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VIA FEDERAL EXPRESS

Richard L. Rosen, Esq.
Chief of Communications and Finance Section
United States Department of Justice
555 4th Street, N.W., Room 8104
Washington, D. C. 20001

Dear Mr. Rosen:

As you know from your recent discussions with Paul Allen, VISA believes that it is extremely important for the United States to participate as *amicus* in the Tenth Circuit in the pending litigation between Sears and VISA. As explained further below, the case is not only exceptionally important to the parties but presents overarching policy issues which should be of substantial concern to the Antitrust Division.

In anticipation of a further meeting which we would like to have with you and other members of the Antitrust Division, we have summarized below the circumstances which, in our view, make it important for the Division to involve itself in the current appellate proceedings.

THE BANK CARD BUSINESS, DUALITY AND MEMBERSHIP RULES

The current VISA and MasterCard joint ventures evolved from regional credit card programs that were formed by relatively small groups of banks operating in different areas of the country. As the ventures originally were constituted, members of the BankAmericard (or NBI) and MasterCharge systems were

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authorized to issue credit cards bearing the logos of their respective systems. The same member banks also were licensed to enroll merchants to accept the trademarked cards as payment for goods and services. The role of the venture, itself, was to provide a unifying trademark that was displayed on cards issued to customers by venture members. The mark was also displayed by participating merchants to indicate their willingness to accept them. In addition, the systems operated central clearing, settlement and authorization systems (all governed by uniform network "rules") which, in the aggregate, permitted the ventures to function. From the outset, however, neither NBI nor MasterCard controlled end-point pricing: that is, issuers and acquirers have always set their own interest and merchant discount rates in competition with one another. Similarly, members are not and never have been constrained as to output or territory.

By the early 1970's, the two joint venture systems were beginning to achieve stability and had begun to recoup the very substantial investments made by their members in developing the hitherto unknown product, the "general purpose credit card." In addition to the substantial intra-system competition promoted by the structure of the ventures (as described above), there was substantial competition between the two systems. As observed by Don Baker, "[t]he first decade of national bank card development was one of vigorous inter-system competition, which was new to the banking industry. A major card issuer tended to regard itself as either a Master Charge bank or a BankAmericard bank." Baker & Brandel, <u>The Law of Electronic Fund Transfer Systems</u>, ¶23.02[2] (2nd Ed.) This latter competition was the product of an NBI by-law that prohibited card-issuing (or "Class A") members from also belonging to the Master Charge system. However, NBI's by-law did permit so-called Class B, or agent, banks to sign merchants in both the BankAmericard and Master Charge systems, thus providing those agent banks with an advantage over the Class A members in competing for merchant business. <u>Id.</u> This rule, as you know, led to an antitrust challenge in 1971 by the Worthen Bank & Trust Company of Little Rock, Arkansas. Worthen was a Class A Member of NBI. It alleged that NBI's by-law restricting it from issuing Master Charge as well as BankAmericard cards constituted a group boycott and, thus, was illegal <u>per se</u>. The

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district court agreed. However, that ruling was reversed by the Eighth Circuit which remanded the case for trial.[1]

Following that remand, NBI sought a Business Review Clearance letter from the Department of Justice. After considering the matter for some time, the Department advised VISA that it would not challenge a membership by-law that compelled exclusivity on the issuing side of the business but that it could not grant similar assurances with respect to exclusivity on the acquirer (or merchant) side of the business, nor could it provide such assurances with respect to a rule that precluded an NBI agent bank "from becoming a card-issuing bank in another system." Letter, October 7, 1975, from Thomas E. Kauper to Francis R. Kirkham. "At this point, an understandably disappointed NBI completely reversed its position and removed all restrictions on dual membership. Almost immediately, banks rushed to join both systems at an astounding rate, in part to protect their existing merchant accounts." Baker, supra. Thus was born "duality."

Seventeen years on, the effect of duality has been to significantly reduce intersystem competition between the two bank card joint ventures. Competition between the two systems in interchange fees and in systems development has greatly diminished. That is scarcely surprising given the almost total overlap of membership between the two organizations. To the extent that system-level competition remains, it is now largely a function of competition from the two principal proprietary competitors, Discover and American Express. For example, competition in interchange rates between the two systems effectively disappeared following duality. Baker, supra, at 23.02[3]. However, evidence introduced in the Sears trial demonstrated that, as part of its effort to build a competitive merchant base for its Discover card in the late 1980's, Sears has offered merchant discount rates materially below those quoted by VISA and MasterCard members. That aggressive pricing policy, in turn, has had a substantial competitive effect upon the interchange rates of the two bank card systems. By the same token, VISA and MasterCard merchant discount rates materially constrain the higher rates typically charged by American Express. This competition led, in one highly publicized instance, to the so-called "Boston restaurant revolt" in which several leading restaurants in Boston threatened to discontinue accepting the

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1 The United States participated in the appeal as amicus, having been asked to do so by the court.

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American Express card because of its higher merchant discount fees.

