to an industrial organization problem. No-surcharge rules were adopted, along with no-discount rules, to avoid violations of usury laws. Even though TILA has been amended and usury laws made generally inapplicable,¹⁶⁰ no-surcharge rules have remained in place, however. Second, a network effect justification makes little sense for merchant restraints in the context of a mature payment network competing against

¹⁵⁹ *MasterCard Raises Some Rates, Lowers Others for Web Retailers*, DIGITAL TRANSACTION NEWS, Feb. 28, 2007, at <http://www.digitaltransactions.net/newsstory.cfm?newsid=1270>.

¹⁶⁰ See *supra* note 71.

other payment networks. Third, although no-surcharge rules discourage free-riding, they do not protect justified expectations and circumvent intellectual property law. And fourth, the experience of ATM surcharging by banks indicates that there will be a positive, rather than negative network effect in terms of network participants, but a decline in the number of transactions on the network. Thus, the value of the network to its participants will increase, even if they utilize it less.

Negative network effects are only a reasonable concern if the existence of the network itself produces net social welfare. This is the assumption that underlies much of the economic modeling of payment networks.¹⁶¹ This assumption makes sense if there are no good substitutes for the networked product or if the entrance of a new product to a market creates beneficial competition in the market. The assumption makes little sense in the context of mature products, like credit cards, that compete with other network products.

The assumption of inherent value or social benefit in the existence of a network developed in the classical network economic situation—the railroad. In the late 19th century, there was clear net social welfare benefit from the railroad. If the railroad didn't haul goods, the goods didn't get moved. No comparable alternative existed to the network; barges and horses were not a good substitute. The same logic applied to telephone networks; telegraphs and the post office were poor alternatives to the network, and the service offered by the network produced a net increase in social welfare.

When credit cards came onto the market in a meaningful way in the 1970s, the situation was not unlike that of the railroad and the telephone. The alternative payment technologies—cash and check were not great substitutes. Consumers did not want to carry large amounts of cash, and merchants did not want to take the credit risk of checks. Accordingly, there was a real benefit to social welfare from the existence of credit card technology. Merchant restraint rules originally shielded the nascent credit card networks from the competitive price pressures that would have inhibited their development.¹⁶² Merchant restraints effectively subsidized the development of credit card networks, although these were self-granted, *sub rosa* subsidies, rather than legislative subsidies.

In the early days of credit cards, merchants were price inelastic relative to consumers. Merchants were willing to tolerate relatively high interchange fees in the early days of credit card networks both because

¹⁶¹ See Evans & Schmalensee, *supra* note 142, at 91-92.

¹⁶² See *Id.* at 85.

the number and volume of card transactions were relatively small and because they experienced a marginal benefit from card acceptance as cards enabled greater spending by masses of credit constrained consumers. If consumers had been required to pay more at point-of-sale in the early days of credit cards, however, it is unlikely that credit cards would have become a mass-market product. No-surcharge rules allowed the card networks to retain control over allocation of costs within the network so as to grow the network and benefit from positive network effects. Moreover, honor-all-card rules assured early credit card consumers that their cards would be accepted, while no-surcharge rules assured card consumers of standard terms.¹⁶³

Now, however, credit card networks are past the chicken-and-egg problem.¹⁶⁴ They are widely accepted by merchants and used by consumers. Credit cards are a mature product that does not need subsidization to thrive. Moreover, there are comparable, competing payments products that are reasonably strong substitutes for each other for transacting purposes: debit and ACH. In particular, debit cards are a very strong substitute for credit cards as a transacting mechanism.¹⁶⁵ They offer similar convenience and better security against fraud. While the maximum liability for unauthorized transactions is higher for debit cards in the United States, a debit card fraud will not affect a consumer's credit report, unlike a credit card fraud.

These other payment systems are also networks and exhibit network effects. Credit card merchant restraints, which once eased the entry of credit cards into the payments marketplace, are now a barrier to entry for new payment systems. While there may be social value in

¹⁶³ Robert M. Hunt, *An Introduction to the Economics of Payment Card Networks*, Fed. Res. Bank of Phila. Working Paper No. 03-10 (June, 2003) at 5.

¹⁶⁴ This critique of the network effect justification for merchant restraints may also have relevance to charges that interchange fees are unnecessary and should be set at cost or at zero. While interchange fees have been held not to violate antitrust laws in *Nat'l Bank Corp. (NaBanco) v. Visa U.S.A.*, 779 F.2d 592, 601-604 (11th Cir. 1986), the continuing validity of *NaBanco* is dubious in light of the maturity of the credit card networks, the increased percentage of card issuer revenue that comes from interest, rather than interchange, and the proven ability of multi-party card networks to operate profitably with at-cost interchange (see section VI, *infra*, discussing Australian experience).

¹⁶⁵ See Jonathan Zinman, *Debit or Credit*, working paper, Aug. 10, 2006, available at https://www.dartmouth.edu/~jzinman/Papers/Zinman_Debitor%20or%20Credit_aug06.pdf, at 3-4 (debit is a strong substitute for credit). Some debit card networks also have no-surcharge rules. See Levitin, *Antitrust Super Bowl*, *supra* note 101, at 323. Debit networks too are likely sufficiently mature payment networks that their no-surcharge rules have outgrown any defensible purpose.

having a networked product when there is no reasonable alternative, when the choice is between competing networked products, there is no inherent value to the existence of any particular network. It is not an all-or-nothing proposition of having payment systems or not, but a question of which payment system, and that question should be answered by the free market.

Indeed, in the context of competing networks, the no-surcharge rules impose a competition externality by shifting usage from more to less efficient payment networks. No-surcharge rules, designed to protect against negative network effects, actually impose them on the more efficient networks. As credit cards have matured and new payment systems have emerged, merchant restraints have become a sword not a shield. The network effect justification for merchant restraints is inappropriate in the context of a mature network that competes with other networks.¹⁶⁶

While no-surcharge rules limit newer payment systems' gains from free-riding, this is not necessarily a desirable outcome. First, it draws an artificial distinction between credit cards and other payment systems, although the distinction should be between the first credit card network (Bank AmeriCard, now Visa) and all other credit card brands and payment systems. Second, as we know from the software industry, especially from the case of Microsoft, network effects can be a powerful tool for keeping out competition. They create a huge barrier to entry precisely because they create a lock-in effect and a chicken and egg effect. From a societal perspective, do we really want to discourage future payments innovation? Finally, we have systems for rewarding innovators and trailblazers—patents and copyrights. These systems allow the innovator to reap the rewards of its endeavors . . . but only for a limited period. To the extent that credit card networks operated outside the intellectual property system, they had no reasonable expectation of exclusivity or reduced competition, and should not be allowed to arrogate these rights to themselves.

Finally, the parallel experience of ATM surcharging by banks indicates that the network effects argument is off-base. The ATM network is a two-sided network, requiring a balance of ATM operators and ATM consumers. When operator banks began to surcharge for ATM

¹⁶⁶ Similarly, the sole study of honor-all-card rules, *see* Rochet & Tirole, *supra* note 148, does not attempt to determine the effect of multiple networks all having honor-all-card rules; it only considers the possibility of one network that competes with competitors who do not similarly bundle products. Nor does the study attempt to account for the use of honor-all-card rules to bundle identical products of different price.

transactions on cards issued by other banks, the number of ATMs soared.¹⁶⁷ The increased number of ATMs made having an ATM card more valuable to consumers.¹⁶⁸ Yet the number of ATM transactions per machine declined as consumers shifted some of their cash withdrawals to PIN debit cashback at merchants. This shift has not dampened operator bank enthusiasm for ATM deployment, however, because they can recoup the costs of deployment via surcharging. The value of the ATM network has not declined for operators and consumers; rather it has declined for ATM card issuers, who often pay the surcharges in order to entice consumers to maintain deposit accounts at their bank. There has been a positive network effect from ATM surcharging and a distributional shift away from ATM card issuers and toward operators.

