PANDORA’S DIGITAL BOX: DIGITAL WALLETS AND THE HONOR ALL DEVICES RULE

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EXECUTIVE SUMMARY

Digital wallets are software applications based on mobile devices, desktop computers, or the Web that store and transmit payment authorization data for one or more credit or deposit accounts. After a consumer loads her payment account data into a digital wallet, the digital wallet then functions as a payment device for that account, transmitting the data to merchants to authorize payment. Data for multiple accounts can be stored in a single digital wallet, just as multiple payment cards can be stored in a physical wallet, allowing the consumer to select which account to use for payment.

Despite the functional similarities, payments from digital wallet present materially different risks and costs for merchants than traditional plastic card payments. Digital wallets can reallocate flows of consumer data from merchants to financial institutions and thus deprive merchants of valuable customer information used for anti-fraud, advertising, loyalty, and customer service purposes. Digital wallets can also facilitate poaching of customers by competitors, impair merchants’ customer relationship management, deprive merchants of influence over tender choice and payment routing, increase fraud risk, subject merchants to patent infringement liability, and ultimately increase the costs of accepting payments.

The particular risks involved vary by digital wallet, but merchants are highly restrained in their ability to refuse or condition payments from digital wallets because of “Honor All Devices” rules promulgated by American Express, MasterCard, and Visa for merchants that accept payments with their network brands. The Honor All Devices rules require merchants to accept all network-branded payments from any device that uses a communications technology accepted by the merchant—magnetic stripe, Near Field Communications, Internet, etc. The Honor All Devices rules thus tie acceptance of a card network’s payments via digital wallets to the acceptance of traditional plastic cards that use the same communications technologies. The Honor all Devices rules force merchants to accept payments from all digital wallets utilizing a card network brand and thereby to open a digital Pandora’s Box that entails an unknown set of risks.
While the Honor All Devices rules impose various risks and costs on merchants, they also skew the competitive landscape for digital wallets. By preventing merchants from accepting only certain brands of payments from digital wallets, the Honor All Devices rules operate as interbrand restrictions on trade because they foreclose entry to digital wallets that make low-cost PIN-debit and ACH payments. The Honor All Devices rules thus artificially increase the market shares of the high-cost credit and signature debt products of American Express, MasterCard, and Visa in the payment card network services market. The Honor All Devices rules should invite serious antitrust scrutiny because they produce cognizable harms to competition.

Key Findings:

- For payments processed through credit and debit card networks, digital wallets do not change the fundamental design of the five-party payment card system set up. Nor do they necessarily change the basic fee structure in the design, although they may reallocate some of the value in the system and possibly increase costs . . . What digital wallets do change is the possible range of communication technologies for transmitting payment authorization from consumers to merchants and, more importantly, the format of the payment authorization data. These changes are significant because they may affect the flow and control of consumer data.

- Among the Card Networks’ rules are “Honor All Cards” rules that require merchants to accept all cards carrying the Card Network’s logo. The Card Networks interpret their Honor All Cards rules to be “Honor All Devices” rules, meaning that merchants are required to accept all devices set up to transact through the Card Network, to the extent that the merchant accepts payments using the communications technology employed by the device.

- The Honor All Devices rule not only requires acceptance of all wallets using a technology, but also non-discrimination among devices and among technologies. Therefore, a merchant that takes magnetic stripe payments must accept emulated magnetic stripe payments, such as those used by SamsungPay, without discrimination. Similarly a merchant that takes NFC cards must accept all NFC devices, including devices running ApplePay and Android Pay wallets, without discrimination.

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1 Since a 2003 litigation settlement, there has been a carve-out from the MasterCard and Visa Honor All Cards rules allowing merchants to choose whether to accept only their credit products, only their signature debit products, or both. Within each category of cards accepted, however, the Honor All Cards rule still applies.

