COMMENTS ON

FEDERAL RESERVE SYSTEM
NOTICE OF PROPOSED RULEMAKING
ON
DEBIT CARD INTERCHANGE FEES AND ROUTING
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RECOMMENDATION

This proceeding raises an unusual question of administrative law and practice: Could circumstances exist under which a Federal agency that is instructed by Congress to issue regulations on a particular topic should decline to exercise this authority unless and until Congress takes additional action to clarify its intent on crucial issues?

The answer is "yes," and the Federal Reserve Board (FRB) should recognize that the Durbin Amendment presents such a case.

The FRB has been told to implement the law, but the assumptions underlying this instruction and the terms of the delegation are so uncertain and ill-defined that the agency will find it impossible to act rationally unless it receives further instruction from Congress.

Obviously, the preferred route to this end would be for Congress itself to enact a law directing the FRB to refrain from rulemaking while the agency and others study the many unresolved questions, but the FRB should also consider an explicit regulatory ruling that it will not act in the absence of such clarification.

Support for such restraint by the FRB can be found in the familiar administrative law principle that delegations of legislative power by Congress are valid only if the delegee's discretion is guided by intelligible standards laid down in the statute.[1]

To be sure, this "non-delegation doctrine" is often stated but rarely applied, and standards as vague as "the public interest" or "imminent hazard" are routinely upheld. As Justice Scalia emphasized in *American Trucking*: "[W]e have 'almost never felt qualified to second guess Congress regarding the permissible degree of policy judgment that can be left to those executing or applying the law.' "[2]

Indeed, if the Durbin Amendment directed the FRB to regulate Electronic Funds Transfer (EFT) systems or interchange fees "in the public interest" its validity and legitimacy would be uncontestable.

That is not what the law does, however. It mandates a series of detailed interventions into specific parts of a complicated financial ecosystem without providing sufficient guidance as to how the FRB agency should deal with the ramifications of these interventions on other parts of the system, or on the system as a whole, and without providing the agency with the tools, the time, or the authority to consider and deal with these *N*-order effects.

The detail of the law's guidance on some topics does not render the over-all guidance intelligible.

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[1] See, *e.g.*, *Touby* v. *United States,* 500 U. S. 160, 165 (1991); *United States* v. *Shreveport Grain & Elevator Co.,* 287 U. S. 77, 85 (1932); *J. W. Hampton, Jr., & Co.* v. *United States,* 276 U. S. 394, 407 (1928); *Field* v. *Clark,* 143 U. S. 649, 692 (1892). [NB: Supreme Court cases are so readily available on the Internet that no links are necessary.]

[2] *Whitman v. American Trucking Ass'ns*, 531 U.S. 457 (2001).

Nor is this a situation like *American Trucking*, in which the EPA resisted exercising the power it had been given. Here, Congress has created a confusing combination of delegation and silence, to the point where the agency has not been instructed on the policies Congress wishes it to follow, but neither has it been delegated the discretion to itself decide on the appropriate policies.

The problem here is not excessive delegation, but incoherent delegation, and the FRB should decline to drink from the poisoned cup.

BACKGROUND

The growth of EFT systems has exploded over the past few decades, apace with the computer and telecommunications revolutions.

The system is a marvel that has developed almost entirely by private contracts among thousands of participants, helped out of course by the confidence that the public has in the regulations that govern the banking industry that is at the core of these networks. It is exceedingly complex, involving millions of merchants and consumers, card issuers, merchant banks, and competing payment networks.

The FRB staff is familiar with its complexities, as demonstrated by its 2009 staff paper.[3] Others have also explored this complex industry – see, for example, Prof. Todd Zywicki's paper[4] and the connected Mercatus Center Conference,[5] and the 2009 GAO Report on credit cards.[6] The FRB has collected volumes of additional material – comments, meeting notes, learned studies – and made it available at its Regulatory Reform webpage.[7]

The background of the Durbin Amendment has been widely reported. It was added to an already-chaotic Dodd-Frank Financial Reform bill in Conference, without having been considered or voted on by either house of Congress, and without passing through Congress's normal filtering processes of committee assignment, hearings, and public dialogue, despite the fact that the interchange fee issue had been the subject of rancorous and inconclusive previous congressional consideration.[8]

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[3] R. Prager, M. Manuszak, E. Kiser & R. Borzekowski, *Interchange Fees and Payment Card Networks: Economics, Industry Developments, and Policy Issues* (FRB 2009-23) [http://www.federalreserve.gov/pubs/feds/2009/200923/200923pap.pdf].