Given that ATM issuers are in the position of credit card issuers and ATM operators are in the position of merchants, the banks' experience with ATM networks undercuts the network effect justification of merchant restraints. The network effects argument for merchant restraints is an *ex-post facto* rationalization that rings hollow on its own terms. There is no convincing theoretical justification for merchant restraints. The remainder of this article considers the anticompetitive effects of merchant restraints and analyzes them under antitrust law.

V. The Anticompetitive Effects of Merchant Restraints

Merchant restraints have profound effects on competition within the credit card industry and on competition within the payments industry in general. Credit card networks use merchant restraints to leverage their market power by forcing more card transactions than is efficient. This results in greater front-end (interchange) and back-end (interest) revenue for the networks. By inhibiting merchants from signaling the costs of payment systems to consumers, merchant restraints insulate credit cards from market discipline, and thus limit competition. By preventing cost signaling, merchant restraints limit pricing competition (1) between payment systems, (2) between different brands in the same payment system, and (3) between different products in the same payment system within the same brand. The effect of limited price competition is to avoid commoditization by shifting the basis of competition from price to other bundled products and brand image.

¹⁶⁷ See *supra*, text accompanying notes 129 - 131.

¹⁶⁸ See *supra*, text accompanying notes 132 - 133.

A. Avoiding Commoditization by Limiting Price-Based Payment System Competition

First, no-surcharge rules equalize the price at point-of-sale between all payment systems. This accrues to the benefit of costlier payment systems, particularly credit cards, because they are able to impose a cost externality on the merchant who either absorbs it or passes it along to the consumers of other payment systems. Credit card networks are based on 1970s technology. For consumers who use credit cards only to transact, and not for their credit function, including the float, newer payment systems like PIN-based debit cards offer the same convenience, but are cheaper and more secure. Although PIN-debit is a more secure and cost-effective transaction system than credit cards, PIN-debit's market share has been limited by the advantage no-surcharge rules give to credit cards and more expensive signature-based debit cards that use credit card technology. More generally, no-surcharge rules are a barrier to the widespread acceptance of any new payment system because they negate any cost advantage that other payment systems might have.

The corollary of increasing other payment systems' point-of-sale costs relative to credit cards' is that the point-of-sale costs of credit cards are relatively reduced, which results in an increase in credit card usage. The credit card industry is structured to allow issuers to take advantage of the externality no-surcharge rules impose on competitors. This translates into higher interchange revenue and is amplified into higher interest revenue because of the tendency of consumers who intend to use credit cards solely for transacting to overestimate their ability to pay off their balances in full and on time.¹⁶⁹ Higher purchase volume per card further amplifies interest revenue because the interest is compounding on more principal.

Second, merchant restraints make costlier cards within a brand competitive with cheaper cards. Here honor-all-card rules come into play, as they allow card issuers to shift their portfolios to include greater percentages of more profitable, high interchange rate reward cards without experiencing a decline in card usage.¹⁷⁰ Indeed, by offering more reward cards, card issuers actually encourage greater card usage.

Third, no-surcharge rules equalize the price at point-of-sale between all credit card brands. No-surcharge rules thus insulate the card networks from having to compete with each other on point-of-sale price to consumers. Most of this benefit accrues to American Express, the card brand with the highest interchange rate. It is limited, however, by

¹⁶⁹ See Bar-Gill, *supra* note 100.

¹⁷⁰ See Rochet & Tirole, *supra* note 148.

merchants' ability to refuse all American Express cards; no-surcharge rules do not restrict merchants' ability to opt out of a brand altogether. If American Express were to be too aggressive in exploiting its competitive advantage from no-surcharge rules, it would lose business. Indeed, when American Express raised its merchant discount rates on restaurants in 1991, over 250 Boston restaurants threatened to stop accepting American Express.¹⁷¹ American Express relented, but the "Boston Fee Party" shows that there are limits both to merchants' price elasticity to merchant discount (and hence interchange) fees and thus to the ability of American Express to exploit no-surcharge rules to gain a competitive advantage. American Express's inter-brand competitive advantage (and the other networks' disadvantage) is limited by merchants' price elasticity.

Why hasn't one of the card networks attempted to gain a competitive advantage on the others by *dropping* its merchant restraints? The answer lies in the multiple dimensions of credit card competition. Credit card products compete in three dimensions in-brand, between brands, and with other payment systems. As long as the competitive advantages of no-surcharge rules vis-à-vis other payment systems and in-brand outweigh the inter-brand competitive disadvantage (for brands other than American Express), card networks will not voluntarily compete with each other based on merchant restraints. As long as merchant restraints continue to grow credit cards' slice of the total payments pie, the networks will not abandon merchant restraints in order to gain a larger share of the credit card slice of the pie.

Moreover, because many of the ten large issuers that comprise over 87% of the card market¹⁷² issue cards on as many as three networks. These issuers are often locked in to maintaining current issuance levels on the networks through penalty provisions should their issuance levels drop beneath certain thresholds.¹⁷³ Therefore, any inter-brand competition would be robbing Peter to pay Paul. Credit card issuers have little ability to shift old card portfolios en masse, only to move new cards. Thus, absent the threat of imminent regulatory or legislative intervention or other countervailing market factors, none of the brands will try to gain a competitive advantage over the others by rescinding merchant restraint rules.

¹⁷¹ EVANS & SCHMALENSSEE, *PAYING WITH PLASTIC* (1st ed.), *supra* note 8, at 169-72.

¹⁷² NILSON REPORT, Issue 849 (Jan. 2006) at 1, 10.

¹⁷³ MasterCard, Form S-1 Registration Statement Under the Securities Act of 1933 (Sept. 14, 2005) at 19. 74. 78, F-33.

The card networks are also content with the lack of inter-brand competition based on point-of-sale price because it helps issuers avoid commoditization. Commoditization is a major concern of the card industry. Commoditized industries—where sellers compete solely on the basis of price for the sale of identical products—have low profit margins. Credit cards are virtually identical products on all non-price (point-of-sale and interest rate) points and should function as a commoditized industry. That they do not is in part because of merchant restraints.

Card issuers attempt to avoid commoditization by diverting competition from cards' three easily comparable price points—annual fee, cost at point-of-sale, and interest rate—to bundled rewards¹⁷⁴ and other features like “identity theft protection,” which are hard to value and thus less prone to commoditization. Calculating the bundled pricing of credit and affinity programs would involve a formula far too complex for consumers to calculate. Therefore, consumers cannot rationally choose between credit cards based net cost/benefit; instead, they choose based solely on perceived benefit.

The card industry is structured to avoid commoditization. Few cards now have annual fees,¹⁷⁵ which is an easy way for consumers to distinguish between cards based on a definite, up-front price point. Annual fees also alert consumers to the price difference between credit cards and other payment systems. Interest rates should be comparable using TILA disclosure forms, but in practice TILA forms are of little use because inscrutable cardholder agreements with universal cross-default clauses make it impossible for a consumer to understand the true interest rate on a card.¹⁷⁶ Because penalty interest rates are nearly uniform, cross-default clauses make all of an individual consumer's credit card interest rates uniform by moving them all to the penalty rate upon a default. Moreover, teaser introductory APR offers, often of 0%, mask the true interest rate.¹⁷⁷ Finally, it seems that consumer demand is highly price inelastic to interest rates,¹⁷⁸ part of which may be explained by the

¹⁷⁴ See Press Release, Vertis, Bonus Points and Other Incentives Attract Consumers to Credit Cards (July 20, 2005), <http://biz.yahoo.com/bw/050720/205200.html?.v=1> (“Obtaining Points and Getting Money Back Are Most Appealing Reasons to Select a Credit Card”).

