TESTIMONY OF PAUL A. ALLEN
BEFORE THE
FEDERAL TRADE COMMISSION,
Joint Venture Project
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My name is Paul Allen. I am Executive Vice President and General Counsel of Visa U.S.A. I commend the Commission for holding these hearings and I am pleased to be here.

<u>Background</u>

My purpose, in coming from Silicon Valley to Washington, is to urge the Commission to rethink in a fundamental way the legal rules applied to joint ventures creating new, branded consumer products and services. I speak as the chief legal officer of an organization that – to its increasing dismay – has been one of the great patrons of the antitrust bar – and even of antitrust economics and learning. Visa (and its predecessor, BankAmericard) has engaged in fairly continuous dialogue with the federal antitrust agencies during the entire three decades of our existence, and we have been willing to litigate our business and legal judgments in substantial antitrust cases brought by disgruntled rivals and opponents. While we have won the litigation battles, we have not won the war in a broader sense – any more than the victorious allies sitting at the Versailles Peace Conference had won the First World War. We have expended a great deal of our resources and a great deal of our management time in thrashing and battling with antitrust issues. Such expensive triumphs were only "victories" in the sense that the alternatives were very much worse.

And it is not just Visa. I first got into the payments business in 1982, as General Counsel to a new nationwide ATM system – called "Plus" – which was designed to compete with traveler's cheques and cash advances to enable business travelers and tourists to obtain cash when far away from home. This was a small enterprise headquartered in Denver with a staff of only half a dozen. It had the trademark that we were just beginning to promote around the country, it had high costs and low volumes – and nothing approaching "market power." Yet, even so, we were bedeviled by antitrust issues at every turn. Ultimately, we found ourselves in a very expensive antitrust battle with a regional bank, represented by formidable Washington counsel, that did not like the Plus rule against surcharges[1]. This fledgling network did not want to permit ATM owners to impose surcharges or "access fees" for a simple reason: Surcharges could discourage consumers from using their ATM cards at distant locations and could drive already low network volumes lower. It seemed reasonable judgment at the time; yet, we faced a bitter battle at the hands of an opportunistic bank that thought that <u>it</u> could do better, even if <u>the network</u> did worse, and that case ended up in something of a draw – because the state legislature, acting on behalf of the bank – mandated surcharges in that state. (Years later the Plus System ultimately prevailed on the same issue in a later battle in another circuit.)

In 1987 Visa acquired a substantial stake in the Plus network, and it was thus that I came to this much larger joint venture with its own rather rich antitrust history (that was due to get even richer).

<u>My Question</u>

As I think about Visa's history (and that of Plus, too), I find in the law and government enforcement policy a deep and pervasive bias against product-creating joint ventures that seems totally unjustified from the standpoint of productive efficiency or consumer welfare. If Visa were a unitary enterprise rather than a joint venture, with the same market share position in any relevant

[1] Surcharges are access fees levied by an ATM owner on the cardholders of other financial institutions when such cardholders use the ATM.

market, would Visa have faced any antitrust case or business review clearance issue worth talking about, or even had an interesting law review article written about it? The answer, it seems, is a clear "no."

Yet because Visa is a joint venture – composed of thousands of members that are regulated financial institutions – its business practices are subject to scrutiny in a manner and to a degree unthinkable for a unitary enterprise. In short, it is structure not behavior that shapes our legal battlefield. And that is bad legal and economic policy.

Let's look at what Visa is and compare it to some arguably comparable enterprises.

Visa is the creator of a famous consumer service based on a network that enables its members (card issuers and acquirers) to communicate with each other, interchange traffic, and allocate risks and losses. Because it is a consumer product, the network (unlike an automated clearing house or an electric power pool) has had to create and promote a new, but now famous, service mark among consumers and merchants. The network has had to persuade (a) consumers that its trademarked cards would be widely accepted and (b) merchants that these cards would be so widely used as to generate additional sales volume. All this has required creation of technically sophisticated systems that are capable of processing the consumer-merchant transactions efficiently and reliably, as well as rules to assure that risks are appropriately allocated and that there would be no discrimination against any particular Visa card or card issuer. This is a formidable task operationally and legally, but it has created a system in which small banks as well as large banks can offer customers a very widely accepted product over which the issuing bank retains substantial control.

