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Promoting Competition Protecting Consumers

THE EXCHANGE

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In this Issue

The Durbin Amendment of the Dodd-Frank Wall Street Reform Act, which instructs the Federal Reserve Board to enact standards for assessing whether interchange fees are reasonable and proportional to transaction costs, has been a contentious issue between banks and merchants. Merchant trade associations are dissatisfied with the Federal Reserve Board's interchange fee regulations and have sued to invalidate them.

The European Commission's decision to block the proposed merger between NYSE Euronext and Deutsche Börse AG is only the fourth merger blocked by the EC over the past ten years. How far did the EC depart from other regulators by defining derivatives product markets based on the location of the underlying assets and whether the derivatives are traded on exchanges or over-the-counter?

Competition authorities from all around the world have espoused a range of legal theories in challenging Visa and Mastercard's restrictions on merchants. Canada's Commissioner of Competition sued the payment processing companies under an antitrust statute condemning downstream price maintenance.

EDITORS' NOTE

Henry B. McFarland & Joseph H. Tipograph

With this issue of *The Exchange*, we are introducing our new format. We hope that the new format will greatly improve the newsletter's appearance and readability. If you have any comments on the new format, please let us know.

As always, this issue covers a wide variety of developments affecting the insurance and financial services industries worldwide. We want to thank our authors for their excellent contributions. We also want to encourage all Committee members to contact us with ideas for articles for our next issue, which is scheduled to come out at the end of January next year.

CO-CHAIRS' REPORT

Renata Hesse & Elai Katz

Welcome to the second issue of our revamped and renamed newsletter. *The Exchange* is an integral part of our committee's continuing efforts to be at the forefront of timely news, information and analysis wherever antitrust and consumer protection issues intersect with the insurance and financial services industries. For example, since the last issue, we co-sponsored Spring Meeting panels on the Consumer Financial Protection Bureau, behavioral economics, most favored nations clauses, and compliance. We also co-sponsored a teleconference on the municipal bond investigations and co-hosted a consumer protection networking reception in Washington.

We would like to welcome our new leaders for the coming year. Our new Vice-Chairs are Kate McMillan and David Wales as well as Joseph Tipograph (who had served as our Young Lawyer Representative). We also want to welcome our new Young Lawyer Representative, Creighton Macy, and our new Responsible Council Member, Howard Morse. We are pleased that Scott Scheele and Henry McFarland will continue as Vice-Chairs. We thank Lisl Dunlop, who is moving to a different Section position, for her hard work and commitment as a Vice-Chair.

Finally, we encourage you to visit our Facebook and LinkedIn pages. You can become a "fan" and receive updates at: www.facebook.com/IFSComm and www.linkedin.com/groups?gid=3054445. Please visit our pages often to review listserv posts you may have missed, learn about Committee programs, and talk about issues that are interesting to you!

As always, we welcome your participation in the Committee, so please contact any of us if you would like to write an article or have thoughts on a potential program or ideas for how we can better serve you.

The Debit Card Interchange Fee Litigation

John F. Cooney and David D. Conway[1]

The pending litigation challenging the Federal Reserve Board ("Board") regulation that sets the maximum interchange fee will have important lessons for antitrust policy. The interchange fee is the price banks charge merchants for processing electronic debit card transactions. The Board issued the regulation pursuant to the Durbin Amendment of the Dodd-Frank Act. Several merchant trade association and retailers filed suit to invalidate the regulation. *NACS v. Board of Governors of the Federal Reserve System*, D.D.C., No. 11-2075.

The Durbin Amendment was designed to remedy Visa and MasterCard's perceived exercise of market power in establishing fees charged to merchants for debit transactions.[2] The Amendment required the Board to establish a maximum interchange fee that would be "reasonable and proportional" to certain costs incurred by the bank that issued the card. In recent decades, federal policy has moved away from having agencies establish prices for goods and services; the Durbin Amendment reverses that trend. The Board's experience in implementing the statute shows why the use of regulation to address competition issues has largely been abandoned. For several years prior to passage of the legislation, the Board's economists had studied interchange fees in an attempt to determine the most efficient price in the two-sided debit card market. When given a statutory mandate to establish a maximum price, the Board produced a regulation that cut interchange fees roughly in half and will transfer an estimated $4.5 billion per year from banks to merchants.[3] Yet the Board satisfied no one – including Senator Durbin.

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1 John F. Cooney is a partner in the Regulatory Litigation group and David D. Conway is an associate in the Antitrust group and Intellectual Property Litigation group of Venable LLP in Washington, D.C.

2 Brief of Senator Richard J. Durbin as *Amicus Curiae* in Support of Plaintiffs' Motion for Summary Judgment in *NACS v. Bd. of Governors of the Fed. Reserve Sys.*, No. 11-cv-2075 (D.D.C. filed May 9, 2012) ("Durbin Brief") at 3-4.

3 Memorandum in Support of Plaintiffs' Motion for Summary Judgment in *NACS v. Bd. of Governors of the Fed. Reserve Sys.* (D.D.C. Mar. 2, 2012) ("Plaintiffs' Brief") at 45.

A coalition of merchants filed suit in the U.S. District Court for the District of Columbia challenging the interchange fee and network exclusivity provisions of the Final Rule. The case has been fully briefed and is ripe for disposition. The decision will be a fascinating case study in how a federal trial court deals with complicated statutory language and with sophisticated economic arguments, grounded in competition principles, to determine whether a price fixed by a federal agency for an electronic transaction is reasonable and proportional to the regulated entity's costs.

I. **Debit Cards**

Debit cards have replaced checks as the most common form of non-cash payment in the United States, accounting for approximately 38 billion transactions worth more than $1.4 trillion annually.[4] When a merchant is presented with a debit card and seeks electronic authorization for the payment, the requisite funds are set aside in the consumer's deposit account at the bank that issued the card. To clear and settle the transaction, the merchant's bank (the "acquirer") routes the transaction data to the consumer's bank (the "issuer") over a payment card network, such as Visa or MasterCard, and the issuer transfers the funds to the acquirer for credit to the merchant. The payment card networks provide the infrastructure and routing software necessary to authorize, clear, and settle debit transactions between the two banks.

Debit transactions are divided into two categories, depending upon the method of authentication and payment. "PIN-based" transactions, which require the consumer to enter a personal identification number to initiate the processing request, evolved from ATM networks; the authorization of the transaction and the transfer of funds occur through a single message. "Signature-based" transactions, which are cleared through the networks used for processing credit card transactions, require the consumer to sign a receipt to initiate the transaction; the authorization and subsequent transfer of the funds occur through separate messages at different times. At present, the number of signature-based transactions significantly exceeds the number of PIN-based transactions.

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4 Brief *Amici Curiae* of the Clearing House Association *et al.* in Support of Neither Party in *NACS v. Bd. of Governors of the Fed. Reserve Sys.* (D.D.C. Apr. 3, 2012) ("Clearing House Brief") at 3 (citing Federal Reserve System, *2010 Federal Reserve Payments Study* at 16 (Dec. 8, 2010)).

Debit cards offer both consumers and merchants substantial advantages over checks. For consumers, debit cards provide a more convenient, secure, and widely-accepted method of payment than checks. For merchants, debit cards offer greater efficiency and faster payment, and facilitate additional sales at unattended locations like gas pumps and parking garages. As with credit cards, because the authorization message from the issuer guarantees payment for the transaction, debit cards also reduce security and financial risks for merchants, including credit losses for returned checks and fraudulent transactions.

To provide consumers and merchants with these conveniences and efficiencies, issuing banks and payment card networks have made enormous capital investments in debit card processing systems.[5] In addition to these fixed costs, issuers and networks also incur variable costs for each debit card transaction that is authorized and processed. To recover these costs, issuers and the payment card networks charge various fees that are assessed on each transaction. The largest of these charges is known as an "interchange fee," which the issuer charges the acquirer for its involvement in the transaction. Until passage of the Durbin Amendment, each payment card network established a uniform "interchange fee" schedule that determined the amount that each issuing bank received for authorizing a debit transaction. The payment card network also charges the acquiring bank a "network fee" for its role in processing the transaction. The acquirer typically passes these fees on to the merchant as part of its overall "merchant discount,"[6] the rate that a bank charges a merchant for providing debit card services.

Determination of the appropriate level for the interchange fee has long been a controversial issue and has triggered significant antitrust litigation over the years, due to the collective nature of the decision-making among the members of payment card networks.[7] The debit market is what economists characterize as a "two-sided market" – that is, a market for the provision of a service whose value

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5 See Clearing House Brief at 3.

6 See Federal Reserve Board, Final Rule, Debit Card Interchange Fees and Routing, 76 Fed. Reg. 43,394, 43,396 (July 20, 2011).

7 *See* Plaintiffs' Brief at 11; Brief *Amici Curiae* of 7-Eleven, Inc., *et al.* in Support of Plaintiffs' Motion for Summary Judgment and in Opposition to Defendant's Cross Motion ("Merchants' Brief") (D.D.C. May 14, 2012) at 3 n.4.

can be realized only if two distinct sets of participants simultaneously agree to its use. The debit card market requires the participation of both card holders, who must use the debit card to pay a merchant for products, and merchants, who must agree to accept the cards as a form of payment, and both groups benefit from the willingness of the other side of the market to participate. The costs of utilizing a debit card must be allocated between consumers, who are more price-sensitive, and merchants.[8] Despite extensive analysis of the data over the last decade, the Board's economists were unable to develop a conceptually satisfactory basis for dividing the costs between the two sides of the market in a manner that would optimize use of debit cards.[9]

> The costs of utilizing a debit card must be allocated between consumers, who are more price-sensitive, and merchants.

As use of debit cards has become more common, the interchange fees charged by the payment card networks have increased substantially. The National Association of Convenience Stores asserts that debit interchange fees grew for its members by as much as 8.1% annually between 2007 and 2010.[10] A survey conducted by the Board as part of its rulemaking concluded that in 2009, interchange fees averaged 44 cents, or 1.15 percent of the average debit card transaction of $38, amounting to a total of approximately $16.2 billion annually.[11] Merchant groups complained to Congress that this significant increase in a major operational expense demonstrated that the payment networks had market power over debit cards and could raise interchange fees without fear of losing business, because merchants had no choice but to accept debit cards from consumers who wished to use this form of

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8 Clearing House Brief at 4-5.

9 *See generally* Robin A. Prager *et al.*, Federal Reserve Board, *Interchange Fees and Payment Card Networks: Economics, Industry Developments, and Policy Issues* (2009), *available at* http://www.federalreserve.gov/Pubs/FEDS/2009/200923/200923pap.pdf.

10 *See* Plaintiffs' Brief at 10.

11 *See* Federal Reserve Board, Notice of Proposed Rulemaking, *Debit Card Interchange Fees and Routing*, 75 Fed. Reg. 81,722, 81,725 (Dec. 28, 2010).

payment. They asked Congress to remedy this exercise of market power by constraining the ability of the networks to raise interchange fees.[12]

The groups also complained that Visa and MasterCard had imposed network exclusivity provisions in their operating agreements, which prohibited merchants from processing debit transactions on other networks and thereby denied vendors the benefits of price competition. They requested that Congress bar the networks from imposing exclusivity provisions on merchants.[13]

II. The Durbin Amendment

In July 2010, Congress enacted the Dodd-Frank Act to address various risks to the financial system that had helped precipitate the credit bubble and the near meltdown of the country's financial markets in late 2008.[14] As part of that legislation, Congress adopted the Durbin Amendment of the Electronic Fund Transfer Act ("EFTA"), which regulated the interchange fee and network exclusivity provisions for debit card transactions.[15] The Durbin Amendment was incorporated in the Senate version of the Dodd-Frank Act one day after its introduction, and was included in the final version of the bill by the Conference Committee. The legislative history of the provision is limited to six Senate floor speeches by its principal sponsor, Senator Richard Durbin (D-IL).

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12 *See, e.g.,* 156 Cong. Rec. S3,698 (daily ed. May 13, 2010) (floor statement of Sen. Richard J. Durbin) ("I have received letters and comments from merchants and businesses across the State of Illinois supporting my amendment for interchange reform").