¹⁷⁵ Bar-Gill, *supra* note 100, at 1391.

¹⁷⁶ Ronald J. Mann, “Contracting” for Credit, 104 MICH. L. REV. 899, 924-26 (2006).

¹⁷⁷ Bar-Gill, *supra* note 100, at 1392.

¹⁷⁸ See Christine Chandran et al., *Competition in the New Zealand Credit Card Market from the Consumer Perspective*, 6 J. ASIA-PAC. BUS. 63 (2005), available at <http://centre-banking->

inability of consumers to gauge true interest rates in a meaningful sense. Consumer price inelasticity toward credit card interest rates may also be explained by consumers not anticipating paying any interest when they choose a card. The result is that interest rates are not the basis of competition in the card industry.¹⁷⁹ Merchant restraints mask the final price-point on which cards could be commoditized—point-of-sale pricing. The card industry's complex pricing structure is crafted to avoid commoditization.

B. Shifting the Basis of Competition to Bundled Rewards Programs

Instead of competing on price, card issuers compete for consumers on the basis of bundled rewards. Consumers eagerly pursue bundled intangibles, such as frequent flyer miles and rewards points; a 2002 survey found that half of consumers with rewards cards said that rewards points influenced their decision to use the credit card instead of another payment method.¹⁸⁰ Accordingly, card companies market themselves based on bundled rewards. Hence, American Express, which is less desirable as a card because it is accepted by fewer merchants than MasterCard or Visa due to its higher discount rates, offers better mileage deals and cardholder services to cardholders in order to stay competitive. Similarly, the largely defunct Diners Club Card is attempting to push its way back into the market by offering better frequent flyer mile terms than other cards.¹⁸¹ Indeed, a recent Citigroup advertisement trumpets “Points for banking. Points for credit cards. Points for Mortgages. Points, Points, Points!” One starts to wonder whether Citigroup is in the banking business or the rewards business.

Rewards programs like frequent flyer miles and cash-back rebates have the effect of reducing the net cost to consumers of transactions made with a credit card. A consumer who purchases goods using cash for the same sticker price as a consumer who purchases the

studies.massey.ac.nz/research_outputs/CreditCardCompetitionUpdate.pdf; see also Peter Pae, *Credit Card Rates Keep Rising Despite the Competition*, WALL ST. J., Sept. 6, 1991, at B1.

¹⁷⁹ See Todd J. Zywicki, *The Economics of Credit Cards*, 3 CHAPMAN L. REV. 79, 104-09 (2000). Zywicki argues, however, that credit card users who have large revolving balances do shop around based on interest rates. See also Chandran *et al.*, *supra* note 178, at 59.

¹⁸⁰ See Allen C. Grommet, *Economic Analysis*, CAMBRIDGE CONSUMER CREDIT INDEX 2 (May 7, 2002), available at http://www.cambridgeconsumerindex.com/archive/analysis/economic_analysis_0502.pdf.

¹⁸¹ See Ron Lieber, *The Diners Club Card Tries a Comeback*, WALL ST. J., Mar. 30, 2005, at D1.

good with a cash-back rebate card will have paid more in net terms for the goods. Likewise, bundling of products like frequent flyer miles at far better than retail prices only increases the attractiveness of credit transactions.¹⁸² Bundled benefits also allow issuers to target the marketing toward particular consumer demand niches. Frequent flyer and cash-back programs increase card usage. Increased card usage and transaction volume mean that there is more grist for the interest and penalty fee mill. Indeed, some card issuers account for rewards programs as reductions to their interchange income.¹⁸³ Rewards programs present a classic bundling problem and distort competition among payment systems. Thus, the efficient result in one market—credit card issuers competing for consumers by providing bundling that consumers want—is used to exploit an artificially restrained market—competition among payment systems.

Merchant restraints insulate the interchange rate from market discipline, which makes credit cards more competitive with other payment systems, limits competition within the credit card industry, and allows card issuers to shift their portfolios toward increasingly expensive cards. Merchant restraints also let card issuers shift the basis of competition in the card industry from price to bundled intangibles, thereby helping them to avoid commoditization and maintain higher prices.

C. Antitrust Violations of Merchant Restraints

Merchant restraints likely violate sections 1 and 2 of the Sherman Antitrust Act.¹⁸⁴ Section 1 provides that “Every contract,

¹⁸² Levitin, *The Antitrust Super Bowl*, *supra* note 101, at 291-93 (analyzing pricing of frequent flyer point rewards programs). Query, though, whether all such bundling is ultimately efficient. Many premium cards also bundle various insurance-type services with their cards—everything from extending the limitation cardholders’ liability on unauthorized purchases beyond the federally mandated minimum consumer liability of \$50, to extending warranties on products purchased with the cards, to offering entertainment event and travel ticket insurance, to providing for repatriation of remains if the cardholder dies abroad. Such bundling might be economically efficient, in the sense of allowing consumers cheaper access to such insurance than if consumer purchased the insurance separately, but it is far from clear that most consumers would purchase such insurance at all, much less at the bundled price.

¹⁸³ *E.g.*, Capital One 2005 Annual Report 28, 68; Discover Bank 2005 Annual Report 12; MBNA 2004 Annual Report 42.

¹⁸⁴ Notably, while interchange fees have been held not to violate antitrust laws, albeit in a decision that pre-dates the widespread use of credit cards, *NaBanco*, 779 F.2d at 601-604, no court has yet ruled on merchant restraints. No-surcharge rules are also arguably a violation of the Cash Discount Act, Pub. L. No. 97-25, § 201, 95 Stat. 144

combination in the form of trust or otherwise, or conspiracy, in restraint of trade or commerce . . . is . . . illegal,”¹⁸⁵ while section 2 provides that “Every person who shall monopolize, or attempt to monopolize, or combine or conspire with any other person or persons, to monopolize any part of the trade or commerce . . . shall be deemed guilty of a felony.”¹⁸⁶ Merchant restraints rules can be characterized as different types of traditional section 1 violations. They may also represent a new type of amalgamated section 1 violation. Additionally, merchant restraints are the device by which credit card networks jointly monopolize or attempt to monopolize the payments industry. This article does not purport to provide a full antitrust analysis of merchant restraints; rather it highlights some of the more important merchant restraints’ most obvious antitrust violations.

No-Surcharge Rules have many of the characteristics of “competitor-based pricing provisions” (CBPP) or parity clauses, such as “Most Favored Nation” (MFN) “Meeting Competition” (MCC) clauses in contracts. MFN clauses provide that one party in a contract will receive the most favorable price or terms offered by the other party. MFN clauses are essentially guarantees of receiving the best price offered. MCC clauses provide that one buyer (seller) will match any offer made by a competing buyer (seller). There can be good reasons for parties to seek CBPPs, such as when a customer negotiates for a MFN clause from a supplier of unique or hard to obtain goods/services. CBPPs can help parties allocate risk of price changes and insure against competitive disadvantage, as well as incentivize cost minimization.¹⁸⁷

The problem with CBPPs is that while on their face they appear to have no effect other than to guarantee the best possible price for one party in the contract, they may actually lead to higher prices for competitors and deter price competition. Legal scholarship has demonstrated how CBPPs can “create the same effect as a horizontal conspiracy to fix price [in which] the contract with the ‘victim’ can substitute for the horizontal contract or agreement.”¹⁸⁸ Absent a CBPP, a

(1981), but it is hard to read too much into the Cash Discount Act given the twists and turns in the Act’s history. *See supra* section III.A.

¹⁸⁵ 15 U.S.C. § 1 (2006).

¹⁸⁶ 15 U.S.C. § 2 (2006).