In short, Visa has created a system that permits the smallest independent bank – to say nothing of regional or super-regional banks – to compete head to head with Visa's brand competitors (such as MasterCard, American Express or Discover) and with Visa's biggest members such as Citicorp or First U.S.A. Indeed, competition among members is a critical part of the way that Visa has chosen to have its trademarked services offered to consumers and merchants. Visa does not set the terms on which a card-issuing bank deals with a consumer, or an acquirer bank (or processor) deals with a merchant. Visa left these issues to competition – which is intense. Intra-brand competition among Visa members is manifested in the financial terms, such as annual fees, APR's, and miscellaneous fees; as well as credit lines, payment terms, airline miles, special discounts, or other bonuses as special differentiating inducements. It is thus Visa's task to define the core product, maintain its integrity, and promote the brand in a noisy marketplace. It is the member's task to set the key terms of the consumer and merchant relationship, to sign up cardholders to initiate transactions, and to sign merchants to accept them. Visa does not dictate any of these terms to members, cardholders, or merchants.

In other words, Visa has created a powerful trademark and the system behind it to make the trademark valuable. It licenses its trademark and systems to its members, who happen to be the "owners" of this "not for profit" corporation.

Now let's contrast Visa with several other familiar licensors of well-known trademarks. For example, take Coca-Cola: It has developed the formula, promoted the familiar trademark, and provided the syrup to franchisees who bottle the product and sell it, generally within assigned territories. In a few cases, the bottling company is owned by Coca-Cola itself, but the majority of bottlers are apparently independent. Coca-Cola itself, of course, is a publicly-traded company listed on the New York Stock Exchange. So is McDonald's. It, too, has developed a famous trademark based on expensive advertising, careful positioning of franchisees, and a quality control system. What the public eats at the McDonald's stand is produced by the franchisee under McDonald's specifications.

Now, why should everything be so different, because Coca-Cola and McDonald's happen to be owned by the public at large, rather than by their franchisees? Should it make a difference that these are two, profit-seeking companies structured as unitary enterprises – rather than a not for profit company structured as a joint venture with its thousands of member financial institutions?

As I understand it, Coca-Cola and McDonald's would be free to do many things under the antitrust laws that could raise problems if done by Visa:

- Under the so-called Colgate doctrine, such a company is free to decide who it wants as a franchisee;
- Under the GTE Sylvania doctrine, it is free to assign licensees particular territories;
- Under the trademark laws, it cannot be compelled to license its mark involuntarily;
- Under the Tampa Electric doctrine, it is free to impose an exclusive dealing license requirement on its licensees;
- It is free to price services to its licensees in any manner that it regards as making good business sense.

And, in fact, Coca-Cola and McDonald's have generally done exactly these kinds of things while Visa has had to forego doing so or litigating about the right to do so.

Networks Are Different

Of course, the operation of a network involves an even greater degree of interdependence – and need for rules – than the fast-food franchising or self-drink bottling businesses. There is more room for fraud, free riding, and opportunism among the participants in a network than there probably is among bottlers or hamburger vendors. Accordingly, I suggest that in the name of efficiency networks ought to have even more flexibility in setting the rules of operation and in deciding who is going to participate and on what terms.

In fact, it is probably true that a network does have substantial flexibility so long as it can show that its rules are necessary to the working of the network – provided that the network is controlled by a unitary enterprise rather than a joint venture.

In our own business, Visa competes (among other areas) at the “brand creation” and “systems” level with at least two enterprises which are part of publicly-traded companies, not joint ventures. These are, of course, (a) American Express and (b) Morgan Stanley, Dean Witter, Discover & Co. These companies can and do make legal demands against Visa on various “conspiracy” and “boycott” theories that neither Visa nor its members can make against them. Visa had a long and costly battle with Dean Witter over the latter’s claim that Visa had to admit Dean Witter as a member and license it to use the Visa marks – but never with a hint of a suggestion that Visa could demand a compulsory license to Dean Witter’s “Discover” mark for use by it and its members. Similarly, Visa and American Express are now engaged in a noisy legal dialogue over whether Visa can exercise the right enjoyed by the typical trademark owner of licensing its mark on the condition that the licensee not issue products under certain competing marks. Thus, it is structure – joint venture or unitary enterprise – rather than conduct that made Visa a target, not American Express or Discover.