13 *See* Durbin Brief at 10 (citing Comment Letter of Senator Richard J. Durbin to Federal Reserve Board (Feb. 22, 2011) at 11) ("The intent behind this provision was to inhibit the continued consolidation of the dominant debit networks' market power and to ensure competition and choice in the debit network market").

14 *See* Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010).

15 Section 1075 of the Dodd-Frank Act, amending the EFTA (15 U.S.C. § 1693 *et seq.*) by adding a new Section 920, 15 U.S.C. § 1693o-2.

The Durbin Amendment prohibited an issuing bank from charging or receiving an interchange fee for an electronic debit transaction unless the charge is "reasonable and proportional to the cost incurred by the issuer with respect to the transaction."[16] Congress directed the Board to promulgate "standards for assessing whether the amount of any interchange fee" satisfies the "reasonable and proportional" requirement.[17] In issuing those standards, Congress instructed the Board to consider the "functional similarity" between debit card transactions and check transactions, which are cleared by the banking system without imposition of a fee; and to "distinguish between" two categories of costs:

> (i) the incremental cost incurred by an issuer in the authorization, clearance, or settlement of a particular electronic debit transaction, which cost shall be considered [by the Board]; and
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> (ii) other costs incurred by an issuer which are not specific to a particular electronic debit transaction, which costs shall not be considered [by the Board].[18]

The Durbin Amendment prohibited an issuing bank from charging or receiving an interchange fee for an electronic debit transaction unless the charge is "reasonable and proportional to the cost incurred by the issuer with respect to the transaction."

Congress further directed the Board to promulgate debit card fraud reduction standards and to allow issuers to recover a separate "fraud-related adjustment" to the interchange fee as an "allowance for costs incurred by the issuer in preventing fraud" consistent with those measures.[19] It also instructed the Board to prevent payment card networks from using their network fees to circumvent the debit interchange regulations by, for example, compensating issuers for lost interchange revenue with increased network fee revenues.[20]

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16 15 U.S.C. § 1693o-2(a)(2).

17 15 U.S.C. § 1693o-2(a)(3)(A).

18 15 U.S.C. § 1693o-2(a)(4)(A)-(B).

19 15 U.S.C. § 1693o-2(a)(5).

20 15 U.S.C. § 1693o-2(a)(8)(B)(i)-(ii).

With respect to network exclusivity, the Durbin Amendment directed the Board to adopt regulations forbidding issuers and networks from (1) "restricting the number of payment card networks on which an electronic debit transaction may be processed" to either one network or multiple affiliated networks; and (2) preventing merchants from routing transactions over any debit card network that is enabled on a debit card.[21]

III. The Federal Reserve Rulemaking

After the Durbin Amendment was enacted, the Board initiated a consultation process with payment card networks, banks, and consumer groups. The Board also undertook an extensive process of data gathering and analysis to determine the costs and revenues that financial institutions had recognized in the debit card market. On December 28, 2010, the Board published a Notice of Proposed Rulemaking (NPRM) to implement the Durbin Amendment.[22]

A. Interchange Fee

The Board proposed that the interchange fee should be based solely on "those costs that are specifically mentioned for consideration in the statute," namely, the incremental costs related to the "authorization, clearing, and settlement ["ACS"] of a transaction."[23] Among the costs the Board specifically would have excluded from consideration in calculating the maximum permissible interchange fee were network fees and a recovery for actual fraud losses (as opposed to the cost of adoption of fraud protection technology).[24] Based on these criteria, the Board proposed two alternative interchange fee standards, both of which would have capped debit interchange fees at a maximum of 12 cents per transaction, a substantial reduction from the average interchange fee in 2009 of 44 cents per transaction.[25] The Board specifically invited comments on the types of costs that it should consider as the basis for establishing the interchange fee and what level of interchange fee would be reasonable and proportional to those costs.

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21 15 U.S.C. § 1693o-2(b)(1)(A)-(B).

22 *See* Notice of Proposed Rulemaking, 75 Fed. Reg. at 81,725.

23 *Id.* at 81,734-35.

24 *Id.* at 81,760.

25 *Id.* at 81,736-38.

The Board received over 11,000 comments on the NPRM, including extensive submissions from the payment card networks, major financial institutions, the principal financial trade associations, and representatives of consumer and merchant interests. The comments from financial institutions included extensive discussions of the costs incurred in operating debit card processing networks, backed by legal analyses from leading law firms and policy analyses from some of the country's leading economists. Merchant representatives submitted comments arguing that the Board's proposal considered impermissible costs and that a reasonable interchange fee should be substantially lower than the Board's proposal. Senator Durbin also submitted detailed comments that set forth his views about the intended operation of the statute.

The Board concluded that the terms of the Durbin Amendment, requiring it to limit the interchange fee to a level that was "reasonable and proportional to the costs incurred by the issuer with respect to the transaction," were ambiguous in significant respects. . .

On July 20, 2011, the Board issued a Final Rule that modified its proposed approach to the interchange fee by expanding significantly the types of costs that it would include within the baseline on which the calculation of a "reasonable and proportional" fee would be based.[26] The expansion in the costs deemed eligible for consideration resulted in a decision that the maximum interchange fee should be increased from 12 cents to 21 cents per transaction, plus an *ad valorem* adjustment to permit issuers to recover a portion of their actual fraud losses.[27]

The Board concluded that the terms of the Durbin Amendment, requiring it to limit the interchange fee to a level that was "reasonable and proportional to the costs incurred by the issuer with respect to the transaction," were ambiguous in significant respects, especially concerning the "costs" that it may consider, and thus gave it substantial discretion in construing and implementing the law. The Board found that while the Durbin Amendment directed it to consider costs that were incremental to the costs of authorizing, clearing, and settling transactions,

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26 *See* Final Rule, 76 Fed. Reg. 43,404.

27 76 Fed. Reg. at 43,422, 43, 394.

the statute did not limit the universe of permissible costs to those listed. Rather, it concluded that the statute only excluded from consideration costs "not specific to a particular electronic debit transaction," which the Board interpreted as consisting of costs like those from reward programs, customer service, corporate overhead, and card production.[28] The Board included within the baseline categories of costs those "that are specific to a particular electronic debit transaction but that are not incremental costs related to the issuer's role in authorization, clearance, and settlement," such as network fees, actual fraud losses, and transaction monitoring costs.[29]

Further, it found that the statute did not attempt to differentiate between "fixed" and "marginal" costs, but required only that eligible costs must be "specific" to an electronic debit transaction, and thus permitted it to consider the average variable costs of a transaction. The Board also issued an interim final rule (subject to revision in an ongoing rulemaking) that authorizes a further one cent adjustment to the interchange fee for those issuers that comply with measures it established to reduce debit card fraud.[30]

B. Network Exclusivity

The NPRM also proposed two possible options for implementation of the network exclusivity provision. One alternative would have required issuers to make available only two unaffiliated networks for each debit card, regardless of the transaction type (PIN-debit or signature-debit) involved.[31] An issuer could comply with this requirement by enabling one network for PIN-based transactions and another for signature-based transactions. The second alternative would have required that two unaffiliated networks be made available for each transaction type.[32] Thus, if an issuer chose to enable both PIN-based and signature-based processing on a debit card, it would have to make two PIN- and two signature-based processing networks available. In the Final Rule, the Board adopted the narrower proposed alternative, under which issuers and networks would only be

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28 76 Fed. Reg. at 43,427-29.

29 76 Fed. Reg. at 43,429-31.

30 12 C.F.R. § 254.4(a).

31 *Id.* at 81,749.

32 *Id.* at 81,749-50.

required to make two unaffiliated processing networks available for each debit card.[33] The Board concluded that this approach would "minimize the compliance burden on institutions, particularly small issuers" and "present less logistical burden on the payment system overall."[34]

IV. Litigation Challenging the Durbin Amendment Rule

Several merchant trade associations and retailers filed suit to invalidate the interchange fee standard (12 C.F.R. § 235.3) and network exclusivity (12 C.F.R. § 235.7) provisions of the Final Rule under the Administrative Procedure Act ("APA").[35] Despite their disagreements with the Board's interpretation of the statute and its determination of the maximum interchange fee, issuing banks and payment card networks have not challenged the regulation.

Under the APA, challenges to an agency's interpretation of a statute are resolved under the *Chevron* doctrine,[36] which has two parts. In Step One, the court inquires whether Congress has spoken directly to the precise question at issue; if it has, the reviewing court applies the literal language of the law. If Congress has not explicitly resolved the precise question at issue and the statutory language is silent or ambiguous, then the court proceeds to Step Two, under which it is required to defer to any reasonable agency interpretation of the statute that is incorporated into a regulation. The agency enjoys a substantially greater probability of success when the deferential standard of *Chevron* Step Two is applied.

Plaintiffs' principal argument was that the challenged provisions should be overturned under *Chevron* Step One as inconsistent with the express language of the statute. Plaintiffs thus have assumed the difficult burden of showing that the terms of the statute explicitly resolve the questions at issue and that the Board decided them in a manner that is expressly prohibited by the literal language of the law. Plaintiffs also argued that even assuming the case is decided under *Chevron* Step Two, the maximum interchange fee established by the agency is unreasonable based on the facts in the administrative record.

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33 12 C.F.R. § 235.7(a)(1).

34 76 Fed. Reg. at 43,447-48.

35 *NACS v. Bd. of Governors of the Fed. Reserve Sys.*, 1:11-cv-02075-RJL (Nov. 22, 2011).

36 *Chevron U.S.A., Inc. v. Natural Resources Defense Council, Inc.*, 467 U.S. 837 (1984).

The Board defended on the ground that the language of the statute is ambiguous and that its interpretation of the law should be reviewed and sustained under the deferential standard of *Chevron* Step Two. Other interested entities submitted several *Amicus* briefs that address the legal issues in the case, but also spell out their continuing policy objections to the Board's decision, in the event Congress later considers revising the Durbin Amendment. The case is ripe for resolution on cross-motions for summary judgment.

A. Interchange Fee Standard

The Final Rule established a maximum price nearly 50 percent lower than the prior average interchange fee and transferred an estimated $4.5 billion dollars annually from banks to merchants.[37] Nonetheless, Plaintiffs argued that the interchange fee standard is unlawful under *Chevron* Step One because the Board "failed to give effect to Congress's unambiguously expressed intent" when it set the fee in a manner that "allows issuing banks to recover costs beyond those explicitly delineated by Congress."[38]

Plaintiffs also contended that even if the Board's interchange fee standard could survive review under *Chevron* Step One, it nonetheless fails under *Chevron* Step Two because the standard is arbitrary and capricious, and inconsistent with the purpose of the Durbin Amendment. They claimed that the Board's interpretation is unreasonable because it impermissibly construes "those costs that are 'specific' to a 'particular electronic debit transaction' to mean *general costs* common to *all* debit card transactions."[39] Plaintiffs also argue that the "basic purpose of the Durbin Amendment" was to shift interchange costs from merchants to issuers, making it unlikely that Congress, by its silence, intended to grant the Board discretion to shift a large percentage of those costs back onto merchants.[40]

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37 Plaintiffs' Brief at 45.

38 Plaintiffs' Brief at 23.

39 *Id.* at 43.

40 *Id.* at 45.

The Board defended the Rule on the ground that the language of the interchange fee provision is ambiguous and that its interpretation must be reviewed under the highly deferential standard of *Chevron* Step Two. The Board argued that the statute instructed it only to establish an interchange fee that is "reasonable and proportional to cost," without defining those terms or mandating the universe of costs the Board may lawfully consider. It reasoned that among the many different categories of costs involved in electronic debit transactions, the text of the statute addresses only two subsets of costs -- one category the Board must consider (incremental ACS costs specific to a transaction), and another category the Board may not consider (costs not specific to a debit transaction). All other costs, the Board argued, fall into a third category about which the statute is silent. Therefore the Board has substantial discretion to consider these costs in determining what constitutes a "reasonable and proportional" interchange fee.[41]

> The Board argued that the statute instructed it only to establish an interchange fee that is "reasonable and proportional to cost," without defining those terms or mandating the universe of costs the Board may lawfully consider.