¹⁸⁷ Joseph J. Simons, *Fixing Price with Your Victim: Efficiency and Collusion with Competitor-Based Formula Pricing Clauses*, 17 HOFSTRA L. REV. 599, 608-10 (1989).

¹⁸⁸ *Id.* at 601. *See also* Beth Ann Wright, *How MFN Clauses Used in the Health Care Industry Unreasonably Restrain Trade Under the Sherman Act*, 18 J.L. & HEALTH 29 (2003); Jonathan B. Baker, *Vertical Restraints with Horizontal Consequences: Competitive Effects of “Most-Favored Customer” Clauses*, 64

seller might provide some purchasers with greater discounts than others. If the party imposing a CBPP makes up a significant portion of the seller's revenues, however, the CBPP may inhibit the seller from discounting for other purchasers.¹⁸⁹ Thus, the FTC has undertaken enforcement actions against MFNs used by parties to market power because, "An MFN clause imposed by a dominant group of competing sellers can establish a price floor and restrict competition that otherwise would allow prices to go below that floor."¹⁹⁰

While Richard Posner has gone so far as to argue that all interdependent pricing should itself constitute an agreement for the purposes of the Sherman Act,¹⁹¹ his position remains a minority view. The majority position is that the key factor in distinguishing between CBPPs that have procompetitive effects and those with anticompetitive effects is the market power of the party imposing the CBPP. In terms of market power, there is no difference between a single actor and a cartel; a CBPP imposed uniformly and from concerted action by multiple parties has the same effect as if the parties were aggregated into a single entity.

CBPPs are efficient mechanisms for cartel self-enforcement. Cartels consist of individual firms in an industry that band together to reduce output and/or raise prices, like a monopolist would. Cartels tend to form in industries with small numbers of competitors, homogeneous products, good information about rivals' prices, and high barriers to entry.¹⁹² The credit card industry bears all of these indicia of an industry suited for an oligopolistic cartel.

ANTITRUST L.J. 517, 519, 525 (1996); Anthony J. Dennis, "Best Price" Clauses in Health Care Provider Contracts: An Antitrust Critique, 3 CONN. INS. L.J. 79 (1996); Anthony J. Dennis, *Potential Anticompetitive Effects of Most Favored Nation Contract Clauses in Managed Care and Health Insurance Contracts*, 4 ANN. HEALTH L. 71 (1995); Anthony J. Dennis, *Most Favored Nation Contract Clauses Under the Antitrust Laws*, 20 DAYTON L. REV. 821 (1995); Arnold Celnicker, *A Competitive Analysis of Most Favored Nations Clauses in Contracts Between Health Care Providers and Insurers*, 69 N.C.L. REV. 863 (1991); Susan E. Stenger, Note & Comment, *Most-Favored-Nation Clauses and Monopsonistic Power: An Unhealthy Mix?* 15 AM. J.L. & MED. 11 (1989); Jonathan B. Baker, *Vertical Restraints Among Hospital Physicians and Health Insurers that Raise Rivals' Costs*, 14 AM. J.L. & MED. 147 (1988).

¹⁸⁹ Baker, *Vertical Restraints with Horizontal Consequences*, *supra* note 188, at 519, 525.

¹⁹⁰ William J. Baer, Director of the FTC's Bureau of Competition, at <http://www.ftc.gov/opa/1996/01/rxcare.htm>.

¹⁹¹ RICHARD POSNER, ANTITRUST LAW: AN ECONOMIC PERSPECTIVE, 71-75 (1976).

¹⁹² Joseph J. Simons, *Fixing Price with Your Victim: Efficiency and Collusion with Competitor-Based Formula Pricing Clauses*, 17 HOFSTRA L. REV. at 614-15.

Cartels tend to be inherently unstable because of the incentive for cartel members to cheat and undercut the cartel price, while still charging an inflated price.¹⁹³ Competitor-based pricing is an effective cartel-enforcement mechanism. To the extent that the credit card industry operates as a cartel, no-surcharge rules prevent price-cheating by cartel members because lower merchant discount rates do not garner increased card usage from consumers.

It is important to note that no court has held that competitor-based pricing is necessarily a violation of the antitrust laws.¹⁹⁴ Yet courts have also declined to hold CBPPs to be *per se* legal, and have denied motions to dismiss complaints based on competitor-based pricing clauses.¹⁹⁵ If No-Surcharge Rules are seen as a form of CBPP, it raises the question of whether imposition of an CBPP clause by a party with market power constitutes an antitrust violation when the party imposing the CBPP clause knows that its product costs the purchaser more than other competing products.

1. Sherman Act §1 Violations

It appears merchant restraints violate section 1 of the Sherman Act. Section 1 is not read literally to bar *every* contract, conspiracy, or combination in restraint on trade. Instead, it is interpreted to bar only *unreasonable* restraints on trade.¹⁹⁶ Among the traditional types of section 1 violations are horizontal price-fixing (i.e., between competitors), tying, and vertical price-fixing (i.e., between wholesaler and retailer).

¹⁹³ *Id.* at 612.

¹⁹⁴ *Blue Cross & Blue Shield United of Wisconsin v. Marshfield Clinic*, 65 F.3d 1406, 1415 (7th Cir. 1995) (Posner, C.J.) (holding that MFN clause by a lawful monopolist was not price-fixing “in this case.”); *Ocean State Physicians Health Plan v. Blue Cross and Blue Shield of Rhode Island*, 883 F.2d 1101 (1st Cir. 1989), cert. denied, 494 U.S. 1027 (1989); *Kartell v. Blue Shield of Massachusetts, Inc.* 749 F.2d 922 (1st Cir. 1984) (Breyer, J.), cert. denied 471 U.S. 1029 (1984); *Ethyl Corp.*, 101 F.T.C. 425 (1983), *rev'd sub nom.* *E.I. du Pont de Nemours & Co. v. FTC*, 729 F.2d 128 (2d Cir. 1984).

¹⁹⁵ *Blue Cross and Blue Shield of Ohio v. Bingaman*, 1996 U.S. Dist. LEXIS 17091, at *9-*10 (N.D. Ohio, June 24, 1996); *United States v. Delta Dental of Rhode Island*, 943 F.Supp. 172 (D.R.I. 1996) (holding that allegations that MFN clause constituted violation of sections 1 and 2 of the Sherman Act were sufficient to survive a motion to dismiss under FED.R.CIV.P. 12(b)(6)).

¹⁹⁶ *Texaco Inc. v. Dagher*, 126 S. Ct. 1276, 1279 (2006).

i. Horizontal Price-Fixing

Horizontal price-fixing between competitors is a *per se* section 1 violation.¹⁹⁷ Thus, courts will not weigh the anti-competitive effects of horizontal price-fixing against any pro-competitive effects, as they would for restraints on trade analyzed under the “rule of reason.”¹⁹⁸

No-surcharge rules likely constitute horizontal price-fixing arrangements. First, no-surcharge rules are the fixing *between the competing banks within a network* of the price of credit card services to consumers, and, arguably to merchants as well.¹⁹⁹ Second, no-surcharge

¹⁹⁷ See, e.g., *Ariz. v. Maricopa County Med. Soc.*, 457 U.S. 332, 348 (1982); *Catalano, Inc. v. Target Sales, Inc.*, 446 U.S. 643, 647 (1980).

¹⁹⁸ Justice Brandeis provided the classic statement of the rule of reason:

The true test of legality is whether the restraint imposed is such as merely regulates and perhaps thereby promotes competition or whether it is such as may suppress or even destroy competition. To determine that question the court must ordinarily consider the facts peculiar to the business to which the restraint is applied; its condition before and after the restraint was imposed; the nature of the restraint and its effect, actual or probable. The history of the restraint, the evil believed to exist, the reason for adopting the particular remedy, the purpose or end sought to be attained, are all relevant facts. This is not because a good intention will save an otherwise objectionable regulation or the reverse; but because knowledge of intent may help the court to interpret facts and to predict consequences.