But let’s go beyond payment cards. Today we have a variety of non-dominant long-distance telephone networks – and indeed it is nevertheless clear that AT&T can still be called a “dominant” competitor. Sprint and MCI – and I think even AT&T – have broad freedom to deal with whom they want and to set prices and terms designed to assure that their individual networks are effective, reliable and viable. They don't seem to get sued for what we get sued for.

My main point here is simply that being a network may require more sophisticated rulemaking and more sophisticated pricing to make sure the right incentives exist to generate traffic and to restrain the opportunistic instincts of individual users. All that we ask is to be treated to the same set of rules as a network that is owned by the investing public rather than its users.

The Black "Joint Venture" Badge

The response to my plea may be: "Well, you have chosen to be a joint venture and you must just take the legal baggage that goes with it." Such a response harms competition and consumers – because it makes a distinction based simply on the type of organization, on structure rather than conduct, and it fails to recognize that a joint venture may make it possible to create something efficient that might not otherwise exist. This seems particularly true in the network environment.

Starting a new network – particularly one involving a branded consumer service – is complicated and difficult. In the payment card area, somebody has to issue the consumer a card and educate the consumer on its value and use. Somebody else has to persuade a merchant to accept the card in payment of a sales transaction – or to persuade an ATM owner to accept the card and dispense cash. Somebody has to finance all the start-up costs. In order for this to work, cardholders have to be assured that there will be a reasonable range of outlets where the card will be accepted, and the merchants (or the ATM owners) have to be persuaded that there are sufficient number of cards in the hands of consumers willing to use them to generate an economic level of traffic. There have to be rules to allocate risk and assure timely settlement. Such a system necessarily has a high degree of interdependence, and the network brand becomes ever more valuable to all concerned if more card issuers, consumers, and merchants can be added up to the point that transaction costs level out (beyond that point, the branded service may lose its potential product differentiation advantage to those participating licensees). And, given the potential harm to the brand, rules must insure that all network participants are financially sound and conduct their programs in a safe manner.

A large, well-funded corporation, with mass merchandising experience, can by itself create a successful branded payment service. The Discover card was launched by Sears Roebuck, a successful merchandiser with a great many existing customer relationships and a history of issuing proprietary cards. Another major issuer, American Express, created the original "travel and entertainment" card, enjoyed a well-known brand and a long customer list comprised of the most desirable customer segments, and can generate new network-type payments products, including credit and ATM cards. AT&T no doubt could have started a payments network: It had technical expertise, immense customer base, undeniable marketing skills, and a well-known brand. Instead, it opted to issue a Visa card, and Visa swallowed its reservations on this, rather than face the risk of antitrust litigation. My point is that AT&T could not have gone to American Express and demanded as a matter of law the right to issue American Express cards. And the law, by forcing Visa to acquiesce, achieved the rather perverse result of discouraging the creation of a new systems competitor. Indeed, Professor Philip Areeda, with whom I had the wonderful opportunity to work in connection with our appeal from the adverse trial decision in the Discover case, noted the perversity of the antitrust laws encouraging overinclusion in existing joint ventures rather than encouraging competition through formation of new competing ventures.

Visa's Expensive History

Let me illustrate the issues I have described by briefly recounting some chapters from Visa's history[2]. We will, of course, amplify these in subsequent written presentations. In each instance, what I am offering you is a very brief view of what is a much longer story.

1. **Exclusivity.** Visa's original predecessor was organized in the late 1960s by Bank of America (which owned the "BankAmericard" trademark) and a series of licensees in other parts of the country. The basic BankAmericard model was to have one licensee in each major market with the exception of New York City (where there were two). Meanwhile, a more "town meeting" type of organization was created by others: It was called Master Charge and ultimately become today's MasterCard. Thus, in each local market, a BankAmericard issuer (such as

[2] (Some of this history was recounted to the Commission over two years ago at a similar setting by my colleague Bennett Katz, Group Executive Vice President and General Counsel of Visa International.)

Philadelphia National Bank or First National Bank of Chicago) competed against several other banks in offering what it believed was a distinct "blue, white and gold" product. BankAmericard members were very committed to this idea of exclusivity, because each thought it had something special to offer that no other local rival could.