The Board claimed that under these circumstances, "[t]he fact that the statute is silent in this respect creates an ambiguity that is within the Board's discretion to resolve" under *Chevron* Step Two, and since the language of the Durbin Amendment does not expressly foreclose its interpretation, the interchange fee provision should be sustained.[42] In reaching this conclusion, the Board expressly argued that Senator Durbin's contrary arguments based on his floor statements must bow to "the actual language of the statute[,] which is ambiguous."[43] Finally, with respect to Plaintiffs' reasonableness challenge, the Board argued that determination of the proper interchange fee standard "is ultimately a line drawing exercise in which the Board faithfully executed and

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41 Defendant's Combined Memorandum of Points and Authorities in Support of its Motion for Summary Judgment and in Opposition to Plaintiffs' Motion for Summary Judgment in *NACS v. Bd. of Governors of the Fed. Reserve Sys.* (D.D.C. Apr. 13, 2012) ("Federal Reserve Brief") at 17-18.

42 *Id.* at 18.

43 *Id.* at 20.

ultimately achieved the goals set forth by Congress."[44] It submitted that based on the extensive administrative record it compiled, the interchange fee it established was "reasonable and proportional" to permissible costs and reduced by approximately 50 percent the average interchange fee charged prior to passage of the Durbin Amendment.

B. Network Exclusivity Provision

Plaintiffs argued that under *Chevron* Step One, the network exclusivity provision explicitly requires the Board to provide that two non-affiliated networks must be provided for each type of processing mechanism that is enabled on a debit card. They claimed that, in formulating the Final Rule, the Board incorrectly focused on the number of networks "on which each debit *card* is enabled" rather than on the number of networks "on which an electronic *transaction* may be processed."[45] Plaintiffs asserted that the Durbin Amendment expressly requires the latter interpretation and that the Board's contrary interpretation guarantees that "large numbers of electronic debit transactions," such as hotel, rent-a-car or "card not present" transactions, will not have two or more routing options.[46] Plaintiffs also submitted that if *Chevron* Step Two does apply, the network exclusivity provision nonetheless fails because the Final Rule fails to implement Congress's clear intent, as expressed in Senator Durbin's floor statements, to increase competition by allowing all debit transactions to be processed over at least two independent networks.

The Board defended its network exclusivity rule by arguing that the express language of the Durbin Amendment imposes no affirmative duty upon it to require multiple routing options for every debit transaction, regardless of transaction type. To the contrary, the statute only imposed a <u>negative</u> prohibition that forbids issuers and networks from restricting routing to one network or to multiple affiliated-networks.[47] The Board thus claimed that it satisfied the requirements of the law by making two unaffiliated networks available on each debit card, even if a small

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44 *Id.* at 33.

45 Plaintiffs' Brief at 48.

46 *Id.*

47 Federal Reserve Brief at 50.

percentage of transactions could only use one network under certain circumstances that result from the merchant's own choice or decisions by consumers.

C. Objections of the *Amici* to the Rule

Three *amicus* briefs were submitted, one by Senator Durbin, a second by a group of merchants, and a third by a coalition consisting of every major financial trade association that represents issuers. Each brief expressed strong policy objections to the implementing rule.

Senator Durbin argued that the Proposed Rule would have properly implemented the law but that due to influence exerted by the financial industry, the Board unlawfully "deviated from the plain text and intent of the statute" in an ill-advised effort to accommodate issuing banks.[48] He asserted that by considering other costs not explicitly mentioned in the text of the statute, the Board had "attempt[ed] to claim regulatory authority that Congress did not give."[49] Senator Durbin also argued that his floor statements constituted a definitive statement of Congressional intent and that the Final Rule violated the law because it did not adhere to his positions. In its reply, the Board directly challenged Senator Durbin's position, arguing the text of the statute as enacted does not say what the Senator claimed; that the language of the actual statute is so ambiguous that the Board has substantial discretion in implementing its provisions; and that the post-enactment legislative history submitted by the Senator was not a legitimate tool of statutory construction.[50]

Senator Durbin argued that the Proposed Rule would have properly implemented the law but that due to influence exerted by the financial industry, the Board unlawfully "deviated from the plain text and intent of the statute."

The merchants who filed an *amicus* brief, a group of restaurant and convenience store chains whose outlets accept large numbers of small-ticket debit transactions ($15 or less), challenged the reasonableness of the Final Rule. They argued that, rather than restraining further exercises of market power by the pay-

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48 Durbin Brief at 11.

49 *Id.* at 14.

50 *See* Federal Reserve Brief at 10-12; 30-32 n.13.

ment card networks as Congress intended, the Rule actually empowered the networks to "drastically raise debit card interchange fees for small-ticket transactions."[51] Pointing to evidence in the administrative record, the merchants contended that debit transactions below $12 would incur a substantially higher interchange fee under the Rule than previously. Before the Board capped interchange fees at approximately 24 cents per transaction, Visa and MasterCard had used a sliding scale to assess fees for small-ticket transactions (*i.e.*, 1.55% of price + 4 cents), so that a debit transaction below $12 would incur a lower interchange fee than permitted by the Rule.[52] The merchants noted that within two months of adoption of the Final Rule, these two networks had abandoned this sliding scale and had begun imposing the maximum regulatory interchange fee on all debit transactions.[53] The switch to this flat rate meant that the effects of the increased interchange fee were greater as the size of the transaction decreased (*e.g.*, a 15% fee increase for a $10 transaction, but a 211% fee increase for a $2 transaction). The merchants therefore claimed that the interchange fee provision should be invalidated under either prong of the *Chevron* analysis because it "effectively endorse[s] a price increase . . . on the fastest-growing segment of debit transactions."[54]

In its reply, the Board argued that the Durbin Amendment requires it to set fees in proportion to the issuers' costs and does not mandate lower interchange fees for small-ticket transactions or use of a sliding-scale for fees.[55] The Board also argued that the networks' abandonment of the sliding-scale approach in favor of charging an identical interchange fee for all debit transactions was not required by the Rule, but constituted their independent business decisions.

The brief submitted by the Clearing House Association and leading trade associations representing issuing banks supported neither party. Its principal ar-

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51 Senator Durbin concurred, arguing that "[b]y setting a high fee cap that far exceeds the customary fees levied on small ticket transactions, the Fed has given its regulatory blessing to the setting of interchange rates by Visa and MasterCard that are over three times larger than rates previously charged on small dollar transactions." Durbin Brief at 23.

52 Merchants' Brief at 14.

53 *Id.* at 19.

54 *Id.* at 23.

55 Federal Reserve Brief at 33.

gument was that the interchange fee standard in the Final Rule, while a marked improvement upon the approach in the Proposed Rule, nonetheless violated the statute by not allowing issuers to recover all eligible costs they incurred in debit transactions, plus a reasonable rate of return. The banks also argued that Plaintiffs' position, if accepted, would "exacerbate the Board's error" by excluding more eligible costs and imposing even greater below-cost caps on interchange fees.[56] Either approach, the banks submitted, would inflict "substantial harm on financial institutions and consumers, with no tangible offsetting economic benefit to the public," while allowing merchants to realize a multi-billion dollar windfall.[57] With respect to network exclusivity, the banks followed the same approach of preserving their legal and policy objections to the Board's decision, while attacking the Plaintiffs' position as producing an even worse outcome. They submitted that the Durbin Amendment imposes no affirmative obligation of any kind on issuers to enable any additional payment networks, much less the two networks for each type of debit transaction that the Plaintiffs sought.

V. Conclusion

The Durbin Amendment rulemaking serves as a reminder of the difficulty government agencies face when called upon to establish prices and why Congress has largely abandoned agency price setting as a mechanism for addressing concerns regarding alleged abuses of market power. The Board's economists worked for years to understand the debit card market, and it conducted extensive data collection and analysis before establishing a maximum interchange fee. Nonetheless, its work satisfied none of the competing interests but served only to change the focal point of their continuing policy dispute about how billions of dollars annually should be allocated between banks and merchants in this two-sided market. It will be interesting to see how the District Court assesses and resolves these issues, armed only with the normal tools of statutory construction and record review under the APA.

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56 Clearing House Brief at 14.

57 *Id.* at 27.

ABA SECTION OF ANTITRUST LAW

THE EXCHANGE

INSURANCE AND FINANCIAL SERVICES DEVELOPMENTS

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European Union Blocks Merger of NYSE Euronext and Deutsche Börse AG

Bryan Gant and S. Lynn Diamond[1]

The European Commission's February 2012 decision barring the proposed merger between NYSE Euronext and Deutsche Börse AG raises difficult questions regarding the approach the Commission will take towards mergers in the derivatives markets and the exchange industry generally. Specifically, the Commission appears to define derivatives product markets more narrowly than other regulators by distinguishing between derivatives based on the location of the underlying assets and whether the derivatives are traded on exchanges or over-the-counter.

The parties sharply disagreed with the decision, with Deutsche Börse calling it "a black day for Europe and for its future competitiveness on global financial markets"[2] and NYSE Euronext saying that the decision was "based on a fundamentally different understanding of the derivatives market."[3] The transaction could no longer be pursued as a result of the Commission's decision,[4] but Deutsche Börse continues to appeal, stating that it believes the "decision does not

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1 Bryan Gant and S. Lynn Diamond are associates in White and Case's New York office. They would like to thank Jack E. Pace III for his wise counsel and guidance and Joshua Levy for research support. The views expressed herein are those of the authors alone, and not necessarily those of the firm or its clients.

2 Press Release, Deutsche Börse AG, European Commission blocks merger between Deutsche Börse and NYSE Euronext (Feb. 1, 2012), available at: http://deutsche-boerse.com/dbg/dispatch/en/notescontent/dbg_nav/press/10_Latest_Press_Releases/20_Deutsche_Boerse/INTEGRATE/mr_pressreleases?notesDoc=740C4FC2A99C2D27C12579970037E9C4&newstitle=europeancommissionblocksmerger&location=press. ("DB Press Release.")

3 Press Release, NYSE Euronext, NYSE Euronext Statement on EU Decision to Prohibit Merger Announces Resumption of $550 Million Stock Repurchase Program Following Termination of Merger Statement (Feb. 1, 2012), available at: http://www.nyse.com/press/1328005620708.html. ("NYSE Euronext Press Release.")

4 *See* Ad-hoc Announcement, Deutsche Börse AG, Deutsche Börse AG: European Commission prohibits proposed business combination between Deutsche Börse and NYSE Euronext (Feb. 1, 2012), available at: http://deutsche-boerse.com/dbg/dispatch/en/listcontent/dbg_nav/investor_relations/60_News/20_Ad_hoc_Announcements/Content_Files/10_adhoc/db_adhoc_120202.htm.

do justice to the realities of global competition in derivatives trading."[5] Although as of the time of this writing the Commission had not yet publicly disclosed its report supporting the decision to block the merger,[6] there is reason to question whether that decision appropriately took account of prior merger review decisions and the structure of the industry; indeed, according to press reports, the decision may even have been controversial within the Commission itself.[7]

This article briefly reviews the history of exchange mergers, taking particular account of prior regulatory decisions affecting derivatives or similar markets, analyzes the Deutsche Börse / NYSE Euronext merger review in light of that history, and highlights lessons learned for future exchange mergers. This analysis may provide guidance as to whether the Commission's Deutsche Börse / NYSE Euronext merger review represents the end of market consolidation in the industry or a mere bump in the road for continuing globalization.

I. **Market Consolidation Prior to Deutsche Börse / NYSE Euronext**

Although there have been many mergers or acquisitions in the exchange in-

5 *See* Annual Report 2011, Deutsche Börse AG, at 4-5, available at: http://deutsche-boerse.com/dbg/dispatch/en/binary/gdb_content_pool/imported_files/public_files/10_downloads/12_db_annual_reports/2011/10_complete_version/Annual_Report_2011.pdf ("It focuses solely on the European market and refuses to recognize that the environment for exchanges has not only changed but will continue to do so, particularly in Asia. Furthermore, the European Commission's perspective completely excludes off-exchange (over-the-counter, OTC) derivatives trading, even though, by far, this accounts for the largest proportion of trading. As a result, we consider the decision to be a mistake.").

6 Although the Commission has not published its report on the decision, it has published an extensive press release and list of frequently asked questions from which at least some insight can be drawn.