The emergence of full-fledged duality also led to cooperation in new product development by the bank card systems. Most prominently, in the mid-80's, VISA and MasterCard announced plans for the development of a single point-of-sale product to be known as "Entree." It was at this point, as you know, that NAAG began to view duality as a matter of significant antitrust concern. In 1990, several states sued VISA and MasterCard in the Southern District of New York alleging, inter alia, that the joint development of Entree by VISA and MasterCard would be anti-competitive. That lawsuit was settled by a consent decree which effectively ended the Entree venture. As a result, VISA and MasterCard subsequently have announced separate POS programs (Interlink and Maestro, respectively) in which duality is not permitted. Similarly, the two national ATM networks, Plus and Cirrus, currently mandate issuer-side exclusivity (although individual ATM terminals are available for use by any number of competing systems). Finally, within the past two years, there even have been nascent efforts at creating a rollback of duality in the credit card business. According to testimony at trial, VISA's Directors have been considering incentive pricing strategies designed to encourage the long-term divergence of the two systems. In addition, while both VISA and MasterCard maintain generally "open" membership policies (except, of course, as to direct intersystem competitors (see below)), MasterCard has made a greater effort to encourage the participation of so-called "non-bank" members. As a result, most of the major new card programs offered by industrial corporations, such as the AT&T Universal Card and the new GM and GE cards, have been solely or predominantly MasterCard programs.[2] One consequence of this development is that voting control in Mastercard is beginning to move away from traditional banks to the newer members. This trend, if continued, could have major pro-competitive consequences for the payment systems business.

THE SEARS LITIGATION

Despite an otherwise open membership policy, in 1989 VISA adopted a by-law which precludes major proprietary

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[2] VISA, of course, does have a number of very substantial "non-bank" members. These include, e.g. Ford, Household Finance and General Electric.

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interbrand competitors (specifically, any affiliate of Sears or American Express) from becoming VISA members. That is, of course, the rule which Sears has challenged under Section 1 of the Sherman Act in its lawsuit in Utah. Very briefly, Sears contends that VISA's refusal to let Sears become a VISA member harms competition by preventing Sears from issuing a new, allegedly low-cost, brand of VISA card along with its own proprietary Discover card. Sears makes this argument notwithstanding its conceded ability to compete successfully in the relevant market on its own and notwithstanding the existence of a market structure that its own expert consultant previously described as "bordering on the atomistic." Lexecon, Interest Rate Controls on Credit Cards -- An Economic Analysis (1985) at 25.[3] VISA does not dispute that, as a joint venture, its rules are subject to scrutiny under Section 1 of the Sherman Act. However, it maintains that the mere refusal by an efficiency-creating joint venture to share its property is not unlawful, as a matter of law, in the absence of proof that such a refusal effectively precludes the excluded party from competing successfully in the market (a notion akin to the concept of "essentiality"). A contrary rule, we have argued, would not only encourage free-riding but would discourage the formation of, or investment in, efficient, innovative joint ventures, such as VISA or MasterCard. (Sears has conceded that if it were required to prove that VISA membership is an "essential facility," its case would fail).[4]

In the course of pretrial proceedings, Judge Benson rejected VISA's contention that Sears' claims fail as a matter of

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[3] That is an accurate description. At present, VISA has some 6,000 active members and is open to any solvent financial institution with the exception of affiliates of Sears or American Express. Further, as noted previously, VISA has never constrained output or dictated the prices to be charged by any member, either to cardholders or merchants.

[4] VISA also asserts that, as a matter of law, Sears' claim fails because VISA lacks market power, i.e., that with 6,000 issuers and no restrictions upon price, output or territory, VISA's members lack the ability to raise prices or reduce output, particularly where the rule in question -- by its very terms -- applies only to those entities which have demonstrated the ability to compete successfully in the marketplace on their own.

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law. Specifically, the court held that VISA's by-law is subject to challenge under the rule of reason and that no showing of essentiality or its equivalent was required. To the contrary, the court ruled that the case should be submitted to the jury under "unstructured" rule of reason instructions that simply asked the jury to evaluate the asserted effects of VISA's by-law on intra- and inter-system competition in the general purpose credit card market. As thus submitted, the jury returned a verdict for Sears.

Following that verdict, the court denied VISA's motion for judgment notwithstanding the verdict in a very lengthy opinion in which the Judge stated that while he believed that VISA had the better of the argument both as to antitrust policy and factual matters, Sears' case did not fail as a matter of law. In particular, the court stated that, had it been the trier of fact, it "would have concluded that the harm to competition from letting Sears into the VISA system is greater than any harm from keeping Sears out." Opinion and Order, April 1, 1993 at 56-57. Judge Benson further noted that, in his view, "Bylaw 2.06 fosters intersystem competition in the relevant market" and that "[s]uch competition is important in the general purpose charge card market, with only five active intersystem competitors...." Id. at 58. Thus, he continued:

> Simply adding another high-priced card issuer, as Sears has always been with both the Discover Card and the Sears charge card, to the Visa system will not solve the problem. It may provide short-term intrasystem competitive benefits within the Visa system, but in the long run, in the court's judgment, the damages from such inclusion will outstrip the benefits. Eventually, consumers will be left with one more top-ten Visa issuer charging relatively high interest rates and a Visa/MasterCard system which will dominate the general purpose charge card field to an even greater extent than it does today. In addition, the court found Visa's policy and economic arguments to be the more compelling. As a factual matter, the court found persuasive Visa's positions regarding the need to protect joint venture innovation, the

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> importance of protecting private property, and the economic and competitive consequences of keeping the owner of the Discover Card out of the Visa system. The court found Visa's expert witness, Professor Richard Schmalensee, more compelling than Sears' expert witness, Professor Kearl, and was persuaded by Visa's industry expert, Mr. Robert McKinley.

