Federalism and Federalization on the Fintech Frontier

Brian Knight[*+]

ABSTRACT

The rise of financial technology (fintech) has the potential to provide better-quality financial services to more people. Although these enhanced financial services have arisen in order to meet consumer need, their regulatory status threatens that progress. Many fintech firms are regulated on a state-by-state basis even though their transactions are interstate, and they compete with firms that enjoy more consistent rules through federal preemption. This dynamic can harm efficiency, competitive equity, and political equity. This Article examines developments in marketplace lending, money transmission, and online sales of securities in an attempt to identify situations in which greater federalization of the rules may be justified. It also considers a situation in which the federal government should abstain from intervening, even if it has the right to do so. Whether the states or federal government should take the lead in regulating fintech is an emerging and important question whose answer will affect the financial lives of consumers and investors. This Article seeks to begin a conversation about how to determine whether federalism or federalization is appropriate.

---

[*] The Author would like to thank Hester Peirce, J.W. Verret, Kelly Maguire, and two anonymous peer reviewers for their comments. The Author would also like to thank Vera Soliman and Nick Ingros, as well as Nicole Keefe and the staff of the *Vanderbilt Journal of Entertainment & Technology Law* for their very able research and editing assistance. Finally, the Author would like to thank Thaya Knight for her excellent feedback and near-infinite patience.

[+] *Disclaimer:* The Author was a cofounder of, and retains an interest in, CrowdCheck, an online securities due diligence company.

TABLE OF CONTENTS

I. INTRODUCTION

Financial technology, or "fintech," is the application of technology to the provision of financial services. Although fintech itself is not new, the ways in which people can transmit money, access credit, and invest have recently significantly changed. The influx of new competitors leveraging technology to provide more access, more efficiency, and better value than the status quo is destabilizing the financial industry because these new methods and market participants often do not easily fit in the existing regulatory boxes. These rapid changes are straining existing regulatory assumptions, including the issue of whether and how the states or federal government should regulate fintech firms.

Technology allows fintech firms, many of which lack a traditional financial pedigree or charter, to compete at scale with established entities such as banks—something previously considered too difficult to profitably do in the past. Adding to the momentum, venture capitalists and institutional investors put significant money into fintech startups, either as investors or customers.[1] Meanwhile, incumbents have reacted to the disruption with a mix of trying to "beat them,"[2] "join them,"[3] and "sic the cops on them."[4] Regulators and policymakers have also taken an interest in fintech; they have

---

1. JULIAN SKAN ET AL., FINTECH AND THE EVOLVING LANDSCAPE: LANDING POINTS FOR THE INDUSTRY 2–3 (2016), http://fintechinnovationlab.com/wp-content/uploads/2017/05/Fintech_Evolving_Landscape_2016.pdf [https://perma.cc/AW9Z-QPPQ]. In 2015, approximately $22.3 billion was invested in fintech firms globally—an increase of 75 percent from the previous year. *Id.* at 3.

2. *See, e.g.*, Jason Del Rey, *America's Biggest Banks Have Announced Their Venmo Competitor, Zelle*, RECODE (Oct. 24, 2016, 12:18 AM), https://www.recode.net/2016/10/24/13376676/payments-zelle-banks-venmo-paypal-send-money [https://perma.cc/PHP5-96M6] (discussing a product created by a consortium of banks to compete with Venmo for the person-to-person payments market); Kevin Wack, *The Battle Begins: Banks Take on Online Lending Rivals*, AM. BANKER (Oct. 30, 2016, 9:00 PM), https://www.americanbanker.com/news/the-battle-begins-banks-take-on-online-lending-rivals [https://perma.cc/88AZ-ABUT] (discussing bank-created online lending platforms designed specifically to compete with marketplace lenders).

3. *See, e.g.*, Peter Rudegeair, Emily Glazer & Ruth Simon, *Inside J.P. Morgan's Deal with On Deck Capital*, WALL ST. J. (Dec. 30, 2015, 6:44 PM), http://www.wsj.com/articles/inside-j-p-morgans-deal-with-on-deck-capital-1451519092 [https://perma.cc/F5EY-7THZ].

4. CLEARING HOUSE, ENSURING CONSISTENT CONSUMER PROTECTION FOR DATA SECURITY: MAJOR BANKS VS. ALTERNATIVE PAYMENT PROVIDERS 2–3 (2015), https://www.theclearinghouse.org/-/media/files/research/tchconsumer%20protection%20for%20data%20security%20august%202015%20final.pdf?la=en [https://perma.cc/3LAN-PE84] (arguing that regulation of nonbank payment services providers is inadequate and should be brought to the level of banks).

hosted events[5] and hearings[6] and have otherwise pondered what changes in technology mean for regulation.[7]

From a regulatory perspective, it is significant that fintech facilitates companies of all sizes to compete on a national scale.[8] Although certain market participants—especially banks—enjoy relatively uniform regulation of important aspects of their business because of federal law, many new competitors are governed on a state-by-state basis.[9] If these new entrants' activities are primarily intrastate, there is little cause for concern. However, if the scope of the transaction exceeds the reach of regulation, there could be a significant problem.

Incongruous regulation could place new entrants at an undue disadvantage compared to their incumbent competitors and may deprive consumers of a fully competitive market. Different business methods may create different risks, in which case differential regulation may be justified. However, if the ensuing risks are functionally identical, then different regulatory structures—such as a federal grant of uniformity for only some competitors—are inappropriate.[10]

However, new companies and their consumers are not the only ones who stand to lose from a mismatch between the economic reality and the level of regulation. This mismatch can also lead to people being subject to regulation without representation—as some states

---

5. Adrienne Harris, *The Future of Finance Is Now*, WHITE HOUSE BLOG (June 10, 2016, 6:00 PM), https://www.whitehouse.gov/blog/2016/06/10/future-finance-now [https://perma.cc/8UCG-XWWJ] (summarizing a 2016 White House summer event regarding fintech); *see* Press Release, Office of the Comptroller of the Currency, Forum on Supporting Responsible Innovation in the Federal Banking System (June 23, 2016), https://www.occ.treas.gov/news-issuances/news-releases/2016/nr-occ-2016-55a.pdf [https://perma.cc/NM6E-9JTB]; *see also* Adrienne Harris & Alex Zerden, *A Framework for FinTech*, WHITE HOUSE BLOG (Jan. 13, 2017, 6:36 PM), https://www.whitehouse.gov/blog/2017/01/13/framework-fintech [https://perma.cc/4ZS3-US63] (providing a framework for fintech policy).

6. *See Examining the Opportunities and Challenges with Financial Technology ("FinTech"): The Development of Online Marketplace Lending: Hearing Before the Subcomm. on Fin. Insts. and Consumer Credit of the H. Comm. on Fin. Servs.*, 114th Cong. (2016); *Disrupter Series: Digital Currency and Blockchain Technology: Hearing Before the Subcomm. on Commerce, Mfg., and Trade of the H. Comm. on Energy and Commerce*, 114th Cong. (2016); *Bitcoin: Examining the Benefits and Risks for Small Businesses: Hearing Before the H. Comm. on Small Bus.*, 113th Cong. (2014).

7. *See* Letter from Sens. Sherrod Brown & Jeffrey A. Merkley to Janet Yellen, Chair of Fed. Reserve, Thomas J. Curry, Comptroller of the Currency, Martin Gruenberg, Chair of the FDIC, Rick Metsger, Chair of the Nat'l Credit Union Admin. & Richard Cordray, Dir. of the CFPB (July 21, 2016), http://www.brown.senate.gov/download/fintech-letter_-2016-07-21.

8. *See infra* Part II.

9. *See* discussion *infra* Part III.A–C.

10. *See infra* Part IV.

may be more economically important than others—which may allow those states to disproportionally control the types of products that companies offer in national markets.

State regulation in certain situations has its benefits; after all, state regulation may lead to socially beneficial competition among regulators.[11] Nevertheless, when state regulators wrest control over national markets, the citizens of less powerful states may become subject to de facto regulation in which those citizens have no say.[12] This "predation," as Professors Samuel Issacharoff and Catherine Sharkey call it,[13] denies citizens democratic recourse and harms their autonomy. Conversely, if the transaction is intrastate, states are likely able to handle regulation and impose their own requirements without the federal government's intrusion, even if it technically has jurisdiction.

This Article considers whether the current balance of state and federal regulations in markets for credit, money transmission, virtual currency, and the sale of securities makes sense. Has the reality of those markets changed such that the balance should be reconsidered? Does the current balance damage the interests of efficiency, competitive equity among market participants, or political equity among citizens?

The answer is mixed. In cases of nonbank "marketplace lending"[14] (online lending by a nonbank entity that is funded by the

---

11. *See* Henry N. Butler & Larry E. Ribstein, *A Single-License Approach to Regulating Insurance* (Nw. Univ. Pritzker Sch. of Law, Working Paper No. 154, 2008), http://scholarlycommons.law.northwestern.edu/facultyworkingpapers/154 [https://perma.cc/TQ6Q-Q4EY] (arguing for a federal law that allows insurance companies to sell insurance nationwide using their home state license); J.W. Verret, *A Dual Non-Banking System? Or a Non-Dual Non-Banking System? Considering the OCC's Proposal for a Non-Bank Special Purpose National Charter for Fintech Companies, Against an Alternative Competitive Federalism System, for an Era of Fintech Banking* 35–37 (George Mason Univ. Law & Econ., Research Paper No. 17-05, 2017), https://ssrn.com/abstract=2906329 [https://perma.cc/7XUQ-AAUQ].

12. *See infra* Part IV.C.

13. Samuel Issacharoff & Catherine M. Sharkey, *Backdoor Federalization*, 53 UCLA L. REV. 1353, 1431 (2006).

14. Strictly defined, marketplace lending would require a market for selling the loan to potential buyers, which already exists at lenders such as Prosper and Lending Club. *See How Does an Online Credit Marketplace Work?*, LENDING CLUB, https://www.lendingclub.com/public/how-peer-lending-works.action [https://perma.cc/YKZ7-UAPD] (last visited Sept. 28, 2017); *Peer-to-Peer Lending Means Everyone Prospers*, PROSPER, https://www.prosper.com/plp/how-it-works [https://perma.cc/QE2X-AMFZ] (last visited Sept. 28, 2017). However, the term "marketplace" has been used more broadly when discussing the wave of recent innovative lenders, as in the case of the California Department of Business Oversight's inquiry. *See* Press Release, Jan Lynn Owen, Comm'r of Bus. Oversight, Cal. Dep't of Bus. Oversight, California DBO Announces Inquiry into 'Marketplace' Lending Industry (Dec. 11, 2015), http://www.dbo.ca.gov/Press/press_releases/2015/DBO%20Inquiry%20Announcement%

sale of the loans or by lender equity, frequently involving a bank partnership),[15] money transmission,[16] virtual currency,[17] and the interstate sale of securities over the Internet,[18] the transactional reality has become far more national in nature. As a result, transactions subject to state-by-state regulation are less efficient and less equitable.[19] This lack of efficiency and equitability could justify harmonizing or displacing existing state regulations, either by the states themselves or through preemptive federal regulations. By contrast, the recent reform of Rule 147 by the Securities and Exchange Commission (SEC), a rule that initially sought to impose substantive federal requirements on inherently interstate transactions (use of the Internet notwithstanding), is an area where the federal government should defer to the states.[20]

This Article cannot tackle all the issues implicated by changes in financial technology.[21] Although this Article does not fully cover topics such as cybersecurity regulation, it offers principles for analyzing a wide range of topics.[22] This Article is agnostic as to the underlying substance of regulation. It takes no position on the wisdom of any interest rate limit or licensing requirement. Rather, this Article seeks to analyze whether discrepancies between the entities that regulate competitors are justified. Given the scope and breadth of the topic, the dynamism of the market, and the fact that some of these questions ultimately come down to different policy preferences, this Article does not purport to be the definitive work on the topic. Rather, it merely seeks to propose criteria to be used by policymakers and citizens and debated by all interested parties.

Part II of this Article discusses some of the characteristics of fintech that are most salient for determining whether the states or the

---

2012-11-15.pdf [https://perma.cc/5LQP-9PEH]. This Article adopts the broader definition. *See infra* Part III.A.3.

15. *See infra* Part III.A.3.

16. *See infra* Part III.B.

17. *See infra* Part III.C.

18. *See infra* Part III.D.3.

19. *See infra* Part IV.

20. *See infra* Parts III.D.4, IV.D.

21. This Article does not address issues relating to international regulation of financial products and services. Although some of the issues and dynamics may be similar, there are also significant differences that merit their own examination.

22. In fact, cybersecurity is developing into an area where concerns about political equity among states are highly salient, as a small number of states may wield disproportionate influence. *See, e.g.*, Penny Crosman, *N.Y. Could Set National Standard with Cybersecurity Proposal*, AM. BANKER (Sept. 15, 2016, 1:53 PM), http://www.americanbanker.com/news/bank-technology/ny-could-set-national-standard-with-cybersecurity-proposal-1091341-1.html?zkPrintable=1&nopagination=1.

federal government should regulate the industry. Part III provides an overview of state and federal regulation of interest rates and the effect of such regulations on new marketplace lenders. Part IV then turns to money transmitters and the implications for fintech, followed first by the related but sufficiently separate topic of virtual currencies and then by the topic of online corporate securities offerings. Finally, Part V discusses how the interests of efficiency, competitive equity among market participants, and political equity among residents of various states affect whether the states or the federal government should take the lead in regulating a particular aspect of fintech.

II. WHAT CHARACTERISTICS OF FINTECH MATTER FOR FEDERALISM?

The modern fintech moment is marked by several characteristics that are relevant to the question of who should regulate the industry. Professor Christopher Brummer and Daniel Gorfine have identified several common elements of fintech that can change the economic and legal realities of financial transactions, including the use of borderless platforms, low barriers to entry, and disintermediation of traditional players and the entry of new competitors.[23]

As Brummer and Gorfine note, the Internet "does not observe geographic boundaries or borders."[24] As a result, assumptions about the geographic and political limits of a company's market that underpinned previous regulations may no longer hold. For example, it used to be relatively hard to reach customers in multiple states, but now it is fairly straightforward. The Internet makes it simple for anyone with a functioning search engine to find a financial services provider. To avoid reaching out-of-state customers, the service provider would need to take explicit steps to exclude customers on the basis of their location—steps that can be easily circumvented. This cross-border capability can make financial services more efficient by leveraging the economies of scale provided by a national market, but it places service providers at risk of running afoul of state regulations.

Technology allows new competitors to replace brick-and-mortar stores with customers' computers and smartphones and to replace some staff through automation.[25] By lowering barriers to entry, new technology allows new entrants into previously stable markets and

23. CHRISTOPHER BRUMMER & DANIEL GORFINE, FINTECH: BUILDING A 21ST-CENTURY REGULATOR'S TOOLKIT 4–6 (2014), http://www.milkeninstitute.org/publications/view/665 [https://perma.cc/7MP6-EZ6S].

24. *Id.* at 6.

25. *Id.* at 5–6.

allows new business models that would not have been possible with the markets' traditional economics. For example, by leveraging technology to lower overhead and to obtain capital efficiently, marketplace lenders can compete with banks[26] without the need for deposits or ancillary lines of business found in universal banks. As a result, companies with dramatically different corporate profiles and regulatory regimes can compete for the same customers.

Ease of access and the ability to offer products to a very broad audience have very quickly attracted new entrants to compete with traditional players.[27] It may be necessary to revisit regulations premised on relatively fixed typology for financial market participants. New companies and new methods, such as virtual currency, can quickly become significant from a regulatory perspective. Additionally, established players in other industries may now intentionally or inadvertently enter highly regulated financial markets.

These technological factors affect the economic and business reality of transactions in ways that implicate the division of state and federal regulation.[28] Although technology is not the be-all or end-all of the federalism debate, to the extent that innovation is changing the line between interstate and intrastate transactions, it bears consideration.

III. EXAMPLES FROM THE FINTECH FRONTIER

The examples that follow highlight situations where the changing technological and competitive landscape puts pressure on the current allocation of regulatory authority. This Part examines the examples of lending, money transmission, virtual currencies, and online securities offerings. It also examines how the allocation of power between state and federal law, and the differences between competitors, impact both the competitive landscape and how services can be provided.

A. Consumer and Small-Business Lending and Interest Rates

Lending is a highly regulated space with a long history. Although many lending basics remain unchanged, lending mechanics

26. Letter from author to Thomas J. Curry, Comptroller of the Currency, Office of the Comptroller of the Currency 3–4 (May 12, 2016) (citing MIKLOS DIETZ ET AL., CUTTING THROUGH THE NOISE AROUND FINANCIAL TECHNOLOGY (2016)), https://www.occ.gov/topics/responsible-innovation/comments/comments-brian-knight.pdf [https://perma.cc/8PVM-8GZV].

27. BRUMMER & GORFINE, *supra* note 23, at 5.

28. *See infra* Part III.

are undergoing significant innovation. What was once a face-to-face transaction can now be handled over the Internet. Data and algorithms are supplanting community reputation and the loan officer's "gut," and the question of who should regulate the transaction has become more complex as geography becomes less relevant.

1. State Regulation of Consumer and Small-Business Interest Rates

State governments have traditionally played a leading role in lending regulation, including limitations on the amount of interest and fees a lender can charge.[29] Regulation has varied from state to state and over time.[30] Recent actions by the Consumer Financial Protection Bureau (CFPB) and federal banking regulators may indicate a growing "federalization" of interest rate regulation.[31] Although many observers believe that interest rate and fee limits protect consumers,[32] others argue that such limits are

29. *See* Efraim Benmelech & Tobias J. Moskowitz, *The Political Economy of Financial Regulation: Evidence from U.S. State Usury Laws in the 19th Century*, 65 J. FIN. 1029, 1036 (2010). The earliest usury laws on this continent predate the founding of the United States. For example, the Massachusetts Bay Colony enacted a usury law in 1641, with the remaining colonies following suit in the 1700s. *Id.*

30. *See* Thomas W. Miller, Jr. & Harold A. Black, *Examining Arguments Made by Interest Rate Cap Advocates*, *in* REFRAMING FINANCIAL REGULATION: ENHANCING STABILITY AND PROTECTING CONSUMERS 342, 343–44 (Hester Peirce & Benjamin Klutsey eds., 2016); Benmelech & Moskowitz, *supra* note 29, at 1029.

31. *See, e.g.*, CFPB v. CashCall, Inc., No. CV 15-7522-JFW (RAOx), 2016 WL 4820635, at *1 (C.D. Cal. Aug. 31, 2016); *see also* OFFICE OF THE INSPECTOR GEN., OIG-16-001, REPORT OF INQUIRY INTO THE FDIC'S SUPERVISORY APPROACH TO REFUND ANTICIPATION LOANS AND THE INVOLVEMENT OF THE FDIC LEADERSHIP AND PERSONNEL 2 (2016) (full report not publicly available), https://financialservices.house.gov/uploadedfiles/fdic_oig_ral_report_2-19-16-_searchable_redacted_3.16.16_redacted.pdf [https://perma.cc/R3GM-DKKN] (detailing supervisory conduct that the Office of the Inspector General (OIG) felt improperly discouraged certain banks from issuing refund anticipation loans, a high-interest but legal product). *But see* Letter from Doreen R. Eberley, Dir. of FDIC Risk Mgmt. Supervision & Charles Yi, FDIC Gen. Counsel, to Fred W. Gibson Jr., Acting Inspector Gen. for the FDIC 8 (Feb. 17, 2016), http://www.ballardspahr.com/~/media/files/alerts/2016-FDIC-letter-February [https://perma.cc/V4JV-VEZQ] (disputing many of the OIG's conclusions).

32. *See, e.g.*, Oren Bar-Gill & Elizabeth Warren, *Making Credit Safer*, 157 U. PA. L. REV. 1, 81 (2008) (lamenting that interest rate exportation has rendered states "powerless to protect their citizens from such lending practices [rates in excess of a state's cap] going on within their borders"); Adam J. Levitin, *Hydraulic Regulation: Regulating Credit Markets Upstream*, 26 YALE J. REG. 143, 157 (2009) ("Usury laws were historically the major form of consumer protection in banking because they shielded borrowers from assuming obligations that they could not afford."); Amanda Katherine Sadie Hill, Note, *State Usury Laws: Are They Effective in a Post-GLBA World?*, 6 N.C. BANKING INST. 411, 421 (2002) (noting that "[t]he primary public policy reason supporting usury laws is consumer protection").

counterproductive at best and a means of rent-seeking by incumbents at worst.[33]

In the late nineteenth and early twentieth centuries, there was concern that interest rate limits too low to attract legal capital for small loans left borrowers at the mercy of illegal lenders (or "loan sharks").[34] This concern prompted reformers—most notably the Russell Sage Foundation—to propose changing state laws to allow lenders to charge significantly higher interest rates[35] in exchange for complying with certain requirements, including licensing, registration, and a simplified and limited cost structure that prohibited noninterest fees.[36]

This arrangement reflected the realization that to attract and maintain stable legal lenders, the potential rates of return had to be sufficient.[37] It also reflected the reformers' belief that what made small loans dangerous was not necessarily their cost, but the lack of transparency and the loan sharks' use of fraudulent or misleading terms.[38] Lenders that wanted to operate under the new law would be able to charge more interest than previously allowed but would need to maintain high levels of transparency and simplicity.[39] These recommendations took the form of the Uniform Small Loan Law of 1916 (USLL), which was passed in various versions by two-thirds of states.[40] The USLL faced opposition from a classic "bootleggers and Baptists"[41] coalition of (1) illegal lenders who feared competition from

33. *See* Benmelech & Moskowitz, *supra* note 29, at 1070–71 (arguing that rent-seeking by incumbents looking to cut off competition for capital better explains the course of state usury laws in the nineteenth century than the alternative public interest explanation); Miller & Black, *supra* note 30, at 344 (asserting that one explanation for interest rate caps is rent-seeking behavior by those who set them); William Cullen Bryant, Editorial, *On Usury Laws*, N.Y. EVENING POST (Sept. 26, 1836), *as reprinted in* 31 FREEMAN 45 (1981), https://fee.org/media/16244/1981-01.pdf [https://perma.cc/ZF52-MJPY] (arguing that interest rate limits harmed the poor by cutting off access, to the benefit of the rich).