Chic. Bd. of Trade v. United States, 246 U.S. 231, 238 (1918).

¹⁹⁹ Horizontal price-fixing through no-surcharge rules does not depend on whether the network is a joint venture between the banks or publicly owned company. Thus although price-fixing by members of a joint venture is reviewed under the “rule of reason,” and is not a *per se* violation, *Texaco Inc. v. Dagher*, 126 S. Ct. 1276 (2006), this is of little relevance. In a traditional “open” card network, like MasterCard and Visa before 2006, which were structured as joint ventures, the price-fixing of no-surcharge rules was in the promulgation of the rule, agreeing to be bound by them, and enforcing them.

Even if the network association is publicly owned and independently governed, no-surcharge rules continue to be a horizontal price-fixing arrangement, because the banks that serve as issuers and acquirers for a network agree to be bound by the network’s rules, and that constitutes the contract, combination, or conspiracy required by section 1. Unless a single corporate entity or corporate family serves as the network, the issuer, and the acquirer, no-surcharge rules are horizontal price-fixing in violation of section 1 of the Sherman Act. See *Copperweld Corp. v. Independence Tube Corp.*, 467 U.S. 752, 777 (1984) (holding that parent and wholly owned subsidiary are incapable of conspiring with each other to violate section 1 of the Sherman Act). See also *Midland v. F. Hoffman-Laroche, Ltd. (In re Vitamins Antitrust Litig.)*, 270 F. Supp. 2d 15, 22 (D.D.C. 2003) (using multi-factored control test to analyze whether parent exercised sufficient control over subsidiary so as to be a unitary entity that could not conspire with itself).

rules can also be seen as horizontal price-fixing *between the different networks*. Traditionally, horizontal price-fixing requires some form of an agreement. Conscious parallelism in pricing is itself not illegal,²⁰⁰ but anything beyond mere parallel pricing by oligopolists might be sufficient.²⁰¹ The unusual degree of overlap between the bank participants in the networks satisfy the requisite level of agreement or be a sufficient “plus factor” beyond parallel pricing, regardless of whether the banks are the owners or merely participants in the networks. As an unnamed former MasterCard General Counsel wrote to the Department of Justice in 1992, “each of the Associations is a fishbowl, and officers and board members are aware of what the other is doing, much more so than in the normal corporate environment.”²⁰²

Perhaps more crucially, the very form of the no-surcharge rules provides the agreement. No-surcharge rules are written so that they specifically link different networks’ prices to each other. All the credit card networks, not just one, have no-surcharge rules. This goes beyond mere parallel pricing and has the same effect as if there were an active agreement between networks.²⁰³ Whether such functional collusion would suffice for violation of section 1 absent direct agreement is uncertain, but given the functionalist thrust of recent antitrust

Accordingly, even though MasterCard’s IPO and Visa’s planned IPO provide a defense to the charge that the member banks conspire to fix the interchange rate by merely setting it, the IPOs present no defense to allegations that merchant restraints are antitrust violations.

²⁰⁰ See, e.g., *Brooke Group LTD. v. Brown & Williamson Tobacco Corp.*, 509 U.S. 209, 227 (1993) (“tacit collusion . . . sometimes called ‘conscious parallelism’ . . . [is] not in itself unlawful”). See also Donald F. Turner, *The Definition of Agreement under the Sherman Act: Conscious Parallelism and Refusals to Deal*, 75 HARV. L. REV. 655 (1962).

²⁰¹ *In re High Fructose Corn Syrup Antitrust Litig.*, 295 F.3d 651 (7th Cir. 2002) (Posner, J.) (holding that parallel pricing changes by competitors is *prima facie* evidence sufficient to survive a motion for summary judgment in the case of an oligopoly market in which five sellers controlled 90% of the market.). But see *Williamson Oil Co. v. Philip Morris USA*, 346 F.3d 1287 (11th Cir. 2003) (“Evidence that does not support the existence of a price fixing conspiracy any more strongly than it supports conscious parallelism is insufficient to survive a defendant’s summary judgment motion.”). Judge Posner, however, has long advocated viewing conscious parallel pricing by an oligopoly as a violation of the Sherman Act. See Richard A. Posner, *Oligopoly and the Antitrust Laws: A Suggested Approach*, 21 STAN. L. REV. 1562 (1969). See Matthew M. Bunda, Note, *Monsanto, Matsushita, and “Conscious Parallelism”: Towards a Judicial Resolution of the “Oligopoly Problem,”* 84 WASH. U. L. REV. 179 (2005), for a recent attempt to reconcile the Posner and Turner positions.

²⁰² *Merchants seek structural changes to interchange in amended suit*, THE GREEN SHEET, Issue 06:05:02 (May 22, 2006).

²⁰³ See note 37 *supra* for text of rules.

jurisprudence that looks to the economic realities, rather than to formalities, it should.²⁰⁴ If no-surcharge rules are viewed as horizontal price fixing arrangements, they are illegal regardless of any legal, economic, or business justification.

ii. Tying

Honor-all-card rules are tying provisions that also appear to violate section 1 of the Sherman Act.²⁰⁵ Honor-all-card rules require that merchants who take one type of credit card product/service—non-rewards cards—also purchase another product/service—reward card transactions. Thus two products—regular credit cards and premium rewards cards are tied together by honor-all-card rules. Tying by a party with market power is *per se* illegal.²⁰⁶ MasterCard and Visa have been found by the Second Circuit to have market power jointly and separately in a case that challenged the application of honor-all-card rules to require that merchants who accept a network's credit cards also accept the network's signature-based debit cards.²⁰⁷ The only defense available to the networks against a tying claim is that rewards cards are not a separate product from regular credit cards, so there are not two products to tie. The different pricing and marketing of the products, though, belies such a defense.

iii. Vertical Price-Fixing

No-surcharge rules can also be cast as vertical price-fixing arrangements between the issuer, the network, and the acquirer to fix the price of the interchange rate, as no-surcharge rules ensure that the interchange rate gets passed on in whole to merchants as consumers of card services. Alternatively, no-surcharge rules can be seen, from a

²⁰⁴ See, e.g., *Ill. Tool Works, Inc. v. Ind. Ink, Inc.*, 547 U.S. ___, 126 S.Ct. 1281 (2006) (reversing older doctrine that possessor of a patent was deemed to have market power).

²⁰⁵ 15 U.S.C. § 1 (2006).

²⁰⁶ See *Jefferson Parish Hosp Dist. No. 2 v. Hyde*, 466 U.S. 2 (1984). As with vertical price-fixing, recent Supreme Court decisions indicate that tying might no longer be *per se* illegal, but only a rebuttable presumption. *Ill. Tool Works, Inc. v. Ind. Ink, Inc.*, 547 U.S. ___, 126 S.Ct. 1281 (2006) (eliminating presumption of market power for patent holders) (avoiding use of the term “*per se*” in discussing anticompetitive effects).

²⁰⁷ *United States v. Visa U.S.A., Inc.*, 344 F.3d 229, 239 (2d Cir. 2003) (Leval, J.) (defining market power as the ability “to control prices or exclude competition.”). *Visa U.S.A.* was not premised on the 95% membership overlap between MasterCard and Visa at the time; it only made passing reference to the existence of a significant overlap in membership. Thus, MasterCard's and Visa's IPOs should have no effect on the continuing validity of the ruling.

consumer perspective, as a vertical arrangement between the networks' members and the merchants to fix the price of credit card (and all payment) services at point of sale.