[4] Todd Zywicki, *The Economics of Payment Card Interchange Fees and the Limits of Regulation*, International Center for Law & Economics White Paper (June 2, 2010) [http://mercatus.org/sites/default/files/zywicki_interchange.pdf].

[5] Mercatus Center, Payment Card Interchange Fees: Updates on the Economic Literature (Panel discussion video) (June 9, 2010) [http://mercatus.org/video/payment-card-interchange-fees-updates-economic-literature}.

[6] GAO, *Credit Cards: Rising Interchange Fees Have Increased Costs for Merchants, but Options for Reducing Fees Pose Challenges* (Nov. 2009) [http://www.gao.gov/new.items/d1045.pdf].

[7] http://www.federalreserve.gov/newsevents/reform_interchange.htm.

[8] See Prager *et. al*, p. 40, nn 83-85 for a list of prior considerations of the topic.

At that point, holding up the 2000+ page financial reform bill for the sake of re-examining a provision that was basically a sideshow to the ongoing financial crisis was not a realistic possibility.

Furthermore, the Durbin Amendment is wrapped in an aroma of sharp practice and special interest capture. The press reports attribute its passage to lobbying by large retailers, who, in the parlance of the inside-the-beltway tendency to treat legislation as a sport, are regarded as having put one over on the banks and debit card companies.

To mention such grubby realities is of course a violation of the code of *omerta* that prevails in Washington influence-peddling circles, but in the current atmosphere of financial and governmental stress, the point is too important to be ignored. Surely the FRB is allowed to know what every other person in the nation knows. "Jurors are not to be presumed ignorant of what everybody else knows, and they are allowed to act upon matters within their general knowledge without any testimony on those matters."[9]

The FRB is one of the most important institutions in the government, and the nation. Its long-standing reputation for independence, integrity, ability, and intellectual honesty are invaluable national assets. Its leadership has both the duty and the right to defend this reputation and prevent the Board from being co-opted by special interests, and to protect the institution for which they are responsible.

They can do this by insisting that the instructions they receive from Congress be intelligible and coherent.

SPECIFIC ISSUES

Provisions of the Durbin Amendment

The law focuses on two specific areas of the EFT ecosystem:

- Interchange fees charged by institutions that issue debit cards, with institutions having assets of under $10 billion exempted;

- The payment networks that process charges -- merchants are to be allowed to choose among multiple networks.

As the FRB's NPR recognizes, each of these topics raises a number of uncertainties and problems, and FRB requests comments from the public on these. The requests elide a crucial point, however, which is that most of these questions involve policy judgments, not information that can be supplied by the public; the record is already brimming with information of all kinds. Or they require predictions about the development of markets in the future, predictions which simply cannot be made.

[9] *Commonwealth v. Peckham*, 68 Mass. (2 Gray) 514, 515 (1854).

Thus, for many of these issues, the request for public comments serves no serious purpose. The real question is, "how did Congress intend the agency to respond to the problems?" and to this question the Congress, not the public or the FRB, must supply the answer.

Interchange Fees

The law requires the FRB to limit interchange fees to an amount "reasonable and proportional to the cost incurred by the issuer with respect to the transaction" which is defined as:

> (i) the incremental cost incurred by an issuer for . . . a particular electronic debit transaction, which cost shall be considered . . . ; and
> (ii) other costs incurred by an issuer which are not specific to a particular electronic debit transaction, which costs shall not be considered . . . .

As the NPR recognizes, the general term "considered" leaves unanswered important questions about the scope of the statute and the applicability of such concepts as marginal cost, variable cost, and capital cost.

The FRB interprets the bill as excluding the consideration of capital costs but allowing use of average variable cost. This illustrates the difficulty of interpreting congressional intent in this provision, from both directions. To adopt "average" as an interpretation of "a particular . . . transaction" may seem reasonable, but it certainly stretches the plain words of the law.