34. Bruce G. Carruthers, Timothy W. Guinnane & Yoonseok Lee, *Bringing "Honest Capital" to Poor Borrowers: The Passage of the U.S. Uniform Small Loan Law, 1907–1930*, 42 J. INTERDISC. HIST. 393, 395 (2012); Miller & Black, *supra* note 30, at 360–61.

35. Carruthers, Guinnane & Lee, *supra* note 34, at 403; Letter from Thomas W. Miller, Jr., Todd Zywicki & author, to CFPB for the Rule on Payday, Vehicle Title, and Certain High-Cost Installment Lending (Oct. 7, 2016) (on file with author) (explaining that relevant interest rates were generally under 10 percent per year, and the Russell Sage Foundation proposed allowing rates between 36 percent and 42 percent).

36. Carruthers, Guinnane & Lee, *supra* note 34, at 400.

37. *Id.* at 403; Miller & Black, *supra* note 30, at 360–61.

38. Carruthers, Guinnane & Lee, *supra* note 34, at 403.

39. *Id.*

40. *Id.* at 394.

41. The phrase "bootleggers and Baptists" derives from Bruce Yandle's observation that opposition to pro-competition regulation often is raised by oddly matched partners—civic groups

legitimate lenders and (2) community advocates who thought the interest rates allowed by the USLL were too high.[42] The USLL also influenced numerous subsequent lending regulations,[43] including the federal Truth in Lending Act.[44] To this day, states continue to regulate rates[45]—and the definition of interest[46]—for both banks and nonbank entities, sometimes applying different standards to each.[47]

2. Federal Regulation of Consumer and Small-Business Interest Rates

As the federal government developed a national banking system to compete with the state-chartered banking system,[48] it began to take a greater interest in lending regulation. National banks had to be able to compete with state-chartered depositories and nondepository institutions regulated by the states. Congress passed the National Currency Act of 1863[49] and its successor statute, the National Bank Act of 1864 (NBA),[50] to help further the Union's war effort by increasing the federal government's control over the banking sector.[51] These Acts created a national currency, a federal bank

---

that worry about the public effect (the Baptists) and market participants that worry they will face increased competition and diminished profit (the bootleggers). Bruce Yandle, *Bootleggers and Baptists—The Education of a Regulatory Economist*, 7 REG. 12, 13 (1983).

42. *See* Carruthers, Guinnane & Lee, *supra* note 34, at 401–02.

43. *Id.* at 394 n.1 (citing ELIZABETH RENUART, PUB. POLICY INST., PAYDAY LOANS: A MODEL STATE STATUTE 6 n.6 (2000)).

44. Truth in Lending Act of 1968, Pub. L. 90-321, §§ 101–45, 82 Stat. 146, 146–59 (1968) (codified as amended at 15 U.S.C. §§ 1601–1667f (2012)); *see* Carruthers, Guinnane & Lee, *supra* note 34, at 394.

45. *See, e.g.*, TENN. CODE ANN. § 47-14-103 (2017) (providing general interest rate limits).

46. *See, e.g.*, S.D. CODIFIED LAWS § 54-3-1 (2017) (defining what constitutes interest); TENN. CODE ANN. § 47-14-102(8) (same).

47. *See, e.g.*, S.D. CODIFIED LAWS § 54-3-13. For example, South Dakota is famous (some may say infamous) for not having a maximum usury rate for its banks. *See id.* However, South Dakota recently applied a 36 percent interest rate to payday and car title loans issued by nonbank entities. *South Dakota Voters Approve Interest Rate Cap on Payday Loans*, KSFY (Nov. 8, 2016, 10:30 PM), http://www.ksfy.com/content/news/South-Dakota-voters-approve-interest-rate-cap-on-payday-loans-400489561.html [https://perma.cc/LU6A-ZN9M].

48. Marquette Nat'l Bank of Minneapolis v. First of Omaha Serv. Corp., 439 U.S. 299, 314–15 (1978) (discussing the legislative history of the National Bank Act); *see also* CONG. GLOBE, 38th Cong., 1st Sess. 1256 (1864) (statement of Rep. Samuel Hooper) (stating the purpose of the National Bank Act was to "render the law so perfect that the State banks may be induced to organize under it, in preference to continuing under their State charters").

49. National Currency Act of 1863, ch. 58, 12 Stat. 665 (repealed 1864).

50. National Bank Act of 1864, ch. 343, § 1, 18 Stat. 123 (1864) (codified as amended at 12 U.S.C. § 38 (2012)).

51. Bank Activities and Operations, 68 Fed. Reg. 46119, 46120 (proposed Aug. 5, 2003) (to be codified at 12 C.F.R. pt. 34); *see* Kirby M. Smith, *Banking on Preemption: Allowing National Bank Act Preemption for Third-Party Sales*, 83 U. CHI. L. REV. 1631, 1633 (2016).

charter, and the Office of the Comptroller of the Currency (OCC)—charged with granting charters to and monitoring federally chartered banks.[52]

Given the NBA's intent to replace the state-chartered system with a federal one, the Supreme Court interpreted the NBA as protecting national banks from "unfriendly legislation by the States" and "ruinous competition with State banks."[53] Section 85 of the NBA, for example, allowed a national bank to either export its home-state interest rate to any state in which it did business or to use the host state's rate.[54]

This interest rate exportation power became especially important with the rise of credit cards, which allowed banks to easily lend to borrowers across state lines. In the landmark 1978 case of *Marquette National Bank of Minneapolis v. First of Omaha Service Corp.*,[55] the Supreme Court held that a bank could charge a borrower the rate of interest of the state in which the bank—not the borrower—was located.[56] The Court considered and rejected the argument that extending credit into Minnesota effectively located the bank there.[57] Instead, the Court looked to the bank's charter[58] and to where the bank actually conducted the bulk of its business[59] to determine its location.

Congress, its ardor to replace state banks having cooled, acted quickly after the *Marquette* decision to provide parity to federally insured, state-chartered banks. Section 521 of the Depository Institutions Deregulation and Monetary Control Act of 1980 (DIDA)[60] included language similar to Section 85 of the NBA, and both courts and regulators have interpreted the provisions in parallel.[61] Congress sought to "allow[] competitive equity among financial institutions, and reaffirm[] the principle that institutions offering similar products

52. Bank Activities and Operations, 68 Fed. Reg. at 46120.

53. Tiffany v. Nat'l Bank of Missouri, 85 U.S. (18 Wall.) 409, 413 (1873); *see also* Smith, *supra* note 51, at 1634–35.

54. 12 U.S.C. § 85 (2012); Smith, *supra* note 51, at 1634.

55. Marquette Nat'l Bank of Minneapolis v. First of Omaha Serv. Corp., 439 U.S. 299 (1978).

56. *Id.* at 312–13.

57. *Id.* at 310–13.

58. *Id.* at 309–11.

59. *Id.* at 311–12.

60. Depository Institutions Deregulation and Monetary Control Act of 1980, Pub. L. No. 96-221, § 521, 94 Stat. 132, 164–65 (1980) (codified as amended at 12 U.S.C. § 1831d (2012)).

61. Greenwood Tr. Co. v. Massachusetts, 971 F.2d 818, 826–27 (1st Cir. 1992); General Counsel's Opinion No. 10 on Interest Charges Under Section 27 of the Federal Deposit Insurance Act, 63 Fed. Reg. 19258, 19259 (Apr. 17, 1998).

should be subject to similar rules."[62] As a result, both federally insured, state-chartered banks and federally chartered banks can charge the higher of either the interest rate allowed in their home state or the rate in the borrower's state.[63]

Section 85 of the NBA and Section 521 of DIDA allow banks to export not only the numerical rate of interest, but also the definition of interest used by their home state.[64] In addition, banks enjoy "most favored lender" status, allowing them to charge the highest rate available to any lender—not just banks—under a state's laws.[65] However, bank regulators have been known to discourage banks from making high-interest loans that are technically legal but, in the regulators' view, harmful to consumers or to the safety and soundness of the bank.[66]

Meanwhile, the law of the borrower's home state generally governs the interest nonbank lenders can charge.[67] State laws are, according to Professor Elizabeth Schiltz, "idiosyncratic," without consistent interest rates or a consistent definition of what constitutes interest.[68] However, the CFPB may be using its authority under the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) to attempt to federalize interest rate regulation.[69] Likewise, the recent and controversial Operation Choke Point may represent an effort by banking regulators to discourage high-interest

62. *Greenwood*, 971 F.2d at 826 (quoting 126 CONG. REC. 6907 (1980) (statement of Sen. Bumpers)).

63. *Id.* at 827.

64. *See* Smiley v. Citibank (S.D.), N.A., 517 U.S. 735, 743–46 (1996) (holding that a national bank could charge out-of-state credit card customers interest payments consistent with OCC reasonable interpretation regarding § 85 and allowed by the bank's home state but prohibited in states where cardholders reside); 12 C.F.R. §§ 7.4001(c), 560.110(c) (2017); General Counsel's Opinion No. 10 on Interest Charges Under Section 27 of the Federal Deposit Insurance Act, 63 Fed. Reg. at 19259 (citing 12 C.F.R §§ 7.4001(a), 560.110(a) (2017)).

65. *See* 12 C.F.R. §§ 7.4001(b), 560.110(b); General Counsel's Opinion No. 10 on Interest Charges Under Section 27 of the Federal Deposit Insurance Act, 63 Fed. Reg. at 19259.

66. *See, e.g.*, OFFICE OF THE INSPECTOR GEN., *supra* note 31, at 13. *But see* Letter from Doreen R. Eberley & Charles Yi to Fred W. Gibson Jr., *supra* note 31, at 1–2 (disputing many of the OIG's conclusions).

67. *See e.g.*, TENN. CODE ANN. § 47-14-103 (2017) (limiting interest that can be charged under certain circumstances); VA. CODE ANN. § 6.2-1520 (2017) (limiting interest that can be charged by consumer finance companies in Virginia).

68. Elizabeth R. Schiltz, *The Amazing, Elastic, Ever-Expanding Exportation Doctrine and Its Effect on Predatory Lending Regulation*, 88 MINN. L. REV. 518, 525 (2004).

69. Dodd–Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010) (codified as amended in scattered sections of U.S.C.); *see infra* Part III.A.3.

loans from nonbank entities by cutting off those lenders' access to banks.[70]

3. The Regulation of Marketplace Lending

It was against the backdrop of federal and state regulation that marketplace lending emerged. Marketplace lending is a broad term encompassing several recent models of nonbank lending.[71] Marketplace lenders share certain characteristics, including use of the Internet to solicit borrowers (and, in some cases, investors to provide loan capital), use of proprietary data and algorithms to assess risk, and use of nondeposit capital to fund loans.[72] The first marketplace lenders directly matched borrowers with members of the public, who would pledge to fund a portion of the loan in exchange for a fixed-rate debt security which the borrower's loan backed. However, over time institutional investors came to play a dominant role in this space,[73] which has led to the proliferation of different models. Business models now include the sale of entire loans to institutional investors, the securitization of loans into asset-backed securities, and investor funding of lenders that hold loans on the lenders' own balance sheets.[74] Some lenders originate their loans directly, whereas others

---

70. STAFF OF H. COMM. ON OVERSIGHT AND GOV. REFORM, 113TH CONG., THE DEPARTMENT OF JUSTICE'S "OPERATION CHOKE POINT": ILLEGALLY CHOKING OFF LEGITIMATE BUSINESSES? 1 (2014); Alan Zibel & Brent Kendall, *Probe Turns up Heat on Banks*, WALL ST. J. (Aug. 7, 2013, 10:27 PM), https://www.wsj.com/articles/probe-turns-up-heat-on-banks-1375923859 [https://perma.cc/3U64-7TWH].

71. *See supra* note 14 and accompanying text.

72. Although banks may purchase loans from marketplace lenders—either directly or via asset-backed securities—with funds generated from deposits, the marketplace lender itself is a non-depository institution and does not have its own deposits to fund loans. U.S. DEP'T OF THE TREASURY, OPPORTUNITIES AND CHALLENGES IN ONLINE MARKETPLACE LENDING 5 (2016) [hereinafter TREASURY REPORT], https://www.treasury.gov/connect/blog/Documents/Opportunities_and_Challenges_in_Online_Marketplace_Lending_white_paper.pdf [https://perma.cc/Y7UH-GPGR] (listing funding sources used by marketplace lenders, including funds invested by depository institutions but omitting deposits placed with the marketplace lender itself); Andrew Friedman, *WTF Is Marketplace Lending?*, TEARSHEET (Apr. 26, 2016), http://www.tearsheet.co/2016/04/26/what-is-marketplace-lending [https://perma.cc/WKC7-V85D].

73. Shelly Banjo, *Wall Street Is Hogging the Peer-to-Peer Lending Market*, QUARTZ (Mar. 4, 2015), https://qz.com/355848/wall-street-is-hogging-the-peer-to-peer-lending-market/ [https://perma.cc/CD9Z-NV9D]; *see, e.g.*, Prosper Funding LLC, Prospectus for Borrower Dependent Notes (Form 424B3) 73 (Jan. 12, 2017) (noting whole loans sold to institutional investors comprised 82 percent of the total loans originated in the quarter that ended Sept. 30, 2016); Lending Club Corp., Quarterly Report (Form 10-Q) 39 (Nov. 11, 2016) (showing of the $2 billion in loans that Lending Club originated in the third quarter of 2016, $1.3 billion, or 65 percent, came from whole loan sales to institutions).

74. TREASURY REPORT, *supra* note 72, at 5–8.

partner with a bank to originate the loan that the marketplace lender then purchases and services.[75]

Marketplace lending has grown significantly since its inception.[76] It has allowed borrowers and lenders nationwide to access and extend credit.[77] Marketplace lenders compete with banks and other traditional lenders on cost, speed, and access. Some borrowers are able to obtain credit more cheaply than they previously could[78] or to obtain credit that traditional sources would have refused to provide.[79] This expanded access to credit is in part because market lenders do not bear the costs of physical branches and outdated technological infrastructure.[80] A lender's cost structure is an important determinant of the rates the lender can offer borrowers.[81] Meanwhile, borrowers turn to marketplace lenders because those lenders are often faster than traditional lenders.[82]

Marketplace lenders face exposure to a complex regulatory environment because of their nonbank status and the Internet's use as a distribution channel. Moreover, they lack any physical barriers to

---

75. *Id.* at 5–6.

76. *Id.* at 9.

77. ROBERT WARDROP ET AL., BREAKING NEW GROUND: THE AMERICAS ALTERNATIVE FINANCE BENCHMARKING REPORT 53 (2016), https://www.jbs.cam.ac.uk/fileadmin/user_upload/research/centres/alternative-finance/downloads/2016-americas-alternative-finance-benchmarking-report.pdf [https://perma.cc/3P5U-LEGC].

78. Yulia Demyanyk & Daniel Kolliner, *Peer-to-Peer Lending Is Poised to Grow*, FED. RES. BANK OF CLEVELAND (Aug. 14, 2014), https://www.clevelandfed.org/newsroom-and-events/publications/economic-trends/2014-economic-trends/et-20140814-peer-to-peer-lending-is-poised-to-grow.aspx [https://perma.cc/GYM9-UZSZ]; *see also* Julapa Jagtiani & Catharine Lemieux, *Fintech Lending: Financial Inclusion, Risk Pricing, and Alternative Information* 26 (Fed. Reserve Bank of Phila., Working Paper No. 17-17, 2017), https://www.philadelphiafed.org/-/media/research-and-data/publications/working-papers/2017/wp17-17.pdf [https://perma.cc/YXL9-CE87].

79. Usman Ahmed et al., *Filling the Gap: How Technology Enables Access to Finance for Small- and Medium-Sized Enterprises*, 10 INNOVATIONS 35, 35–36 (2015) (finding PayPal Working Capital loans disproportionately disbursed to areas with relatively high declines in the number of banks and to traditionally underserved populations); *see also* TREASURY REPORT, *supra* note 72, at 21; Jagtiani & Lemieux, *supra* note 78, at 19–22.

80. Miklos Dietz et al., *Cutting Through the Noise Around Financial Technology*, MCKINSEY & CO. FIN. SERVS. (Feb. 2016), http://www.mckinsey.com/industries/financial-services/our-insights/cutting-through-the-noise-around-financial-technology [https://perma.cc/4T9N-6K33].

81. THOMAS A. DURKIN, GREGORY ELLIEHAUSEN & MIN HWANG, RATE CEILINGS AND THE DISTRIBUTION OF SMALL DOLLAR LOANS FROM CONSUMER FINANCE COMPANIES: RESULTS OF A NEW SURVEY OF SMALL DOLLAR CASH LENDERS 5–6 (2014), http://ssrn.com/abstract=2533143 [https://perma.cc/7KYD-X37S].

82. Richard D. Olson, Jr., *Online Lending: Friend or Foe of Community Bankers?*, COMMUNITIES & BANKING, Fall 2014, at 13, 13, https://www.bostonfed.org/commdev/c&b/2014/fall/online-lending-friend-or-foe.htm [https://perma.cc/T6TU-NYJC].

extending credit and raising investment capital nationwide, possessing the capability for instant scale. However, they face regulatory barriers. Federal law provides state-chartered and federally chartered banks significant regulatory consistency regarding what they can charge for loans across state lines.[83] By contrast, marketplace lenders, as nonbank financial companies, face regulatory inconsistency and duplication. They are subject to federal regulation in a number of areas: the federal prohibition on unfair, deceptive, or abusive acts or practices;[84] consumer protection laws; fair lending laws; and the Bank Secrecy Act (BSA).[85] But they are also frequently subject to state-by-state regulations, including usury laws and licensure requirements.[86]

Licensing is one area in which banks enjoy broad consistency[87] while marketplace lenders face inconsistent, state-by-state regulation. With the exception of licensing of mortgage lenders,[88] state licensing laws for lenders often vary. States have different rules for which activities require licensure[89] and different substantive legal requirements for the license. Some lenders cite the lack of regulatory consistency as a significant problem because it increases complexity and costs while lowering certainty.[90]

---

83. *See supra* Part III.A.2.

84. 12 U.S.C. § 5531 (2012).

85. Bank Secrecy Act of 1970, Pub. L. No. 91-508, §§ 201–42, 84 Stat. 1114, 1118–24 (1970) (codified as amended at scattered sections of 12 U.S.C. and 31 U.S.C.); *see* TREASURY REPORT, *supra* note 72, at 36.

86. TREASURY REPORT, *supra* note 72, at 5; John L. Douglas, *New Wine into Old Bottles: Fintech Meets the Bank Regulatory World*, 20 N.C. BANKING INST. 17, 31–32 (2016).

87. Douglas, *supra* note 86, at 34.

88. Mortgage lender requirements are relatively more consistent as a result of the Nationwide Multistate Licensing System and Registry (NMLS), a joint project of the Conference of State Bank Supervisors and the American Association of Residential Mortgage Regulators. *See* Douglas, *supra* note 86, at 33. The Secure and Fair Enforcement for Mortgage Licensing Act mandated that mortgage loan originators register with NMLS, which helped drive uniformity. *Id.*; *see* Pub. L. No. 110-289, §§ 1501–17, 122 Stat. 2654, 2810–24 (codified as amended at 12 U.S.C. §§ 5101–16 (2012)). Note that mortgages are also subject to a federal law that exempts them from state usury laws, *see* 12 U.S.C. § 1735f-7, and regulations that impose significant additional requirements on certain high-cost mortgages, in effect discouraging lenders from making them, *see* 12 C.F.R. § 1026.32 (2017).