Unfortunately, this system was upset by a disrupter – the Worthen Bank in Little Rock – which wanted to issue both cards and acquire both types of transactions. It brought a "boycott" suit which went up to the Eighth Circuit and resulted in a remand for a rule of reason trial. At that point, Visa and Worthen agreed that Visa would submit an exclusivity rule to the Justice Department for clearance under the Business Review procedure, rather than continue to litigate. In 1975, after contemplating the matter for almost a year, the Department declined to issue a favorable business review clearance. Visa, then a small company faced with the risk of litigation and treble damage exposure, abandoned its exclusivity rule; and perhaps to the surprise of the Justice Department, most banks in the country quickly became dual-issuers. If Visa had been a public corporation, not a joint venture, it surely would have had no problem with the Worthen issue at all since at the time it had under 25 percent of all the card transactions. It could have said to Worthen, "No – see Colgate."

2. **Prices.** It is necessary in a network to make sure that critical players have the right incentive to promote the network's products. In credit cards, the key problem was to get cards issued and to reimburse issuers for promotional costs, fraud losses and float (which was substantial under the original paper-based system). In a new ATM network, the problem was different: No ATM owner has any incentive to allow a foreign card in its machine unless it gets paid for it. In dealing with these realities, the credit card network set up a system of interchange fees payable by the merchant's bank to the card issuing bank, while in the ATM environment they created a system

of payments by the cardholder's bank to the ATM-owning bank on a foreign transaction. Visa litigated the legality of the credit card interchange fee at great lengths, all the way up to the Eleventh Circuit, in a suit brought by a third party processor who said that it was disadvantaged. Visa won the case[3], but it took four years and millions of dollars in costs. American Express, or AT&T, or Discover would not have had these issues if they had chosen to franchise part of their system: they could simply provide necessary subsidies to card issuers on credit card transactions and ATM owners on ATM transactions. There would have been no antitrust question at all.

3. **Exclusivity Revisited.** Sears Roebuck, after an exhaustive study, decided to launch its own new credit card (the "Discover Card") in 1985 because this seemed to be the most profitable course. Several years later, it decided that it also wanted to issue a Visa card in competition with the thousands of banks that were already issuing the Visa card. Visa responded with a bylaw that said that those who created competing credit cards (at the time Sears-Dean Witter and American Express) were not eligible to issue Visa cards. Sears-Dean Witter sued on a "boycott" theory in a state (Utah) where it quite publicly – indeed, on the State House steps – promised to set up a large credit card solicitation and processing operation (and hire 4000 Utahns) and it secured a jury verdict that threatened Visa with hundreds of millions of dollars of liability. Visa appealed to the Tenth Circuit Court of Appeals and won a hard-fought victory that rested on findings that Visa lacked market power and that the denial of membership had no effect on consumers[4]. (Dean Witter had alleged that you could simply add up all the market shares of the Visa and MasterCard issuers and thus obtain a 75 percent market share, without considering that those various issuers whose shares

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[3] NATIONAL BANCARD CORP. v. VISA U.S.A. INC., 779 F.2d 592 (11th Cir. 1986)
[4] SCFC ILC, INC. v. VISA U.S.A. INC., 36 F.3d 958 (10th Cir. 1994)

were being aggregated competed very hard with each other.) The plaintiffs sought certiorari and it was denied. Again, there would have been no issue if Dean Witter had chosen to go after American Express and insist on the right to issue American Express cards. That suit would have been eliminated on a motion to dismiss – even if American Express had as large a share of processed credit card transactions as Visa has. Instead, we spent years in discovery and courts and incurred millions of dollars in litigation costs.

4. **Brand Protection.** Earlier this year, Visa successfully defended itself against an antitrust challenge by a member which claimed the right to issue a Visa card that earned points towards the American Express Membership Rewards Program, thereby co-mingling Visa's brand with American Express, threatening to dilute the impact of Visa's successful marketing campaign (…and they don't take American Express) and promoting the brand of a formidable competitor. In other words, opportunistic behavior that may have benefited one member at considerable cost to the other network participants and would have allowed American Express to free ride on the Visa brand. That claim could not have been brought without fear of Rule 11 sanctions if McDonalds objected to one of its franchisees engaging in a promotion with Burger King whereby sales of Quarter Pounders earned points toward a Whopper. And, once again, I ask why the different standard? Why should the law require that Visa, or any other similar product creating joint venture, engage in expensive litigation with no guarantee of success and the consequential risk of treble damages or retreat from a sound business decision protecting its most important assets simply because of its organizational structure?