The standard of review for vertical price-fixing arrangements depends on whether they are arrangements for maximum or minimum prices. Vertical maximum resale price fixing is reviewed under the rule of reason; it is not a *per se* violation.²⁰⁸ Vertical minimum resale price fixing is *per se* illegal, although dictum in a recent Supreme Court decision made no distinction between vertical maximum or minimum price fixing and referred to both as being reviewed under the rule of reason.²⁰⁹

No-surcharge rules have aspects of both maximum and minimum price-fixing. On the one hand, they impose a maximum price level for credit cards—that of competing payment systems. On the other hand, they impose a minimum price *on other payment systems*. Vertical price-fixing typically involves a wholesaler and a retailer fixing the price of their own product at resale rather than fixing the cost of a competitors' product.

Alternatively, no-surcharge rules might be a unique hybrid antitrust violation in that they are a vertical arrangement that has the effect of a horizontal price restraint. No-surcharge rules tie the price of credit card brands to the price of their competitors' products—both other credit cards and other payment systems. No-surcharge rules fix the price of credit cards relative to other payment systems. They also fix the price of credit card brands relative to each other. And finally, they fix the relative prices of different credit card products within each brand. No-surcharge rules are thus really an amalgamated violation that combines price-fixing and tying, "price-tying" as it were. What is incredible about no-surcharge rules as an antitrust violation is that the networks are not price-fixing in the sense of saying, "The price of our product must be \$X." Instead, they are saying, "The price of our product at must be the same as all our competitors' prices." Thus, the card

²⁰⁸ *State Oil Co. v. Khan*, 522 U.S. 3, 10-19 (1997).

²⁰⁹ In *Texaco Inc. v. Dagher*, however, the Supreme Court noted in dictum that *State Oil Co. v. Khan* established the proposition that "vertical price-fixing arrangements are subject to the rule of reason, not *per se* liability." 126 S. Ct. 1276, 1279 (2006). Whether the *per se* rule will continue to govern vertical minimum price fixing is unclear, particularly in light of the Supreme Court's grant of certiorari to review a case challenging the application of the *per se* rule in such instances. See *Leegin Creative Leather Products v. PSKS, Inc.*, 06-480, 2006 U.S. LEXIS 9444 (Dec. 7, 2006) (granting certiorari).

networks are not only fixing their own prices; *they are fixing their competitors' prices as well, without their competitors' consent.*

2. Sherman Act §2 Violations

Merchant restraint rules may also violate section 2 of the Sherman Antitrust Act. As defined by the Supreme Court:

The offense of monopoly under 2 of the Sherman Act has two elements: (1) the possession of monopoly power in the relevant market and (2) the willful acquisition or maintenance of that power as distinguished from growth or development as a consequence of a superior product, business acumen, or historic accident.²¹⁰

Monopoly power is “the power to control prices or exclude competition.”²¹¹ Attempted monopolization requires a specific intent to monopolize and a “dangerous probability” of success.²¹²

The gravamen of any monopolization or attempted monopolization charge based on merchant restraints is that they expand credit cards share of the total payment systems market share at the expense of other payment systems. This charge, of course, depends on payment systems forming the relevant market, as opposed to solely credit cards being the relevant market. In a previous credit card antitrust litigation, when the Department of Justice brought suit against MasterCard and Visa for their dual exclusivity rules, which prohibited banks that issued MasterCard and Visa from issuing other credit cards, the relevant market accepted by the courts was the credit card market, not the overall payments market.²¹³ This market definition went against the defendant card networks, which had argued that the relevant market was the broader payments systems market.

The card networks' arguments as to market definition in prior suits hurt them in the merchant restraint context. The relevant market for an analysis of merchant restraints cannot be solely credit cards, if only

²¹⁰ United States v. Grinnell Corp., 384 U.S. 563, 570-71 (1966). *See also* Eastman Kodak Co. v. Image Technical Servs., Inc., 504 U.S. 451, 481 (1992); Aspen Skiing Co. v. Aspen Highlands Skiing Corp., 472 U.S. 585, 596 n.19 (1985). *See* Einer Elhauge, *Defining Better Monopolization Standards*, 56 STAN. L. REV. 253 (2003), for a criticism of existing Sherman Act section 2 doctrine.

²¹¹ Eastman Kodak, 504 U.S. at 481 (quoting United States v. E.I. du Pont de Nemours & Co., 351 U.S. 377, 391 (1956)).

²¹² *See, e.g.,* United States v. Am. Airlines, Inc., 743 F.2d 1114, 1118 (5th Cir. 1984).

²¹³ United States v. Visa U.S.A., Inc., 163 F. Supp. 2d 322, 336 (S.D.N.Y. 2001), *aff'd* 344 F.3d 229, 239 (2d Cir. 2003).

because the merchant restraints are themselves explicitly designed to affect the *non-credit card transacting market*, unlike the dual exclusivity rules that prohibited banks that issued MasterCard and Visa from issuing other *credit* cards. Interchange and merchant discount fees relate to the transacting function of cards, not the borrowing function. Indeed, that is why debit cards also have interchange and merchant discount fees. The relevant market for merchant restraints is the transacting market, not the borrowing market, and credit cards compete with debit cards, checks, and cash in the transacting market, as shown by credit card commercials that depict cards as providing faster transactions than cash. Credit card networks perceive themselves as being in competition with other payment systems, and it is unlikely that the rulings in the dual exclusivity case will provide the networks with much protection.

Assuming that the relevant market is payment systems, not just credit cards (and arguably even if it is just credit cards), it appears that credit card networks do have the power to control prices. Merchant restraints set the relative level of all payment systems at point of sale by equalizing them, and then through rewards programs, credit card networks actually offer consumers the cheapest transacting system. This system has the same affect as being able to set absolute prices. In doing so, credit card networks manage to exclude or at least limit their competition. Card networks' ability to control prices in this manner is hardly the result of a superior product, business acumen, or historic accident, but instead results from calculated business decisions.

Merchant restraints are likely *per se* violations of antitrust law, but even if they are restraints on trade that are reviewed under the rule of reason, they are still violations of antitrust law because their procompetitive effects are ephemeral, as explained in section IV, *supra*, and do not outweigh their anticompetitive effects. Given the size and ubiquity of the payments industry, merchant restraints create a major inefficiency in the American economy.²¹⁴

VI. Conclusion: Lessons from International Regulatory Responses

Merchant restraints insulate interchange fees from market discipline and thereby lead to increased consumption of credit, which has serious competitive externalities. Merchant restraints constitute a variety of antitrust violations. To the extent that they are *per se* violations, there is no need to consider any of the arguments in their favor. To the extent

²¹⁴ The costs of merchant restraints go beyond harm to competition and include a variety of social costs, as discussed in the companion piece to this article. See Levitin, *Priceless? The Social Costs of Credit Card Merchant Restraints*, *supra* note 117, at ____.

that they are violations that are reviewed under the rule of reason, however, their pro-competitive effects are ephemeral; the main justification for merchant restraints—the need to protect against a impact event that would decrease the value of a network to its participants—is inapplicable to the real world payment systems context in which mature credit card networks are competing against other payment networks. Merchant restraints should be targeted for regulatory, legislative, or judicial intervention.