89. Douglas, *supra* note 86, at 32.

90. *See, e.g.*, Letter from Manuel P. Alvarez, Gen. Counsel, Affirm Inc., to Laura Temel, Senior Advisor, U.S. Dep't of the Treasury 7 (Sept. 30, 2015), https://www.regulations.gov/contentStreamer?documentId=TREAS-DO-2015-0007-0080&attachmentNumber=1&contentType=pdf [https://perma.cc/3HLZ-ENHN]; Letter from Sam Hodges, Co-Founder and U.S. Managing Dir., Funding Circle, & Connor French, Legal & Regulatory Dir., Funding Circle, to Laura Temel, Senior Advisor, U.S. Dep't of the Treasury 27 (Sept. 30, 2015), https://www.regulations.gov/contentStreamer?documentId=TREAS-DO-2015-0007-0081&attachmentNumber=1&contentType=pdf [https://perma.cc/7JH9-B656]; Letter from

The desire for consistency—especially in loan pricing—is one reason some lenders partner with banks. As discussed above,[91] banks are able to charge consistent interest rates nationwide, permitting comparable borrowers to be treated alike regardless of the idiosyncrasies of state law. By partnering with a bank, marketplace lenders can offer uniform prices and extend credit to borrowers whose risk profiles necessitate an interest rate above the state limit imposed on nonbank financial companies. This model relies on two traditionally well-accepted legal doctrines: the previously mentioned ability of banks to export interest rates and the common law doctrine of "valid when made."[92] The latter is one of "two cardinal rules in the doctrine of usury."[93] A loan that is not usurious when it is made (in this case, because of the bank's ability to export its home state interest rate to the borrower's state) cannot subsequently become usurious because it is sold to another party—even if that party itself could not have legally originated the loan.[94]

Frequently, in the bank partnership model, the marketplace lender will conduct independent marketing and serve as the intake point for potential borrowers.[95] The marketplace lender performs its own underwriting to assess risk and determines whether to extend a loan and, if so, at what price.[96] If the marketplace lender wishes to extend credit and its bank partner agrees, the bank will originate the loan and sell it to the marketplace lender after a short period of time.[97] In some cases, the bank sells the loan directly to a third

---

Robert S. Lavet, Gen. Counsel, Social Fin., Inc., to Laura Temel, Senior Advisor, U.S. Dep't of the Treasury 3–5 (Sept. 30, 2015), https://www.regulations.gov/contentStreamer?documentId=TREAS-DO-2015-0007-0050&attachmentNumber=1&contentType=pdf [https://perma.cc/DDU2-9X6X]; Letter from Mitria Wilson, Vice President of Gov't Relations, Oportun, to Office of the Undersec'y for Domestic Fin., U.S. Dep't of the Treasury 11–13 (Sept. 30, 2015), https://www.regulations.gov/contentStreamer?documentId=TREAS-DO-2015-0007-0084&attachmentNumber=1&contentType=pdf [https://perma.cc/3MM2-F9YE].

91. *See supra* Part III.A.2.

92. *See* Nichols v. Fearson, 32 U.S. (7 Pet.) 103, 109 (1833) (describing the foundation for the "valid when made" doctrine).

93. *Id.*

94. *Id.* at 110.

95. TREASURY REPORT, *supra* note 72, at 6–9.

96. *Id.*; *see also* Colleen Honigsberg, Robert J. Jackson, Jr. & Richard Squire, *How Does Legal Enforceability Affect Consumer Lending? Evidence from a Natural Experiment* 13 (Columbia Bus. Sch., Research Paper No. 16-38, 2017), https://ssrn.com/abstract=2780215 [https://perma.cc/AN2D-7S2U].

97. TREASURY REPORT, *supra* note 72, at 6; Letter from Renaude Laplanche, Founder & CEO, Lending Club, to Laura Temel, Senior Advisor, U.S. Dep't of Treasury 8 (Sept. 30, 2015), http://ir.lendingclub.com/interactive/lookandfeel/4213397/LendingClubResponseToTreasuryRFI.pdf [https://perma.cc/Y248-9YHS] (responding to the Treasury Department's request for information on marketplace lending).

party.[98] The marketplace lender services the loan, either on its own behalf or on behalf of the purchaser of the loan.[99]

This bank partnership model has come under pressure recently from both the courts and state regulators. The recent case of *Madden v. Midland Funding, LLC*[100] calls into question the ability of banks to sell loans to nonbank entities that service the loans on the original loan terms. In *Madden*, a borrower sued a debt-buying service, claiming that the debt was usurious and therefore invalid under New York law.[101] The borrower executed a credit card contract with a federally chartered bank, using an interest rate under the bank's home state law.[102] The borrowers account was then sold to another federally chartered bank.[103] The borrower subsequently defaulted, her debt was declared nonperforming, and the loan was sold.[104]

The debt purchaser, Midland Funding, tried to collect the debt under the terms of the original contract, including interest accrued at the original interest rate of 27 percent[105]—a rate in excess of New York's 25 percent limit.[106] The borrower argued that Midland Funding was not entitled to interest that accrued after it purchased the debt because it was not a bank and therefore was not able to take advantage of the NBA's interest rate export provision.[107] Midland Funding maintained that, as assignee of a national bank's debt, it was entitled to preemption under the NBA.[108]

The US Court of Appeals for the Second Circuit sided with the borrower, finding that the nonbank debt buyer was neither covered by the NBA nor able to administer the contract on the same terms as the bank.[109] The court reasoned that preventing a nonbank debt purchaser from enforcing loans on the same terms as the bank that made and sold the loan did not sufficiently impair the bank's powers[110] to trigger the NBA's preemption of New York's usury statute.[111]

---

98. TREASURY REPORT, *supra* note 72, at 6.
99. *Id.*; *see also* Honigsberg, Jackson & Squire, *supra* note 96, at 14.
100. Madden v. Midland Funding, LLC, 786 F.3d 246 (2d Cir. 2015).
101. *Id.* at 248.
102. *Id.* at 247–48.
103. *Id.* at 248.
104. *Id.*
105. *Id.*
106. *Id.*
107. *Id.* at 249.
108. *Id.* at 250.
109. *Id.* at 249.
110. *Id.* at 251.
111. *Id.* at 249.

The Office of the Solicitor General and the OCC strongly criticized the Second Circuit's decision as a misunderstanding of the law and precedent.[112] They argued that the power of banks under the NBA to make a loan includes the power to sell the loan to a nonbank entity and have the loan remain valid.[113]

Even though *Madden* did not involve a marketplace lender, it has clear implications for marketplace lending. Marketplace lenders that partner with banks are in a somewhat similar position to the defendant in *Madden*, and the validity of loans that could violate usury laws in New York, Connecticut, and Vermont (the states covered by the Second Circuit) can no longer be assumed. Some marketplace lenders initially represented to investors that contractual choice-of-law provisions applying Utah law (which excludes interest rate caps) would be sufficient to avoid any impact from *Madden*.[114] However, lenders have changed the structure of their partnerships with banks to let the bank retain an interest in the loan's performance, likely as a way to protect against preemption questions.[115]

The market seems less confident that such a choice-of-law approach rests on solid legal ground.[116] As evidence of the market's uncertainty, the amount of investment pledged to loans with interest rates in excess of state usury caps in the states covered by the Second Circuit has declined significantly after *Madden*, despite growth in states not covered by that decision.[117] After the Supreme Court's refusal to hear the case, concern has grown about credit access for risky borrowers. A bill was introduced in Congress in 2016 to codify

---

112. Brief for the United States as Amicus Curiae Supporting Petitioners at 6, Midland Funding, LLC v. Madden, 136 S. Ct. 2505 (2016) (No. 15-610).

113. *Id.* at 7.

114. *See* Sean Murray, *Renaud Laplanche on* Madden v. Midland, DEBANKED (Aug. 8, 2015), http://debanked.com/2015/08/renaud-laplanche-on-madden-v-midland [https://perma.cc/M23E-YQ2D].

115. Smith, *supra* note 51, at 1680.

116. Joseph Cioffi & Massimo Giugliano, *Spotlight Remains on Marketplace Lenders Post-*Madden, LAW360 (July 13, 2016, 4:13 PM), http://www.law360.com/articles/816802/spotlight-remains-on-marketplace-lenders-post-madden [https://perma.cc/G2UL-RQVD] ("Lenders could include a choice-of-law provision in their loan agreements that mandate[s] the application of the originating bank's home state's laws, including usury laws. The effectiveness of such a provision may be case-specific, however, because a borrower may overcome it by demonstrating that application of the chosen law would undermine a fundamental policy of the borrower's home state."); *see also* Douglas, *supra* note 86, at 31 (noting that choice-of-law provisions "must bear some substantial relationship to the transaction.").

117. Honigsberg, Jackson & Squire, *supra* note 96, at 27–29.

the "valid when made" principle,[118] but it failed to pass. However, in 2017 similar provisions have been introduced in the House and Senate.[119]

Although *Madden*'s impact on marketplace lending may be somewhat indirect, it has prompted at least one suit that directly takes aim at the bank partnership model. *Bethune v. LendingClub Corp.* is a civil suit by a borrower who accused Lending Club of engaging in corrupt practices.[120] The borrower alleges that Lending Club, which purchases and services loans originated by its bank partners, was the "true lender" and merely used the banks as a "sham" to evade New York usury law.[121] The complaint cites *Madden* for the proposition that Lending Club, a nonbank lender, is unable to issue or service the loans it purchases from its bank partners when those loans have interest rates higher than the rate cap in the borrower's home state.[122] The plaintiff sought to form a class of similarly situated borrowers,[123] but the defendants successfully argued that the case must be sent to arbitration under the terms of the plaintiff's loan.[124]

Bethune raises two different regulatory questions facing marketplace lenders. One is the previously mentioned question about the validity of loans sold by banks to nonbank entities.[125] The other question relates to the "true lender" doctrine, under which the court looks past the statements of the parties to the economic reality of the transaction, in order to determine the actual lender—and therefore what law applies. In *Madden*, there was no dispute that the original lender was a bank that made the loan for its own purposes, retained

---

118. The Protecting Consumers' Access to Credit Act of 2016 was introduced by Rep. Patrick McHenry on July 11, 2016. *See* H.R. 5724, 114th Cong. § 2 (2016).

119. *See, e.g.*, H.R. 3299, 115th Cong. (2017); H.R. 3280, 115th Cong. § 925 (2017); H.R. 10, 115th Cong. § 581 (2017); *see also* S. 1642, 115th Cong. (2017) (proposing an identical version of H.R. 3299 in the US Senate). *See generally* Memorandum from Jeb Hensarling, Chairman, Comm. on Fin. Servs., to the Fin. Servs. Comm. Leadership Team 5 (Feb. 6, 2017), https://www.cfpbmonitor.com/wp-content/uploads/sites/5/2017/02/CHOICE.pdf [https://perma.cc/MZ63-U6Q3] (proposing to amend the Financial CHOICE Act with language taken from H.R. 5724).

120. Bethune v. LendingClub Corp., No. 16 CIV. 2578 (NRB), 2017 WL 462287, at *1 (S.D.N.Y. Jan. 30, 2017).

121. Complaint ¶¶ 11–17, *Bethune*, 2017 WL 462287, ECF No. 1.

122. *Id.* ¶ 50.

123. *Id.* ¶¶ 63–73.

124. *Bethune*, 2017 WL 462287, at *1; *see* Robert Loeb et al., *Class Action Against Lending Club and WebBank Headed to Defeat*, ORRICK (Jan. 31, 2017), https://www.orrick.com/Insights/2017/01/Class-Action-Against-Lending-Club-and-WebBank-Headed-to-Defeat [https://perma.cc/R9ZQ-YSDC].

125. *See supra* text accompanying notes 100–22.

the loan and relationship for a period of time, and disposed of the loan only after the loan had ceased to perform.[126] By contrast, the plaintiff in *Bethune* argues that the originating bank was a mere tool of Lending Club, the entity that makes the actual decisions, funds the loans, and owns the relationship.[127]

Disgruntled borrowers are not the only parties raising true lender issues in marketplace lending. For example, regulators in New York[128] and California[129] have begun making inquiries of marketplace lenders. Vermont has passed a law requiring "loan solicitors," which would likely include marketplace lenders, to be licensed and regulated by the state.[130] Additionally, regulators in Colorado have sued two marketplace lenders, arguing that Colorado law applies to the loan—despite the fact it was initially made by a bank—on the grounds that the bank is unable to sell the loan and the marketplace lenders are the true lenders.[131] Identifying the true lender is particularly important for state regulators: if the true lender is a bank, state regulators may be significantly limited by federal preemption; on the other hand, if the true lender is a nonbank entity, state regulators have significantly more authority and flexibility.[132]

Additionally, the CFPB has begun to make interest rate limits a subject of federal regulation. Although Dodd-Frank prohibits the CFPB from imposing an interest rate limit without explicit authorization from Congress,[133] the CFPB has begun to nibble at the edges. In its Proposed Rule on Payday, Vehicle Title, and Certain

126. *See* Madden v. Midland Funding, LLC, 786 F.3d 246, 247–48 (2d Cir. 2015).

127. Complaint, *supra* note 121, ¶¶ 11–17.

128. Suzanne Barlyn, *Exclusive: New York Financial Regulator Gearing Up to Probe Online Lenders*, REUTERS (May 26, 2016, 6:11 PM), http://www.reuters.com/article/us-lending-new-york-probe-exclusive-idUSKCN0YG31O [https://perma.cc/6ND8-4MHL].

129. Consumer Fin. Servs. Grp., *California Launches Marketplace Lending, Merchant Cash Advance Inquiry*, BALLARD SPAHR (Dec. 21, 2015), http://www.ballardspahr.com/alertspublications/legalalerts/2015-12-21-california-launches-marketplace-lending-merchant-cash-advance-inquiry.aspx [https://perma.cc/K8AU-89KM].

130. *Vermont Licenses and Regulates Loan Solicitors Including Lead Generators*, COUNSELORLIBR. (May 5, 2017), https://www.counselorlibrary.net/public/alert.cfm?itemID=2420 [https://perma.cc/2JDR-2UT3].

131. Complaint ¶¶ 29–35, Meade v. Avant of Colo. LLC, No. 17CV30377 (D. Colo. Feb. 15, 2017), https://www.scribd.com/document/344289556/Colorado-v-Avant [https://perma.cc/GST5-JA9L]; Complaint ¶¶ 27–33, Meade v. Marlette Funding LLC, No. 17CV30376 (D. Colo. Feb. 15, 2017), https://www.scribd.com/document/344289584/Colorado-v-Marlette [https://perma.cc/9VRD-YXVG].

132. Douglas, *supra* note 86, at 31–32, 34.

133. *See* Dodd–Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 1027, 124 Stat. 1376, 1995 (2010) (codified as amended at 12 U.S.C. § 5517(o) (2012)).

High-Cost Installment Loans (Payday Rule),[134] the CFPB proposed that certain loans with a total annual cost of credit exceeding 36 percent be subject to considerable disclosure and procedural requirements, which would likely render many of those loans infeasible.[135] Such loans include those with which the lender has a lien or "leveraged payment mechanism" that allows the lender to automatically take payment from the borrower's bank account.[136] The Payday Rule, if adopted in its proposed form, could implicate many of the loans made by marketplace lenders because of the lenders' use of the Automated Clearing House (ACH) to "pull" the borrower's payments.

Recently, the CFPB also successfully applied the true lender doctrine to nonbank entities that partner with Native American tribes to issue loans in excess of the borrower's state usury cap, arguing that those loans could violate Dodd-Frank's prohibition on unfair, deceptive, and abusive acts or practices.[137] In *CFPB v. CashCall, Inc.*, the US District Court for the Central District of California granted summary judgment to the CFPB, holding that CashCall, a lender that prefunded and purchased loans issued by Western Sky Financial—a corporation operating under the laws of the Cheyenne River Sioux Tribe (CRST)—was the true lender.[138] The loan contracts contained a choice-of-law provision stipulating that the CRST law would govern the contracts,[139] while Western Sky personnel conducted underwriting and made lending decisions.[140] The court nevertheless found that CashCall was the true lender.[141] It did so by applying a "totality of the circumstances" test.[142]

The court looked at the underlying economics of the transaction and found that CashCall bore the entire risk of the transaction; Western Sky was insulated from the risk that loans would default both contractually and via a prefunded pool of money provided by

134. Payday, Vehicle Title, and Certain High-Cost Installment Loans, 81 Fed. Reg. 47864 (proposed July 22, 2016) (to be codified at 12 C.F.R. pt. 1041).

135. *Id.* at 47912–13; *see* Tom Miller, Todd Zwyicki & Brian Knight, Comment Letter on the CFPB's Proposed Rule on Payday, Vehicle Title, and Certain High-Cost Installment Loans 11, 13 (Oct. 18, 2016), https://www.regulations.gov/document?D=CFPB-2016-0025-143372 [https://perma.cc/AQ9R-XSZJ].

136. Payday, Vehicle Title, and Certain High-Cost Installment Loans, 81 Fed. Reg. at 47864.

137. CFPB v. CashCall, Inc., No. CV 15-7522-JFW (RAOx), 2016 WL 4820635, at *4, *13 (C.D. Cal. Aug. 31, 2016).

138. *Id.* at *5–6.

139. *Id.* at *3.

140. *Id.*

141. *Id.* at *6.

142. *Id.*

CashCall to cover the next two days' worth of loans.[143] The court then found that the choice-of-law provision in the contract was invalid because the CRST lacked a sufficient connection to the transaction to justify using the tribe's law.[144] Although lending decisions were made on CRST property and the court acknowledged that the law of California (CashCall's home state) could arguably apply, the court held that the law of the borrowers' home state should apply.[145] The court reasoned that the borrowers applied for, paid for, and received the funds from the loans in their home states; therefore, their home states' law should apply because these states had the most important interest in the transaction.[146]

The applicability of the true lender doctrine in the context of marketplace lending is muddled.[147] In determining the true lender's identity, some courts—such as the Central District of California in *CFPB v. CashCall*—look to the totality of the circumstances and seek to determine who has the "predominant economic interest" in the loan at its creation.[148] Other courts look to the legal structure of the arrangement as the guiding principle.[149] One such court cited the concern that making a judgment on the basis of subjective intent instead of legal form is too uncertain and inconsistent with federal banking law's intent to exempt banks from state usury laws.[150] It is unclear how courts will apply the true lender doctrine to marketplace lenders using a bank partnership. Likewise, the CFPB's use of federal law to penalize violations of state usury caps could represent a path to federalization of interest rate regulation, though it too remains unclear how extensively this strategy will be pursued. As they did in

143. *Id.*

144. *Id.* at *7.

145. *Id.* at *9.

146. *Id.* at *8. This analysis appears inconsistent with the Supreme Court's analysis in *Marquette*, where the Court found that the lender's home state should control despite borrowers applying for, receiving, and paying for credit from their home states. Marquette Nat'l Bank of Minneapolis v. First of Omaha Serv. Corp., 439 U.S. 299, 299–300 (1978).

147. *See* Richard P. Eckman & Ashleigh K. Reibach, *True Lender Issues Cloud the Future of Marketplace Lending*, PEPPER HAMILTON (Dec. 9, 2014), http://www.pepperlaw.com/publications/true-lender-issues-cloud-the-future-of-marketplace-lending-2014-12-09 [https://perma.cc/MG72-4PKZ].

148. *CashCall*, 2016 WL 4820635, at *6, *13; *see* CashCall, Inc. v. Morrisey, No. 12-1274, 2014 W. Va. LEXIS 587, at *41 (W. Va. May 30, 2014); Spitzer v. Cty. Bank of Rehoboth Beach, 846 N.Y.S.2d 436, 439 (App. Div. 2007).

149. *See, e.g.*, Krispin v. May Dep't Stores Co., 218 F.3d 919, 923–24 (8th Cir. 2000); Beechum v. Navient Sols., Inc., No. EDCV 15-8239-JGB-KKx, 2016 WL 5340454, at *7 (C.D. Cal. Sept. 20, 2016); Sawyer v. Bill Me Later, Inc., 23 F. Supp. 3d 1359, 1368–69 (D. Utah 2014); Hudson v. ACE Cash Express, Inc., No. 01-1336-C, 2002 U.S. Dist. LEXIS 11226, at *16 (S.D. Ind. May 30, 2002).

150. *Hudson*, 2002 U.S. Dist. LEXIS 11226, at *16.

reaction to the *Madden* decision, some marketplace lenders with bank partnerships—in an effort to avoid true lender issues—have been changing their arrangements so that the bank's compensation is tied to performance over the life of the loan.[151]

One way around the question of the true lender's identity is to allow marketplace lenders to become "banks" themselves. That possibility has been suggested to the Treasury Department in response to its request for information on marketplace lending.[152] That suggestion was also made to the OCC in response to its white paper *Supporting Responsible Innovation in the Federal Banking System*.[153] The OCC has supported this view and announced it would offer a Special Purpose National Bank charter to fintech firms.[154] Supporters of this approach include those in the financial services industry,[155] policy professionals,[156] and some consumer advocates.[157]

---

151. Kevin Wack, *Lending Club Tweaks Business Model in Effort to Thwart Legal Challenges*, AM. BANKER (Feb. 26, 2016, 5:54 PM), https://www.americanbanker.com/news/lending-club-tweaks-business-model-in-effort-to-thwart-legal-challenges [https://perma.cc/HV96-8VWS].