5. **Exclusive Dealing.** Now, American Express (and presumably Discover) are publicly challenging a Visa rule which says that a Visa member, while licensed under the VISA trademark,

cannot issue a branded American Express or Discover card. This would be essentially the same issue that would arise if a Coca-Cola bottler was insisting that it had a legal right to bottle Pepsi. But that is not our world.

In an important sense, these examples represent the tip of the iceberg – decisions that were made and defended. My list does not tell you anything about the decisions foregone because of perceived antitrust risk, especially from treble damage exposure to disgruntled market participants. In many instances, the antitrust risk was not great – but the business benefits were simply not great enough to justify the cost of defending a low-risk case against us. This loss of incremental, but still useful, business decisions is an opportunity cost that a joint venture faces in competing with unitary enterprises.

Conclusion

I have chosen to look at the payments network business more from a business perspective than a legal one: First, because the business environment is important for an understanding of the branded network business, which is very different from the rail terminals, local commodities markets, and electric power pools that are the standard stuff of historic antitrust analysis. Second, the business environment must inform the legal analysis if we, and you as regulators and enforcers, are to vindicate the purpose of the antitrust laws.

We will, of course, provide the Commission with a much more detailed view on the war when we file our written comments in August. What we will be telling you will include these basic points:

1. While the per se rules of the pre-1977 era were worse, the "rule of reason" is still a

source of immense uncertainty – and hence deterrence – to a joint venture that must justify every business decision under it. It often seems a "Brandeisian Swamp"[5] in which everything is relevant but nothing dispositive. Outcomes are very hard for counsel to predict.

2. Joel Klein's proposed "stepwise approach" is the wrong way to look at joint venture operations.[6] It starts with efficiencies (which are notoriously hard to evaluate precisely and like the concept of "good cause" in employee wrongful termination cases always subject to cries of "pretext" that may prove persuasive to a jury) and then turns to competitive effects. When applied to the hundreds of decisions that a joint venture must make every year, it will add nothing but difficulty.

3. The "inside" decisions of a product-creating joint venture ought not to be treated under cartel-flavored "agreement" principles under Sherman Act §1. A joint venture should be as free as a single firm in setting network incentives (interchange fees, etc.), interface standards, service and advertisement requirements, free-riding prohibitions, and anti-fraud standards for its members. Such a joint venture would of course be subject to Sherman Act § 2 type rules for exclusionary "inside" decisions supported by substantial market power; and "agreement" type rules for its agreements with outsiders (suppliers, competing joint ventures, independent licenses, etc.).

I simply ask that the Commission think hard about how a brand-creating joint venture (which is plausibly efficiency-enhancing) can be treated in a way that does not either face it with a series of one-way streets versus unitary enterprises or discourage joint venture partners from taking the risk and making the effort to create a new branded network.

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[5] Due credit here to Donald I. Baker for this apt term.

[6] "A Stepwise Approach to Antitrust Review of Horizontal Agreements", Washington, D.C., November 7, 1996. When it comes to cross licensing and pooling, Mr. Klein advocates the "competitive harm first", "efficiencies second" approach. See "Cross Licensing and Antitrust Law", San Antonio, Texas, May 2, 1997, Mr. Klein's speech to the American Intellectual Property Law Association.

One of the classic joint venture justifications is the "voyages of discovery" idea – where primitive early stock companies were created to finance and share risks on the obviously risky voyages across the Atlantic to the new World in the 15th and 16th centuries. In our world, there are risky voyages and in addition there are potential economies of scope and scale. The Commission should not want to do anything to deter joint ventures from being created, to create new products, or to be independent competitors in our ever changing market of global competitors.

About the Witness

Paul Allen is Executive Vice President and General Counsel of Visa U.S.A. Inc., based in the San Francisco Bay area. As such, he is responsible for legal and government affairs for Visa U.S.A. He joined Visa in 1991 as vice president and staff counsel. From 1983-1991 he was General Counsel of Plus System, Inc., a Denver based joint venture of regulated financial institutions that developed the first global ATM network. Prior to that, he was a partner in a Washington, D.C. law firm that specialized in antitrust litigation.

Mr. Allen has an undergraduate degree from Johns Hopkins University, a law degree from New York University, and an MBA from the University of Colorado.