From the other direction, one should assume that Congress is aware of the rudimentary constitutional doctrine that rate regulation must allow fair rate of return on capital assets, which would allow the FRB to decide that costs of "a particular . . . transaction" include capital costs. The agency decided the other way, however, which means that it is attributing to Congress either appalling ignorance or deliberate anti-constitutional behavior.

Surely the best response from the FRB is to plead bafflement and demand clarification, instead of embracing either of these untenable positions.

The interchange fee provision contains other puzzling provisions and areas of incoherent delegation.

As the FRB notes, the distinction between four-party and three-party networks presents intractable difficulties.

The exemption of issuers with assets of under $10 billion will obviously have significant spillover effects on the networks as a whole, and on the structure of the financial services industry. But what will they be, and how, if at all, is the FRB to respond? Indeed, does the FRB have any authority to respond?

At congressional hearings on February 17, 2011, FRB officials opined that the exemption might well not work to the advantage of small banks, and, indeed, might well harm them. According to the press reports, the reaction was one of general congressional consternation. So what is congressional intent here – that the FRB implement the requirement even if it concludes that the result will be disastrous for the supposed beneficiaries? That the FRB prostitute its professional expertise and pretend to be surprised at a negative outcome? That it invent new authorities to make up for the deficiencies of the granted ones?

The FRB is also to ensure that network fees do not compensate issuers for electronic transactions or circumvent the price controls. The logical implication is that someone else in the system must subsidize the non-variable costs involved in these transactions, so who is this to be, and how is the FRB to compel them to do supply the subsidy, since few private actors will do so willingly?

The fraud exception is also incoherent. The importance of anti-fraud activity cannot be over-stated. It requires a complicated mixture of hardware and software, plus personnel and overhead charges, and a continuing interaction with malefactors.

Which of these costs are recoverable under this exception, and how is the institution supposed to do allocate costs of general purpose equipment and software that also has a fraud-prevention component? Who bears the loss if regulatory restrictions cause harm to card-holders?

The NPR contains two full columns of questions to the public concerning the anti-fraud provisions (75 *Federal Register* at 81742-43). This does not solve the basic problem, however. Many of these questions require answers to basic policy choices that were not made by Congress in the law. Nor were they clearly delegated to the FRB. The difficulties are not alleviated by asking the public to solve them in comments on the NPR.

Underlying all of these discrete issues is the fact that the Durbin Amendment is a price control statute, picking out one set of prices in a complex industrial ecosystem and capping them in a manner deliberately designed to prevent recapture of the costs of providing the service by forcing providers to ignore significant cost elements.

The law's drafters realized that, like all price controls laws, people would naturally try to avoid its impacts, so they added the no-evasion provision. Then someone must have mentioned the fraud issue, so they hastily cobbled another incoherent provision on top of the existing ones.

Price control is not a new idea, since various governments have been imposing price controls and punishing evaders for several thousand years.

From *Wikipedia*:[10]

> [Diocletion] issued his *Edict on Maximum Prices* in 301. The first two-thirds of the Edict doubled the value of the copper and bronze coins, and set the death penalty for profiteers and speculators, who were blamed for the inflation and who were compared to the barbarian tribes attacking the empire. Merchants were forbidden to take their goods elsewhere and charge a higher price, and transport costs could not be used as an excuse to raise prices.

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[10] http://en.wikipedia.org/wiki/Edict_on_Maximum_Prices

> The last third of the Edict, divided into 32 sections, imposed a price ceiling . . . for over a thousand products . . . . include[ing] various food items (beef, grain, wine, beer, sausages, etc), clothing (shoes, cloaks, etc), freight charges for sea travel, and weekly wages.

The entry goes on to recount the failure of and damage caused by Diocletian's initiative.

The FRB is the government's premier economic agency. If there is any proposition upon which professional economists would agree, one would think, it is the pernicious effect of price controls, and the reality that there is no way to avoid deleterious effects. If evasion is not possible, then withdrawal from the market is inevitable.

Yet one searches the NPR in vain for the term "price controls" or for any recognition that imposing them is a dubious exercise, or that it might set off dislocations that the FRB or the Congress might find unpleasant, or that if this price control law works without evil consequences then the entire FRB staff should demand a refund of the costs of their Ph.Ds.