152. Letter from author & Staci Warden, Milken Inst. Ctr. for Fin. Mkts., to Laura Temel, Senior Advisor, U.S. Dep't of Treasury 10–11 (Sept. 28, 2015), https://www.regulations.gov/contentStreamer?documentId=TREAS-DO-2015-0007-0023&attachmentNumber=1&contentType=pdf [https://perma.cc/685L-KQ7E]; Letter from Robert S. Lavet to Laura Temel, *supra* note 90, at 3–5.

153. *See* OFFICE OF THE COMPTROLLER OF THE CURRENCY, EXPLORING SPECIAL PURPOSE BANK CHARTERS FOR FINTECH COMPANIES 2, 3 n.1 (2016) (citing OFFICE OF THE COMPTROLLER OF THE CURRENCY, SUPPORTING RESPONSIBLE INNOVATION IN THE FEDERAL BANKING SYSTEM: AN OCC PERSPECTIVE (2016)), https://www.occ.gov/topics/responsible-innovation/comments/special-purpose-national-bank-charters-for-fintech.pdf [https://perma.cc/7RA9-XNKW].

154. *Id.* at 2.

155. Letter from Joan Aristei, Vice President, Opurtun, Inc., to the Office of the Comptroller of the Currency 3 (May 31, 2016), https://www.occ.treas.gov/topics/responsible-innovation/comments/oportun-response-to-occ-responsible-innovation.pdf [https://perma.cc/FF4Y-NCK6]; Letter from John A. Beccia, Gen. Counsel, Circle Internet Fin., Inc., to Thomas J. Curry. Comptroller of the Currency, Office of the Comptroller of the Currency 5 (May 31, 2016), https://www.occ.treas.gov/topics/responsible-innovation/comments/comment-circle-financial.pdf [https://perma.cc/82DY-NBJQ]; Letter from Robert S. Lavet to Laura Temel, *supra* note 90, at 3–5; Letter from Juan Suarez, Counsel, Coinbase Inc., to the Office of the Comptroller of the Currency 4–5 (June 1, 2016), https://www.occ.treas.gov/topics/responsible-innovation/comments/comment-coinbase-letter.pdf [https://perma.cc/FX5B-SPQM]; Letter from Ryan Zagone, Dir. of Regulatory Relations, Ripple, to the Office of the Comptroller of the Currency 3 (May 30, 2016), https://www.occ.treas.gov/topics/responsible-innovation/comments/comments-ryan-zagone.pdf [https://perma.cc/6P4V-YXG6].

156. Letter from author, Mercatus Ctr. at George Mason Univ., to the Office of the Comptroller of the Currency 7–8 (May 12, 2016), https://www.occ.treas.gov/topics/responsible-innovation/comments/comments-brian-knight.pdf [https://perma.cc/J3K4-YVVU]; Letter from Jackson Mueller & Staci Warden, Milken Inst. Ctr. for Fin. Mkts., to Thomas J. Curry, Comptroller of the Currency, Office of the Comptroller of the Currency 5–6 (Jan. 15, 2017), https://www.occ.treas.gov/topics/responsible-innovation/comments/comment-letter-milken.pdf [https://perma.cc/6PJS-VALQ]; Letter from Peter Van Valkenberg & Jerry Brito, Coin Ctr., to the

The proposed fintech charter has met resistance from the states—which have filed suit to block the OCC[158]—as well as some incumbents[159] and consumer advocates.[160] The OCC has announced that it will offer charters to fintech companies, including marketplace lenders.[161] It remains unclear, however, whether the charter as implemented will be a viable option for many companies.

B. Money Transmission

As with lending, considerable technological innovation has recently occurred in the transmission of money. The Internet, smartphones, and the digitization of money have made it possible to replace traditional intermediaries, such as bank branches or Western Union agents, with (as far as the consumer can tell) direct access without regard for distance between parties. Lower costs of entry have also made providing money transmission services on a large scale more viable, both for new businesses that lack other products to complement or cross-subsidize money transmission (as banks have done in the past) and for the established agent networks traditionally used by companies such as Western Union.

Players in the money transmission space include traditional financial firms,[162] large technology companies that specialize in

---

Office of the Comptroller of the Currency 9–10 (May 27, 2016), https://www.occ.treas.gov/topics/responsible-innovation/comments/comment-coin-center.pdf [https://perma.cc/RK7F-TXHQ].

157. Letter from Jennifer Tescher, Ctr. for Fin. Servs. Innovation, to Thomas J. Curry, Comptroller of the Currency, Office of the Comptroller of the Currency 11 (May 31, 2016), https://www.occ.treas.gov/topics/responsible-innovation/comments/comments-cfsi.pdf [https://perma.cc/AQB8-4VU2].

158. Complaint, Conference of State Bank Supervisors v. Office of the Comptroller of the Currency, No. 1:17-cv-00763, 2017 WL 1488257 (D.D.C. Apr. 26, 2017).

159. Letter from Karen M. Thomas, Senior Exec. Vice President, Indep. Cmty. Bankers of Am., to Thomas J. Curry, Comptroller of the Currency, Office of the Comptroller of the Currency 2–3 (May 31, 2016), https://www.occ.treas.gov/topics/responsible-innovation/comments/comment-icba.pdf [https://perma.cc/WQ57-Q7Q5].

160. Letter from the Nat'l Consumer Law Ctr., to Thomas J. Curry, Comptroller of the Currency, Office of the Comptroller of the Currency 7–8 (May 31, 2016), https://www.occ.treas.gov/topics/responsible-innovation/comments/comments-fintech-nclc.pdf [https://perma.cc/C9TA-QZ9D].

161. OFFICE OF THE COMPTROLLER OF THE CURRENCY, *supra* note 153, at 11.

162. Such firms include traditional credit card networks such as American Express. *See, e.g.*, COMMONWEALTH OF VA. BUREAU OF FIN. INSTS., MONEY TRANSMITTER LICENSEES 1 (2017) [hereinafter MONEY TRANSMITTER LICENSEES], https://www.scc.virginia.gov/bfi/reg_inst/trans.pdf [https://perma.cc/7HFM-EAAL]. They also include networks of banks, as exemplified by Zelle, a payments network ultimately owned by seven large US banks. *See* Sarah Perez, *Zelle, the Real-Time Venmo Competitor Backed by Over 30 U.S. Banks, Arrives this Month*, TECH CRUNCH

moving money,[163] large firms whose interest in money transmission may be incidental or derived from their core businesses,[164] and new insurgent companies.[165] Although many of those firms offer products that leverage existing payment systems, such as credit card networks or the ACH,[166] others use proprietary systems that seek to offer better and faster service. New digital currencies, such as Bitcoin, exist as well. Those currencies also compete in money transmission and introduce unique regulatory issues.[167]

Certain financial technology companies, including PayPal, Google, and Microsoft, have registered with the Department of Treasury's Financial Crimes Enforcement Network (FinCEN) and with some states as money services businesses;[168] others, such as Apple, have not.[169] The determining factor governing FinCEN's registration requirements is whether the service allows the user to

---

(June 12, 2017), https://techcrunch.com/2017/06/12/zelle-the-real-time-venmo-competitor-backed-by-over-30-u-s-banks-arrives-this-month [https://perma.cc/JFB7-7266].

163. *See, e.g.*, *Who We Are*, PAYPAL, https://www.paypal.com/us/webapps/mpp/about [https://perma.cc/C4L5-QZ5Q] (last visited Sept. 29, 2017).

164. *See, e.g.*, AMAZON PAY, https://pay.amazon.com/us [https://perma.cc/WN6H-5JLR] (last visited Sept. 29, 2017); APPLE PAY, http://www.apple.com/apple-pay [https://perma.cc/WDR6-UHSR] (last visited Sept. 29, 2017).

165. *See, e.g.*, DWOLLA, https://www.dwolla.com [https://perma.cc/UM5C-YB9G] (last visited Sept. 29, 2017); RIPPLE, https://ripple.com [https://perma.cc/9PHD-EAYW] (last visited Sept. 29, 2017).

166. The ACH is a network that banks use to move funds between accounts. It is frequently used for direct deposits (e.g., a paycheck) or direct payments (e.g., automatic bill pay). For more information, see the network's website at NACHA, https://www.nacha.org/news/what-ach-quick-facts-about-automated-clearing-house-ach-network [https://perma.cc/4P2K-4NWD] (last visited Sept. 29, 2017).

167. *See, e.g.*, BITCOIN, https://bitcoin.org/en [https://perma.cc/73M6-N8LW] (last visited Sept. 29, 2017). This Article focuses on the regulation of money transmitters, not money transmission (e.g., limits on liability for fraudulent transfers).

168. FinCEN's registrant search confirms the registration of these three companies. *See MSB Registrant Search*, FINCEN, https://www.fincen.gov/financial_institutions/msb/msbstateselector.html [https://perma.cc/FDN9-S2U3] (last visited Sept. 29, 2017). With respect to state registration, PayPal and Google are, for example, registered in the Commonwealth of Virginia. *See* MONEY TRANSMITTER LICENSEES, *supra* note 162, at 3. All three companies are also registered in Idaho. *See Money Transmitters*, IDAHO DEP'T OF FIN., http://www.finance.idaho.gov/MoneyTransmitter/MoneyTransmitterLicense.aspx [https://perma.cc/3KTJ-QMCF] (last visited Sept. 29, 2017).

169. Samuel Rubenfeld, *Apple Pay Faces Lighter Compliance Than PayPal, Google*, WALL ST. J.: BLOG (Oct. 20, 2014, 5:45 AM), http://blogs.wsj.com/riskandcompliance/2014/10/20/why-apple-pay-faces-lighter-compliance-than-paypal-google [https://perma.cc/6MYP-G788]. However, Apple has recently announced a peer-to-peer payment functionality that may include Apple holding customer funds, which could require Apple registering. *See* Jason Del Rey, *Apple Just Announced Its Own Venmo Competitor Built Into iMessage*, RECODE (June 5, 2017, 2:18 PM), https://www.recode.net/2017/6/5/15741636/apple-pay-p2p-venmo-competitor-apple-pay-cash-money-transfer [https://perma.cc/Q5LQ-9SR8].

store value or is merely a means of conveying payment credential information.[170] PayPal users, for example, can store money with PayPal as unsecured creditors of PayPal,[171] whereas Apple Pay, at least so far, stores credit card and debit card credentials securely and allows them to be communicated to merchants, but it does not hold customer money.[172]

Money transmission operates in a hybrid regulatory environment governed by both state and federal law. In general, federal regulation is more concerned with preventing money laundering and other criminal abuses of the payments system than it is with consumer protection.[173] By contrast, state laws are more concerned with consumer protection and the safety and soundness of the service provider.[174] However, the federal government, through the CFPB, is expressing increased interest in consumer protection regarding the money transmission context.

How money transmission is regulated depends on who provides the service. State money transmittal statutes,[175] which are otherwise extremely broad,[176] often exempt banks.[177] These laws potentially sweep in a lot of activity beyond traditional money transmission, such as a courier service moving a store of value (for example, a check or cash) between parties.[178] As such, nonbank entities providing money transfer or payments services, which are subject to state-by-state regulation, may find themselves under a different—and much less consistent—regulatory regime than their bank competitors.

---

170. Rubenfeld, *supra* note 169.

171. *User Agreement*, PAYPAL, https://www.paypal.com/us/webapps/mpp/ua/useragreement-full?bn_r=o#5 [https://perma.cc/VE6L-7XY9] (last visited Sept. 13, 2017).

172. APPLE PAY, *supra* note 164.

173. Kevin V. Tu, *Regulating the New Cashless World*, 65 ALA. L. REV. 77, 86 (2013).

174. *Id.* at 85–86.

175. *Id.* at 89; *see, e.g.*, TENN. CODE ANN. § 45-7-204 (2017) (exempting from money transmitter regulations only the US government, the State of Tennessee, banks, credit unions, and certain insurance transactions); VA. CODE ANN. § 6.2-1902 (2017) (exempting the US government, other states, agents of the government, banks and credit unions, and private security services businesses that are licensed to transport money).

176. Tu, *supra* note 173, at 87–88.

177. *Id.* at 89; *see, e.g.*, TENN. CODE ANN. § 45-7-204; VA. CODE ANN. § 6.2-1902.

178. Tu, *supra* note 173, at 87–88.

1. State Regulation of Money Transmission

State laws regulating money transmission tend to be broadly applicable[179] with limited exemptions.[180] State regulation of money transmitters has traditionally focused on protecting consumers and ensuring that money transmitters are sufficiently safe and sound to avoid failure.[181] As such, these laws often include provisions that limit who can be a money transmitter on the basis of factors such as criminal history,[182] net worth of licensee,[183] and general character, fitness, and competence.[184] For example, some states require a surety bond or equivalent with the application.[185] Money transmitters are generally charged a licensing fee or periodic assessments by the state.[186] Also, they are generally subject to periodic examination[187] and requirements to file reports with the state regulator—either on a

179. *Id.*; *see, e.g.*, TENN. CODE ANN. § 45-7-202(a); VA. CODE ANN. § 6.2-1901 (requiring a license for anyone engaged in the business of money transmission, regardless of whether the money transmitter has a location in Virginia).

180. TENN. CODE ANN. § 45-7-204 (exempting from money transmitter regulations only the US Government, the state of Tennessee, banks and credit unions, and certain insurance transactions); VA. CODE ANN. § 6.2-1902 (exempting the US government, other states, agents of the government, banks and credit unions, and private security services businesses that are licensed to transport money); Tu, *supra* note 173, at 89–91.

181. Tu, *supra* note 173, at 85–86.

182. *See, e.g.*, TENN. CODE ANN. § 45-7-205(c) (prohibiting issuance of a money transmitter license if certain persons affiliated with the company were convicted of a felony within the past 10 years, subject to the discretion of the Tennessee Commissioner of Financial Institutions); VA. CODE ANN. § 6.2-1906(A)(1) (requiring that the character of the applicant and its control people is such that there is reason to believe the business will be operated fairly).

183. *See, e.g.*, TENN. CODE ANN. § 45-7-205(a) (requiring a $100,000 minimum net worth for the company plus an additional $25,000 per additional location or agent located in Tennessee, up to $500,000); VA. CODE ANN. § 6.2-1906(B) (requiring $200,000 minimum net worth of licensee).

184. *See, e.g.*, VA. CODE ANN. § 6.2-1906(A)(1)–(2) (requiring that a potential licensee be "able to and will perform its obligations" and have the "financial responsibility, character, reputation, experience, and general fitness" to perform its duties).

185. *See, e.g.*, TENN. CODE ANN. § 45-7-208(a) (requiring applications be accompanied by a $50,000 surety bond or equivalent device, with an additional $10,000 per location, up to a maximum of $800,000).

186. *See, e.g.*, *id.* § 45-7-209 (requiring an application fee of between $250 and $500); VA. CODE ANN. § 6.2-1905(A) (stipulating a $750 annual fee); *id.* § 6.2-1905(B) (stipulating annual assessment to defray costs of examination).

187. TENN. CODE ANN. § 45-7-214; VA. CODE ANN. § 6.2-1910(A); CONFERENCE OF STATE BANK SUPERVISORS & MONEY TRANSMITTER REGULATORS ASS'N, THE STATE OF STATE MONEY SERVICES BUSINESSES REGULATION & SUPERVISION 9–10 (2016) [hereinafter STATE BANK REGULATORS REPORT], https://www.csbs.org/regulatory/Cooperative-Agreements/Documents/State%20of%20State%20MSB%20Regulation%20and%20Supervision%202.pdf [https://perma.cc/C6H7-CKHV].

regular basis[188] or in response to certain events[189]—that include information on the money transmitter's financial condition and operations. If the examination or reports indicate that the business is not performing its duties or is in danger of failing, the regulator can mandate corrective action or suspend or revoke the license.[190]

Responding to a call from Congress,[191] the National Conference of Commissioners on Uniform State Laws completed the Uniform Money Services Act in 2000.[192] To date, it has been adopted by only ten states, as well as Puerto Rico and the Virgin Islands.[193] The remaining states[194] maintain their own unique laws with varying substantive requirements.[195]

Although state laws differ, state regulators have made an effort to coordinate their supervision of money transmitters that operate in

188. *See, e.g.*, TENN. CODE ANN. § 45-7-211(d)(1)–(7) (requiring that licenses be renewed yearly and that renewal applications contain a report of the licensee's financial condition, including, *inter alia*, financial statements, list of locations and agents, and notification of any "material litigation or litigation relating to money transmission"); VA. CODE ANN. § 6.2-1905(D) (requiring annual reports, including audited financials).

189. *See, e.g.*, TENN. CODE ANN. § 45-7-212 (requiring a licensed money transmitter to notify the state after certain events, including bankruptcy, felony indictment of certain parties related to the firm, and revocation of the firm's license by any state or governmental authority); VA. CODE ANN. § 6.2-1917 (requiring a money transmitter to notify the state if certain events occur, including material changes to information provided in the firm's application, a filing for bankruptcy, and the indictment of certain parties related to the firm).

190. *See, e.g.*, TENN. CODE ANN. § 45-7-217; VA. CODE ANN. § 6.2-1907; STATE BANK REGULATORS REPORT, *supra* note 187, at 10–11.

191. Riegle Community Development and Regulatory Improvement Act of 1994, Pub. L. No. 103-325, § 407(b)(1)–(5), 108 Stat. 2160, 2248 (1994) (codified as amended at 31 U.S.C. § 5311 (2012)).

192. UNIF. MONEY SERVS. ACT (NAT'L CONFERENCE OF COMM'RS ON UNIF. STATE LAWS, amended 2004), http://www.uniformlaws.org/shared/docs/money%20services/umsa_final04.pdf [https://perma.cc/E47J-P9KR].

193. The ten states that have adopted the Uniform Money Services Act at the time of this writing are Alaska, Arkansas, Hawaii, Iowa, New Mexico, North Carolina, South Carolina, Texas, Vermont, and Washington. *See Enactment Status Map*, UNIF. L. COMM'N, http://uniformlaws.org/Act.aspx?title=Money%20Services%20Act [https://perma.cc/3P6Z-RPKJ] (last visited Sept. 29, 2017).

194. Melanie Baravik, *South Carolina Money Transmitters Now Need Bond*, SURETY BOND INSIDER (June 17, 2016), https://www.suretybonds.com/blog/south-carolina-money-transmitters-now-need-bond/13848 [https://perma.cc/QH5Y-FK2P] (noting that only Montana has yet to regulate money transmitters).

195. Tu, *supra* note 173, at 91, 110. *See generally* THOMAS BROWN, 50-STATE SURVEY: MONEY TRANSMITTER LICENSING REQUIREMENTS, http://abnk.assembly.ca.gov/sites/abnk.assembly.ca.gov/files/50%20State%20Survey%20%20MTL%20Licensing%20Requirements (72986803_4).pdf [https://perma.cc/PCX4-Q336] (cataloguing the licensing and investigation requirements for money transmitters within each state).

multiple states.[196] The Money Transmitter Regulators Association (MTRA) and Conference of State Bank Supervisors (CSBS) have developed multiple frameworks, including the Money Transmitter Regulatory Cooperative Agreement;[197] the MTRA Examination Protocol;[198] the joint CSPS-MTRA Nationwide Cooperative Agreement for MSB Supervision,[199] which has been signed by forty-eight states and territories;[200] and the Protocol for Performing Multi-State Examinations.[201] In 2015, 149 examinations of multistate money services businesses were conducted, of which sixty-eight were administered by a multistate examination team.[202] Twenty-six states participated in the joint examinations.[203]

2. Federal Regulation of Money Transmission

Federal regulation of money transmitters traditionally has been primarily concerned with preventing criminals from using the payments system to facilitate crimes, including laundering illicit proceeds and funding criminal or terrorist activities.[204] The BSA is a

196. *MTRA Cooperative Agreement*, MONEY TRANSMITTER REGULATORS ASS'N, http://www.mtraweb.org/about/cooperative-agreement [https://perma.cc/2DAZ-HHUB] (last visited Oct. 17, 2017) ("The purpose of this agreement is to promote a nationwide framework for cooperation and coordination among state money transmitter regulators that have concurrent jurisdiction over a regulated entity in a manner that conserves regulatory resources and minimizes the regulatory burden on supervised entities, consistent with each state attaining its supervisory objectives.").

197. *See id.*

198. *See* STATE BANK REGULATORS REPORT, *supra* note 187, at 11.

199. *See* MONEY TRANSMITTER REGULATORS ASS'N, NATIONWIDE COOPERATIVE AGREEMENT FOR MSB SUPERVISION 2 (2012), https://www.csbs.org/regulatory/Cooperative-Agreements/Documents/MSB/MSB-CooperativeAgreement010512clean.pdf [https://perma.cc/8KPH-7MWB].

200. *MSB Ratification Map*, CONFERENCE OF STATE BANK SUPERVISORS (Oct. 24, 2014), https://www.csbs.org/regulatory/Cooperative-Agreements/Documents/MSB/MSB%20Ratification%20Map%2010.24.14.pptx [https://perma.cc/BF25-4UZ3]. The states that have not signed the agreement are Colorado, Maine, Montana, New Mexico, and South Carolina. *See id.*

201. *See* MONEY TRANSMITTER REGULATORS ASS'N, PROTOCOL FOR PERFORMING MULTI-STATE EXAMINATIONS 2 (2012), https://www.csbs.org/regulatory/Cooperative-Agreements/Documents/MSB/MSB-Protocoll010512.pdf [https://perma.cc/X3UW-YTZZ].