7 *See* Dafydd Nelson, *Block Tactics*, MLEX Magazine, 24 (Eur. Ed. Apr.-June 2012).

dustry over the last ten years,[8] four review decisions in particular may provide useful context for the Deutsche Börse / NYSE Euronext decision.

Euronext's Acquisition of Liffe

In 2001, Euronext and Liffe announced their intention to merge, combining what were then the second and third largest derivatives exchanges in Europe.[9] After a review, the U.K. Office of Fair Trading ("OFT") approved the transaction, de-

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8 These have included NYSE's merger with Euronext, the London Stock Exchange's merger with Borsa Italiana, NASDAQ's purchase of the Philadelphia and Boston Stock Exchanges, the Chicago Mercantile Exchange's (CME) purchase of the New York Mercantile Exchange (NYMEX), NASDAQ's acquisition of OMX, NYSE Euronext's acquisition of the American Stock Exchange, the LSE's acquisition of Turquoise, CBOE Stock Exchange's acquisition of National Stock Exchange, and the merger of Moscow Interbank Currency Exchange (MICEX) and Russian Trading System (RTS), among others. *See* Press Release, NYSE Euronext, Shares of NYSE Euronext begin trading (Apr. 4, 2007); Press Release, London Stock Exchange, Borsa Italiana and London Stock Exchange Group to merge (Jun. 23, 2007); Press Release, NASDAQ OMX, NASDAQ to Acquire Boston Stock Exchange and Key Exchange Assets (Oct. 2, 2007); Press Release, NASDAQ OMX, NASDAQ to Acquire Philadelphia Stock Exchange (Nov. 7, 2007); Press Release, CME Group, CME Group Inc. to Acquire NYMEX Holdings, Inc. on Terms Previously Announced (Mar. 17, 2008); About NASDAQ OMX, http://www.nasdaqomxnordic.com/about_us?languageId=1 (last visited May 25, 2012); Press Release, NYSE Euronext, NYSE Euronext Completes Acquisition of American Stock Exchange (Oct. 1, 2008); Press Release, London Stock Exchange, London Stock Exchange Group and global investment banks to partner in pan-European trading venture (Dec. 21, 2009); Press Release, CBOE Stock Exchange, CBOE Stock Exchange to Acquire National Stock Exchange (Sept. 29, 2011); Press Release, MICEX, MICEX and RTS shareholders sign an agreement of intent (Feb. 3, 2011). Since the Commission's decision, there have three additional mergers announced or cleared by regulators. The Hong Kong Exchange has recently announced an agreement to buy the London Metal Exchange for $2.16 billion. *See Hong Kong Exchange to Buy London Metal Exchange for $2.1 Billion*, New York Times, June 15, 2012, available at http://dealbook.nytimes.com/2012/06/15/hong-kong-exchange-to-buy-london-metal-exchange-for-2-1-billion. The Japan Fair Trade Commission approved, with remedies, the combination of Japan's two largest stock exchanges, the Tokyo Stock Exchange Group and the Osaka Securities Exchange. *See Japan approves stock exchange combination*, July 6, 2012, available at http://www.globalcompetitionreview.com/news/article/32063/japan-approves-stock-exchange-combination. And the Maple Group Acquisition Corporation's bid to purchase the TMX Group, operator of the Toronto Stock Exchange, was approved by Canada's Competition Bureau and the Ontario Securities Commission. *See Toronto Exchange Deal Gets Crucial Regulatory Approval*, July 4, 2012, available at http://www.nytimes.com/2012/07/05/business/global/toronto-exchange-deal-closer-to-completion.html.

9 Office of Fair Trading, *Proposed acquisition by Euronext NV of LIFFE Holdings plc*, 13 December 2001, available at http://www.oft.gov.uk/OFTwork/mergers/mergers_fta/mergers_fta_advice/euronext_nv ("OFT Report on Euronext / Liffe").

termining that the merger would not raise significant competitive concerns because the parties did not offer overlapping types of derivatives and, therefore, were not in direct competition.[10] The OFT further found that the pricing of exchange-traded derivatives ("ETDs") were constrained by competition from derivatives traded over the counter ("OTC"), *i.e.*, from banks or other private parties outside of an exchange, further reducing the risk of harm to competition. Finally, the OFT found the combination of Euronext and Liffe would improve competition against the much larger Eurex trading platform.

<u>Deutsche Börse's and Euronext's Proposed Acquisitions of the LSE</u>

In late 2004, Deutsche Börse offered to purchase the London Stock Exchange ("LSE"); Euronext followed with a similar, competing offer one week later. On March 29, 2005, however, the OFT determined that both proposed acquisitions significantly risked lessening competition, and referred them to the U.K. Competition Commission.[11] The U.K. Commission blocked the acquisitions in November 2005, citing concerns regarding loss of competition in the listing services market, among others.[12]

As part of their reviews, the OFT and the U.K. Commission addressed three markets that may be relevant to the Deutsch Börse/NYSE Euronext merger: "on-book equities trading services," derivatives trading services, and clearing services.

<u>On-Book Equities</u>: The U.K. Commission held that the acquisitions would not substantially affect competition in the market for what it called "on-book equities trading services," the market for services associated with exchange trading of

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10 See id.

11 *See* Office of Fair Trading, *Anticipated acquisition by Deutsche Börse AG of the London Stock Exchange plc*, Mar. 29, 2005, available at: http://www.oft.gov.uk/shared_oft/mergers_ea02/2005/deutsche.pdf ("OFT Report on Deutsche Börse / LSE"); Office of Fair Trading, *Anticipated acquisition by Euronext N.V. of the London Stock Exchange plc*, Mar. 29, 2005, available at: http://www.oft.gov.uk/shared_oft/mergers_ea02/2005/euronext.pdf. ("OFT Report on Euronext / LSE").

12 Competition Commission, *A report on the proposed acquisition of London Stock Exchange plc by Deutsche Börse AG or Euronext NV*, November 2005, available at: http://www.competition-commission.org.uk/assets/competitioncommission/docs/pdf/non-inquiry/rep_pub/reports/2005/fulltext/504.pdf. ("Competition Commission Report on LSE").

equities.[13] There are two notable aspects to this decision. First, the U.K. Commission defined the market to include potential entrants from both Europe and the United States,[14] noting several local and foreign entrants in recent years,[15] including some that had entered in response to customer demand.[16] Second, the U.K. Commission held that "off-book" trading (*i.e.*, equities trading conducted privately, off-exchange[17]) was not a part of the relevant market for on-book equities trading services, as customers would not switch between on-exchange and off-exchange methods of trading in response to increased trading fees.[18] The U.K. Commission did note, however, that the availability of off-book trading provides some competitive constraint on exchange trading, if to a "lesser degree" than competition from other exchanges.[19]

Derivatives: The obvious analogue to off-book trading in the equities market is OTC trading in the derivatives market. The U.K. Commission did not ultimately reach the issue of whether OTC derivatives would compete in the same relevant market as ETDs,[20] but the OFT had earlier found that "OTC trading appears to be the most common method of derivatives trading and exercises an important constraint on exchange operators," suggesting that those products might compete in

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13 Although equities trading markets were not at issue in the Deutsche Börse / NYSE Euronext merger, they may provide a useful analogue.

14 Competition Commission Report on LSE, *supra*, at ¶¶ 4.59.

15 Competition Commission Report on LSE, *supra*, at ¶¶ 4.56-59. For a complete discussion of competition for equities trading, *see id.* at ¶¶ 5.35-86.

16 See id.; see also Competition Commission, A report on the proposed acquisition of London Stock Exchange plc by Deutsche Börse AG or Euronext NV, Appendix H: History of entry and expansion in Europe from 1995, November 2005, available at: http://www.competition-commission.org.uk/assets/competitioncommission/docs/pdf/non-inquiry/rep_pub/reports/2005/fulltext/504ah.pdf.

17 Off-book trading makes up somewhere around two-thirds of all equities trading. *See* Competition Commission Report on LSE at ¶ 4.38.

18 *See* Competition Commission Report on LSE, *supra*, at ¶¶ 4.29-55.

19 *See id.* at ¶ 5.132.

20 The Commission did, however, note that similar concerns would likely have been raised in any analysis of the OTC market for derivatives. *See* Competition Commission Report on LSE, *supra*, at ¶ 4.61.

the same market.[21]

Clearing: Finally, the U.K. Commission found that, although the proposed acquisitions would not result in increased prices for clearing services,[22] the vertical integration of such services into an exchange could allow an exchange to refuse to fairly clear or settle trades conducted on competing exchanges, damaging competition in the trading markets.[23] Because of these concerns, among others, the U.K. Commission blocked the proposed acquisitions.

NASDAQ's Proposed Acquisition of the LSE

Euronext and Deutsche Börse were not the last to try to purchase the LSE, however. In late 2006 NASDAQ announced a hostile public offer for the exchange, and on January 18, 2007 the OFT issued a decision approving the acquisition.[24] The OFT noted the ease with which competitors could enter the market for equities trading services, finding several potential entrants within Europe and internationally and that the LSE's customers had themselves joined together to create a competing trading service.[25] NASDAQ later abandoned the acquisition after it was unable to acquire a sufficient number of shares.[26]

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21 OFT Report on Euronext / LSE, *supra*, at ¶ 86.

22 *Id.* at ¶¶ 5.159, 5.166.

23 *See id.* at ¶¶ 5.136-57.

24 Office of Fair Trading, *Anticipated Acquisition by Nasdaq Stock Market, Inc. of the London Stock Exchange plc*, January 18, 2007, available at: http://www.oft.gov.uk/shared_oft/mergers_ea02/361227/NASDAQ.pdf ("OFT Report on NASDAQ / LSE").

25 *Id.* at ¶44-51. The OFT also found that the two parties were not competitors with respect to listing services, *id.* at ¶43, or other services (including derivatives), *id.* at ¶62. Although derivatives trading was therefore again not a significant part of the OFT's decision, its view of the equities trading services market may provide a useful analogue.

26 *See LSE woos Tokyo after US bid fails*, BBC News, Feb. 11, 2007, available at http://news.bbc.co.uk/2/hi/business/6351555.stm.

CME's Acquisition of the CBOT

The final analogous decision was the successful Chicago Mercantile Exchange ("CME") purchase of the Chicago Board of Trade ("CBOT") in 2007.[27] The DOJ approved the acquisition after an investigation, finding that each of the exchanges was entrenched in trading for different types of derivatives, and that it therefore was unlikely that either would begin competing directly against the other.[28]

The DOJ also found that the merger would not affect innovation in the market, noting that "the two principal impetuses for innovation have been, and will continue to be, the prospect of winning business from the over-the-counter market and the potential to offer products that the OTC community can use to hedge the risk associated with its activities."[29]

In January 2008 the DOJ sent a letter to the Treasury Department that led some to speculate that DOJ would be more likely to challenge future mergers in the exchange industry.

Finally, the DOJ rejected concerns that the "combination might foreclose entry by other exchanges into financial futures as a result of the integration of virtually all financial future contracts into a single clearinghouse."[30] The DOJ instead noted that both the NYSE (which had acquired Euronext / Liffe) and the Intercontinental Exchange had announced their intention to offer derivatives, lessening any potential concerns regarding clearing.[31] The merger closed on July 12,

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27 Press Release, United States Department of Justice, Statement of the Department of Justice Antitrust Division On Its Decision to Close Its Investigation of Chicago Mercantile Exchange Holdings Inc.'s Acquisition of CBOT Holdings Inc. (June 11, 2007), available at: http://www.justice.gov/atr/public/press_releases/2007/223853.htm. ("DOJ Statement on CME / CBOT").

28 *Id.* A similar lack of overlap likely aided the CME's 2008 purchase of NYMEX. *See* Press Release, CME Group, CME Group and NYMEX Receive Unconditional Department of Justice Clearance to Proceed With Acquisition (June 16, 2008), available at: http://cmegroup.mediaroom.com.