2 It is unclear how the Honor All Devices rules operate when there is an intermediate payment aggregator, such as PayPal or Square. In the payment aggregator model, the aggregator pays the merchant using a low-cost payment method, such as ACH, and in turn bills the Card Network as if it were the merchant. The aggregator business model is based on arbitraging the difference in merchant discount fees paid by the aggregator and the merchant. Presumably a merchant that accepts PayPal mobile payments via QR technology is not obligated to accept other QR devices because the merchant has not actually received a payment from a Card Network directly.
Even without the Honor All Devices rules, merchants would have limited ability to accept digital wallets selectively because they cannot identify the particular digital wallet used or even if a digital wallet is being used. When a consumer pays with a digital wallet based on a smart phone, for example, using NFC communication, the merchant cannot determine whether an NFC-enabled card or a NFC-enabled digital wallet was used, much less which wallet on the smartphone was used.

The Card Networks have required card issuers to provide a “Form Factor Indicator” or “device type value” that can identify the device being used to make the transaction. Merchants interviewed for this study, however, uniformly claim that card issuers are not in fact providing form factor information, despite the presence of a data field for such information. As a result, merchants do not even know with which digital wallets they are dealing.

All in all, then, merchants are not able to identify digital wallets, and even if they could they are prohibited from selective or conditional acceptance of digital wallets that use any particular communications technology through which the merchant accepts payments made on a Card Network brand. A merchant cannot decide to take one type of digital wallet, but not another, if the wallets use the same basic communications technology, even if the risks involved in the particular wallets vary materially. In other words, the Honor All Devices rules tie acceptance of different types of payment devices using the same basic communications technology.

The problem merchants face, however, is not simply that other parties are the ones who can harvest and harness the additional data generated by digital wallet transactions. It is that there is nothing that prevents the digital wallet providers or the Card Networks from selling the data to third parties, including the merchant’s competitors, who can then use it to poach the merchant’s customer relationships.

The Honor All Devices rules and lack of ability identify devices means that merchants cannot protect themselves either proactively or reactively by declining to accept certain devices or by limiting the types of purchases they will allow on a device. For example, even if a merchant were to believe that communications via certain NFC wearables were compromisable, the merchant could not refuse to accept NFC payments from those wearables.

Likewise, if a security problem were to emerge with wallet, such as ApplePay, that would allow ApplePay to be used for fraudulent transactions, merchants could not protect themselves reactively by limiting purchases of open loop gift cards (a favorite purchase for fraudsters) or of high-value items with ApplePay. The Honor All Devices rules, however, prevent merchants from refusing to accept or from discriminating against less secure devices despite the risks they pose to merchants.

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3 See, e.g., Visa Rules § 4.1.22.10 (Oct. 16, 2015) at PSR-165; MasterCard Rules § 6.1.1, Dec. 11, 2014 (“An Issuer must ensure that each contactless-enabled MasterCard Card or Access Device newly issued or re-issued on or after 18 October 2013 is personalized with the appropriate device type value.”).
• The Honor All Devices rules raise credible antitrust concerns about illegal restraint of trade. The Honor All Devices rules restrict merchants’ ability to accept digital wallets selectively or conditionally. This enables the Card Networks to maintain their market power in the overall payment card market in the face of technological transformation. Absent the Honor All Devices rules’ restraint on merchants, there would more likely be entry by competing digital wallets offering cheaper payments using PIN debit and automated clearing houses (ACH).

• The Honor All Devices rules also operate as a type of tying arrangement that ties together plastic cards and digital wallets and thereby also ties the markets in the related products of plastic card network services and digital wallet network services. This tying enables the Card Networks to expand their market share in the digital wallet network services area, particularly as token service providers. Accordingly, the Honor All Devices rules should invite serious scrutiny by competition regulators and could presage private litigation.