202. STATE BANK REGULATORS REPORT, *supra* note 187, at 12.

203. *Id.*

204. Tu, *supra* note 173, at 95; *see also, e.g.*, *Bank Secrecy Act (BSA): Combating Money Laundering and Terrorist Financing*, OFF. COMPTROLLER CURRENCY, https://www.occ.treas.gov/topics/compliance-bsa/bsa/index-bsa.html [https://perma.cc/R7BW-Y5ZA] (last visited Sept. 29, 2017) (detailing the OCC's responsibility to assist law enforcement in deterring and detecting "money laundering, terrorist financing and other criminal acts").

major source of federal regulation of money transmitters.[205] The BSA applies to all "financial institutions," which is defined broadly to include "licensed sender[s] of money or any other person who engages as a business in the transmission of funds."[206] FinCEN, which manages BSA enforcement,[207] made the coverage more explicit in its regulations. FinCEN defines "financial institutions" to include money services businesses,[208] and "money services businesses" to include, *inter alia*, money transmitters.[209] As such, money transmitters are required to comply with the BSA's requirements. Money transmitters are required to register with the Treasury Department within 180 days of founding.[210] Federal anti-money-laundering law requires financial institutions to provide information to the government[211] and to retain information on their customers,[212] which can be a significant burden on the companies.[213] Federal law also imposes criminal penalties on firms and individuals that violate state law by operating money transmission businesses without a state license.[214]

Title X of Dodd-Frank[215] applies to any entity that "engages in offering or providing a consumer financial product or service,"[216] which the CFPB has interpreted in at least two cases to include money transmittal services.[217] Consequently, substantive federal consumer protection law may become a greater part of the regulatory environment for nonbank money transmitters. Recently, the CFPB entered into a consent order with Dwolla,[218] a technology provider that is not a money transmitter but serves as an agent of financial

205. *See* Bank Secrecy Act of 1970, Pub. L. No. 91-508, §§ 201–42, 84 Stat. 1114, 1118–24 (1970) (codified as amended at scattered sections of 12 U.S.C. and 31 U.S.C.); *Bank Secrecy Act*, *supra* note 204.

206. 31 U.S.C § 5312(a)(2)(R) (2012); *Bank Secrecy Act*, *supra* note 204.

207. 31 C.F.R. § 1010.810(a) (2017).

208. *Id.* § 1010.100(t)(3); Tu, *supra* note 173, at 95–96.

209. 31 C.F.R. § 1010.100(ff)(5).

210. 31 U.S.C § 5330(a)(1).

211. *See, e.g.*, 31 C.F.R. § 1010.300–.370.

212. *See, e.g.*, *id.* § 1010.400–.440.

213. Daniel P. Stipano, Opinion, *Time to Bring BSA into this Century*, AM. BANKER (Feb. 21, 2017, 9:30 AM), https://www.americanbanker.com/opinion/time-to-bring-bsa-into-this-century [https://perma.cc/3VUW-DEP2].

214. 18 U.S.C. § 1960 (2012); Brian Klein, *Does 18 U.S.C. § 1960 Create Felony Liability for Bitcoin Businesses?*, COIN CTR. (July 21, 2015), http://coincenter.org/entry/does-18-u-s-c-1960-create-felony-liability-for-bitcoin-businesses [https://perma.cc/FLD8-FX85].

215. Pub. L. No. 111-203, §§ 1001–1100H, 124 Stat. 1376, 1955–2113 (2010) (codified as amended in scattered sections of 12 U.S.C. and 15 U.S.C.).

216. 12 U.S.C. § 5481(6)(A) (2012).

217. *See, e.g.*, Dwolla, Inc., CFPB No. 2016-CFPB-0007, ¶ 5 (Mar. 2, 2016); Complaint ¶ 9, CFPB v. Intercept Corp., No. 3:16-cv-00144-ARS (D.N.D. June 6, 2016).

218. *See* Dwolla, Inc., CFPB No. 2016-CFPB-0007 (Mar. 2, 2016).

institutions.[219] The CFPB alleged that Dwolla misrepresented the quality of its cybersecurity practices.[220] The CFPB further argued that the misrepresentation was deceptive under Dodd-Frank's prohibition on unfair, deceptive, or abusive acts or practices.[221] Dwolla was ordered to change its procedures to improve security[222] and to pay a civil fine.[223] The CFPB has also sued Intercept Corporation—a payments processing firm that provides services to payday lenders, debt collectors, and other consumer finance companies—as well as some of its officers and owners for violations of Dodd-Frank.[224] The CFPB alleged that Intercept processed numerous payments for transactions that it knew or should have known were illegal because of the high number of returned payments and other "red flags."[225] This argument represents a possible significant expansion of the scope of the CFPB's jurisdiction, given that Intercept did not directly interact with consumers.[226]

Federal banking regulators have also pressured banks to deny services, including money transmission, to certain clients. Operation Choke Point, a project of the Department of Justice and federal banking regulators, targeted banks that provided services to companies in certain high-risk industries, with the justification of seeking to prevent consumer fraud by stopping fraudsters from accessing banking services.[227] The operation focused on numerous industries. While some of these industries were inherently illegal, regulators also targeted legal industries like payday lending and firearms sales, alleging that those industries carried a high risk for fraud.[228] Payday lending in particular was seen as a prime target.[229] Operation Choke Point proved highly controversial, with some critics

219. *About Us*, DWOLLA, https://www.dwolla.com/about?b=footer [https://perma.cc/H83U-4UJ8] (last visited Sept. 3, 2017).

220. Dwolla, Inc., CFPB No. 2016-CFPB-0007, ¶¶ 15, 23 (Mar. 2, 2016).

221. *Id.* ¶ 51 (citing 12 U.S.C. §§ 5531(a), 5536(a)(1)(b) (2012)).

222. *Id.* ¶¶ 52–62.

223. *Id.* ¶ 63.

224. Complaint ¶¶ 8–25, CFPB v. Intercept Corp., No. 3:16-cv-00144-ARS (D.N.D. June 6, 2016). The case against Intercept was dismissed for failure to plead sufficient facts to support the CFPB's claim, though the CFPB may appeal or file a new complaint. *See* Order Granting Defendants' Motion to Dismiss at 10, No. 3:16-cv-00144-RRE-ARS (D.N.D. Mar. 17, 2017).

225. Complaint, *supra* note 224, ¶ 2.

226. *See id.* ¶ 9.

227. STAFF OF H. COMM. ON OVERSIGHT AND GOV. REFORM, *supra* note 70, at 2–3.

228. *Id.* at 5.

229. *Id.* at 1; *see also* Zibel & Kendall, *supra* note 70.

arguing that it led banks to simply avoid industries seen by regulators as high risk, regardless of the legality of the individual company.[230]

Congress has not created a uniform and preemptive federal regulatory regime for money transmitters. However, Congress has acknowledged that greater uniformity of state law governing money service businesses, including money transmitters, would help combat money laundering and protect the payment system.[231] Congress specifically recommended that states create and adopt a model law to address licensing requirements, standards, reporting requirements, disclosures, and federal BSA compliance, and it further recommended that states impose a criminal penalty for operating a money transmitter without the required state license.[232]

C. Virtual Currency

Virtual currencies[233] share many of the issues of traditional fiat money transmission while also posing unique regulatory challenges. Although innovative money transmitters such as PayPal may give rise to regulatory questions, those transmitters have the advantage of operating in traditional fiat currency (legal tender issued by a government). Virtual currencies such as Bitcoin are a "digital representation of value that function[] as a medium of exchange, a unit of account, and/or a store of value, but d[o] not have legal tender status in any jurisdiction."[234] Although there are over a thousand

230. Michael J. Bresnick, Opinion, *How Regulators Can Fight De-Risking*, AM. BANKER (Apr. 7, 2016, 9:30 AM), https://www.americanbanker.com/opinion/how-regulators-can-fight-de-risking [https://perma.cc/9DVD-KLJW] ("Unfortunately, as the [Operation Choke Point] investigations continue, so too have one of the unintended but collateral consequences of such vigilance: mass de-risking. Members of the industry have raised their hands in frustration and simply avoided lines of business typically associated with higher risk.").

231. Riegle Community Development and Regulatory Improvement Act of 1994, Pub. L. No. 103-325, § 407(a)(1), 108 Stat. 2160, 2246–48 (1994) (codified as amended at 31 U.S.C. § 5311 (2012)).

232. *Id.* § 407(b)(1)–(5), 108 Stat. at 2248–49.

233. Although terminology is evolving, this Article differentiates between digital currencies, which can include digital representations of fiat currencies (e.g., Paypal's use of "digital" dollars), and virtual currencies that lack legal tender status (e.g., Bitcoin). *See* DONG HE ET AL., VIRTUAL CURRENCIES AND BEYOND: INITIAL CONSIDERATIONS 7–8 (2016), https://www.imf.org/external/pubs/ft/sdn/2016/sdn1603.pdf [https://perma.cc/H4EP-ZXTR].

234. Douglas, *supra* note 86, at 39 (citing *In re* Coinflip, Inc., CFTC No. 15–29, at 2 n.2 (Sept. 17, 2015)).

virtual currencies,[235] Bitcoin is by far the most widely used, with a market capitalization of over $70 billion.[236]

Some virtual currencies, including Bitcoin, are decentralized, which means no central administrator controls the system.[237] Instead, the Bitcoin system is administered by a network of computers running a common protocol, which creates a record of transactions on a distributed ledger that is visible to the entire network[238] (Bitcoin's ledger is called the "blockchain").[239] This distributed ledger helps prevent double spending by displaying how each bitcoin is disposed of.[240] The integrity of the system is maintained by computers performing public-key cryptography, for which they are rewarded with bitcoins[241] (of which there is a finite number).[242] That process is called Bitcoin "mining."[243] The Bitcoin network is open to any computer that runs the protocol.[244]

Other virtual currencies are centralized, which means a central party "owns" and ultimately administers the system. For example, Ripple[245] uses a proprietary and permissioned system of computers running a common protocol to record transactions.[246] A fixed number of XRP or "ripples" are premined.[247] Instead of relying on computers mining bitcoins to maintain system integrity, Ripple relies on consensus from trusted computers in the system to validate

---

235. Coinmarketcap.com lists market capitalizations for 1,140 of what it calls "crypto-currencies." *See* COINMARKETCAP, https://coinmarketcap.com/all/views/all [https://perma.cc/7238-GDCZ] (last visited Sept. 29, 2017).

236. *Id.*

237. Jerry Brito, Houman Shadab & Andrea Castillo, *Bitcoin Financial Regulation: Securities, Derivatives, Prediction Markets, and Gambling*, 16 COLUM. SCI. & TECH. L. REV. 144, 148 (2014); Douglas, *supra* note 86, at 39.

238. Brito, Shadab & Castillo, *supra* note 237, at 149; Douglas, *supra* note 86, at 39.

239. *See* Brito, Shadab & Castillo, *supra* note 237, at 146.

240. JERRY BRITO & ANDREA CASTILLO, BITCOIN: A PRIMER FOR POLICYMAKERS 6 (2016), https://www.mercatus.org/system/files/GMU_Bitcoin_042516_WEBv2_0.pdf [https://perma.cc/KPT5-SLPE]; Brito, Shadab & Castillo, *supra* note 237, at 149–50.

241. BRITO & CASTILLO, *supra* note 240, at 7–8; Sarah Jane Hughes & Stephen T. Middlebrook, *Advancing a Framework for Regulating Cryptocurrency Payments Intermediaries*, 32 YALE J. REG. 495, 505 (2015).

242. The number is limited to 21 million. *See* BRITO & CASTILLO, *supra* note 240, at 7; Hughes & Middlebrook, *supra* note 241, at 505.

243. *See* BRITO & CASTILLO, *supra* note 240, at 7.

244. Brito, Shadab & Castillo, *supra* note 237, at 146.

245. *See* RIPPLE, *supra* note 165.

246. *Coins Compared: Seven Differences Between Ripple and Bitcoin*, DIGITAL TECH. OBSERVER (Mar. 30, 2016), http://digitaltechobserver.blogspot.com/2016/03/seven-differences-between-ripple-and-bitcoin-cryptocurrencies.html?m=0 [https://perma.cc/N4ZL-8KA7].

247. *Id.*

transactions.[248] Ripples are not designed to be used as money per se, though some merchants accepted them for a brief period.[249] Instead, the Ripple network is designed to help facilitate transactions that require the conversion of different stores of value by providing a common, but not mandatory, medium of exchange.[250] It has been used for currency exchange and intercompany settlements.[251] XRP also serves as a means to defeat attacks on the Ripple protocol. To write to the ledger, Ripple users must purchase and hold XRP.[252] This requirement increases the cost of creating false users, a step that would be necessary to create sufficient consensus to ratify invalid transactions.[253]

Some virtual currencies, including Bitcoin, can be used as a medium of direct value transfer because the token (i.e., the bitcoin) is considered valuable in itself.[254] Some users accept the token as a cash equivalent, but others treat it like a foreign currency that must be exchanged for fiat currency on the Bitcoin market.[255]

Distributed ledgers associated with virtual currencies facilitate efficient communication of information across multiple parties to a transaction and create a relatively permanent and durable record trail. Financial services industries, including currency exchange and remittances,[256] banking,[257] securities,[258] and real estate,[259] have

248. *Id.*; *see* Marcel T. Rosner & Andrew Kang, Note, *Understanding and Regulating Twenty-First Century Payment Systems: The Ripple Case Study*, 114 MICH. L. REV. 649, 658–59 (2016).

249. *Coins Compared*, *supra* note 246.

250. *Id.*; *see* Rosner & Kang, *supra* note 248, at 660.

251. Penny Crosman, *Is Western Union Ready for the Fintech Threat?*, AM. BANKER (May 12, 2016, 2:40 PM), http://www.americanbanker.com/news/bank-technology/is-western-union-ready-for-the-fintech-threat-1080978-1.html [https://perma.cc/4494-532B].

252. Rosner & Kang, *supra* note 248, at 660.

253. *Id.*

254. BRITO & CASTILLO, *supra* note 240, at 6.

255. *See* Jacob Davidson, *No, Big Companies Aren't Really Accepting Bitcoin*, TIME: MONEY (Jan. 9, 2015), http://time.com/money/3658361/dell-microsoft-expedia-bitcoin [https://perma.cc/92PY-VFP5].

256. *See* Pete Rizzo, *Western Union 'Exploring' Pilot Program with Ripple Labs*, COINDESK (Apr. 29, 2015, 10:04 AM), http://www.coindesk.com/western-union-pilot-program-ripple-labs [https://perma.cc/Y7PY-RXCE].

257. *See* Yessi Bello Perez, *8 Banking Giants Embracing Bitcoin and Blockchain Tech*, COINDESK (July 27, 2015, 7:26 PM), http://www.coindesk.com/8-banking-giants-bitcoin-blockchain [https://perma.cc/8JX2-WPD2].

258. *See, e.g.*, Marion Dankers, *Nasdaq Makes First Share Trade Using Blockchain Technology*, TELEGRAPH (Dec. 31, 2015, 11:36 AM), http://www.telegraph.co.uk/finance/markets/12075825/nasdaq-blockchain-share-trade-bitcoin-technology.html [https://perma.cc/X4UT-REGE] ("The Nasdaq stock exchange has used blockchain to transfer shares for the first time in what the US firm said was 'a seminal moment' in the nascent technology."); Stan Higgins, *40 Banks Trial Commercial Paper Trading in Latest R3 Blockchain*

expressed interest in using distributed ledgers to facilitate and record ownership and transfers of assets. In these cases, virtual currencies, or more specifically the distributed ledgers that record virtual currency transactions, compete not with dollars but with traditional databases.[260] However, firms are also considering borrowing certain characteristics from virtual currency-based systems (such as rendering contracts as functions) without adopting all the attributes, such as tokens or a universally distributed ledger.[261]

Some virtual currencies use private closed systems that require participants to take sole responsibility for the system's security.[262] Other virtual currencies use public chains that rely on miners—who are attracted by the possibility of obtaining valuable tokens—to protect the integrity of the system.[263] Using public systems to record data involves the transfer of value (albeit a tiny amount) between the parties, which could potentially trigger money transmission regulations.

Test, COINDESK (Mar. 3, 2016, 1:08 AM), http://www.coindesk.com/r3-consortium-banks-blockchain-solutions [https://perma.cc/C74C-PBTU] ("A consortium of financial institutions led by startup R3CEV has completed a trial of five different blockchain solutions. . . . '[Participants] modeled a financial asset, commercial paper, a short-term debt instrument.'" (alteration in original)); Nathaniel Popper, *Wall Street Clearinghouse to Adopt Bitcoin Technology*, N.Y. TIMES (Jan. 9, 2017), https://www.nytimes.com/2017/01/09/business/dealbook/wall-street-clearing-house-to-adopt-bitcoin-technology.html?_r=0 [https://perma.cc/MK9N-83H8] (describing the Depository & Trust Clearing Corporation's announcement that it will use distributed ledger technology to record credit default swaps).

259. Kim S. Nash, *Blockchain: Real Estate Industry Could See Benefits in 2016*, WALL ST. J.: BLOG (Dec. 22, 2015, 4:44 PM), http://blogs.wsj.com/cio/2015/12/22/blockchain-real-estate-industry-could-see-benefits-in-2016 [https://perma.cc/F4ST-4G3C].

260. *See* Richard Gendal Brown, *On Distributed Databases and Distributed Ledgers*, RICHARD GENDAL BROWN (Nov. 8, 2016), https://gendal.me/2016/11/08/on-distributed-databases-and-distributed-ledgers [https://perma.cc/W2LV-6YTF] (comparing distributed ledgers and distributed databases in the context of business requirements for storing and sharing data across multiple parties).

261. *See, e.g.*, RICHARD GENDAL BROWN, JAMES CARLYLE, IAN GRIGG & MIKE HEARN, CORDA: AN INTRODUCTION 7, 13 (2016), https://www.r3cev.com/s/corda-introductory-whitepaper-final.pdf [https://perma.cc/3RA2-DQQT] (laying out characteristics of a distributed communication system for regulated financial entities that has certain similarities to Bitcoin but lacks a token, mining, and a universally distributed ledger).

262. SWIFT & ACCENTURE, SWIFT ON DISTRIBUTED LEDGER TECHNOLOGIES 11 (2016), http://www.ameda.org.eg/files/SWIFT_DLTs_position_paper_FINAL1804.pdf [https://perma.cc/DLJ9-NRWS].

263. Anna Irrera, *The Public vs Private Debate on Blockchain*, FIN. NEWS (Oct. 1, 2015, 1:00 PM), http://www.efinancialnews.com/story/2015-10-01/blockchain-fintech-the-public-vs-private-debate [https://perma.cc/3WEA-LETM].

1. State Regulation of Virtual Currency

Regulation of virtual currency by the states is muddled. Certain states have found virtual currency to be fully covered by their existing rules.[264] Other states, including Texas and Kansas, have opined that their state money transmitter laws cover virtual currency exchanges that convert virtual currencies into "real" currencies.[265] However, Texas and Kansas also have found that the mere exchange of virtual currency for a good or service is more akin to a sale of goods than to money transmission and, therefore, is not covered by state money transmission laws.[266] Other states have amended[267] their existing money transmission laws to include virtual currencies. Legislators in California have advanced a bill to create a virtual currency-specific regulatory framework, but they have so far been stymied.[268] At the time of this writing, a small minority of states have provided guidance or rulemaking for virtual currencies, and six states have virtual currency legislation passed or pending.[269] Florida regulators tried to bring an enforcement action under existing state

---

264. *See, e.g.*, *Bitcoin and Virtual Currency Regulation*, WASH. DEP'T FIN. INSTS., http://www.dfi.wa.gov/bitcoin [https://perma.cc/LPX5-4XU7] (last visited Sept. 29, 2017).

265. PETER VAN VALKENBURGH & JERRY BRITO, STATE DIGITAL CURRENCY PRINCIPLES AND FRAMEWORK 2 (2015) (citing Supervisory Memorandum from Charles G. Cooper, Banking Comm'r, Tex. Dep't of Banking, to All Virtual Currency Companies Operating or Desiring to Operate in Texas (Apr. 3, 2014), http://www.dob.texas.gov/public/uploads/files/consumer-information/sm1037.pdf [https://perma.cc/LF5W-QCAJ], and KAN. OFFICE OF THE STATE BANK COMM'R, GUIDANCE NO. MT 2014-01, REGULATORY TREATMENT OF VIRTUAL CURRENCIES UNDER THE KANSAS MONEY TRANSMITTER ACT (2014), http://www.osbckansas.org/mt/guidance/mt2014_01_virtual_currency.pdf [https://perma.cc/M79T-JJKA]), https://coincenter.org/wp-content/uploads/2015/04/State-Principles-Framework-V1.31.pdf [https://perma.cc/7ZF3-8UTZ].