29 DOJ Statement on CME / CBOT, *supra.*

30 *Id.*

31 *Id.*

2007.[32]

In January 2008 the DOJ sent a letter to the Treasury Department that led some to speculate that DOJ would be more likely to challenge future mergers in the exchange industry.[33] The letter expressed concerns regarding "the control exercised by futures exchanges over clearing services," which "has made it difficult for exchanges to enter and compete in the trading of financial futures contracts."[34] Nonetheless, shortly thereafter the DOJ cleared a merger between NYMEX and CME.[35]

These decisions demonstrate three principles: (1) Merger reviews involving derivatives traditionally have focused in large part on the type of derivative, (2) Although not every review has uniformly found OTC traded products to be in the same market as exchange traded products, there is at least an underlying belief that the two types of product have significant influence on one another,[36] and (3) Regulators traditionally have recognized a global environment for exchange markets.

II. <u>The Proposed NYSE Euronext / Deutsche Börse Merger</u>

In February 2011, NYSE Euronext and Deutsche Börse announced their in-

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32 Press Release, CME Group, CME and CBOT Complete Merger Creating the Leading Global Financial Exchange, July 12, 2007, available at: http://cmegroup.mediaroom.com.

33 *See, e.g.*, Matthew Leising, *CME, Nymex Tumble 18% After Justice Antitrust Opinion*, Bloomberg News, Feb. 8, 2008, available at: http://www.bloomberg.com/apps/news?pid=newsarchive&sid=aTtjT0xJwOrs.

34 *See* Review of the Regulatory Structure of Associated With Financial Institutions Before the Department of Treasury, Comments of the United States Department of Justice (Jan. 31, 2008), available at: http://www.justice.gov/atr/public/comments/229911.htm.

35 *See* Press Release, CME Group, CME Group and NYMEX Receive Unconditional Department of Justice Clearance to Proceed With Acquisition (June 16, 2008), available at: http://cmegroup.mediaroom.com.

36 As discussed further below, this is also a point that the European Commission has acknowledged in other circumstances. *See* European Union: European Commission, *Commission Staff Working Paper: Impact Assessment: Proposal for a Council Directive on a common system of financial transaction tax and amending Directive 2008/7/EC*, Sept. 28, 2011, SEC(2011) 1103, at 54-55, available at http://register.consilium.europa.eu/pdf/en/11/st14/st14942-ad10.en11.pdf (discussing switching between ETDs and OTC derivatives in response to tax increases).

tention to combine their businesses.[37] The new company was to be the largest stock exchange in the world, with market capitalization of listed companies of $15 trillion.[38]

NYSE Euronext shareholders approved the deal on July 7, 2011, and Deutsche Börse shareholders followed suit on July 15, 2011.[39] The combined group was to be organized under a Dutch holding company, with dual headquarters in Frankfurt and New York.[40] The parties estimated that the merger would result in cost savings of $410 million,[41] and that improved trading and listing would create economies of scale equal to $3.8 billion.[42] The deal was valued at

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[37] *See* Press Release, NYSE Euronext, Deutsche Boerse AG And NYSE Euronext Agree To Combine To Create The Premier Global Exchange Group (Feb. 1, 2011), available at: http://www.nyse.com/press/1297768048707.html.

[38] *See, e.g.*, *NYSE-Deutsche Boerse deal said in doubt*, United Press Int'l, Jan. 11, 2012, available at: http://www.upi.com/Business_News/2012/01/11/NYSE-Deutsche-Boerse-deal-said-in-doubt/UPI-65471326270600/.

[39] *See* Ad-hoc Announcement, Deutsche Börse AG, Deutsche Börse AG: Minimum acceptance threshold of 75% reached at the end of the acceptance period for the offer by Alpha Beta Netherlands Holding N.V. (July 15, 2011), available at http://deutsche-boerse.com/dbg/dispatch/en/listcontent/dbg_nav/investor_relations/60_News/20_Ad_hoc_Announcements/Content_Files/10_adhoc/db_ad-hoc_150711.htm; *see also* Telis Demos, *NYSE-Deutsche Börse deal clears US hurdle*, Financial Times, Jul. 8, 2011.

[40] *See* Ad-hoc Announcement, Deutsche Börse AG, Deutsche Börse AG: Deutsche Boerse AG And NYSE Euronext Agree To Combine To Create The Premier Global Exchange Group (Feb. 15, 2011), available at http://deutsche-boerse.com/dbg/dispatch/en/listcontent/dbg_nav/investor_relations/60_News/20_Ad_hoc_Announcements/Content_Files/10_adhoc/db_ad-hoc_15022011.htm (describing the transaction); *see also United States v. Deutsche Börse AG & NYSE Euronext*, Competitive Impact Statement, available at http://www.justice.gov/atr/cases/f278500/278554.pdf

[41] Aaron Kirchfeld, Nandini Sukumar and Jeff Kearns, *Deutsche Boerse in Advanced Talks to Buy NYSE Euronext*, Bloomberg News, Feb. 9, 2011, available at: http://www.bloomberg.com/news/2011-02-09/nyse-deutsche-boerse-are-said-to-be-in-advanced-talks-to-merge-exchanges.html.

[42] Edward Taylor and Andreas Kröner, *Deutsche Boerse's NYSE deal seen heading for the rocks*, Reuters, Jan. 11, 2012, available at: http://www.reuters.com/article/2012/01/11/nyse-dboerse-idUSL6E8CB4SG20120111

around $10 billion.[43]

On December 22, 2011 the DOJ filed a proposed final judgment allowing the merger,[44] though it did require Deutsche Börse's subsidiary International Securities Exchange to divest a 31.5% stake in the stock exchange company Direct Edge Inc.[45] The merger also received approval from several European regulators, including in Germany by the Bundesanstalt für Finanzdienstleistungsaufsicht, and in Luxembourg by the Commission de Surveillance du Secteur Financier.[46]

The Commission held that there was a substantial overlap between the parties in a number of types of derivatives. . .

43 Aoife White and Nandini Sukumar, Deutsche Boerse-NYSE Takeover Vetoed by European Commission, Bloomberg Businessweek, Feb. 1, 2012, available at: http://www.businessweek.com/news/2012-02-01/deutsche-boerse-nyse-takeover-vetoed-by-european-commission.html.

44 *United States v. Deutsche Börse AG & NYSE Euronext*, Proposed Final Judgment, available at: http://www.justice.gov/atr/cases/f278500/278552.pdf. The DOJ had rejected a competing offer from NASDAQ as likely to injure competition due to overlap in the equities listing market, among others. *See* Press Release, United States Department of Justice, NASDAQ OMX Group Inc. and Intercontinental Exchange Inc. Abandon Their Proposed Acquisition of NYSE Euronext After Justice Department Threatens Lawsuit (May 16, 2011), available at: http://www.justice.gov/opa/pr/2011/May/11-at-622.html.

45 Jacob Bunge, *SEC Clears NYSE Deal*, Wall Street Journal, Jan. 19, 2012, available at: http://online.wsj.com/article/SB10001424052970204555904577169013011373888.html; *United States v. Deutsche Börse AG & NYSE Euronext*, Proposed Final Judgment, available at: http://www.justice.gov/atr/cases/f278500/278552.pdf; Press Release, United States Department of Justice, Justice Department Dismisses Antitrust Lawsuit Against Deutsche Börse and NYSE Euronext (Feb. 9, 2012), available at: http://www.justice.gov/atr/public/press_releases/2012/280066.htm.

46 *See* Renee Cordes, *Deutsche Borse report hails NYSE Euronext merger*, Deal Pipeline, Sept. 13, 2011, available at http://www.thedeal.com/content/restructuring/deutsche-borse-report-hails-nyse-euronext-merger.php; *Luxembourgish regulator approves Deutsche Börse and NYSE Euronext merger*, ETF World, available at http://www.etfworld.nl/index.php?option=com_content&view=article&id=12236:luxembourgish-regulator-approves-deutsche-boerse-and-nyse-euronext-merger-&catid=477:buitenlandse-etf-engels&Itemid=1077.

However, on February 1, 2012 the European Commission blocked the merger,[47] only the fourth instance in a decade of it having done so.[48] The Commission expressed concerns that the combination of Deutsche Börse's "Eurex" and NYSE Euronext's "NYSE Liffe" would create a quasi-monopoly in the markets for European financial derivatives traded on exchanges.[49]

The Commission held that there was a substantial overlap between the parties in a number of types of derivatives asset classes, and the merger would create a near-monopoly in trading services for these derivatives.[50] In reaching this conclusion, the Commission made three significant findings: (1) the relevant market was limited to derivatives based on European underlying assets,[51] (2) the market did not include OTC-traded derivatives, and (3) appropriate remedies could not alleviate competition concerns regarding the clearing markets.

> The relevant market was limited to derivatives based on European underlying assets.

European or Global Derivatives

The Commission first held that the relevant product market was limited to derivatives based on European underlying assets, which are traded primarily on

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47 EC Press Release, *supra*.

48 *See* European Commission, Merger Statistics (May 8, 2012), available at: http://ec.europa.eu/competition/mergers/statistics.pdf.

49 Press Release, European Commission, Mergers: Commission blocks proposed merger between Deutsche Börse and NYSE Euronext (Feb. 1, 2012), available at http://europa.eu/rapid/pressReleasesAction.do?reference=IP/12/94. ("EC Press Release.")

50 EC Press Release, *supra*.

51 In the colorful world of derivatives jargon, the asset or group of assets on which the derivative is based frequently is referred to simply as an "underlying."

Liffe and Eurex and only very sparsely outside of Europe.[52]

In doing so, the Commission did not appear to object to the scope of the geographic market proposed by the parties; indeed, the Commission's spokesperson has said that the Commission's decision prevented "near monopoly on a global market, the market for exchange-traded derivatives," indicating that the Commission viewed the market as global.[53] And as the NASDAQ / LSE merger review made clear, competitors may enter the European market from foreign locations, including the United States.[54] Recently CME, a major derivatives competitor, has expanded its presence in London, moving from 14,000 square feet of office space up to 40,000 square feet,[55] raising its head count to 150, and shifting its metals and FX derivatives heads to that office.[56] Based on the ease of entry and global nature of the derivatives business, the parties argued that the Deutsche Börse / NYSE merger would create a "European champion" that could compete effectively with other global derivatives exchanges, such as CME and the Singapore Stock Exchange.[57]

Despite the global geographic nature of the market, however, the Commission focused on the location of the underlying asset, apparently treating European-based derivatives as a separate type of derivative, and therefore a separate product market, wherever they might be traded. By defining the market in this way, the Commission effectively defined virtually all foreign competition out of the

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52 Press Release, European Commission, Mergers: Commission prohibits proposed merger between Deutsche Börse AG and NYSE Euronext – frequently asked questions (Feb. 1, 2012), available at: http://europa.eu/rapid/pressReleasesAction.do?reference=MEMO/12/60&format=HTML&aged=0&language=EN&guiLanguage=en. ("EC FAQ.") For example, the Commission found that the CME trades only 2,000 Euribor-based contracts annually, in comparison with Liffe's 250 million. Id.

53 *See* Frances Robinson, *EU Would Defend Deutsche Boerse/NYSE Decision In Court*, Wall St. J., Mar. 20, 2012, available at: http://online.wsj.com/article/BT-CO-20120320-705011.html.

54 OFT Report on NASDAQ / LSE, *supra*, at ¶¶ 44-51.

55 Annual Report Form 10-K, CME Group Inc., at 32 (Feb. 28, 2011), available at: http://files.shareholder.com/downloads/CME/1920867919x0xS1193125-11-50252/1156375/filing.pdf.

56 Jeremy Grant, *CME focus on London as European beachhead, Financial Times,* Apr. 16, 2012, available at: http://www.ft.com/intl/cms/s/0/dc692dfe-86ec-11e1-ad68-00144feab49a.html#axzz1xWbD4CwL

57 *See* EC FAQ, *supra.*

market without defining a limited geographic scope. This approach is difficult to reconcile with prior regulatory decisions, which, although involving a geographic component,[58] typically have divided derivatives into types based not on the geographic location of the underlying but on their usage by traders.[59] As discussed above, the DOJ, for example, noted the lack of overlap between the types of derivatives offered by CME and CBOT / NYMEX in allowing those exchanges to merge.[60]

One example of the difficulties of this approach can be seen by looking at short and long term interest rate derivatives; Liffe concentrates in short term Euribor contracts, and Eurex in long term derivatives. By defining the market based on the location of the underlying, the Commission included both types of derivative within the same relevant market – even though the two products are quite different, and are used for different purposes.[61] Simultaneously, however, the Commission apparently would not have included a competitor selling a short term interest rate product based on, for example, American interest rates, even if that product could be a direct substitute for a Euribor contract, and perhaps even if that product were sold by a potential entrant into the European market.