Opinion at 58-59.

Nonetheless, despite expressing the views summarized above, the court declined to grant judgment for VISA as a matter of law holding that the jury was entitled to weigh the evidence and that VISA's "policy" arguments were for Congress, not a court, to consider.

In addition to passing upon VISA's motion for judgment as a matter of law, the court -- sitting as the trier of fact in equity -- considered VISA's counterclaim under section 7 of the Clayton Act. In that claim, VISA asserted the "flip side" of its Sherman Act defense: not only is it lawful for VISA to exclude Sears, but letting Sears become an owner-member of VISA while operating its own proprietary program would be likely to harm system-level (i.e. intersystem) competition.

Here, again, the court concluded that VISA's arguments were, in general, well-taken. Specifically, the court found that "intersystem competition has helped promote innovation in the development of transactional processing systems and merchant base expansion, thereby benefiting consumers. Therefore, the court concludes that intersystem competition is important in promoting consumer welfare in the general purpose charge card market." Opinion at 88-89. The court further observed "that inter-system competition will be decreased by Sears' entry into the VISA system as the owner of Prime Option VISA. Sears' ownership of Prime Option VISA will likely cause Sears to change its marketing strategy, thereby decreasing competition between VISA and Discover to a certain degree." Id. at 90. The court also noted that VISA has a legitimate concern about Sears having access to its confidential information and that there were unlikely to be any "appreciable" benefits to intra-system competition in the long-run from permitting Sears to join VISA. Id. at 91-92. In summation, the court concluded "that inter-system competition will likely be harmed because Discover will not compete as

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vigorously with VISA after it issues Prime Option and Sears will have access to VISA confidential information. Id. at 94. Once again, however, despite all of these findings, the court declined to enter judgment for VISA because it did not believe that the likely harm to competition would be "significant" in light of Sears' expressed "intention"to continue to market Discover vigorously. Id.

Needless to say, while VISA appreciates the Court's kind expressions about both its arguments and evidence on both the Sherman and Clayton Act issues, it believes that it is entitled to more than a "consolation prize." Specifically, VISA believes that the Court erred in its analysis of market power, in its failure to apply an essentiality standard to joint venture membership rules and in its conclusion that, on the record before it, the jury could find that VISA's by-law has an adverse effect upon competition, particularly when considered in light of its potential adverse impact on inter-system competition. Further, VISA believes that the court misconstrued its own prerogatives in applying the Sherman Act. Contrary to Judge Benson's views, it is the essence, not the antithesis, of the court's role in a rule of reason case to pass upon the threshold sufficiency of the claims and to assure that juries are given sufficient guidance to insure that practices that are incapable of substantially restraining competition are not erroneously condemned.

THE SEARS CASE RAISES SIGNIFICANT POLICY ISSUES
WHICH SHOULD BE OF GREAT INTEREST TO THE UNITED STATES

VISA believes that the United States should participate as amicus curiae in the Tenth Circuit for two principal reasons:

First, the decision below is likely to result in the demise of meaningful intersystem competition in the bank card business and, perhaps, in the payment systems industry as a whole; and

Second, the decision below will have a substantially adverse effect upon joint venture innovation.

Intersystem Competition

In important respects, the payment systems industry finds itself at the same critical juncture that it was at in 1975 when VISA originally sought guidance from the Department of Justice in the face of treble-damage litigation. The result of

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that earlier proceeding was duality and the consequent diminution of meaningful intersystem competition between VISA and MasterCard.

We submit that a repetition of that scenario in 1993 is no more in the government's interest than it is in VISA's. Duality, we submit, was a mistake -- albeit one that is more easily seen with the benefit of hindsight. Yet VISA now finds itself in a position where its right to control membership in even the most modest (we would urge, self-evident) fashion has been rejected by a jury as unreasonably in restraint of trade. If that decision stands, it is inconceivable that American Express or anyone else could be excluded by VISA (or by MasterCard). Further, we suggest that, short of affirmative intervention by the Antitrust Division, there will be no possibility of a phased rollback of duality in the credit card business. Indeed, it is highly unlikely that any form of membership exclusivity will be maintained in the payment systems business generally, be it in debit cards, ATM networks or POS systems.

Faced with the prospect of significant treble damage exposure and what will, at that point, be two "rounds" of inaction by the government, it is improbable, at best, to expect VISA or any other payment system joint venture to stand up to a challenge to its membership rules. The long-term result, we predict, is that system-level competition will diminish even from today's relatively tepid levels and that there will be a largely irresistible movement towards "universal" payment system joint ventures that are, for all intents and purposes, mere utilities. Lest that Cassandra-like view be discounted, we would recall that the predictions of VISA's former CEO, Dee Hock, about the impact of duality on joint venture membership and intersystem competition were similarly dismissed nearly two decades ago.