• The Honor All Devices rules injure competition by restricting competition for network services at point-of-sale (as opposed to on-line). This has the effect of foreclosing the entry of digital wallets that utilize lower-cost point-of-sale payment methods, such as PIN debit and ACH payments. Not only does this foreclosure harm competing digital wallets, but it also harms merchants by forcing them to deal with a market in which prices are artificially inflated because of reduced competition.

• The consumer protection argument [of consumers expecting universal wallet acceptance in stores] does not ring true for digital wallets. Because there are no technology mandates, a consumer with a digital wallet cannot reasonably be confident that any particular merchant will have the technical capability of accepting payments from the wallet. The reasonableness of consumer expectations is premised upon the existence of an Honor All Devices rule. Moreover, to the extent that a digital wallet makes Internet payments, there is little risk of consumer embarrassment, as it would not likely be a point-of-sale transaction. Instead, the consumer would simply have to take another second to fish out a traditional plastic card for payment. Even for point-of-sale transactions, there is little harm from the consumer embarrassment—being told that a digital wallet is not accepted is not the same as having a card declined for being overlimit, for example—and most consumers still carry physical cards in physical wallets, not just digital wallets, and will continue to do so as long as various identity cards such as drivers’ licenses and employee ID cards and transit passes are not digitized.

• Indeed, if merchants were able to negotiate individual deals with digital wallet providers they would likely adopt digital wallets more quickly because there would be clear value propositions for acceptance of those wallets. The Honor All Devices rules may thus actually impede the adoption of digital wallets.

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4 An assumption of this analysis is that there is no collusion between the Card Networks; such collusion would raise different and additional antitrust issues. Likewise, a consideration of the antitrust issues presented by the EMVCo joint venture and of its reported limited licensing of its tokenization specification is beyond the scope of this study.
Functionally, then, what the Honor All Devices rules do is to tie together the markets for network services for plastic cards ("plastic network services") with that for digital wallets ("digital network services"). Digital network services include additional services beyond plastic network services, particularly related to tokenization. The test for distinct products under the *per se* rule is, at a minimum, whether there is consumer demand for both products separately. The answer here is clearly yes, in that not all merchants accept digital wallets currently—for example, merchants who use only "knucklebusters" or take cards only by telephone orders—and therefore not all merchants demand digital wallet network services. Thus, there are distinct services involved in the tying.

The Honor All Devices rules are different, in that the risks that merchants are compelled to accept under the rule are not always easily quantifiable price terms. The Honor All Devices rules compel merchants to accept digital wallets that are Pandora’s Boxes, of varied and unknown risks. A merchant cannot know if by accepting NFC payments, for example, it will be opening a window into its transactions for a competitor, or whether it will be exposing itself to a patent infringement suit. These risks are real, but the probability and magnitude of these risks are difficult to estimate. The Honor All Devices rules thus impose a set of serious, but hard to quantify risks on merchants. While these harms are real, they are not a cognizable antitrust injury. Instead, the antitrust problem presented by the Honor All Devices rules is that they also operate to raise barriers to entry to lower-cost digital wallets that make PIN-debit and ACH payments. Thus, instead of technological advances lowering the cost of payments to merchants, the Honor All Devices rules all but ensure that technological advances will raise the cost of payments to merchants. The result is likely to impede the speed of adoption of digital wallets overall.

The fact that this is the third round of antitrust problems with the Card Networks’ merchant restraint rules is also a strong indication of the inadequacy of the settlements in the prior rounds of litigation. The prior rounds’ settlements addressed specific applications of the merchant restraint rules, but left the door open for other applications. As long as the Card Networks continue to exercise market power, their merchant restraint rules are likely to remain problematic. Given the glacial speed of antitrust litigation and the rapid pace of technological change, addressing these problems through the courts is likely to be a slow-motion game of antitrust Whack-a-Mole. Litigation may simply not be a sufficient tool for solving the problem long-term; instead, the persistent problems stemming from the concentrated market power of the Card Networks may require regulatory interventions.

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5 Merchants access these network services markets only indirectly, through their acquirers.