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58 For example, the U.K. Competition Commission has found that the market for trading equities includes competition both from the United States and Europe. Competition Commission Report on LSE, *supra*, at ¶ 4.59.

59 *See* OFT Report on LSE / Euronext, *supra*, at ¶ 83; Competition Commission Report on LSE, *supra*, at ¶4.60; (dividing derivatives market into equity derivatives, equity index derivatives, capital market or long-term interest rate derivatives, money market or short-term interest rate derivatives, commodity derivatives, and currency derivatives); OFT Report on Euronext / Liffe, *supra* (dividing market into five types); *see also* Ioannis Kokkoris & Rodrigo Olivares-Caminal, Some Issues on Cross-Border Stock Exchange Mergers, 29 U Pa. J. Int'l L. 455, 508 (2007-08).

60 *See* DOJ Statement on CME / CBOT, *supra*.

61 The Commission found that the line between the two products had "blurred," and that they had begun to compete. *See* EC FAQ, *supra*.

Nonetheless, there may be some justification for the Commission's approach. The core question in defining derivatives markets is the willingness of traders to substitute one type of derivative for another.[62] Particularly in light of recent financial difficulties encountered in Europe, it is not clear that European-based derivatives offer the same risk profiles and investment outcomes as those in other countries – and therefore to what degree traders may view non-European-based derivatives as truly substitutable for European-based ones.[63] The Commission has not yet released the evidence that it might have to support this view, or any evidence that the parties might have submitted contrary to the Commission's view.

> Exchanges must attract both buyers and sellers, and the attractiveness to one group will depend on their attractiveness to the other.

At the same time, however, exchanges must attract both buyers and sellers, and the attractiveness to one group will depend on their attractiveness to the other. An exchange is unattractive to buyers if it lacks sellers, and vice versa.[64] Although in theory there might be the potential for market power to be exercised against either buyers or sellers, if the result is that one group (or part of the group) leaves the exchange, the exchange will become less attractive to the other group as well. As a result, any market definition would need to take account of how the exercise of market power would affect the fundamental dynamics and attractiveness of the market both from a buyer's and seller's perspective, but it is unclear if the Commission considered this issue.

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62 *See, e.g.,* Ioannis Kokkoris & Rodrigo Olivares-Caminal, Some Issues on Cross-Border Stock Exchange Mergers, 29 U Pa. J. Int'l L. 455, 509 (2007-08) ("In order for investors to substitute between two derivatives contracts having different underlying assets, these contracts must provide the same investment outcome that the investors want to achieve.")

63 There may be at least some reason to believe that exchanges will continue to trade primarily in derivatives based on local underlyings, even in an increasingly global market. As the OFT noted in reviewing the proposed acquisitions of the LSE, movement in trading markets is typically episodic, rather than gradual. *See* OFT Report on Deutsche Börse / LSE, *supra*, at ¶ 51. As such, a transformation in the market would require a significant volume (including perhaps a majority) of European-based derivatives moving to a non-European exchange.

64 *See, e.g.,* David S. Evans and Michael D. Noel, The Analysis of Mergers That Involve Multi-Sided Platform Businesses, April 2008, available at http://econ.ucsd.edu/~mdnoel/research/NOEL_twosidedmergers.pdf.

Exclusion of Derivatives Traded Over the Counter

A second aspect of the Commission's decision worth noting is the exclusion of OTC-traded derivatives. Derivatives can be traded either on an exchange (such as Eurex or Liffe) or over the counter (typically through banks or other financial institutions, but also privately). At present, 90-95% of the total volume of derivatives trading is conducted over the counter.[65] Although OTC-traded derivatives make up the majority of the market, the Commission excluded them from its analysis, noting significant differences between OTC-products and those sold on exchanges.[66]

This decision may not be consistent with other agencies' findings regarding the substitutability of OTC-traded derivatives for ETDs. Moreover, this decision appears to ignore upcoming regulatory actions, discussed below, that are likely to substantially change the industry.

- Derivatives Traded Over the Counter May Be Substitutable for Derivatives Traded on an Exchange

Although the full reasoning has not yet been released, the Commission's press release and FAQ noted several differences between ETDs and OTC-traded derivatives that led to placing them in separate markets.

First, ETD contracts typically will be subject to a standardized set of terms and conditions.[67] The Commission believed that parties trading derivatives over the counter, by contrast, typically will draft their own terms and conditions, allowing greater flexibility but also significantly increasing transaction costs; the Commission found that, on average, derivatives traded over the counter have costs up

65 Press Release, European Commission, Regulation on Over-the-Counter Derivatives and Market infrastructures – Frequently Asked Questions (Mar. 29, 2012), available at: http://europa.eu/rapid/pressReleasesAction.do?reference=MEMO/12/232.

66 EC Press Release, *supra*.

67 *See* EC FAQ, *supra*.

to eight times as high as ETDs.[68]

Second, perhaps in light of these costs, most OTC-traded derivatives are significantly larger than their ETD counterparts. For example, the Commission estimated that the average ETD contract is valued at around €100,000, while the average OTC-traded derivative contract is valued at around €200,000,000, or 2,000 times larger.[69]

Finally, ETDs are frequently cleared through a clearinghouse connected with the exchange, whereas OTC-traded derivatives are not tied to a particular clearinghouse.[70] For example, trades executed on Deutsche Börse's Eurex exchange are handled by Eurex Clearing, an approach that has been characterized as a "vertical silo."[71] Had the merger been successful, trades executed on both NYSE Euronext and Liffe would have been cleared through Eurex Clearing as well.[72]

Based on these differences, the Commission held that OTC-traded derivatives were outside the relevant market and did not exert competitive pressure on ETDs.

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68 *See id.* However, the Commission likely overstated the extent to which OTC derivatives contracts are drawn from scratch. For example, the International Swaps and Derivatives Association provides master agreements that govern a significant number of transactions. Moreover, others claim that nearly all OTC-traded derivatives are standardized, that is, just like derivatives traded on exchanges. *See Deutsche Börse/NYSE battle revived at GCR Live*, Global Competition Review, June 21, 2012, available at http://www.globalcompetitionreview.com/news/article/31996/deutsche-b-246rsenyse-battle-revived-gcr-live.

69 *Id.*

70 A derivatives purchase is "cleared" through contract novation, in which a clearinghouse steps between the parties to the transaction to become each party's counterparty. The clearinghouse ensures that the details and terms match between the parties, and guarantees that the terms are satisfied by each party.

71 *See, e.g.*, EC Press Release, *supra.*

72 *See* Michelle Price, *There is no way back after NYSE-Börse talks*, Financial News, Jan. 23, 2012, available at http://www.efinancialnews.com/story/2012-01-23/there-is-no-way-back-after-nyse-börse-talks.

Although the Commission may have accurately described the status quo with respect to OTC-traded derivatives (*i.e.*, that they are often larger and more expensive), it is difficult to see why OTC traders would not respond to price increases by increasing competition with ETDs. For example, the banks and other financial institutions that trade OTC likely could respond to market demand by adopting standardized contracts, offering lower transaction costs, providing smaller derivatives contracts, and establishing a clearing process through one of several external clearinghouses currently available. Moreover, recent changes to the regulatory environment, discussed below, likely will increase competition between OTC and ETD platforms.

Recent changes to the regulatory environment, discussed below, likely will increase competition between OTC and ETD platforms.

Indeed, in a different context the Commission appears to have suggested that this switching would occur. In a 2011 Working Paper, the Commission noted that an increase in the financial transaction tax on ETDs could lead customers to switch to OTC-traded derivatives – even if the increase was very small. The Commission said, "[a]s an example, if a developed OTC-market for a financial product exists, a tax on exchange based trading of the same product will give an incentive to shift from exchange based trading towards OTC trading," noting an example in which small tax increases had caused a 98% decrease in ETD volume, with customers appearing to switch to OTC-traded products.[73] This suggests that OTC-traded products will seek to compete with ETD products in response to increases in price, and that customers will switch if prices increase.

Moreover, the Commission's approach, by focusing categorically on the trading mechanism rather than the type of product traded, excludes from the relevant market even OTC-traded products identical to those traded on exchanges. For example, an exchange traded short term interest rate derivative that is identical in

73 European Union: European Commission, Commission Staff Working Paper: Impact Assessment: Proposal for a Council Directive on a common system of financial transaction tax and amending Directive 2008/7/EC, Sept. 28, 2011, SEC(2011) 1103, at 54-55, available at http://register.consilium.europa.eu/pdf/en/11/st14/st14942-ad10.en11.pdf.

virtually every way to an OTC-traded derivative of the same type would be classified not to compete with it under the Commission's rubric, but would be held to compete with a long term interest rate derivative that happened to be traded on an exchange. It is by no means clear that this approach is correct.

- <u>Prior Regulatory Decisions Suggest That There Is Competition Between OTC-Traded Derivatives and ETDs</u>

The Commission's approach is also difficult to reconcile with prior regulatory approaches. All of the agencies that previously addressed OTC-traded derivatives found at least some competitive overlap with ETDs. First, the OFT in 2001 took the view that OTC-traded derivatives "provide[] some degree of competitive constraint on exchanges, in terms of both prices and services."[74] It echoed this view in 2005 with respect to the proposed acquisitions of the LSE, calling OTC trading "an extremely important constraint on exchange operators."[75] The DOJ similarly noted that, in the long term, OTC-traded derivatives are responsible for most innovation in the derivatives market.[76] Even outside of the derivatives context, the U.K. Competition Commission has noted that "off book" trading in equities, although in a different relevant market from exchange trading, exerts some competitive pressure on exchanges.[77] The European Commission's recent view seemingly contradicts these earlier viewpoints.

- <u>The Commission's Decision May Not Fully Take Account of Recent Changes to the Derivatives Market</u>

Finally, the Commission's decision may not fully account for the significant changes that are likely to occur in the derivatives market as a result of increased regulation. OTC-traded derivatives have come to be viewed as one of the many causes of the recent economic downturn, due principally to a perceived lack of

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74 OFT Report on Euronext / Liffe, *supra*.

75 *See* OFT Report on Euronext / LSE, *supra*, at ¶ 86.

76 DOJ Statement on CME / CBOT, *supra*.

77 *See* Competition Commission Report on LSE, *supra*, at ¶¶ 4.55; 5.132.

regulation.[78] As a result, both U.S. and European regulators are seeking to regulate OTC trading, and to force such trades onto exchanges wherever possible.[79]

To this end, in 2009 G-20 leaders issued a statement indicating that (1) all standardized OTC-traded derivatives should be traded on exchanges or electronic trading platforms, (2) all such derivatives should be cleared through central counterparties, and (3) all OTC-traded derivatives contracts should be reported to trade repositories.

New regulations also increase incentives to clear OTC transactions by imposing higher capital and margin requirements on uncleared transactions. These objectives will be met in the United States by the Dodd-Frank Act and in Europe by the creation of the European Securities and Market Authority, and the implementation of new regulations expected to take effect in 2012.[80] This regulation, the European Market Infrastructure Regulation, is likely to cause a significant number of derivatives contracts that had been traded over the counter to move to new or existing financial exchanges or similar entities, which may provide substantial competition to Liffe and Eurex. (Because of the higher transaction costs, these regulations may make it affirmatively unattractive to trade over the counter in some situations.) Indeed, through this regulation the Commission seems to be forcing ETDs and OTC derivatives into direct competition, at the same time that it declares the two to be in separate markets.[81]

The Commission discounted such competition, however, arguing that a dominant exchange would simply absorb all of these formerly OTC-traded deriva-

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78 Press Release, European Commission, Regulation on Over-the-Counter Derivatives and Market infrastructures – Frequently Asked Questions (Mar. 29, 2012), available at: http://europa.eu/rapid/pressReleasesAction.do?reference=MEMO/12/232&format=HTML&aged=0&language=EN&guiLanguage=en.