We are confident that we do not need to convince you about the importance of maintaining intersystem, as well as intrasystem, competition in this industry. We have noted previously the significance of inter-system competition for merchant discount pricing. Equally important, a collapse of inter-system competitive incentives would have a materially adverse effect upon systems innovation. For example, VISA's principal clearing, authorization and interchange networks (Base I and Base II) represent an early attempt at competitive brand differentiation by VISA. Similarly, there has been substantial

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system competition (though not between VISA and MasterCard) in the creation of POS authorization systems.

The unique nature of the payment system business necessitates that some form of competition take place at a central, or network, level. It is that competition that the district court decision in this case most plainly threatens (that being, as well, the point of VISA's Clayton Act counterclaim). As VISA International's General Counsel, Bennett Katz, put it during his testimony at trial: If there are a thousand competing auto dealers but only one automaker, you will have a great deal of retail price and service competition, but very little product innovation.

If it is clear that intersystem competition should be preserved, we trust that it is equally apparent that permitting Sears (and, perforce, American Express) to become members of the bank card joint ventures would be inimical to that objective, and will have unfortunate competitive consequences at the systems level in what is (<u>at that level</u>) a highly concentrated business.[5] Indeed, measured by usual HHI concentration standards and tested against traditional incipiency concerns about strategic coordination and similar competitive harms, the case against permitting existing intersystem competitors to join VISA is not only real, but compelling.[6] The likely

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5 Permitting the owners of proprietary cards to become VISA members will also place current system members at an unavoidable disadvantage on the merchant side of the business. Today, joint venture members can offer merchants one or both of the system products, but not Discover. Sears, for its part, can offer only its Discover card. If Sears were a member, however, it -- and only it -- could offer merchants all three card products. Since, under Judge Benson's analysis, Sears -- as a single entity -- is not subject to suit under Sherman Act §1, VISA members would be unable to level that important part of the playing field.

6 For the first time at trial, Sears urged that VISA's by-law is also anticompetitive because it creates a "disencentive" for existing VISA members to create proprietary systems. Not surprisingly, Sears could not produce any direct evidence to support this theory (which was presented solely through its economics expert). Nonetheless, the Court permitted the theory to be submitted to the jury.

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consequences for future innovation and merchant-side price competition are forceful arguments against the result reached below. Moreover, if VISA is correct that the consequence of affirmance by the Tenth Circuit will be the effective demise of membership exclusivity in all segments of the payment system industry, the potential consequences of this case are very far-reaching, indeed.

Placed against these concerns, one cannot realistically rely upon private ordering and private treble damage litigation to yield a suitable outcome in the absence of active participation by the Department of Justice. (In this regard, see the remarks by Don Baker at the recent ABA Spring Antitrust meeting, attached). The potential of treble damages is simply too Draconian a sanction to permit payment system joint ventures to vigorously resist antitrust challenges in the face of continuing silence from government antitrust agencies. To be blunt, we are hard-pressed to suggest -- in the face of Worthen and the alleged billion dollar exposure faced by VISA in the Sears case -- that VISA (or anyone else) will continue to "fight the good fight" to preserve intersystem competition in this industry. Similarly, it is not safe to predict that this matter ultimately will be decided in the Supreme Court and that the United States, therefore, can await that stage of the proceedings before taking a formal position. The uncertainties of obtaining Supreme Court consideration are simply too great to make reliance upon such discretionary review a prudent course.

Joint Venture Innovation

There is a second, equally important, issue raised by this case that merits participation by the Antitrust Division. The district court held that any joint venture action is subject to consideration under generalized, "unstructured," rule of reason standards. The practical effect of that holding is that virtually any joint venture rule is subject to "veto" (*cum* treble damages and attorneys fees) by a jury with no more guidance than

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Apart from its evidentiary failing, the theory gets matters backwards. If there is a need for increased system competition, then the correct rule from an antitrust standpoint would be to require VISA to close membership, not open it further. So long as banks can join VISA or MasterCard, their incentives to take on the risk and expense of creating a new system -- independently or by forming new joint ventures -- effectively is non-existent.

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that it should consider and weigh all aspects of the rule or practice in question. Thus, a joint venture (or, at least, a joint venture found by the jury to possess market power) is not, ultimately, governed by its members or Directors, but by a jury in a federal or state court.

That, we submit, is an untenable result. Joint ventures are encouraged as a form of business integration because they offer the potential for innovation, e.g., by permitting participating firms to achieve scale economies and/or capture network externalities. Moreover, they do so in a far less competitively intrusive fashion than outright mergers which, definitionally, result in total integration and the elimination of competition between the merged firms. While VISA has never suggested that joint venture practices are not subject to review under section 1 (see, e.g., NCAA; BMI), the correct -- and prevailing -- approach to such ventures is that they are given more, not less, leeway than other antitrust actors.[7] Specifically with regard to membership rules, the Division has noted previously that "selectivity in the membership of a joint venture often enhances a joint venture's competitive potential." 1988 Antitrust Guidelines for International Operations at 3.42. Antitrust concerns are raised by such rules only when the venture's refusal to share its property precludes meaningful competition in the market by the excluded firm -- a notion akin to essentiality. Guidelines at 3.42. That, concededly, is a standard Sears cannot satisfy.