266. KAN. OFFICE OF THE STATE BANK COMM'R, GUIDANCE NO. MT 2014-01, REGULATORY TREATMENT OF VIRTUAL CURRENCIES UNDER THE KANSAS MONEY TRANSMITTER ACT 3–4 (2014), http://www.osbckansas.org/mt/guidance/mt2014_01_virtual_currency.pdf [https://perma.cc/2EG8-TD2H]; Supervisory Memorandum from Charles G. Cooper, Banking Comm'r, Tex. Dep't of Banking, to All Virtual Currency Companies Operating or Desiring to Operate in Texas 3 (2014), http://www.dob.texas.gov/public/uploads/files/consumer-information/sm1037.pdf [https://perma.cc/Q65K-LKZD].

267. Connecticut H.B. 6800 was signed into law on June 19, 2015. It amended Connecticut's money transmitter law to specifically cover virtual currencies. Jeffrey Alberts & Meghan Dwyer, *Another Sweeping State Virtual Currency Law*, LAW360 (July 9, 2015, 10:39 AM), http://www.law360.com/articles/675801/another-sweeping-state-virtual-currency-law [https://perma.cc/7TSG-UPNF].

268. Yessi Bello Perez, *California's Bitcoin Bill Shelved by State Senator*, COINDESK (Sept. 16, 2015, 12:16 PM), http://www.coindesk.com/californias-bitcoin-bill-shelved-by-state-senator [https://perma.cc/ZH8N-GGLK].

269. *State-By-State Regulatory Tracker for Digital Currency Policy*, COIN CTR., https://coincenter.org/page/state-digital-currency-regulatory-tracker [https://perma.cc/LM2M-HWLV] (last updated Aug. 23, 2017).

laws, only to find that those laws do not cover virtual currencies.[270] However, because many state money transmitter laws are broad, regulators in other states may be more successful at bringing cases under existing law.[271]

New York, through its Department of Financial Services (NYDFS), is the first state to create a new stand-alone regulatory framework for virtual currencies.[272] The New York BitLicense[273] requires a license before a person can engage in "virtual currency business activity,"[274] defined as any conduct involving New York or a New York resident:

> (1) receiving Virtual Currency for Transmission or Transmitting Virtual Currency, except where the transaction is undertaken for non-financial purposes and does not involve the transfer of more than a nominal amount of Virtual Currency;
>
> (2) storing, holding, or maintaining custody or control of Virtual Currency on behalf of others;
>
> (3) buying and selling Virtual Currency as a customer business;
>
> (4) performing Exchange Services as a customer business; or
>
> (5) controlling, administering, or issuing a Virtual Currency.[275]

Importantly, the definition of "virtual currency business activity" does not include the development and dissemination of software or the transfer of virtual currency for a nonfinancial purpose, provided that only a nominal amount of currency is transmitted (such as using the Blockchain to record securities transactions).[276] Likewise, the superintendent of the NYDFS allows New York-chartered banks to engage in virtual currency business activities, and merchants and consumers who exclusively use virtual currency to buy and sell goods need not obtain licenses.[277] However, to participate in virtual currency business activities, banks that do not have a New York charter or approval from the NYDFS need to obtain a BitLicense.[278]

---

270. Order Granting Defendant's Motion to Dismiss at 5, State v. Espinoza, No. F14-2923 (Fla. Cir. Ct. July 22, 2016) (finding that the sale of Bitcoin did not constitute money transmission under Florida law).

271. Tu, *supra* note 173, at 87–88.

272. *New York Becomes First State to Finalize Digital Currency Regulatory Framework, BitLicense*, HUNTON & WILLIAMS (June 2015), https://www.hunton.com/images/content/2/1/v2/2177/ny-1st-digital-currency-regs.pdf [https://perma.cc/3XW4-2MTD].

273. N.Y. COMP. CODES R. & REGS. tit. 23, §§ 200.1–.22 (2017).

274. *Id.* § 200.3(a).

275. *Id.* § 200.2(q).

276. *See id.*

277. *Id.* § 200.3(c)(1)–(2).

278. Hughes & Middlebrook, *supra* note 241, at 540.

The BitLicense contains many consumer protection provisions that are similar to those found in traditional money transmitter laws and regulations. For example, the BitLicense requires applicants to provide information about and fingerprints of those in control of the company, as well as information about the company's financial status.[279] The BitLicense specifies minimum capital requirements based on the nature and scope of the licensee's business,[280] requires a surety bond to be maintained for the benefit of the licensee's customers,[281] requires the licensee to maintain books and records that are available for inspection,[282] and mandates that the licensee undergo examination by the NYDFS at least every two years.[283]

While much of the BitLicense is similar to traditional state money transmitter regulation, the BitLicense has certain unique elements. The most striking is that the BitLicense mandates a state-specific anti-money-laundering program in addition to that required by FinCEN.[284] New York mandates reporting of certain transactions not required to be reported to FinCEN.[285] Additionally, compared to FinCEN's risk-based approach, the BitLicense requirements are far more prescriptive.[286] Likewise, the BitLicense's mandatory disclosures are more onerous and prescriptive than those generally found in traditional money transmission laws.[287] The BitLicense also requires licensees to maintain a cybersecurity program[288] and to name a chief information security officer.[289]

The BitLicense has been controversial with virtual currency companies and supporters. A number of market participants have complained that the cost of application and compliance exceeds the value of the New York market.[290] Others object to the lack of an "on-ramp" for smaller businesses to begin operations in New York without having to either comply with the full slate of regulations or go

279. N.Y. COMP. CODES R. & REGS. tit. 23, § 200.4.

280. *Id.* § 200.8.

281. *Id.* § 200.9.

282. *Id.* § 200.12.

283. *Id.* § 200.13.

284. *Id.* § 200.15.

285. *See id.* § 200.15(e)(2)–(3).

286. Hughes & Middlebrook, *supra* note 241, at 542.

287. *Id.* at 544–45.

288. N.Y. COMP. CODES R. & REGS. tit. 23, §200.16.

289. *Id.* § 200.16(c).

290. Daniel Roberts, *Behind the "Exodus" of Bitcoin Startups from New York*, FORTUNE (Aug. 14, 2015), http://fortune.com/2015/08/14/bitcoin-startups-leave-new-york-bitlicense [https://perma.cc/L7N9-XLTE].

through the full application process.[291] Still others take issue with the redundant anti-money-laundering requirements.[292] Those concerns have prompted a number of companies to cease doing business in New York.[293] Meanwhile, as of this writing, only three companies—Circle, Coinbase, and Ripple—have obtained BitLicenses.[294]

Some efforts have been made to create uniform state laws and regulations for virtual currencies. The Uniform Law Commission, for example, formed a drafting committee to create a uniform law to govern virtual currency businesses.[295] The committee produced a bill that was approved by the Commission in July 2017.[296] In September 2015, the CSBS also launched a coordination effort through its Model Regulatory Framework for Virtual Currency Activities.[297] Although these efforts seek to harmonize (at least to a degree) the regulation of virtual currencies at the state level, states seem to be moving in their own directions, albeit in fits and starts.

2. Federal Regulation of Virtual Currency

The federal government currently regulates virtual currency in several ways. FinCEN responded relatively early to the rise of virtual

---

291. Tom Jackson, *The Bitcoin Community Reacts to the NY BitLicense*, COINTELEGRAPH (June 4, 2015), https://cointelegraph.com/news/the-bitcoin-community-reacts-to-the-ny-bitlicense [https://perma.cc/3QFB-K6M5] (reproducing the statement of Perianne Boring, the president of the Chamber of Digital Commerce, who claimed the "most worrisome aspect [of the BitLicense] is the lack of a clear on-ramp for digital currency startups").

292. *Id.* (reproducing also the statement of Peter Van Valkenburgh, the director of research at Coin Center, who lamented the BitLicense's "unprecedented and discriminatory state-level anti-money laundering regime").

293. *See* Roberts, *supra* note 290.

294. Grace Caffyn, *Circle Granted First BitLicense by NYDFS*, COINDESK (Sept. 22, 2015, 10:51 AM), https://www.coindesk.com/circle-granted-first-bitlicense-rebrands-as-circle-pay [https://perma.cc/3J5W-SZU2]; Pete Rizzo, *New York Regulators Grant Second BitLicense to Ripple*, COINDESK (June 13, 2016, 6:25 PM), http://www.coindesk.com/new-york-bitlicense-ripple [https://perma.cc/7SL9-WUA5]; Juan Suarez, *Coinbase Obtains the BitLicense*, COINBASE BLOG (Jan. 17, 2017), https://blog.coinbase.com/coinbase-obtains-the-bitlicense-f1c3e35c4d75#.r0cfxw6ev [https://perma.cc/YP4A-BUL8].

295. The drafting committee is called the Committee for the Regulation of Virtual Currency Businesses Act. Its membership and purpose are described on the Uniform Law Commission's website. *Regulation of Virtual Currency Businesses Act*, UNIFORM L. COMM'N, http://www.uniformlaws.org/Committee.aspx?title=Regulation%20of%20Virtual%20Currency%20Businesses%20Act [https://perma.cc/L3L9-QF7U] (last visited Sept. 29, 2017).

296. Press Release, Unif. Law Comm'n, National Law Group Concludes 126th Annual Meeting (July 19, 2017), http://www.uniformlaws.org/NewsDetail.aspx?title=Uniform%20Law%20Commission%20Concludes%20126th%20Annual%20Meeting [https://perma.cc/2X3Z-A89K].

297. CONFERENCE OF STATE BANK SUPERVISORS, STATE REGULATORY REQUIREMENTS FOR VIRTUAL CURRENCY ACTIVITIES: CSBS MODEL REGULATORY FRAMEWORK 1 (2015), https://www.csbs.org/regulatory/ep/pages/framework.aspx [https://perma.cc/KU38-Q6YK].

currency with guidance on what constitutes money transmission.[298] That guidance addressed the use of "convertible virtual currency," which refers to currency that "has an equivalent value in real currency, or acts as a substitute for real currency."[299] FinCEN divided virtual currency actors into three groups: users, administrators, and exchangers.[300] Users are the people who buy things with the currency.[301] Administrators are in the business of putting virtual currency into circulation and have the power to redeem or withdraw currency from circulation.[302] Exchangers are in the business of exchanging virtual currencies for real currency or other virtual currencies.[303] FinCEN advised that administrators and exchangers of virtual currency are money services businesses and are therefore subject to the requirements of the BSA, whereas users of virtual currency are not.[304] FinCEN subsequently clarified that miners[305] and investors in virtual currencies[306] are not considered money services businesses.

As discussed previously, Bitcoin does not have an administrator, but exchanges that facilitate the sale or conversion of Bitcoin into fiat currency or other stores of value are required to register with FinCEN.[307] In fact, FinCEN fined Ripple in 2015 for failing to register and maintain an appropriate anti-money-laundering program.[308]

---

298. FIN. CRIMES ENF'T NETWORK, U.S. DEP'T OF THE TREASURY, GUIDANCE NO. FIN-2013-G001, APPLICATION OF FINCEN'S REGULATIONS TO PERSONS ADMINISTERING, EXCHANGING, OR USING VIRTUAL CURRENCIES (2013).

299. *Id.* at 1.

300. *Id.*

301. *Id.* at 2.

302. *Id.*

303. *Id.*

304. *See id.* at 2–3.

305. FIN. CRIMES ENF'T NETWORK, U.S. DEP'T OF THE TREASURY, GUIDANCE NO. FIN-2014-R001, APPLICATION OF FINCEN'S REGULATIONS TO VIRTUAL CURRENCY MINING OPERATIONS 2 (2014).

306. FIN. CRIMES ENF'T NETWORK, U.S. DEP'T OF THE TREASURY, GUIDANCE NO. FIN-2014-R002, APPLICATION OF FINCEN'S REGULATIONS TO VIRTUAL CURRENCY SOFTWARE DEVELOPMENT AND CERTAIN INVESTMENT ACTIVITY 2 (2014).

307. *See* Brito, Shadab & Castillo, *supra* note 237, at 148; Douglas, *supra* note 86, at 39. Such companies include Coinbase and Kraken, both of which are registered with FinCEN. *See MSB Registrant Search*, FinCEN, https://www.fincen.gov/msb-registrant-search [https://perma.cc/N4NJ-HDEC] (last visited Sept. 29, 2017) (enter "Coinbase" into "legal name" field and click "search," enter "Payward Ventures" into "legal name" field and click "search" for "Kraken").

308. Press Release, Fin. Crimes Enf't Network, U.S. Dep't of the Treasury, FinCEN Fines Ripple Labs Inc. in First Civil Enforcement Action Against a Virtual Currency Exchanger (May

Other federal agencies have begun to regulate, or at least take an interest in, virtual currencies. The Internal Revenue Service (IRS) provided tax guidance for virtual currency in 2014.[309] For tax purposes, virtual currency is to be treated as property,[310] meaning the owner must recognize a gain or loss when the virtual currency is exchanged for a good, a service, or another currency.[311] As Professor Julie Hill points out, this arrangement may lead to some seemingly absurd results where Bitcoin users are technically obligated to perform basis calculations for every purchase (no matter how small) and need to assess which bitcoins they spent to determine appreciation, because the basis in different bitcoins will vary depending on what the user paid for them.[312] Expressing concerns regarding the risk of tax noncompliance that virtual currencies may create, the IRS inspector general has called for the IRS to develop a more coordinated strategy, to provide more guidance on documentation requirements, and to update third-party information-sharing documents to reflect the amounts of virtual currency held.[313] The IRS has also sought records from any user of Coinbase who made a virtual currency transaction between 2013 and 2015.[314]

The Commodity Futures Trading Commission (CFTC) also has expressed an interest in Bitcoin. In a settlement order with Coinflip, a platform "that connects buyers and sellers of standardized Bitcoin options and futures contracts,"[315] the CFTC announced that Bitcoin constitutes a commodity under the Commodity Exchange Act.[316] Additionally, the CFTC has brought an enforcement action against a

---

5, 2015), https://www.fincen.gov/news/news-releases/fincen-fines-ripple-labs-inc-first-civil-enforcement-action-against-virtual [https://perma.cc/ANV3-W6C7].

309. INTERNAL REVENUE SERV., IR-2014-21, IRS VIRTUAL CURRENCY GUIDANCE: VIRTUAL CURRENCY IS TREATED AS PROPERTY FOR U.S. FEDERAL TAX PURPOSES; GENERAL RULES FOR PROPERTY TRANSACTIONS APPLY (Mar. 25, 2014).

310. *Id.* at 2.

311. *Id.*; Julie Andersen Hill, *Virtual Currencies & Federal Law*, 18 J. CONSUMER & COM. L. 65, 67 (2014).

312. Hill, *supra* note 311, at 67.

313. TREASURY INSPECTOR GEN. FOR TAX ADMIN., 2016-30-083, AS THE USE OF VIRTUAL CURRENCIES IN TAXABLE TRANSACTIONS BECOMES MORE COMMON, ADDITIONAL ACTIONS ARE NEEDED TO ENSURE TAXPAYER COMPLIANCE 3 (2016), https://www.treasury.gov/tigta/auditreports/2016reports/201630083fr.pdf [https://perma.cc/MN9G-82C6].

314. Lalita Clozel, *IRS Casts Unusually Wide Net for Bitcoin User Data*, AM. BANKER (Nov. 28, 2016, 1:18 PM), https://www.americanbanker.com/news/irs-casts-unusually-wide-net-for-bitcoin-user-data [https://perma.cc/XKP6-33QT].

315. *In re* Coinflip, Inc., CFTC No. 15-29, at 2 (Sept. 17, 2015).

316. *Id.* at 4; *see* Commodity Exchange Act, ch. 545, §§ 1–13, 49 Stat. 1491, 1491–1501 (1936) (codified as amended at 7 U.S.C. §§ 1–15 (2012)).

swap execution facility, TeraExchange, for facilitating wash trading and prearranged trading of contracts based on the value of Bitcoin.[317] In 2014, the CFTC held an advisory committee meeting on Bitcoin and Blockchain derivatives.[318]

Meanwhile, the SEC established a virtual currencies working group.[319] It also brought enforcement actions involving virtual currency, including actions against unregistered stock exchanges using Bitcoin and other virtual currencies to facilitate securities transactions,[320] and others involving Bitcoin-related Ponzi schemes.[321] In mid-2014, the SEC issued an investor alert "to make investors aware about the potential risks of investments involving Bitcoin and other forms of virtual currency."[322] And in July 2017, the SEC also announced that virtual currency tokens could constitute a security under certain circumstances.[323] Finally, the Federal Trade Commission (FTC) brought an enforcement action against a company that sold computers used for Bitcoin mining to consumers but failed to deliver the computers in a timely manner and used them for the company's own profit without the purchasers' consent.[324]

Bank regulators have also expressed an interest in Bitcoin. The OCC has mentioned virtual currencies as a potential source of risk for banks,[325] as has the Federal Reserve.[326] The CFPB has

---

317. *In re* TeraExchange LLC, CFTC No. 15-33, at 2 (Sept. 24, 2015).

318. Press Release, Commodity Futures Trading Comm'n, CFTC's Global Markets Advisory Committee to Meet October 9, 2014 (Sept. 25, 2014), http://www.cftc.gov/PressRoom/PressReleases/pr7010-14 [https://perma.cc/V78H-QDE4].

319. Jeffrey Jacobi & Marco A. Santori, *Say Hello to the SEC's Digital Currency Working Group*, PILLSBURY (Jan. 12, 2015), http://www.pillsburylaw.com/publications/secs-digital-currency-working-group [https://perma.cc/4YC6-3JFG].

320. Press Release, SEC, SEC Sanctions Operator of Bitcoin-Related Stock Exchange for Registration Violations (Dec. 8, 2014), https://www.sec.gov/News/PressRelease/Detail/PressRelease/1370543655716 [https://perma.cc/9UJD-E345].

321. Press Release, SEC, SEC Charges Bitcoin Mining Companies (Dec. 1, 2015), https://www.sec.gov/news/pressrelease/2015-271.html [https://perma.cc/X8UJ-ZVSN]; Press Release, SEC, SEC Charges Texas Man With Running Bitcoin-Denominated Ponzi Scheme (July 23, 2013), https://www.sec.gov/News/PressRelease/Detail/PressRelease/1370539730583 [https://perma.cc/XL3U-5YYL].

322. Press Release, SEC, Investor Alert: Bitcoin and Other Virtual Currency-Related Investments (May 7, 2014), https://www.sec.gov/oiea/investor-alerts-bulletins/investoralertsia_bitcoin.html [https://perma.cc/JAV5-K4ML].

323. Press Release, SEC, SEC Issues Investigative Report Concluding DAO Tokens, a Digital Asset, Were Securities (July 25, 2017), https://www.sec.gov/news/press-release/2017-131.

324. Hill, *supra* note 311, at 69; Press Release, Fed. Trade Comm'n, Operators of Bitcoin Mining Operation Butterfly Labs Agree to Settle FTC Charges They Deceived Consumers (Feb. 18, 2016), https://www.ftc.gov/news-events/press-releases/2016/02/operators-bitcoin-mining-operation-butterfly-labs-agree-settle [https://perma.cc/A434-4TCR].

325. Jerry Brito, *The OCC's New Banking Risks Report Mentions "Virtual Currency" Twice*, COIN CTR. (July 13, 2016) (citing OFFICE OF THE COMPTROLLER OF THE CURRENCY,

warned consumers about the risks posed by Bitcoin,[327] especially given that Bitcoin transactions may not be covered by the Truth in Lending Act or the Electronic Funds Transfer Act.[328] Meanwhile, the Federal Reserve has begun to analyze distributed ledger technology in the context of payments systems.[329]

There appears to be a split between federal agencies that view virtual currencies as a form of property, such as the IRS and the CFTC, and those that view it as more akin to a traditional currency, such as FinCEN and the CFPB. FinCEN worries about the illicit use of virtual currency, just as it does in connection with fiat currency.[330] The CFPB highlights virtual currency's risk as compared to fiat currency (e.g., lack of government insurance for balances, volatile exchange rates, and lack of redress for fraudulent transactions as compared to credit and debit transactions).[331] It is too early to tell whether a more coherent and unified federal position will emerge organically or through congressional action. Given that virtual currencies are often more of a means than an end in themselves, it may make sense to keep regulation of the various uses of virtual currency with the underlying market regulators.

D. Securities Offerings

The sale of corporate securities is an important means by which companies access the capital they need to grow, thrive, and create prosperity and opportunity for Americans. Technology has been a major driver of change in the securities market, and technology's ability to cheaply and efficiently provide information to

---

SEMIANNUAL RISK PERSPECTIVE 8 (2016), http://www.occ.gov/publications/publications-by-type/other-publications-reports/semiannual-risk-perspective/semiannual-risk-perspective-spring-2016.pdf [https://perma.cc/3FP6-MK4C]), http://coincenter.org/link/the-occ-s-new-banking-risks-report-mentions-virtual-currency-twice [https://perma.cc/9WF7-TB7B].

326. Wallace Young, *What Community Bankers Should Know About Virtual Currencies*, COMMUNITY BANKING CONNECTIONS (2015), https://www.communitybankingconnections.org/articles/2015/q2/virtual-currencies [https://perma.cc/CJE2-NPCS].