Given the unanimity of professional opinion, it would seem wise for the FRB to go back to Congress and ask "are you sure?"

Multiple Networks

The NPR acknowledges many problems associated with the requirement that merchants be allowed to choose among multiple networks.

In particular, consumers are in for nasty surprises when they discover that brands no longer mean anything, and that the security and reliability that consumers assume are associated with a particular brand name do not exist because a merchant chose a different network more advantageous to itself.

They will also be surprised to learn of the adverse selection involved, in that the merchant has an incentive to opt for the network that charges the merchant the least, even if it achieves its low-cost status by skimping on fraud-prevention, or even, like P2P sites that traffic in pirated content, by going into cahoots with the fraudsters.[11]

Again, did Congress intend this result? Did it decide, after due consideration, that consumer deception and outrage are prices worth paying? It seems highly improbable that this was a deliberate decision. It also seems undesirable, from the standpoint of the Federal Reserve as an institution, that it accept responsibility for a decision which was not delegated to the FRB and over which it had no control. If this decision is to be made, the FRB, as a matter of institutional self-defense, should insist that Congress make its will known in unequivocal terms and make clear the locus of responsibility.

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[11] Thomas D. Sydnor, *et. al.*, *Filesharing Programs and "Technological Features to Induce Users to Share"*, Report to USPTO (Nov. 2006) [http://www.uspto.gov/web/offices/dcom/olia/copyright/oir_report_on_inadvertent_sharing_v1012.pdf].

Were a private actor to engage in such deception, implicitly promising one level of security and trust and then substituting another, the Federal Trade Commission would have a solid basis for enforcement action under its consumer protection authority.

Mobile Payment Systems

One of the most important topics in the world of Information/Communications/Technology (ICT) is the development of payments systems based on mobile telephones, especially Near Field Technology (NFT), which works via short-range wireless devices that can be swiped near a payment terminal.

The NPR says that mobile payment systems are covered by the Durbin Amendment, even though not explicitly mentioned in the law. (See 75 *Federal Register* at pp. 81729, 81733, 81751, 81758.)

It is unclear how coverage would work. Mobile payments could involve:

1) A mobile phone, another electronic device (*e.g.*, a radio, for music, or a Kindle, for books), or even a special fob;
2) Adding the payment to a phone bill or other kind of account;
2) Debiting a bank account, as chosen by the customer;
3) Debiting a separate account, as in PayPal or by numerous retailers at which the consumer establishes a credit balance;
4) Debiting a PayPal account which then debits a bank account or draws on credit card account

So who is the "issuer"? Which of these is a debit? Durbin seems to anticipate nothing except a card issued by a bank, not a multi-use cell phone. What authority does the FRB have to leverage Durbin into more general power over mobile payment systems? What about the multiple network requirement if, for example, an Amazon Kindle is the device used?

The NPR punts on these questions with such statements as:

> The Board understands that some institutions may wish to issue a card, or other payment code or device, that meets the proposed definition of ''debit card,'' but that may be capable of being processed using only a single authorization method. For example, **a key fob or mobile phone** embedded with a contactless chip may be able to be processed only as a signature debit transaction or only on certain networks. Under the proposed rule (under either alternative), the issuer would be required to add at least a second unaffiliated signature debit network to the device to comply with the requirements of § 235.7(a). The Board requests comment on whether this could inhibit the development of these devices in the future and what steps, if any, the Board should take to avoid any such impediments to innovation. (75 *Fed. Reg.* at 81751). [bf added]

Unfortunately, kicking the can to the public on how to avoid "impediments to innovation" (a euphemism for "hobbling the mobile phone world"), is bootless. *Of course*, imposing these regulatory requirements could inhibit innovation, and if the statute does indeed require this, then what is the public supposed to do about it?

For that matter, what is the FRB supposed to do about it? Is this really what Congress intended, because, if so, one would think it would have been worth mentioning in the law, or in some legislative history.

Again, the rational agency response is to put the issue back on Congress, asking for explicit guidance on whether that body intended this coverage of the mobile phone system, and further instruction on how the FRB should deal with the problems created, or at least on the basic framework of values within which the FRB should act, in applying the law to the mobile device space.