The approach taken by the court below, we suggest, is not only flawed, but leaves the law in an unacceptable posture. While VISA and the Antitrust Division may differ, themselves, about the relative benefits of government regulation, surely we should be able to agree that subjecting joint ventures to the kind of random scrutiny and oversight which such an approach implies is not a sensible way to create coherent antitrust policy. Compare Areeda, "Antitrust Law as Industrial Policy: Should Judges and Juries Make It" in Antitrust, Innovation and Competitiveness (1992) at 29. The net effect, without question, will be to discourage innovation through joint venture cooperation (even when such ventures are plainly pro-competitive). We put to you, further, that these concerns are

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[7] For example, even "price-fixing" that is ancillary to a true integration and is "reasonably necessary" will be permitted. See, e.g., BMI; NaBanco vs. VISA, 779 F.2d 592 (11th Cir. 1985).

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not an overstatement but, rather, follow necessarily from the proceedings to date in the Sears litigation. Judge Benson's instructions offered the jury little more than a summary recitation of the rule of reason standards derived from Chicago Board of Trade and his opinion following the verdict reduces to "The Jury has spoken."

Plainly, this is an issue that we expect the Tenth Circuit to scrutinize with care. As Professor Areeda has pointed out, the cost of randomness in the face of potential treble damage exposure will result in significant over-deterrence of conduct that may be highly efficient and, hence, pro-competitive. Areeda, supra, at 40. That is a result that, we believe, should be of concern not only to potential antitrust defendants but to those agencies of the government which have a stake in maintaining a coherent industrial and trade policy and in furthering integrations that are efficiency-creating. Indeed, if anything, government antitrust regulators should have even more concern about potential randomness and over-deterrence in antitrust decision-making since errors in both directions harm coherence and frustrate efficient outcomes.

We look forward to pursuing these issues with you further and thank you for your interest.

Sincerely yours,

Stephen V. Bomse

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THE GREAT ANTITRUST MYSTERY: WHY HAVE JUSTICE AND THE FED BEEN SO VIGOROUS ON BANK MERGERS AND SO PASSIVE ON BANK NETWORKS?

DONALD I. BAKER
Jones Day Reavis & Pogue
Washington, D.C.

American Bar Association
Antitrust Section Meeting
Washington, D.C.

April 1, 1993

Here we are gathered on April Fools Day, 1993. The thirtieth anniversary of the Supreme Court's landmark Philadelphia National Bank decision is only a few weeks away (on June 17). The Justice Department has recently blocked (or forced restructuring of) several bank acquisitions in Texas. And a District Court in Utah has just handed down today a decision in what is the most closely-watched banking antitrust case in a long time: Sears' "boycott" suit to compel admission of its affiliates to the Visa credit card joint venture.

There is a lot of deja vu here. If we look back at thirty years of history, we find that Justice and the Fed have made most of the law and most of the critical decisions in the bank merger area. Justice appealed and won six horizontal bank merger antitrust cases in the Supreme Court, beginning with Philadelphia (in 1963) and ending with Phillipsburg (in 1970); and it also made law by appealing and losing Marine Bancorporation, Connecticut Mutual Bank and Citizens & Southern National Bank on potential competition and related theories in the 1970s.

Meanwhile, Justice and the Fed have been virtual non-events in pursuing antitrust issues in the payment joint venture area. For all practical purposes, the payments network field has been left to the state attorneys general and private plaintiffs.

Why is this so? Not, I suspect because each of the hundred or so bank mergers which Justice and Fed have challenged or blocked is very interesting and important competitively - while not one of the payment joint ventures is interesting and important competitively.

Rather the answer, I submit, has to do with procedural simplicity as much as with substance. Bank mergers after Philadelphia National could be subjected to a fairly standard analysis based largely on market shares in reasonable predictable markets; and this analysis had to take place under a fast track administrative review process enacted in the Bank Merger Act

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Amendments of 1966. This whole scheme has forced the government agencies to make final up or down decisions very quickly and also has provided the Justice Department with a statutory stay which gives it a unique leg up if it sues to stop a bank acquisition.

Meanwhile, payment joint ventures come up with less consistency, less specificity and less clarity, under a process in which inaction or delay often seem acceptable alternatives to a decision. There has been a great tendency for Justice to cogitate and ultimately to punt, while the Fed has tended to define away the antitrust problem by using a broad "data processing" market when it had to analyze EFT network applications under § 4(c)(8) of the Bank Holding Company Act Amendments of 1970. No doubt delay and indecision has been much encouraged by substantive uncertainty about how to analyze these joint ventures and what markets to use in appraising potential anticompetitive effects under the rule of reason.

THE BANK MERGER STORY

This is like an old piece of choral music with many recurrent themes. Its Hallelujah Chorus no doubt comes from the last page of Justice Brennan's Philadelphia National opinion: "The fact that banking is a highly regulated industry critical to the Nation's welfare makes the play of competition not less important but more so."