327. CONSUMER FIN. PROT. BUREAU, RISKS TO CONSUMERS POSED BY VIRTUAL CURRENCIES (2014), http://files.consumerfinance.gov/f/201408_cfpb_consumer-advisory_virtual-currencies.pdf [https://perma.cc/4A2Y-WWYS].

328. Hill, *supra* note 311, at 68–69.

329. David Mills et al., *Distributed Ledger Technology in Payments, Clearing, and Settlement* (Bd. of Governors of the Fed. Reserve Sys., Finance and Economics Discussion Series No. 2016-095, 2016), https://doi.org/10.17016/FEDS.2016.095 [https://perma.cc/6MSG-MR7S].

330. *The Present and Future Impact of Virtual Currency: Joint Hearing Before the Subcomm. on Nat'l Sec. and Int'l Trade and Fin., and the Subcomm. on Econ. Policy, of the S. Comm. on Banking, Housing, and Urban Affairs*, 113th Cong. 4–6 (2013) (statement of Jennifer Shasky Calvery, Dir. of the Fin. Crimes Enf't Network, U.S. Dep't of the Treasury).

331. *Id.* at 3–5.

potential investors nationwide has contributed to a tension between state and federal regulators.[332]

This Section focuses on two recent developments that illustrate that tension. First, the amendments to Regulation A[333] made pursuant to the Jumpstart Our Business Startups (JOBS) Act[334] are an example of where the federal government has stepped in to address potentially problematic state regulation. Second, the proposed changes[335] to Rule 147[336] represent a case where the federal government can support capital formation by ceding jurisdiction to the states, which are in the best position to regulate.

The regulation of securities in the United States began as a state project, but as the scope of the economy became more national, the federal government took on a more dominant and preemptive role. The rise of technology that facilitates the scaling of securities transactions is contributing to the increasing pressure placed on preexisting regulatory assumptions about whether the federal government or the states should regulate an area exclusively, concurrently, or at all.

1. State Regulation of Securities Offerings

Regulation of the sale of securities in the United States can be traced back to 1911, when Kansas passed the first state law regulating the sale of corporate securities to the public.[337] This "blue sky" law was soon followed by other state laws, and by 1933, Nevada was the only state without such a law.[338] These laws were generally merit-based—meaning regulators looked both to whether the company

---

332. *See* Letter from Jack Herstein, President, N. Am. Sec. Admin'r Ass'n, to A. Nicole Clowers, Fin. Mkt. & Cmty. Inv. Dir., U.S. Gov't Accountability Office (June 26, 2012) ("Current Regulation A was adopted before the internet age and . . . it was not designed for nationwide offerings."), *reprinted in* U.S. GOV'T ACCOUNTABILITY OFF., GAO-12-839, SECURITIES REGULATION: FACTORS THAT MAY AFFECT TRENDS IN REGULATION A OFFERINGS app. 1 at 23–24 (2012), http://www.gao.gov/products/GAO-12-839 [https://perma.cc/8XZE-XZSN].

333. 17 C.F.R. §§ 230.251–63 (2017).

334. Jumpstart Our Business Startups (JOBS) Act, Pub. L. No. 112-106, §§ 401–02, 126 Stat. 306, 323–25 (2012) (codified as amended at 15 U.S.C. §§ 77c, 77d, 77r (2012)).

335. Exemptions to Facilitate Intrastate and Regional Securities Offerings, 80 Fed. Reg. 69786 (Nov. 10, 2015) (to be codified at 17 C.F.R. pt. 230).

336. Rule 147 serves as a "safe harbor" to companies seeking to do an intrastate securities offering. *See* 17 C.F.R. § 230.147(g). Such offerings are exempt from the requirements of the Securities Act of 1933, Pub. L. No. 112-106, § 3(a)(11), 48 Stat. 74, 75–76 (1933) (codified as amended at 15 U.S.C. § 77c(a)(11) (2012)).

337. THOMAS LEE HAZEN, TREATISE ON THE LAW OF SECURITIES REGULATION § 1:15 (6th ed. 2009).

338. Renee M. Jones, *Dynamic Federalism: Competition, Cooperation and Securities Enforcement*, 11 CONN. INS. L.J. 107, 111–12 (2005).

selling securities had fully and properly disclosed the terms of the offer and the company's circumstances and to whether the substantive terms of the offering were appropriate (in the regulators' opinion) for the prospective buyers.[339] Even after the federal government began to take a more active role in securities regulation, the states remained involved in combating fraud and retained responsibility for certain offerings.

2. Federal Regulation of Securities Offerings

The perception of widespread and brazen fraud[340] leading up to the stock market crash of 1929[341] convinced many that state blue sky laws failed to provide adequate protection,[342] and it served as the final impetus for federal securities regulation.[343] Congress subsequently passed the Securities Act of 1933 (Securities Act) to govern the original issuance of securities and the Securities Exchange Act of 1934 (Exchange Act) to govern—among other things—reporting requirements for certain companies, secondary sales of securities, and exchanges.[344] The Exchange Act also created a dedicated federal regulator for securities—the SEC.[345] The federal laws favored mandatory disclosure over merit regulation.[346] As first passed, the federal laws were not particularly preemptive of state power, but instead created a broad realm of concurrent jurisdiction.[347]

This situation changed with the passage of the National Securities Markets Improvement Act of 1996 (NSMIA),[348] which preempted and displaced state regulation for many securities.[349] NSMIA amended the Securities Act to preempt state regulation and

339. HAZEN, *supra* note 337, § 1:15.

340. Chris Brummer, *Disruptive Technology and Securities Regulation*, 84 FORDHAM L. REV. 977, 983 (2015) (discussing the Ivar Krueger and Musica brothers frauds in the 1920s).

341. *Id.* at 983–84; *see* HAZEN, *supra* note 337, § 1:15.

342. Brummer, *supra* note 340, at 983–84; *see* HAZEN, *supra* note 337 § 1:15.

343. HAZEN, *supra* note 337, § 1:15. *But see* PAUL G. MAHONEY, WASTING A CRISIS: WHY SECURITIES REGULATION FAILS 39 (Chris Rhodes & Jillian Tsui eds., 2015) (disputing the argument that widespread fraud significantly contributed to the crash).

344. Hal S. Scott, *Federalism and Financial Regulation*, *in* FEDERAL PREEMPTION: STATES' POWERS, NATIONAL INTERESTS 139, 148 (Richard A. Epstein & Michael S. Greve eds., 2007).

345. HAZEN, *supra* note 337, § 1.18.

346. *See id.*

347. Scott, *supra* note 344, at 148–49; Jones, *supra* note 338, at 111.

348. National Securities Markets Improvement Act of 1996, Pub. L. No. 104-290, 110 Stat. 3416 (1996) (codified as amended in scattered sections of 15 U.S.C.).

349. HAZEN, *supra* note 337, § 1.24.

registration requirements for "covered securities,"[350] which were defined to include those traded on certain exchanges,[351] sold to "qualified purchasers" (the definition of which could be set by the SEC via rulemaking),[352] or sold under an exemption from registration.[353] NSMIA was passed in response to Congress's view that the dual regulatory system had become "redundant, costly, and ineffective."[354] Congress determined that technology, in particular, had changed capital raising and that changes to the allocation of regulatory authority between the states and federal government were necessary to facilitate effective capital formation.[355]

NSMIA did not completely displace the states. States retained the ability to require notice filings from companies[356] and to enforce state antifraud laws.[357] States also retained their authority over noncovered securities, including intrastate offerings[358] and certain registered securities not traded on national exchanges. Importantly for smaller businesses, offerings made under Rule 506 of Regulation D were covered securities that were nonetheless exempt from state law because they were not considered public offerings.[359] By contrast, Regulation A offerings were not exempt.[360]

Recently, Congress continued its preemption of the states in the JOBS Act,[361] which exempted "crowdfunding" offerings—small offerings for private companies designed to be conducted over the Internet—from state regulation,[362] though the states retained enforcement authority.[363] As discussed below, the JOBS Act also empowered the SEC to expand the definition of "qualified purchaser" under Regulation A.[364]

---

350. 15 U.S.C. § 77r(a) (2012).

351. *See id.* § 77r(b)(1).

352. *See id.* § 77r(b)(3).

353. *See id.* § 77r(b)(4).

354. H.R. REP. NO. 104-864, at 39 (1996) (Conf. Rep.).

355. *See id.*

356. 15 U.S.C. § 77r(c)(2).

357. *See id.* § 77r(c)(1).

358. H.R. REP. NO. 104-864, at 40.

359. *See* Securities Act of 1933, Pub. L. No. 104-290, § 4(a)(2), 48 Stat. 74, 77 (1933) (codified as amended at 15 U.S.C. § 77d(a)(2) (2012)).

360. U.S. GOV'T ACCOUNTABILITY OFF., GAO-12-839, *supra* note 332, at 2.

361. Jumpstart Our Business Startups (JOBS) Act, Pub. L. No. 112-106, § 305, 126 Stat. 306, 322 (2012) (codified as amended at 15 U.S.C. §§ 77r, 78o (2012)).

362. *See id.* § 305(c), 15 U.S.C. § 77r(c)(2)(F) (2012).

363. *Id.* § 305(b)–(d), 15 U.S.C. §§ 77r(c), 78o.

364. *Id.* § 305(a), 15 U.S.C. § 77r(b)(4)(D).

3. Regulation A Offerings

Regulation A is a federal securities regulation aimed at helping smaller businesses access capital without having to bear the cost of a full registration.[365] The regulation allows companies to offer freely tradable securities to the general public without going through the full registration process.[366] The SEC originally promulgated Regulation A pursuant to its authority under Section 3(b) of the Securities Act, which allows the SEC to exempt certain offerings if registration is "not necessary in the public interest and for the protection of investors by reason of the small amount involved or the limited character of the public offering."[367]

Although Regulation A exempted companies from full registration, companies had to submit offering statements to the SEC for review and respond to the SEC's comments.[368] Once the company's disclosures were sufficient for the SEC, the offering was considered "qualified" and could be offered to potential investors.[369] The firm was required to provide investors with the qualified disclosure circular.[370] Additionally, Regulation A offerings were generally not exempt from state regulation,[371] which meant the issuing company had to comply with each relevant state's registration process in addition to the SEC's.

Unlike the SEC, which focused on the adequacy and accuracy of the company's disclosure,[372] the majority of states employed "merit review."[373] Merit review consists of a substantial evaluation of the merits of the offering to determine whether the offering is "fair."[374] State standards often differ substantively,[375] which means issuers (or their counsel) need to (1) research the specific requirements for each state in which they plan to offer securities, (2) comply with each state's requirements, and (3) address comments from each state's

365. Rutheford B. Campbell, Jr., *Regulation A: Small Businesses' Search for "A Moderate Capital"*, 31 DEL. J. CORP. L. 77, 79–80 (2006); *see* U.S. GOV'T ACCOUNTABILITY OFF., GAO-12-839, *supra* note 332, at 1–2.

366. Campbell, *supra* note 365, at 80.

367. 15 U.S.C. § 77c(b)(1); *see also* Campbell, *supra* note 365, at 99–100.

368. U.S. GOV'T ACCOUNTABILITY OFF., GAO-12-839 *supra* note 332, at 11–12.

369. *See id.* at 10–12.

370. *See id.*

371. *See id.* at 2.

372. *See id.* at 11.

373. *Id.* at 13.

374. *Id.* at 8.

375. *Id.* at 14; *see* Campbell, *supra* note 365, at 109–10.

regulators.[376] In some cases, companies warned by counsel of a state's compliance burdens will simply avoid that state.[377]

According to the Government Accountability Office (GAO), most companies opted not to rely on Regulation A at all.[378] Use of Regulation A declined from a peak of 116 initial offerings in 1997 to nineteen in 2011.[379] Qualified offerings also declined from fifty-seven in 1998 to a single offering in 2011.[380] Possible reasons for the decline included the time required to comply with the SEC's requirements,[381] the burden of complying with the differing state requirements,[382] and an offering limit that was perceived to be too low to justify the costs.[383] These factors came together in the growing preference among companies seeking capital for Regulation D[384] (specifically, Rule 506)[385] offerings. These offerings were more cost-effective because state law was largely preempted, the SEC required only notice of the offering (provided that the offer was made only to accredited investors), and there was no offering limit.[386]

The decline in Regulation A offerings prompted Congress to increase the offering limit from $5 million to $50 million as part of the JOBS Act.[387] Early versions of Title IV of the JOBS Act explicitly preempted state law for Regulation A offerings, but such provisions were withdrawn after some members of Congress expressed concerns about the risk of fraud.[388] Ultimately, Congress amended NSMIA to

376. U.S. GOV'T ACCOUNTABILITY OFF., GAO-12-839, *supra* note 332, at 17–18.

377. *See id.* at 18.

378. *See id.* at 8–9.

379. *Id.* at 9.

380. *Id.*

381. *See id.* at 16–17.

382. *See id.* at 17–18; *see* Campbell, *supra* note 365, at 106–10; *see also* Rutheford B. Campbell, Jr., *Regulation A and the JOBS Act: A Failure to Resuscitate*, 7 OHIO ST. ENTREPRENEURIAL BUS. L.J. 317, 322–23 (2012).

383. U.S. GOV'T ACCOUNTABILITY OFF., GAO-12-839, *supra* note 332, at 19.

384. 17 C.F.R. §§ 230.501–.508 (2017); Campbell, *supra* note 382, at 321–22; *see* David Burton, *Offering and Disclosure Reform*, *in* RETHINKING FINANCIAL REGULATION, *supra* note 30, at 277, 278.

385. 17 C.F.R. § 230.506.

386. U.S. GOV'T ACCOUNTABILITY OFF., GAO-12-839, *supra* note 332, at 19; *see* Campbell, *supra* note 382, at 323.

387. Pub. L. No. 112-106, § 401(a), 126 Stat. 306, 323 (2012) (codified as amended at 15 U.S.C. § 77c(b) (2012)); *see also* U.S. GOV'T ACCOUNTABILITY OFF., GAO-12-839, *supra* note 332, at 19–20 (identifying the $5 million offering ceiling as a reason for the decline in Regulation A offerings).

388. *See* Lindeen v. SEC, 825 F.3d 646, 651 n.8 (D.C. Cir. 2016) (citing 157 CONG. REC. H7231 (daily ed. Nov. 2, 2011) (statement of Rep. Gary Peters) ("Regulation A securities can be high-risk offerings that may also be susceptible to fraud, making protections provided by the State regulators an essential [feature]."), and H.R. REP. NO. 112-206, 13 (2011) (minority view)

permit preemption if the Regulation A securities were sold to a qualified purchaser[389] as defined by the SEC.[390] Congress also directed the GAO to assess the impact of state regulation on Regulation A offerings.[391] The GAO study identified the burden of complying with state regulations as a possible deterrent to issuers using Regulation A.[392]

Reacting to the ease with which small businesses reach potential investors nationwide through the Internet, the states have acknowledged the need for greater uniformity in their registration.[393] However, they also argue that the state regulatory process is important for consumer protection and that consumers have suffered as a result of preemption for Rule 506 offerings.[394] The states further argue that assessing the effects of state regulation and extending preemption are premature, given the changes to Regulation A and technological changes. Moreover, creating a more coordinated review system would remove the need for preemption.[395]

In response to the JOBS Act, the SEC proposed amendments to Regulation A[396] in January 2014.[397] So-called Regulation A+ created two tiers of offerings. Tier 1 offerings were limited to $5 million[398] (later increased to $20 million in the final rule)[399] and remained subject to concurrent state regulation. Tier 2 offerings were limited to $50 million;[400] were subject to continuing mandatory disclosure, including annual reports;[401] and were effectively exempt from state registration because all purchasers of Tier 2 offerings were deemed to be qualified purchasers.[402] To use either tier of offering, a company

("Regulation A securities are sometimes high-risk offerings that may be susceptible to fraud, making the protections provided by state review essential.")).

389. JOBS Act § 401(b), 15 U.S.C. § 77r(b)(4)(D) (2012) (amending 15 U.S.C. § 77r(b)(4) (1996)).

390. National Securities Markets Improvement Act, Pub. L. No. 104-290, § 102(b)(3), 110 Stat. 3416, 3418 (1996) (codified as amended at 15 U.S.C. § 77r (2012)).

391. JOBS Act § 402.

392. U.S. GOV'T ACCOUNTABILITY OFF., GAO-12-839, *supra* note 332, at 20.

393. Letter from Jack Herstein to A. Nicole Clowers, *supra* note 332, at 23.

394. *See id.* at 24.

395. *See id.* at 23.

396. *See* Proposed Rule Amendments for Small and Additional Issues Exemptions Under Section 3(b) of the Securities Act, 79 Fed. Reg. 3926, 3926 (proposed Jan. 23, 2014) (to be codified at 17 C.F.R. pt. 230) [hereinafter Proposed Rule Amendments].

397. *See id.* at 3925.

398. *Id.* at 4000.

399. 17 C.F.R. § 230.251 (2017).

400. Proposed Rule Amendments, *supra* note 396, at 4000.

401. *Id.* at 4004.

402. 15 U.S.C. § 77r(b)(3) (2012).

needed to submit an offering statement to the SEC containing a significant amount of information about the company and its offering.[403]

Unsurprisingly, this preemption of the states was highly controversial. Numerous state regulators,[404] consumer advocates,[405] members of Congress,[406] and at least one company[407] wrote to oppose Tier 2 preemption on the grounds that it would harm investors and represent an inappropriate power grab by the SEC. The states also pointed to the development of a coordinated review process for existing Regulation A offerings they believed would mitigate the costs of state regulation.[408] However, the majority of commenters,[409] including businesses,[410] business advocates,[411] members of Congress,[412] think

403. Proposed Rule Amendments, *supra* note 396, at 4000; *see also id.* at 4008–41 (providing a template for Form 1-A).

404. *See, e.g.*, Letter from William M. Beatty, Sec. Adm'r, Wash. Dep't of Fin. Insts., to Elizabeth M. Murphy, Sec'y, SEC (Mar. 24, 2014) (on file with author); Letter from Irving L. Faught, Adm'r, Okla. Dep't of Sec., to Elizabeth M. Murphy, Sec'y, SEC (Mar. 24, 2014) (on file with author); Letter from William F. Galvin, Sec'y, Commonwealth of Mass., to SEC Comm'rs (Mar. 24, 2014) (on file with author); Letter from Andrew M. Hartnett, Mo. Comm'r of Sec., to Elizabeth M. Murphy, Sec'y, SEC (Mar. 24, 2014) (on file with author); Letter from Chad Johnson, Bureau Chief, Inv'r Prot. Bureau, N.Y. State Attorney Gen.'s Office, to Mary Jo White, Chair, SEC (May 7, 2014) (on file with author); Letter from Andrea Seidt, President, N. Am. Sec. Adm'rs Assoc., to Elizabeth M. Murphy, Sec'y, SEC (Mar. 24, 2014) (on file with author).

405. *See* Letter from Barbara Roper, Dir. of Inv'r Prot., Consumer Fed'n of Am., to Elizabeth M. Murphy, Sec'y, SEC (Feb. 11, 2015) (on file with author).

406. *See* Letter from Edward Markey et al., Members of Cong., to Mary Jo White, Chair, SEC (Aug. 1, 2014), https://www.sec.gov/comments/s7-11-13/s71113-123.pdf [https://perma.cc/ZXV8-JFRS].

407. *See* Letter from Nick Bhargava, Exec. Vice President, Groundfloor Fin. Inc., to Mary Jo White, Chair, SEC (Nov. 18, 2014), https://www.sec.gov/comments/s7-11-13/s71113-139.pdf [https://perma.cc/LZX4-5ZD6].

408. *See* Letter from William Beatty, President and Wash. Sec. Dir., N. Am. Sec. Adm'rs Ass'n, to Brent J. Fields, Sec'y, SEC (Feb. 11, 2015), https://www.sec.gov/comments/s7-11-13/s71113-144.pdf [https://perma.cc/2657-KGVK].

409. *See* Lindeen v. SEC, 825 F.3d 646, 652 (D.C. Cir. 2016).

410. *See* Letter from William Klehm, Chairman and CEO, Fallbrook Techs., Inc., to Elizabeth M. Murphy, Sec'y, SEC (Mar. 22, 2014), https://www.sec.gov/comments/s7-11-13/s71113-54.pdf [https://perma.cc/PR86-Y9SE]; Letter from John Rodenrys, Exec. Dir. R&D, Leading BioSciences, Inc., to Elizabeth M. Murphy, Sec'y, SEC (Mar. 24, 2014), https://www.sec.gov/comments/s7-11-13/s71113-58.pdf [https://perma.cc/W53M-BGA9].

411. *See* Letter from Kim Wales, Exec. Bd. Member, CrowdFund Intermediary Regulatory Advocates, to Kevin M. O'Neill, Deputy Sec'y, SEC (May 14, 2014), https://www.sec.gov/comments/s7-11-13/s71113-109.pdf [https://perma.cc/B56G-RDAG].