Small Sellers

The EFT industry is an example of a phenomenon in industrial organization that has been accentuated by the digital revolution – the platform industry. In this model, one company or group of companies supplies an essential element of a broader network -- the framework or platform for which large scale is necessary. The platform supplier then allows other, smaller participants to ride on it, providing ancillary goods and services that can be produced economically on a smaller scale.

Examples of platforms include:

- Operating systems (Linux; Windows; Android), which allow tens of thousands of apps writers to access millions of customers;
- Telecom carriers that provide platforms for mobile phone handset makers;
- Mobile phone handset makers that in turn provide platforms for apps writers;
- Content creators that rely on the Internet Service Providers;
- Small businesses that tap into cloud computing so that they can avoid hardware and maintenance expense and buy only the computing power needed at the moment.

The platform phenomenon is not totally new, since one can regard transportation networks such as railroads as an example, and even the financial system as a whole.[12] But the Information/Communication/Technology explosion has opened up new vistas of possibility and interaction.

From this perspective, EFTs are an important platform. They allow small merchants to tap into national and international markets and to deal safely and efficiently with customers about whom they know nothing. EFT systems eliminate check risk and credit risk. Since such costs bear

[12] See, *e.g*., James V. DeLong, "Avoiding a Tech Train Wreck," *The American* (May/June 2008) [http://american.com/archive/2008/may-june-magazine-contents/avoiding-a-tech-train-wreck].

disproportionately on small merchants, the existence of large-scale payment platforms allows the small merchants to tap into economies of scale.

This capability improves the ability of small sellers to compete against the giant retailers. A Wal-Mart or Home Depot can establish its own payment system because it can spread the costs over locations, customers, and transactions. Such giants are might well be better off in a world without comprehensive payment cards.

It is no secret that large retailers constitute the moving force behind the Durbin Amendment. This leads to a logical question is to whether the real intent here is to cripple the broad payment systems so as to deprive small competitors of their benefits.

After all, if a large retailer objects to the level of interchange fees, it has an easy answer: set up its own system or cut a deal with a single card issuer. CostCo has done this with American Express, and it accepts no other cards.

The multiple networks provision of the Durbin Amendment also seems likely to work for the benefit of large retailers and to the detriment of small ones. A large seller can police networks more effectively, or, again, set up its own. And again, it is in the interests of large retailers to hamstring the ability of their smaller brethren to tap into the economies of scale created by the payment platforms.

Among the other items of general knowledge of which the FRB can take notice is the fact that the large retail chains are ruthlessly efficient at squeezing out costs and at killing smaller competitors, and are exceedingly well-capitalized. If excess profits were available in the payment business, they would be entering and profiting from it rather than whining to Congress in an effort to cripple it.

So perhaps the real (and intended) effect of the Durbin Amendment will be to hamstring small retailers for the benefit of the large ones.

Perhaps raising this possibility that the Durbin Amendment is in fact an assault on small retailers as much as banks is overly conspiratorial, but on the other hand Andy Grove, CEO of Intel wrote a well-regarded book on why *Only the Paranoid Survive*, so the FRB could do with a bit of paranoia. It certainly should not propose a rule that makes no mention of this disturbing possibility.

CONCLUSION

One could continue through the NPR, picking out issues on which the FRB seeks, ostensibly, public help and guidance, but on which, in fact, the public cannot help the Board, except in the marginal sense of confirming that these are indeed difficult and unanswered problems and that the legislation is problematical in the extreme.

Column after column of the NPR lists the problems – three- and four-party payments networks, gift cards, reloadable pre-paid cards, costs and even the possibility of establishing multiple networks, effects on small financial institutions, effects on small sellers – the list of possible unintended consequences is stupefying. The list of answers – is less impressive.

The solutions and guidance must come from Congress, not from public comment. As stated at the outset of this comment, the basic legal tools of the doctrines of legitimate and illegitimate delegation may be rusty, but they have never been discarded, and the Durbin Amendment provides a fine example of why they remain necessary.

The logical course of action is for the FRB to ask Congress to clarify its desires on the numerous uncertainties created by the Durbin Amendment.

If the FRB proceeds to enact a final rule, whether a private party could argue incoherent delegation as a reason to invalidate the result is an interesting and novel question of administrative and constitutional law, and one that the agency should avoid.