Since Philadelphia and its Phillipsburg progeny in 1970, there has not been much for the Fed, Justice or the other banking agencies to argue about other than how exactly the Philadelphia methodology should apply to the particular facts of a particular horizontal merger case. In the horizontal bank merger area, only two questions of "policy" or "principle" seem to have recurred. One is, how is the product market to be defined? And the second is, how is the statutory "convenience and needs" defense ought to be applied in a time of excess capacity?

The product market to debate is wonderfully ironic. Here we have the Fed (with one of the finest economic staffs in Washington) clinging to the so-called "cluster" market (of commercial banking services) which professional economists have questioned from almost the moment of when it was announced by the Supreme Court in 1963, while the Justice Department has moved off its victorious Philadelphia formula in the direction of more tailored and defined markets oriented towards particular classes of customers (especially small businesses) which it believes may be at risk from mergers among commercial banks. Both the Fed and Justice recognize that the overall banking market has changed substantially: the Fed chooses to deal with this by watering down the "cluster" numbers with a prescribed (and arbitrary) dose of thrift deposits, while Justice appears to focus narrowly on small business lenders and borrowers, including thrifts only to the extent that they actively participate in the market.

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Everybody debating this issue needs to be reminded is that market definition is a fact question in every merger case, rather than being "legal" issue based on some old precedents. The core fact inquiry is: "is there any set of customers which is likely to face an enhanced risk of monopoly power flowing from a particular merger, which power is not likely to be defeated by prompt new entry or responsive action by existing competitors?" If such a situation exists, then it is entirely appropriate to draw a market - either a product market or a geographic market - based on the demand characteristics of this set of customers. This is in fact the direction in which the Justice Department seems to be moving with its "locally limited business customer" markets.

The "convenience and needs" defense is also an intriguing subject, but a largely dormant one. It was enacted in 1966 in order to give the banking agencies, Justice and the antitrust courts greater flexibility in dealing with anticompetitive bank mergers, because Congress believed that the traditional antitrust "failing company" doctrine was far too strict. In fact, the Justice Department immediately cleaned the board in litigation by getting the Supreme Court in Third National Bank in Nashville (decided in 1968) to impose a "no less anticompetitive alternative purchaser" requirement, borrowed from the antitrust "failing company" doctrine, as a condition to any use of this new statutory defense. This proved to be a show stopper for the "convenience and needs" defense. When this "no less anticompetitive alternative" test is applied to an industrial merger under the "failing company" doctrine, Justice requires the merger proponents to show that there is absolutely nobody around who would be prepared to pay something above scrap value for the distressed assets; and thus they are entirely prepared to treat a "scrap dealer" as an acceptable "alternative purchaser". Thus, in practical reality, the "alternative purchaser" issue is very much one of money - but in the banking sector we should have more concern about not using a antitrust merger case to confiscate the seller's (or the FDIC's) capital and, hence, there ought to be more flexibility.

The issue is a very live and real one today because of the inevitable contraction of the banking industry. Back in the era of Philadelphia and Nashville, the banking industry was highly regulated in terms of geographic expansion, with local bankers often protected against outside intruders by archaic legislative rules; and the rates that banks could pay for consumer deposits were artificially constrained by statute and Fed regulation. Thus, banks, being barred from competing on price, tended to compete on the basis of ever-more bricks, mortar and brass. The result was a great deal more bricks, mortar and brass than would be needed under a system of price competition for deposits and where ATMs to provide convenient consumer access to cash. Most of it is still around. How all this excess branch capacity gets worked out of the system is a nice question, but it seems to me that the Justice Department and the Fed ought to try to work out

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a more sensitive and sensible system of dealing with a lot of excess capacity in the industry. So far, what we have had is lots of bureaucratic mumbling in very long paragraphs (many of which are quoted in my recent article in the Antitrust Bulletin).[1]

The bottom line in the bank merger area is that any practical problems may flow from too much or too inflexible antitrust action, and too much dogmatic talk, by the federal agencies. The same is not true in the bank network area.

BANKING NETWORK JOINT VENTURES

We have had a recurring series of fascinating antitrust questions and disputes among bank networks -- but here the choral music is probably something like Benjamin Brittain's "War Requiem".

These payments joint ventures are all around us on all sides. Visa and MasterCard are some of the biggest, oldest and most highly visible on a national scale; local or regional joint venture ATM networks are everywhere, as illustrated by the MOST system here in Washington; and new on-line electronic debit systems have been under study for years and are beginning to generate volume in various parts of the country.

The antitrust analysis of network issues is not easy. As I indicated, the Fed and Justice have tended to waffle and punt, thus leaving it up to a working group of state attorneys general to challenge a Visa-MasterCard proposal to create a joint POS debit network, and disgruntled private plaintiffs to bring quite a few antitrust suits against banking networks. (I am not necessarily endorsing any of these actions, each of which should turn on its facts, but simply noting that they are the only "antitrust enforcement" in the area for almost two decades.)

Dealing with these antitrust issues requires market analysis and such market analysis really occurs at two levels. One is the level at which the network operates -- which we might call the "interchange" market. The other is the level at which the member banks compete -- the "primary" markets for plastic payment services to consumers and merchants.