America has by far the highest interchange fees in the world, more than double those in the U.K and nearly quadruple those in Australia.²¹⁵ (See chart 5, below.) In spite of the United States having the highest interchange rates in the world,²¹⁶ the movement to eliminate merchant restraints has been more pronounced abroad. The Reserve Bank of Australia (RBA) led the way in 2003 with a sweeping series of on-going reforms. These reforms required MasterCard and Visa (but not American Express) interchange rates to be set according to a cost-based schedule and banned no-surcharge rules, while capping surcharges at the amount of the merchant discount fee.²¹⁷ The average MasterCard and Visa interchange rates in Australia have fallen by nearly half, from .95% of purchase price to .50%,²¹⁸ while the average merchant discount fees for MasterCard and Visa have fallen from 1.40% of purchase price to .86%.²¹⁹

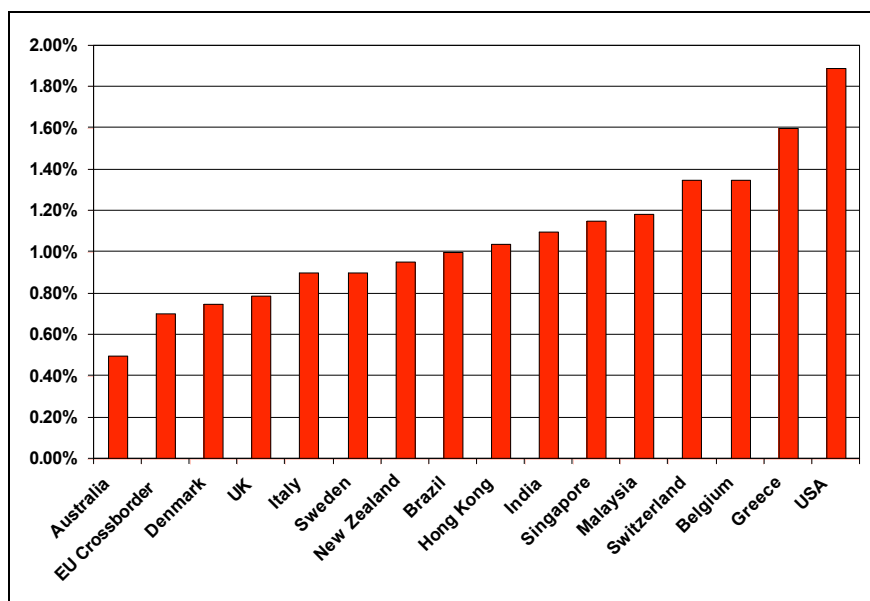
²¹⁵ Merchants Payments Coalition, *Interchange Graphs*, available at http://www.unfaircreditcardfees.com/pdf/Interchange_GraphsMay-06.pdf; NILSON REPORT, Issue 862 (Aug. 2006), at 11; Reserve Bank of Australia, Credit Card Benchmark Calculation (Sept. 29, 2006), available at http://www.rba.gov.au/MediaReleases/2006/Pdf/mr_06_08_benchmark_calc_credit_card.pdf.

²¹⁶ *Id.*

²¹⁷ RESERVE BANK OF AUSTRALIA, STANDARD, THE SETTING OF WHOLESALE (“INTERCHANGE”) FEES IN THE DESIGNATED CREDIT CARD SCHEMES (Nov. 25, 2005), available at http://www.rba.gov.au/MediaReleases/2006/Pdf/mr_06_02_creditcard_standard.pdf.

²¹⁸ RESERVE BANK OF AUSTRALIA, DEBIT AND CREDIT CARD SCHEMES IN AUSTRALIA: A STUDY OF INTERCHANGE FEES AND ACCESS (Oct. 2000) 43, available at http://www.rba.gov.au/PaymentsSystem/Publications/PaymentsInAustralia/interchange_fees_study.pdf (providing .95% average interchange fee in 1999); Reserve Bank of Australia, Credit Card Benchmark Calculation (Sept. 29, 2006), available at http://www.rba.gov.au/MediaReleases/2006/Pdf/mr_06_08_benchmark_calc_credit_card.pdf (setting the cost-based interchange rate to .5% from its previous level of .55%).

²¹⁹ RESERVE BANK OF AUSTRALIA PAYMENT STATISTICS, BULLETIN TABLE C1, CREDIT AND CHARGE CARD STATISTICS, <http://www.rba.gov.au/Statistics/Bulletin/C03hist.xls>. Total merchant fees on MasterCard and Visa have declined from 1.45% of purchase price in March 2003 to .92% of purchase value in December, 2006. *Id.*

Chart 5. Comparison of Interchange Rates Among Select Countries²²⁰

It appears, then, that MasterCard and Visa interchange rates in Australia were almost twice what they would be in a free and unrestrained market. Annual fees on standard rewards cards have gone up over forty percent,²²¹ while rewards programs have been scaled back to where rewards constitute only .65% of purchase price, down from .8%.²²² More importantly, perhaps, the rate of growth for credit card spending dropped to its lowest level since the RBA began gathering data in the early 1990s, while the rate of growth for debit card spending rose to its highest level since 1999.²²³ Whether this is attributable to the RBA reforms is unclear; there was already a decline in credit card growth rates before the RBA reforms. The RBA is still considering action to force the end of honor-all-cards rules.²²⁴

²²⁰ *Id.*

²²¹ Visa International, Supplementary Submission to the House of Representatives Standing Committee on Economics, Finance and Public Administration, June 2006, available at <http://www.aph.gov.au/house/committee/efpa/rba2005/subs/sub023.pdf>.

²²² Philip Lowe, Assistant Governor (Financial System), Reserve Bank of Australia, Opening Statement of House of Representatives Standing Committee on Economics, Finance and Public Administration—The Australian Payments System (May 15, 2006), available at http://www.rba.gov.au/Speeches/2006/sp_ag_150506.html.

²²³ *Id.*

²²⁴ *Id.*

Chart 6. Year-on-Year Quarterly Growth Rate of Credit and Debit Cards in Australia by Transaction Value²²⁵

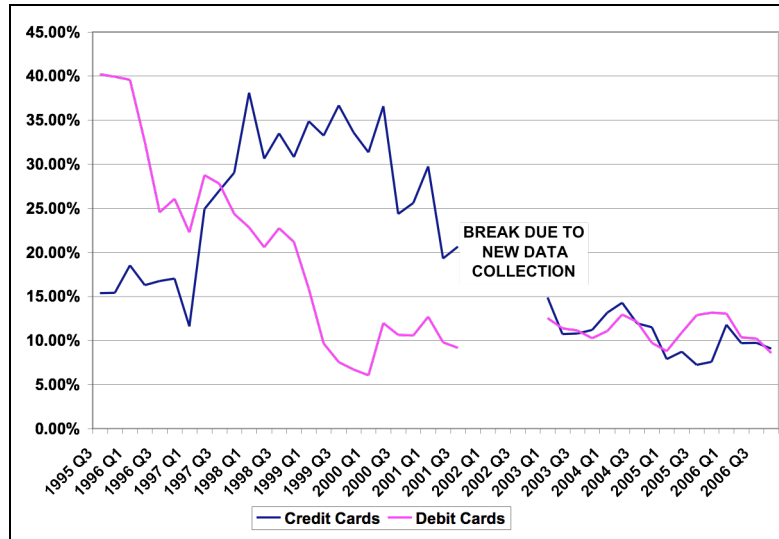
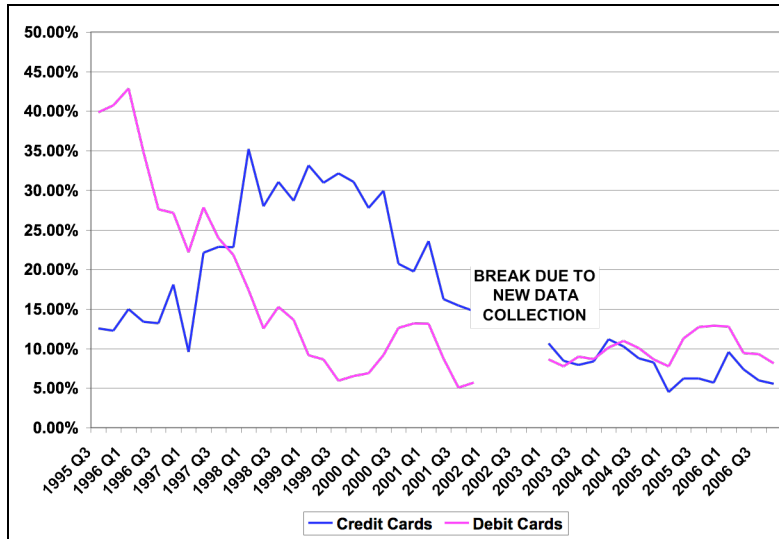


Chart 7. Year-on-Year Quarterly Growth Rate of Credit and Debit Cards in Australia by Number of Transactions²²⁶



²²⁵ Reserve Bank of Australia, Statistical Releases C01, C04. The high growth rate of debit cards in the mid-'90s is attributable to their relatively recent introduction into the Australian market.