79 *Id.*

80 *Id.*

81 Editorial, Deutsche Börse's legal challenge is not just sour grapes: Why the Competition Commission's decision conflicts with EU regulation, Futures & Options World, Mar. 21, 2012, available at: http://www.fow.com/Article/2998686/Themes/26528/Editorial-Deutsche-Brses-legal-challenge-is-not-just-sour-grapes.html ("There is an obvious contradiction in the DG Comp's ruling and the intentions of European regulation and it is this contradiction that will be at the heart of DB's challenge.").

tives.[82] But several prior merger review decisions have noted that OTC markets tend to cause new types of derivatives to be invented,[83] and that each new type tends to cluster and compete only with others of that type.[84] As a result, it is difficult to see why new and different types of OTC-traded derivatives would simply join whatever exchange happened to be dominant, rather than choosing the LSE or another existing exchange, forming a new exchange, or any other of a range of possibilities.

And, indeed, there is currently a range of such possibilities, particularly in light of the creation of Organized Trading Facilities (OTFs) and Multilateral Trading Facilities (MTFs) after the Commission's Markets in Financial Instruments Directives of 2007 and 2011 (MiFID and MiFID II). MTFs such as BATS, Chi-X, and Turquoise have significant potential to create competing trading options – including options for trading OTC derivatives – and it is by no means clear that newly created OTC-traded derivatives would bypass such options when trading on an exchange. The Commission's view, therefore, may not be in line with actual market expectations, and may not fully reflect the actual range of competition from OTC-traded derivatives.

Remedies Proposed by the Parties

In addition, the Commission found that the combined entity could have sufficient market power in clearing to prevent effective competition in the trading market.[85] Accordingly, as one of several proposed remedies, the parties proposed opening up their combined entity's clearinghouse to certain kinds of materially "new" interest rate, bond, and equity index derivatives contracts, though not existing types of contracts.[86]

82 EC FAQ, *supra*.

83 DOJ Statement on CME / CBOT, *supra*.

84 *See id.*; OFT Report on Deutsche Börse / LSE, *supra*, at ¶ 51.

85 *See* EC Press Release, *supra*; EC FAQ, *supra*.

86 *See* EC FAQ, *supra*.

The Commission rejected this proposal, arguing that there were effectively no such contracts in existence at the present, and questioning whether any could come into existence absent the innovation allegedly foreclosed by the merger.[87] However, as the DOJ found in respect of the CME acquisition of CBOT, OTC-traded derivatives are a major source of innovation in the derivatives market.[88] These new derivatives, which make up 90-95% of the overall derivatives market, will soon be pushed onto exchanges (whether Eurex, Liffe, or competing platforms), and will need to be cleared. The parties' remedy was designed to allow this innovation and competition to occur, but was dismissed by the Commission as insufficient because it did not incorporate clearing for the other 5-10%. Here, too, the Commission appears to have taken a view of the market that discounted the significant changes likely to occur as a result of increased regulation.

The Commission challenged only one part of the proposed merger, and did not see competitive concerns with respect to equities trading, listing services, and a range of other markets.

III. What the Commission's Decision Suggests for Future Exchange Mergers

It is important to remember that the Commission challenged only one part of the proposed merger, and did not see competitive concerns with respect to equities trading, listing services, and a range of other markets. While the Commission's decision does not necessarily indicate antipathy towards exchange mergers generally, practitioners should take away three points from the Commission's decision:

First, the Commission appears to view the derivatives market as a series of markets separable not (or perhaps not only) by type of derivative, but also location of underlying asset or index. While this view argued against the merger between two European exchanges, it might make challenges to some mergers less likely.

Second, from at least the Commission's point of view, products traded over

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87 See id.

88 DOJ Statement on CME / CBOT, *supra*.

the counter likely are not substitutable with, and therefore will tend to be in a separate market or markets from, products traded on exchanges.

Third, regulators continue to express concerns about clearing services, and the effect that a monopoly on clearing may have on trading markets. Any merger that risks creating market power in clearing must be carefully structured to avoid such effects. Moreover, the DOJ's rejection of NASDAQ's proposed acquisition of NYSE Euronext indicates that overlap in the listing services market will remain a possible basis for rejection. [89]

Due to Deutsche Börse's appeal the Commission's decision is not yet legally binding.[90] It remains to be seen whether the European Court of Justice will follow the European Commission's approach to market definition, and practitioners in this area should follow the proceedings closely.

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89 Remarks As Prepared For Delivery by Assistant Attorney General Christine Varney Regarding NASDAQ OMX Group Inc. And IntercontinentalExchange Inc. Abandoning Their Bid For NYSE Euronext," May 16, 2011, available at http://www.justice.gov/atr/public/speeches/271259.htm.

90 Deutsche Börse is appealing the decision in the hopes of overturning the Commission's key findings on market definition and efficiencies, but does not plan to revive the deal with NYSE Euronext. *See Deutsche Börse/NYSE battle revived at GCR Live*, Global Competition Review, June 21, 2012, available at http://www.globalcompetitionreview.com/news/article/31996/deutsche-b-246rsenyse-battle-revived-gcr-live.

Credit Card Wars In Canada – The Commissioner Of Competition Challenges Visa And MasterCard Merchant Rules

Subrata Bhattacharjee and Jon Smithen[1]

I. INTRODUCTION

The Canadian Competition Tribunal (the "Tribunal") recently concluded hearings concerning a challenge to the restrictions that Visa and MasterCard place on merchants who accept their cards. In December 2010, Canada's Commissioner of Competition Melanie Aitken (the "Commissioner"), who is charged with enforcement of the Canadian Competition Act[2], brought an application (the "Application") to the Tribunal naming Visa and MasterCard as respondents and challenging restrictions that she alleges constrain the ability of merchants to encourage the use by consumers of lower cost credit cards or other low-cost payment methods.[3] These practices, in her view, impede competition for credit card network services and result in increased costs that are ultimately passed on to consumers.[4]

The restrictions subject to the challenge include provisions that prohibit merchants from:

- Effectively encouraging the use of lower-cost methods of payment or discouraging the use of credit cards with higher card acceptance fees;
- Declining to accept certain credit cards, including those with higher fees; and
- Surcharging Visa or MasterCard credit cards or any one of their premium cards.

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2 Competition Act, R.S.C. 1985, C-34, as amended (the "Act").

3 Commissioner of Competition v. Visa Canada Corporation and MasterCard International Incorporated (December 15, 2010), CT-2010-010 (Notice of Application of the Commissioner of Competition).

4 Supra, note 2 at paras. 3-5.

The Commissioner commenced the Application under the price maintenance provisions contained in Section 76 of the Act. The Application is the first case brought under the price maintenance provisions since they were amended in 2009. The hearing of the matter took 20 days and involved evidence from 32 witnesses. The decision is expected to be released before the end of 2012. This article summarizes the positions taken by the parties in the Application and discusses the issues they raised.

> The issues that have arisen in Canada over merchant rules and card acceptance fees are, in some ways, similar to those in other jurisdictions.

To provide some context, the issues that have arisen in Canada over merchant rules and card acceptance fees are, in some ways, similar to those in other jurisdictions, including the United States, the United Kingdom and Australia. As has been the case in those countries, there has been a debate in Canada over aspects of the relationship between merchants and networks.[5] Much of this debate has been driven by merchants, and by industry advocates like the Canadian Retail Council, which has conducted a vigorous and high profile lobbying campaign. Complaints from merchants led the Commissioner to commence a formal inquiry into the industry in April 2009.[6] The inquiry formed the basis of the Application.

The Canadian Federal Government also has responded in a number of other ways. In 2009, the Senate Committee on Banking Trade and Commerce (the "Committee") reviewed the credit and debit card markets in Canada. Following public hearings, the Committee issued a report in July of that year which contained a number of recommendations for Government action, including that sur-

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5 See, e.g. "Report on Credit and Debit Card Markets" at pp. 36-39, online: Task Force for the Payments System Review <http://paymentsystemreview.ca/index.php/papers/on-dialogue-our-discussion-papers/credit-and-debit-card-markets/> (accessed June 20, 2012) for an overview of merchant initiatives in this regard.

6 Competition Bureau, Announcement, "Competition Bureau Alleges Anti-Competitive Conduct by Visa and MasterCard: Hearing Starts Today" (May 8, 2012), online: Competition Bureau <http://www.competitionbureau.gc.ca/eic/site/cb-bc.nsf/eng/03465.html> (accessed June 30, 2012).

charging and discounting be permitted by merchants, and that any "honour-all-cards" rules be prohibited (the "Senate Committee Report").[7]

In May 2010, the Minister of Finance announced a voluntary Code of Conduct for the Credit and Debit Industry in Canada (the "Code of Conduct"), and indicated that it had been adopted by all payment card networks, major credit and debit card issuers and payment processors.[8] The Code of Conduct did not implement all of the recommendations in the Senate Committee Report, but included some provisions relating to merchant rules – notably provisions allowing merchants to provide discounts for different methods of payment and engage in differential discounts among different payment card networks. Surcharging, though, was not contemplated by the Code of Conduct. Notwithstanding the provisions of the Code of Conduct, the Commissioner commenced the Application eight months later, an initiative characterized at that time by the Minister of Finance as a "parallel effort."[9]

II. OVERVIEW OF THE CANADIAN PRICE MAINTENANCE PROVISIONS

The Canadian approach to price maintenance following the 2009 amendments is now similar to that espoused by the U.S. Supreme Court in *Leegin.*[10] Unlike the old criminal *per se* price maintenance provisions of the Act, the current provisions are reviewable by the Tribunal (i.e. they are civil) and contain a competitive impact requirement. If the Tribunal is satisfied that the elements of the provisions have been met, it may issue a remedial order addressing the conduct in question. However, the Tribunal cannot impose monetary penalties for price maintenance.

Section 76 of the Act provides that:

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7 Canada, Standing Senate Committee on Banking, Trade and Commerce, "Transparency, Balance and Choice: Canada's Credit Card and Debit Card Systems" (July 2, 2009), online: Parliament of Canada <http://www.parl.gc.ca/Content/SEN/Committee/402/bank/press/02jul09-e.htm> (accessed June 29, 2012).

8 Canada, Department of Finance, "Code of Conduct for the Credit and Debit Card Industry in Canada" (May 2010), online: Department of Finance <http://www.fin.gc.ca/n10/data/10-049_1-eng.asp> (accessed June 29, 2012).

9 Dana Flavelle, "Visa, MasterCard Fees Under Scrutiny" The Toronto Star (December 16, 2011), online: Moneyville <http://www.moneyville.ca/article/907254--watchdog-wants-visa-and-mastercard-s-restrictive-rules-struck-down> (accessed June 29, 2012).

10 Leegin Creative Leather Products, Inc. v. PSKS, Inc, 551 U.S. 877 (2007).

76. (1) On application by the Commissioner or a person granted leave under section 103.1, the Tribunal may make an order under subsection (2) if the Tribunal finds that:

(a) a person referred to in subsection (3) directly or indirectly

(i) by agreement, threat, promise or any like means, has influenced upward, or has discouraged the reduction of, the price at which the person's customer or any other person to whom the product comes for resale supplies or offers to supply or advertises a product within Canada, or

(ii) has refused to supply a product to or has otherwise discriminated against any person or class of persons engaged in business in Canada because of the low pricing policy of that other person or class of persons; and

(b) the conduct has had, is having or is likely to have an adverse effect on competition in a market.[11]

The Commissioner is required to establish several elements to secure a remedial order from the Tribunal, in particular:

- The person or company against whom the application is made must be one of the enumerated classes set out in subsection 76(3);[12] and
- The conduct has, or is likely to have, an adverse effect on competition in a market; and
- There must be an agreement, threat, promise or like means that has maintained or increased the price of a product sold by the respondent's downstream suppliers; or there must be a refusal to supply or other discrimination against a person or class of persons as a result of its low pricing policy.

III. THE PARTIES' POSITIONS

The Commissioner does not have a straightforward case – and indeed, the Tribunal is being urged by the Commissioner to take a fairly expansive (and arguably novel) view of the scope and application of the price maintenance provisions.

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[11] Act, s. 76.