In viewing this situation, you can see a spectrum of different types of network joint ventures in the banking industry. At one pole, you have what I might call the "invisible back office" joint venture such as the California Automated Clearing House and, at the other, you have the "product creating" joint venture such as Visa or MasterCard. In the latter instance, the availability of service in the "interchange" market

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[1] Searching For An Antitrust Beacon In The Bank Merger Fog, 37 ANTITRUST BULL. 651 (1992).

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is a very important part of the consumers' sense of value and this leads to highly advertised and valued service marks being owned by the network joint ventures.

The Justice Department has largely avoided having to take any definitive positions on market definition in this area.[2] Meanwhile, the Fed has used a "data processing" market to analyze proposed ATM and POS joint ventures under Section 4(c)(8) of the Bank Holding Company Act of 1970. Neither the Fed nor the Justice Department has looked at the product differentiation issue in payments joint ventures and I would respectfully suggest that this failure to do so is a serious deficiency in their market analysis.

The most visible antitrust disputes in the bank network joint venture area have come up in the context of network rules concerning membership. The Sears-Visa dispute is a classic example, with very big stakes and a large press gallery.

Often such a venture starts as a relatively modest competitive thrust by its founders and then, if it is successful, then competitors come along and seek to get in. The founders often initially resist but usually give in when faced with the prospect of a prolonged expensive and uncertain boycott suit by some anxious participant.

This story can be wonderfully illustrated in the bank credit card area. Visa's predecessor ("National BankAmericard" or "NBI") started off as a group of issuers which were usually given an exclusive (or nearly exclusive) franchise in a particular geographic area, while the rest of the local banks in the area tended to become part of the "MasterCharge" program. Thus, for example, Bank of America was the NBI issuer in California, State

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[2] There is one limited exception. In 1977, Justice did bring two antitrust cases against automated clearing houses ("ACHs") for excluding thrift institutions from membership in these joint ventures. <u>See</u> <u>U.S. v. Rocky Mountain Automated Clearing House Assn.</u>, (D. Colo. 1977) and <u>U.S. v. California Automated Clearing House Assn.</u> (N.D. Cal. 1977). These were brought by me when I was Assistant Attorney General. "[T]he department believed that the Federal Reserve's almost total subsidy of ACH operations made independent competitive alternatives economically unfeasible; accordingly, compulsory access was appropriate." BAKER and BRANDEL, THE LAW OF ELECTRONIC FUNDS TRANSFER SYSTEMS (2d Ed. 1988) at page 21-35. To say the least, they were very limited cases (which the Government promptly dropped when the ACH's eliminated their rules), because of the unique role of the Federal Reserve banks. Therefore, they really provide no useful guidance on the standards for compelling access into the <u>purely private</u> "product creating" type of joint venture such as Visa or PULSE.

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Street was the issuer in Boston, Philadelphia National (the famous Philadelphia National Bank!) was the issuer in Philadelphia, and so forth. They generally wanted to keep the NBI franchise exclusive and passed a bylaw to that effect.

However, the Worthen Bank - the market leader in the now-notorious city of Little Rock - wanted to be in both systems and brought a boycott case against NBI. The Eighth Circuit Court of Appeals told the parties (reversing an initial decision by a District Judge) that their case was to be tried under the Rule of Reason rather than a per se "boycott" rule; interestingly, the Justice Department had urged this course in an amicus brief filed in this case at the request of the court. However, being reluctant to undertake a full scale rule of reason trial, NBI filed a Business Review Request with the Justice Department in Washington, asking for its approval of a slightly modified network exclusivity rule. Ultimately, the Department declined to give a favorable Business Review letter in late 1975. At that point, NBI reversed positions and said that it would open its doors to all of the depository financial institutions. Mastercard issuers rushed to join the organization. Within a few years, dual membership in the two systems was the overwhelming way of life in the bank card industry.

The same thing happened in the early 1980s in Texas in connection with the PULSE ATM Network. This joint venture had been organized by a group of Texas banks to compete with an ATM system called MTECH which had organized by Mercantile Texas Corporation and was widely offered throughout the state in conjunction with another party called First Texas. The MTECH members applied to join PULSE and were turned down. When these applicants threatened an antitrust boycott suit, the parties ultimately agreed to send the case to the Justice Department for a ruling under the Business Review Clearance procedure. I was representing PULSE at the time and we said to ourselves, "now we have an Assistant Attorney General who really understands bank networks, because he even wrote a book on the subject, so let's get a ruling from him." Well, it turned out that former Professor William Baxter gave the same effective answer as his predecessor Professor Thomas Kauper had, declining the Business Review Request. PULSE, following VISA's lead, opened the door to everybody, rather than face antitrust "boycott" litigation.

The story gets even more ironic. In late 1988, PULSE was charged with having "market power" in the "ATM interchange" market, as part of an antitrust suit with First Texas over PULSE's interchange fees; and, of course, any such "market power" had been created by letting MTECH members in. Meanwhile, today, in the pending Sears-VISA litigation, Sears points to the overlapping membership of VISA and Mastercard as a source of collective market power. What this means, alas, is that, once a network with a valuable franchise opens its doors -- even reluctantly -- to new members shouting "boycott", in order to avoid the immediate threat of an antitrust litigation, the

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network sets itself up for future antitrust claims based "market power" theories. This is what happened to PULSE interchange fees and is clearly happening to Visa on membe restrictions.