²²⁶ *Id.*

Elsewhere, Banco de México has forced the card associations to cut interchange fees by 43 basis points on credit cards and 143 basis points on debit cards.²²⁷ The Israel Antitrust Authority reached an agreement with MasterCard issuers that will result in interchange fees dropping 37.5 basis points over six years.²²⁸ Argentina has imposed price controls on acquirers,²²⁹ and the United Kingdom's Office of Fair Trading recently determined that MasterCard's interchange structure was anti-competitive.²³⁰ The European Community declined to take action against Visa's no-surcharge rule,²³¹ but five European countries have individually banned no-surcharge rules,²³² and MasterCard has recently voluntarily rescinded its no-surcharge rule for Europe.²³³ Regulatory authorities in Brazil, the EU, Columbia, Hungary, New Zealand, Norway, Poland, Portugal, South Africa, Spain, Sweden, Switzerland, and the United Kingdom are reviewing interchange fees and related practices with an eye toward further possible regulation.²³⁴

²²⁷ Guillermo Ortiz, *Remarks on Interchange Fees: Central Bank Perspectives and Options*, PROCEEDINGS OF THE KANSAS CITY FEDERAL RESERVE BANK 2005 CONFERENCE ON INTERCHANGE, 289, 293 (2005), at <http://www.kansascityfed.org/PUBLICAT/PSR/Proceedings/2005/Ortiz.pdf>.

²²⁸ Israel Antitrust Authority, Press Release, *Ha-mamunah ve-chaverot kartisei ashra'i higi'u le-hesder arukh tevach she-yiftach le-tachrut 'anaf ha-MasterCard ve-yorid be-ofen mashma'uti et 'amalut haslikah she-govot chaverot ha-ashra'i bi-Yisrael*. ("The General Director [of the IAA] and the Credit Card Associations Reach a Long-Term Arrangement that will Open MasterCard Branches up to Competition and Will Meaningfully Lower the Interchange Fees Charged by Credit Associations in Israel") (October 30, 2006), available at <http://www.antitrust.gov.il/Antitrust/he-IL/PublicInformation/WhatsNew/Messages/Mac.htm>.

²²⁹ Manfred, *supra* note 61, at 1.

²³⁰ Office of Fair Trading, Mastercard Agreement Anti-competitive Rules OFT, Press Release 168/05 (Sept. 6, 2005), <http://www.oft.gov.uk/News/Press+releases/2005/168-05.htm>.

²³¹ EU Case Comp/29.373, Visa International 2001/782/EC 15 (Aug. 9, 2001). In European countries where no-surcharge rules are permitted, the rules also ban cash discounts. See Jean-Charles Rochet & Jean Tirole, *Cooperation Among Competitors: The Economics of Payment Card Associations* 1 n.5, <http://www.ifk-cfs.de/papers/Cac.pdf>.

²³² Finland, the Netherlands, Portugal, and Sweden ban surcharge restrictions for credit and debit cards. NILSON REPORT, Issue 819, at 1, 6 (Sept. 2004). The UK bans surcharge restrictions for credit cards but not debit cards. Weiner & Wright, *supra* note 216, at 19, 23.

²³³ MasterCard rescinded without comment its no-surcharge rule for all of Europe effective as of January 1, 2005, but has retained the rule for other regions. MASTERCARD BYLAWS AND RULES, Rule 18.A.2.3 (Oct. 2004); NILSON REPORT, Issue 819, at 6 (Sept. 2004).

²³⁴ MasterCard 10-Q (Mar. 31, 2006) 20-21.

In the United States, merchants have filed what has been described by a former FTC Chairman as “the largest private antitrust litigation in the hundred-plus year history of the Sherman Act” against the networks and their leading member banks.²³⁵ These putative class actions are scheduled to go to trial in 2008.

The Federal Reserve has been studying payment system regulation issues, but does not believe it has regulatory authority over the credit card networks beyond the provisions of TILA,²³⁶ and the Department of Justice is remaining on the sideline for the time being. Although the Federal Reserve may lack authority to directly regulate interchange and merchant discount rates, it is unclear why the Federal Reserve could not issue regulations under TILA that clarify that the Cash Discount Act includes not just a right to discount for cash, but to do its mathematic equivalent and surcharge for credit. Congress has also begun to take an interest in credit card antitrust issues, although no legislation has yet been proposed.²³⁷

As an array of new electronic payment systems begins to attempt to break into the market,²³⁸ the time is ripe for a reconsideration of merchant restraint rules in the United States. Regulators abroad have been involved in setting the interchange rate as part of their reforms, aiming to achieve something close to an at-cost level. Such intense and on-going government intervention seems unnecessary and raises the possibility that regulators might set the interchange rate too low (or too

²³⁵ *In re Payment Card Interchange Fee & Merch. Disc. Antitrust Litig.*, 398 F. Supp. 2d 1356 (J.P.M.L. 2005) (consolidating suits in E.D.N.Y.) *Credit Card Interchange Rates: Antitrust Concerns? Hearing Before the Senate Judiciary Comm.*, 109th Cong. (July 19, 2006), available at http://judiciary.senate.gov/testimony.cfm?id=1999&wit_id=5592 (statement of Timothy J. Muris, former FTC Chairman). Other litigation alleges antitrust violations through the Honor All Cards rule by tying charge cards (which require the consumer to pay the balance in full each billing cycle) with credit cards (which only require a minimum payment each billing cycle). *The Marcus Corp. v. Am. Express Co.*, No. 04-cv-05432, 2005 U.S. DIST. LEXIS 13170 (S.D.N.Y. July 1, 2005) (denying motion to dismiss).

²³⁶ *What's at Stake*, *supra* note 21, at 70 (statement of Stuart E. Weiner, Vice President and Director of Payment System Research of the Federal Reserve Bank of Kansas City). See also James M. Lyon, *The interchange Fee Debate: Issues and Economics*, THE REGION (June 2006), available at <http://www.minneapolisfed.org/pubs/region/06-06/interchange.cfm> (quoting a letter from Federal Reserve Board Chairman Alan Greenspan to Congress, “The Board's regulatory authority does not currently encompass regulating the interchange fees established by payments networks.”).

²³⁷ See *Credit Card Interchange Rates: Antitrust Concerns? Hearing Before the Senate Judiciary Comm.*, 109th Cong. (July 19, 2006).

²³⁸ See Levitin, *Payment Wars*, *supra* note 16, at ____.

high), thereby skewing competition. Credit card networks are for-profit systems²³⁹ that should be allowed to set their own prices; banning merchant restraints is a one-time intervention, which would limit card networks to setting their own prices, not merchants'.

Banning merchant restraint rules would not be the regulation of credit card networks so much as it would be forbidding networks with market power from regulating the market themselves. The removal of merchant restraints would subject interchange fees to market discipline and allow the free market, rather than powerful market players, to set the cost of payments.

²³⁹ Technically, Visa (and MasterCard before its IPO) were not-for-profit, but the network family of banks is most definitely a for-profit venture.