[12] These classes include those who produce or supply a product, extend credit through credit cards or are in a business related to credit cards, or who have "the exclusive rights and privileges conferred by a patent, trade-mark, copyright, registered industrial design or registered integrated circuit topography." (Act, s. 76(3))

An outline of the Commissioner's case is as follows:

- Canadian merchants pay significant card acceptance fees for credit card network services. These fees include a number of components, including an interchange fee, and vary depending on a number of factors, including the type of credit card used by the customer;
- Card acceptance fees mean that merchants must bear processing costs that are multiples of what would be paid if consumers used cash or debit;
- Visa and MasterCard supply credit card network services indirectly to merchants through acquirers. Acquirers are required to impose restrictions on merchants pursuant to their agreements with the respondents, and merchants must abide by the restrictions to obtain credit card network services (and therefore accept credit card payments from customers);
- The restrictions constrain the ability of merchants to "foster competition" on the level of card acceptance fees. Moreover, the restrictions are alleged to raise or maintain prices paid for credit card network services on the Visa and MasterCard networks. The Commissioner alleges that in the absence of the restrictions, card acceptance fees would be lower; and
- The conduct described above is alleged to justify the issuance by the Tribunal of an order prohibiting Visa and MasterCard from implementing arrangements or agreements that would prevent merchants from encouraging customers to use lower cost methods of payment, including the restrictions in question.[13]

The Commissioner's case raises a number of important issues concerning the interpretation and application of Section 76. The most significant of these relate to (a) the "resale" requirement of the provision; (b) market definition and (c) the competitive effects analysis contemplated by the "adverse impact on competition" requirement.

1. Is there a Resale ?

Section 76 requires the Commissioner to demonstrate that an agreement to raise or maintain prices is with respect to "the price at which the person's cus-

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13 Supra, note 2 at paras. 6-17.

tomer or any other person to whom the product comes for resale supplies or offers to supply or advertises a product within Canada" (emphasis added).[14]

In the Application, the Commissioner appeared to suggest that the resale requirement in Section 76 has been met because the respondents supplied credit card network services indirectly to merchants through acquirers.[15] In her subsequent reply, however, the Commissioner took the position that Section 76 does not contain a resale requirement as applicable to the facts in issue. In her view, it is sufficient that the conduct raise or maintain a price that a customer pays for a product within Canada. In the alternative, the Commissioner states that the networks provide access to acquirers on mandatory terms, and that acquirers in turn provide access to card networks to merchants (also on terms specified by the networks).[16]

The issue of resale raises serious questions for the Tribunal's consideration.

Visa and MasterCard argue that there is no product being resold, and that Section 76 therefore does not apply. According to their submissions, the services provided by Visa and MasterCard to acquirers are different services than provided by acquirers to merchants, and acquirers are free to set prices for the services they offer.[17] A card acceptance fee (including interchange) is but a cost incurred by acquirers that must be considered when setting their prices for merchants. Visa and MasterCard have no control over and do not dictate the amount charged by acquirers to merchants, or the amount charged by merchants to consumers. Accordingly, there is no resale.

The issue of resale raises serious questions for the Tribunal's consideration. The Commissioner's approach essentially requires an interpretation that would bifurcate Subsection 76(1)(a) such that the reference to resale would not apply to customers of a supplier but remain applicable to "any other person…[who] sup-

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14 Act, s. 76(1)(a)(i).

15 Supra, note 2 at para. 76.

16 Commissioner of Competition v. Visa Canada Corporation and MasterCard International Incorporated (February 14, 2011), CT-2010-010 (Reply of the Commissioner of Competition), paras. 31-51.

17 Commissioner of Competition v. Visa Canada Corporation and MasterCard International Incorporated (January 31, 2011), CT-2010-010 (Response of Visa Canada Corporation), paras. 41-42.

plies or offers to supply or advertise a product within Canada." No authority under Section 76 supports this position, and indeed it is unclear whether this interpretation is supported by conventional rules of statutory interpretation in Canada, even taking the legislative history of the provision into account. Moreover, if accepted, the Commissioner's suggestion could be seen as significantly broadening the scope and reach of Section 76.

2. Relevant Market

The Commissioner will have to establish that the merchant restraints have harmed or are likely to harm competition. . .

The Commissioner alleges that the relevant market is the market for credit card network services in Canada to the exclusion of other forms of payment, such as cash, cheque or debit card, and that Visa and MasterCard together have a share of this market that exceeds 90 percent. In support of this position, the Commissioner cites, among other things, high barriers to entry in the credit card network services industry and the alleged ability of both Visa and MasterCard to continually raise fees without any associated loss in merchant acceptance.[18]

Visa and MasterCard both take the position that this approach to market definition is incorrect, and assert that the relevant market includes essentially all payment methods. Visa, for example, states that credit cards compete with other forms of payment services and payment options, including card-based forms of payment, paper-based forms of payment, mobile forms of payments, and other electronic forms of payment not typically tied to a payment card or similar device, and that the relevant geographic market is national.[19] MasterCard takes a similar approach. The respondents therefore assert that each would have shares well below the threshold typically established by the Tribunal as indicative of market power.[20] As a general matter, the Application essentially characterizes the relevant

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18 Supra, note 2 at paras. 80-87.

19 Supra, note 16 at paras. 52-54.

20 MasterCard takes the position that even if the relevant market as defined by the Commissioner were used, its share of that alleged market would be below 35%: Commissioner of Competition v. Visa Canada Corporation and MasterCard International Incorporated (December 15, 2010), CT-2010-010 (Response of MasterCard International Incorporated) at para. 50.

markets as being one sided, focusing on the interests of merchants. Both respondents have sought to recast the context in which credit card networks function to assert the existence of a two sided market, and to argue that card acceptance fees (including interchange) are not "prices" but balancing tools used to maximize output.

Though the Tribunal has considered the appropriate analytical approach to market definition on numerous occasions, including under the identical adverse effect standard contained in the Act's refusal to deal provisions, there is limited authority in the context of payments (at least in a non-merger situation). It remains to be seen what the Tribunal will conclude on this point.

3. Competitive Effects

Apart from the resale requirement, the Commissioner will have to establish that the merchant restraints have harmed or are likely to harm competition as required by the provision. Unlike other aspects of Section 76, there is some Tribunal authority on the meaning of this requirement, albeit under the refusal to deal provisions of the Act.[21] In this context, the Tribunal has stated that determination of whether conduct results or is likely to result in harm to competition requires demonstrating that "the remaining market participants must be placed in a position…of created, enhanced or preserved market power."[22] This demonstration requires "a relative and comparative assessment of the market with the [impugned conduct] and that same market without the [impugned conduct]."[23] Reference to the "market" is taken to be "the market in which the applicants participate."[24]

The Commissioner alleges that the merchant restrictions reduce competition in the supply of credit card network services in a number of ways, including:

- Raising or maintaining card acceptance fees;
- Distorting or harming the competitive process and proper functioning of the price setting mechanism for card acceptance fees;
- Increasing retail prices for customers of merchants;

21 Act, s. 75.

22 B-Filer Inc. et al. v. Bank of Nova Scotia, 2006 Comp. Trib 42 [B-Filer] at para. 208, cited with approval in Nadeau Poultry Farm Limited v. Groupe Westco Inc., [2011] F.C.J. No. 844 at para. 38; 2011 FCA 188.

23 B-Filer, supra, note 20 at para. 197.

24 Ibid. at para. 213.

- Preventing competition with respect to card acceptance fees;
- Reducing competition between respondents, as well as between the respondents and rival credit card networks and within each respondent's network;
- Reducing output of lower-cost payment methods; and
- Creating or increasing already significant barriers to entry or expansion for lower cost credit card networks.[25]

The Commissioner has characterized the combined effects of the merchant restraints as resulting in a subsidization of premium card customers by low/no fee customers. The Commissioner argues that merchants must recoup the fees charged for accessing the credit card network through higher prices. These higher prices allegedly apply to all purchasers, whether premium or regular credit cards are used, or whether any other type of payment is used. As a result of these alleged higher prices, premium credit card users are able to enjoy rewards, while being subsidized by the presumably less affluent consumers that use cash, debit or non-premium credit cards.[26]

The respondents present broadly similar defenses concerning the competitive effects of the relevant merchant restrictions. Visa's response can be summarized as follows.

- Steering consumers to other forms of payment will not affect the price that acquirers may charge for merchant services, and even if so, surcharging is not a uniquely effective means of steering consumers to adopt other forms of payment. The Visa response notes that the Code of Conduct does not prohibit its merchant restrictions.
- Though merchants may be inclined to cover costs associated with accepting card payments, it does not mean that prices to consumers are increased.
- To the extent that the Commissioner suggests that competition is prevented with respect to card acceptance fees, issuers do not compete with each other in this regard.

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25 Supra, note 2 at paras. 79, 93-94.

26 See, e.g. Competition Bureau, Backgrounder, "Competition Bureau Alleges Anti-Competitive Conduct by Visa and MasterCard" (May 8, 2012), online: Competition Bureau <http://www.competitionbureau.gc.ca/eic/site/cb-bc.nsf/eng/03466.html> (accessed June 29, 2012).

- The merchant restrictions do not inhibit competition between Visa and MasterCard or other suppliers of credit cards.
- Visa's rules do not prohibit merchants from encouraging customers to use other forms of payment to complete purchases, and merchants can charge different prices depending on the method of payment. In any event, steering consumers to other forms of payment cannot constrain pricing in the market for credit card network services (or merchant services, for that matter).
- Lower cost credit networks are viable for merchants, as the Visa rules provide that merchants are free to accept any credit cards they choose. Accordingly, the merchant restrictions do not create or increase barriers to entry.[27]

The Tribunal litigation between the Commissioner and the parties also includes significant consideration of the experience in other jurisdictions. . .

MasterCard emphasizes the relationship between merchants and consumers, noting that to the extent that merchants would benefit from lower interchange fees, consumer cardholders would lose. MasterCard further states that the Commissioner should not be permitted to substitute its judgment of the optimal level of MasterCard's interchange fees for those of MasterCard or to choose between benefiting merchants or consumers.[28]

The Tribunal litigation between the Commissioner and the parties also includes significant consideration of the experience in other jurisdictions, notably Australia (indeed, the Commissioner's witnesses at the hearing before the Tribunal included a representative of an Australian retailer, and Visa, for example, provided evidence about the impact of the Australian rules on its business there). In 2003, the Reserve Bank of Australia (the "RBA") instituted a series of regulations governing card networks that capped interchange fees for MasterCard and Visa networks and removed prohibitions on surcharging contained in merchant rules which, in the RBA's view, allowed merchants to pass their cost of accepting credit cards directly on to consumers and to use the "threat" of surcharging to negotiate lower

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27 Supra, note 16 at paras. 56-65.

28 Supra, note 19 at paras. 83 and 94-95.

merchant service fees from their acquirer.[29] Though there are suggestions that the RBA changes have reduced merchant service fees, other Australian stakeholders, notably consumer advocacy groups, have raised concerns about excessive surcharging by merchants.[30] It will be interesting to see what the Tribunal makes of what may be a shifting experience in a country that has experimented with some of the measures that the Commissioner is requesting it to take.

IV. CONCLUSION

Having heard the submissions of the parties, the Tribunal is now deliberating. The outcome of its decision may have a significant impact on the Canadian payments industry and on the interpretation of one of the newer provisions of the Act. It is equally important to note that the Application represents only one front in the ongoing debate between merchants and card networks, as underlined by the Minister of Finance's characterization of the proceedings as a "parallel effort." As a result, it remains to be seen what will happen on the broader regulatory stage following the Tribunal's decision.

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29 Reserve Bank of Australia, Bulletin, "The Personal Credit Card Market in Australia: Pricing over the Past Decade" (March Quarter 2012), online: Reserve Bank of Australia <http://www.rba.gov.au/publications/bulletin/2012/mar/7.html> (accessed June 29, 2012).

30 Supra, note 28; but cf. "Qantas 'pocketing 100m' in excess card fees", ABC News Online (May 18, 2012), online: ABC News <http://www.abc.net.au/news/2012-05-18/qantas-accused-of-credit-card-rip-off/4019762> (accessed June 29, 2012). In argument before the Tribunal, the Commissioner addressed the possibility of excessive surcharging on the part of merchants by suggesting that the Tribunal order could permit Visa and MasterCard to specify in their merchant agreements that any surcharges be reasonably related to the actual cost of credit card network services.

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