The whole question of access in these "boycott" cases highly uncertain and legal uncertainty helps explain why the networks have chosen to open their doors rather than fight in antitrust courts. With the "invisible back office" type of j venture (such as a classic clearinghouse), the practical issue are largely ones of available capacity, proper cost allocation, and appropriate terms of access under what might be called "public utility" principles. By contrast, when the outsider seeks to use a "boycott" complaint to get into a product-creatin joint venture, it is in essence asking for a compulsory trademar license and access to the ancillary systems necessary to make the trademarked network offering work. This is a strong remedy indeed, with many potentially adverse competitive implications.

The problem goes back to a most confusing 1944 Supreme Court decision - involving access to the Associated Press joint venture - where a divided Court seemed to announce a very broad and highly pejorative rule in relation to valuable innovations created by network joint ventures. In fact, the Supreme Court affirmed a District Court decision (written by the famous jurist Learned Hand) that was premised on the press being a unique resource in a free society and hence appropriately subject to some "public utility" duty to deal, and the crucial fifth vote in the Supreme Court was provided by Justice Frankfurter who also believed that the press was totally different from anything else. Unfortunately, the three-Justice plurality opinion (by Justice Black) in the Supreme Court contains sweeping language against restraints on access to jointly-created property (such as Associated Press news services) and it is this language which tends to get quoted and used in cases taking "compulsory dealing" rules far beyond the press context in ~~which~~ the AP case.[3]

As I say, the net result of all this legal confusion is that payment joint ventures have had a real sense of a precarious antitrust existence. They have had no real help and reassurance from the Justice Department or the Fed and have been left to deal with claims of compulsory access on the basis of random "boycott" litigation.

It is interesting - and all too instructive - to look north of the border to Canada. There they do not allow private

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[3] Interestingly, the Supreme Court dissenters warned that the "open access" rule might lead to the demise of the strong competition between Associated Press, United Press and International News Service -- which has in fact largely come to pass. There is an obvious parallel to the Visa-MasterCard and PULSE-MTECH stories here.

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antitrust remedies and they have not spent nearly as much public money on government antitrust enforcement over the years. Yet, in Canada the VISA and Mastercard networks remain entirely separate and very competitive. Thus, a major Mastercard bank (such as the Bank of Montreal) competes for consumer loyalties with only a "Mastercard" offering against, say, Royal Bank, which pushes the superiority of its "VISA" cards. Thus, it seems clear, as a result of less antitrust litigation in Canada, there is more inter-system competition in bank credit card area than we have in the United States. Is that ironic? (Incidentally, when a Canadian bank tried to follow Worthen Bank's lead and break down the system exclusively by bringing a "boycott" antitrust suit under the Sherman Act, the Second Circuit Court of Appeals declined to entertain it on jurisdictional and comity grounds.)

As the Justice Department looks at this north-of-the-border history, it must feel a certain sense of sadness - or, in the alternative, believe that competition at the network level is not all that important, even when the networks could develop highly differentiated offerings for consumers.

CONCLUSION

As we look back over this history of bank mergers and banking networks, we can certainly draw a few broad-brush conclusions. One is that simpler rules affect results - and Philadelphia National gave us a simpler set of rules. Secondly, specific review processes, with real time deadlines, can force "go" or "no go" decision-making that tends to result in more action by government agencies.

By contrast, confusing rules and hard-to-sort-out facts will cause hard pressed and under-staffed government agencies to stand aside and not take positions even on competitive issues which they recognize -- in an uneasy way -- may have a lot long term importance.

I have just had a memorable but minor example of difficulties faced by joint venture partners in this area. About five years ago, I submitted to the Justice Department a request for Business Review clearance in connection with a series of rules contained in a joint payment venture which a group of European airlines wished to set up in order to offer an "air travel card" to business travelers and merchants in the United States and Europe. Their vehicle was a little English joint venture company called "Airplus, Limited". The airlines had had a lot of trouble with the Justice Department in the early 1980s over North Atlantic air fares and they wanted a little reassurance from Justice this time. After a certain amount of back and forth of particular facts, the whole Business Review request seemed to disappear, and presumably Airplus eventually lost interest in it too.

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Then suddenly, in February 1993, I received Business Review Response - and a favorable one too - from Justice. How marvelous, I thought, even if it had not seemed a terribly hard case. But meanwhile, frankly, I had lost touch with Airplus, in part because its chief executive (with whom I had had most of my dealings) had I knew died about a year ago. Anyway, I contacted Jones Day's London office, confirmed the postal address for Airplus, and sent off by mail a "Dear Sirs" letter enclosing their favorable Business Review from Justice. A couple of weeks later, I received a letter back from an accountant who said he had been appointed receiver for Airplus, now in liquidation; he acknowledged receiving my communication, but said that they would not be needing my legal services in the future. Perhaps he feared that I was going to ask for a bonus for this vintage "success"!

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