412. *See* Letter from Patrick McHenry et al., Members of Cong., to Mary Jo White, Chair, SEC (Sept. 25, 2014), https://www.sec.gov/comments/s7-11-13/s71113-129.pdf [https://perma.cc/P2MX-LDF8].

tanks,[413] and academics,[414] argued in favor of preemption as necessary to make Regulation A cost-effective.

The preemption provision remained in the final rule,[415] prompting a lawsuit by the state securities regulators of Montana and Massachusetts.[416] The state regulators challenged the legality of the SEC's designation of all Tier 2 purchasers as "qualified purchasers,"[417] in part because the SEC did not adequately consider investor protection in making the designation.[418] The court rejected those arguments.[419]

The new Regulation A went into effect on June 19, 2015.[420] Online securities platforms[421] that facilitate corporate offerings and individual companies have used Regulation A+ to offer securities directly to the public.[422] As of October 31, 2016, 147 new Regulation A+ offerings had been filed with the SEC.[423] Of these, eighty-one had been reviewed by the SEC and found to have sufficiently complete disclosures to be offered for sale.[424] Although total offerings were fairly evenly split between Tier 1 and Tier 2 (49 percent to 52 percent, respectively), 61 percent of qualified offerings were Tier 2.[425] Tier 2

413. *See* Letter from Daniel Gorfine & Staci Warden, Dirs. of Ctr. for Fin. Mkts., Milken Inst., to Elizabeth M. Murphy, Sec'y, SEC (Mar. 19, 2014), https://www.sec.gov/comments/s7-11-13/s71113-45.pdf [https://perma.cc/ZS7D-BLDS].

414. *See* Campbell, *supra* note 382, at 329–32; Letter from Rutheford B. Campbell, Jr., Spears-Gilbert Professor of Law, Univ. of Ky., to Elizabeth M. Murphy, Sec'y, SEC 2 (Mar. 5, 2014), https://www.sec.gov/comments/s7-11-13/s71113-36.pdf [https://perma.cc/ASS7-YAG8] (arguing that the SEC did not go far enough).

415. *See* 17 C.F.R. § 230.256 (2017).

416. *See* Lindeen v. SEC, 825 F.3d 646, 646 (D.C. Cir. 2016).

417. *See id.* at 653.

418. *See id.* at 654.

419. *See id.* at 656.

420. *SEC Final Rules*, SEC, https://www.sec.gov/rules/final/finalarchive/finalarchive2015.shtml [https://perma.cc/2NTW-6A52] (last visited Sept. 30, 2017).

421. See, for example, new firms such as SEEDINVEST, https://www.seedinvest.com [https://perma.cc/KD44-45ES] (last visited Sept. 30, 2017), and STARTENGINE, https://www.startengine.com [https://perma.cc/Q3L3-AUCG] (last visited Sept. 30, 2017), as well as traditional broker-dealers such as *A+ Offerings: JOBS Act Changes to Regulation A*, WR HAMBRECHT & CO., https://wrhambrecht.com/regulation-a-ipo-offering [https://perma.cc/BP3W-2VCU] (last visited Sept. 30, 2017).

422. See, for example, THRILLCORP, http://www.thrillcorp.com [https://perma.cc/FHD5-ZCEH] (last visited Aug. 2, 2016), a builder of theme parks that offers securities (at the time of this writing) directly on its website.

423. *See* ANZHELA KNYAZEVA, SEC, REGULATION A+: WHAT DO WE KNOW SO FAR? 1 (2016), https://www.sec.gov/dera/staff-papers/white-papers/18nov16_knyazeva_regulation-a-plus-what-do-we-know-so-far.html [https://perma.cc/BU9R-4Z9D].

424. *Id.*

425. *See id.* at 7 tbl.1.

offerings are on average larger[426] and solicit investment from more states.[427] A greater percentage of Tier 2 offerings are made for the maximum amount allowed, as compared to Tier 1 offerings, though the majority of offerings in both tiers are made for less than the cap.[428] The use of intermediaries (for example, a broker-dealer) is "significantly higher" for Tier 2 offerings, consistent with nationwide solicitation and higher investor search costs.[429]

The relative use of Tier 1 versus Tier 2 offerings indicates that firms seeking to cast a wider net for investors value preemption. Although the different limits for the tiers also likely play a role in selection, the fact that a significant number of firms use Tier 2 for offerings at or under $20 million—but solicit in many more states than firms using Tier 1 offerings—indicates that preemption becomes more valuable as the number of states increases, even if Tier 1 is an option.

4. Rule 147 Offerings

While Regulation A represents a case of technology helping to move the transactions to a national level, Rule 147 presents the opposite problem—transactions that are truly intrastate in nature but that may technically qualify as interstate because of the limits (or lack thereof) of technology. This dynamic leads to the risk that the federal government will needlessly regulate in an environment where the states are better suited—practically and politically.

Rule 147 is a safe harbor provision for offerings that are exempt from registration under Section 3(a)(11) of the Securities Act for intrastate securities offerings.[430] That section originally exempted securities offered only to residents of the state in which the issuer is incorporated and does business.[431] Rule 147 provides a set of criteria that insulate a compliant issuer from the risk that its Section 3(a)(11)

426. Among all offerings, Tier 1 offerings average $10 million requested compared to $26 million for Tier 2; for qualified offerings, the average sought for Tier 1 offerings is $7 million compared to $26 million for Tier 2. *See id.* The median offering amount for Tier 1 offerings is $6 million ($5 million for qualified offerings), compared to $20 million for Tier 2 offerings (both general and qualified). *See id.*

427. The median number of states in which a firm using Tier 1 would solicit investors is four (eight among qualified offerings), compared to a median of fifty states for Tier 2 offerings (both general and qualified). *Id.* at 8–9.

428. Among all Tier 1 offerings, 26 percent are made at the tier limit, though this figure declines to 6 percent for qualified offerings. *Id.* at 7 tbl.1. For all Tier 2 offerings, meanwhile, 32 percent are made at the tier limit, with a slight increase to 33 percent for qualified offerings. *Id.*

429. *Id.* at 25.

430. 17 C.F.R. § 230.147 (2017).

431. Exemptions to Facilitate Intrastate and Regional Securities Offerings, 81 Fed. Reg. 83494, 83498–99 (Nov. 21, 2016) (to be codified at 17 C.F.R. pt. 200).

offering would be deemed an unregistered sale of securities subject to potential sanction.[432]

Recently, numerous states have adopted or expanded intrastate "crowdfunding" laws to make it easier for companies to raise money from their local communities.[433] Compliance with Rule 147 was traditionally a prerequisite under state securities law for local offerings.[434] However, the requirements of Rule 147 may have presented an impediment to companies using the new intrastate crowdfunding laws. For example, the SEC's Advisory Committee on Small and Emerging Companies identified several potential problems, including the concern that using the Internet to advertise an offering would be impermissible under Rule 147 because people outside of the state could see the offering.[435]

In response to these concerns, the SEC proposed changes to Rule 147,[436] including allowing issuers to engage in general solicitation.[437] Under the proposal, issuers may use the web to advertise their offerings—provided that they comply with other requirements, including notifying potential purchasers that the offer is only for residents of a single state.[438] The proposed rule also would simplify the test for an issuer to show that its principal place of business is within the state in which it is making its offering.[439] These requirements would effectively ensure that the issuer has an exclusive relationship to the state of the offering.[440]

Importantly, the SEC proposed the changes to Rule 147 using its general authority under Section 28 of the Securities Act, as opposed to Section 3(a)(11).[441] Doing so enabled the SEC to introduce

---

432. *Id.* at 83494–95.

433. Letter from Judith M. Shaw, President, N. Am. Sec. Adm'rs Ass'n, to Brent J. Fields, Sec'y, SEC 2 (Jan. 11, 2016), https://www.sec.gov/comments/s7-22-15/s72215-22.pdf [https://perma.cc/UU3N-SNZK].

434. *Id.*

435. *See* Exemptions to Facilitate Intrastate and Regional Securities Offerings, 80 Fed. Reg. 69786, 69788–89 (proposed Nov. 10, 2015) (to be codified at 17 C.F.R. pt. 230) [hereinafter Exemptions to Facilitate Offerings]; Letter from Stephen M. Graham & M. Christine Jacobs, Co-Chairs, Advisory Comm. on Small and Emerging Cos., to Mary Jo White, Chair, SEC (Sept. 23, 2015), https://www.sec.gov/info/smallbus/acsec/acsec-recommendation-modernize-rule-147.pdf [https://perma.cc/533K-35FA].

436. *See* Exemptions to Facilitate Offerings, *supra* note 435, at 69786.

437. *See id.* at 69788.

438. *Id.* at 69828.

439. *Id.* at 69830.

440. Letter from author & Staci Warden, Milken Inst. Ctr. for Fin. Mkts., to Brent J. Fields, Sec'y, SEC 6 (Jan. 11, 2016), https://www.sec.gov/comments/s7-22-15/s72215-26.pdf [https://perma.cc/TJ6W-NB22].

441. *See* Exemptions to Facilitate Offerings, *supra* note 435, at 69789.

substantive requirements on the nature of the offering. Those requirements included a $5 million annual limit on offerings made under Rule 147.[442] The proposal also required that the relevant state place limits on the amount certain investors could purchase.[443] The SEC acknowledged that moving Rule 147 away from Section 3(a)(11) to Section 28 meant the rule would no longer function as a safe harbor for offerings made under Section 3(a)(11), but the SEC stated that the Section 3(a)(11) exemption would remain an option for issuers.[444]

The SEC's proposal was met with skepticism from commenters, including legal practitioners,[445] industry advocates,[446] think tanks,[447] and state securities regulators.[448] Commenters noted that moving Rule 147 from Section 3(a)(11) would jeopardize state securities laws that require Rule 147 compliance.[449] Commenters also pointed out that imposing substantive federal requirements would prevent the states from creating the securities offerings that best suited their residents' needs.[450] A comment letter this Author coauthored with Staci Warden argued that even though use of the Internet—which inevitably connects issuers with residents of other states—likely gives the federal government jurisdiction as a constitutional matter, the federal government should nevertheless refrain from imposing substantive regulation.[451] Offerings made under Rule 147 are true intrastate offerings. Commenters argued that when all the parties to a transaction are in one state, they can influence the state's policy. Thus, the state is likely to be, on average, more nimble and

442. *Id.* at 69788–89.

443. *Id.*

444. *Id.* at 69789.

445. *See* Letter from Sara Hanks, CEO, CrowdCheck, Inc., to Brent J. Fields, Assistant Sec'y, SEC 2 (Jan. 2, 2016), https://www.sec.gov/comments/s7-22-15/s72215-9.pdf [https://perma.cc/2Z6V-JLF8]; Letter from David Lynn, Chair of Fed. Regulation of Sec. Comm., Am. Bar Assoc., to Brent J. Fields, Sec'y, SEC (Apr. 8, 2016), https://www.sec.gov/comments/s7-22-15/s72215-29.pdf [https://perma.cc/H5UP-2947].

446. *See* Letter from Kim Wales, Exec. Bd. Member, CrowdFund Intermediary Regulatory Advocates, to Brent J. Fields, Assistant Sec'y, SEC (Jan. 10, 2016), https://www.sec.gov/comments/s7-22-15/s72215-17.pdf [https://perma.cc/V64F-ABEP].

447. *See* Letter from author & Staci Warden to Brent J. Fields, *supra* note 440, at 2.

448. *See* Letter from Judith M. Shaw to Brent J. Fields, *supra* note 433, at 2–9.

449. *See id.*; *see also* Letter from Sara Hanks to Brent J. Fields, *supra* note 445, at 1; Letter from author & Staci Warden to Brent J. Fields, *supra* note 440, at 4.

450. *See* Letter from Sara Hanks to Brent J. Fields, *supra* note 445, at 2; Letter from author & Staci Warden to Brent J. Fields, *supra* note 440, at 6–7; Letter from Judith M. Shaw to Brent J. Fields, *supra* note 433, at 3–4.

451. Letter from author & Staci Warden to Brent J. Fields, *supra* note 440, at 6–7.

responsive, rendering it the appropriate actor to regulate the offerings.[452]

On October 26, 2016, the SEC finally amended Rule 147.[453] The SEC also created a new Rule 147A for offerings made by companies that are incorporated under the laws of a state different from their primary place of business and that use general solicitation to offer their securities.[454] Rule 147A sales are limited to residents of the state that is the company's primary place of business.[455] The SEC concurred with commenters that it was "appropriate that the resident investor protections in intrastate offerings primarily flow from the requirements of state securities law."[456] The SEC declined to move forward with the federally imposed limits on offering and investment size.[457] It noted that most states already limit relevant offerings to less than $5 million per year and limit how much individuals can invest.[458] In light of the policy motivating Section 3(a)(11)—to facilitate companies financing themselves from local investors[459]—and the fact that states were engaged in providing consumer protection, the SEC deferred to the states on whether such limits are appropriate.[460] Under the new rules, Rule 147 and 147A offerings are subject to the antifraud and civil liability provisions of federal securities law.[461]

IV. WHO SHOULD REGULATE?

Under the current expansive reading of the Interstate Commerce Clause[462]—which grants Congress the ability to regulate the channels and instrumentalities of interstate commerce, persons or things in interstate commerce, and anything that has a substantial effect on interstate commerce[463]—Congress can regulate and displace state regulation of fintech. But just because Congress *can* regulate

452. *Id.*

453. *See* Press Release, SEC, SEC Adopts Final Rules to Facilitate Intrastate and Regional Securities Offerings (Oct. 26, 2016), https://www.sec.gov/news/pressrelease/2016-226.html [https://perma.cc/5ZQS-H8YY].

454. *Id.*

455. Exemptions to Facilitate Intrastate and Regional Securities Offerings, 81 Fed. Reg. 83494, 83500 (Nov. 21, 2016) (to be codified at 17 C.F.R. pt. 200).

456. *Id.* at 83509.

457. *Id.*

458. *Id.*

459. *Id.* at 83495.

460. *Id.*

461. *Id.* at 83509.

462. U.S. CONST. art. I, § 8, cl. 3.

463. Gonzales v. Raich, 545 U.S. 1, 16–17 (2005).

does not necessarily mean it *should*. Instead, Congress should have a compelling reason to intervene. The circumstances described herein highlight three such reasons that could justify intervention: efficiency, competitive equity among market participants, and political equity among the residents of the various states. However, the case of Rule 147 presents a counterexample: although Congress and, by extension, the SEC have the authority to regulate, they should refrain from doing so.

A. Efficiency

Commentators who likely disagree significantly on what the substance of the law should be nevertheless recognize the value of efficiency provided by consistent national rules.[464] Whether efficiency is best served by federalism or federalization is a case-by-case question. For example, Professor Barry Weingast describes "market-preserving federalism," in which a federalist structure encourages competition among governments in the regulation of markets and thus discourages rent-seeking and contributes to greater prosperity.[465] If a market met those criteria, federalization would be unnecessary, if not harmful.

Unfortunately, the regulation of nonbank lenders, money transmitters, and pre-reform Regulation A offerings should not qualify as market-preserving federalism. The missing element is what Weingast calls a "common market" that would prevent states from creating trade barriers to the products of other states.[466] Instead, the states are able to impose state-specific conditions on market entry, including licensing requirements and limits on product offerings and service offerings.[467] Consumers and market participants suffer under

---

464. *Compare* Bar-Gill & Warren, *supra* note 32, at 83 ("The erosion of state power in itself need not be problematic from a consumer protection perspective. In an era of interstate banking, uniform regulation of consumer credit products at the federal level may well be more efficient than a litany of consumer protection rules that vary from state to state. *The problem is not in the federal preemption; it is in the failure of federal law to offer a suitable alternative to the preempted state law*." (emphasis added)), *with* Joseph R. Mason, Robert Kulick & Hal J. Singer, *The Economic Impact of Eliminating Preemption of State Consumer Protection Laws*, 12 U. PA. J. BUS. L. 781, 787–88 (2010) (citing Bar-Gill & Warren, *supra* note 32, at 83) ("A deeper examination of the economics of preemption reveals that Professor Warren had it right in her law review article: preemption has been a force for increasing the efficiency of the banking sector.").

465. Barry R. Weingast, *The Economic Role of Political Institutions: Market-Preserving Federalism and Economic Development*, 11 J.L. ECON. & ORG. 1, 5–6 (1995).

466. *Id.* at 4.

467. *See, e.g.*, *supra* Parts III.A.1, III.B, and III.B.2.

redundant and contradictory regulation rather than reaping the benefits of market-preserving federalism.

Having to research and comply with multiple regulations or having to pay for multiple licenses is inefficient, time consuming, and costly for companies, especially new firms with limited resources. This lack of competition imposes a direct cost on consumers and benefits incumbents who are able to capture the surplus that would otherwise be competed away. An example from lending is the credit card market in the 1980s, which was primarily intrastate at the beginning and shifted to interstate competition over time.[468] Christopher Knittel and Victor Stango show that state usury limits served as a "focal point for tacit collusion" among banks that clustered their rates at the upper limit of what they could charge under state law.[469] Over time, as the credit card market became subject to interstate competitive pressures in the wake of the *Marquette* decision, DIDA, and other reforms, the ability for in-state firms to collude declined, resulting in decreased costs to consumers.[470] Similar tacit collusion may also exist in payday loans, an industry subject primarily to state-by-state regulation.[471]

State-by-state regulation also contributes to regulatory uncertainty. As Professor Kevin Tu points out in the context of money transmission, the state-by-state regulatory picture dramatically increases "search costs" for firms, as those firms constantly need to assess just what the law is.[472] That burden is likely to fall hardest on younger and smaller firms that lack industry experience and the resources to hire large legal teams.[473] These are the very firms most likely to introduce new, innovative products.[474]

The search cost problem is compounded by the fact that it is not a one-time expense. Even if states all agree to a uniform law and

---

468. Christopher R. Knittel & Victor Stango, *Price Ceilings as Focal Points for Tacit Collusion: Evidence from Credit Cards*, 93 AM. ECON. REV. 1703, 1707–08 (2003).

469. *See id.* at 1719.

470. *Id.* at 1721–22.

471. Robert DeYoung & Ronnie J. Phillips, *Payday Loan Pricing* 2 (Fed. Reserve Bank of Kansas City, Research Working Paper No. 09-07, 2009), https://www.kansascityfed.org/publicat/reswkpap/pdf/rwp09-07.pdf [https://perma.cc/X5ED-QY56].

472. Tu, *supra* note 173, at 112.

473. *Id.* at 112–13.

474. *See, e.g.*, William J. Baumol, *Education for Innovation: Entrepreneurial Breakthroughs Versus Corporate Incremental Improvements* (Nat'l Bureau of Econ. Research, Working Paper No. 10578, 2004), *in* 5 INNOVATION POLICY AND THE ECONOMY 33, 54 (Adam B. Jaffe et al. eds., 2005), http://www.nber.org/chapters/c10806.pdf [https://perma.cc/Y7UM-5GH6] (finding that startups and entrepreneurs are more likely to create breakthrough innovations and that established firms are more likely to create incremental improvements of existing products and services).

the law remains uniform as enacted, there is always the risk that some states will change their laws or their statutory and regulatory interpretations.[475] Preemption limits the scope of necessary monitoring and provides greater stability and certainty.

Pre-reform Regulation A illustrates the way redundant and contradictory regulation can interfere with the functioning of a national market. The inability of firms to use Regulation A because of the costs of working with multiple regulators harmed businesses and their would-be employees and customers, and it reduced economic growth. Providing a consistent legal environment can facilitate greater access and opportunity, as shown by the increase in usage of Regulation A, which went from one qualified offering in 2011 to eighty-one as of October 2016, the majority of which used the preemptive features of Tier 2.

The inconsistent treatment of nonbank loans by the courts provides another example. With regard to interest rates and the definition of what constitutes interest, it is clear that state law will control.[476] What is unclear, however, is *which* state's law should control and what role the federal government should play in ensuring respect for the proper state's law. Opponents of bank partnerships view an agreement made over the Internet between a lender in State *A* and a borrower in State *B* as an example of the lender coming to the borrower, which means State *B*'s law should control. However, one could as easily argue that State *A*'s laws should control because the borrower came to the lender to take advantage of the products available under the lender's state laws. In the latter case, an effort by State *B* to reach into State *A* to prevent State *B*'s residents from conducting a transaction in State *A* would likely be viewed as an unconstitutionally extraterritorial statute.[477]

This tension was noted in *Marquette* in the context of determining the location of the bank. The court found that the

475. This drift away from uniformity has been seen in other contexts, including the Uniform Commercial Code (UCC). *See generally* John C. Minahan, Jr., *The Eroding Uniformity of the Uniform Commercial Code*, 65 KY. L.J. 799 (1976) (discussing how factors including amendments, subsequent state laws, and judicial decisions had reduced the degree of similarity between all states that nominally enacted the UCC).

476. *See supra* Part III.A.2 (discussing how federal law looks to underlying state law for regulation of interest rates).

477. *See* Healy v. Beer Inst., 491 U.S. 324, 332 (1989) ("[S]tate law that has the 'practical effect' of regulating commerce occurring wholly outside that State's borders is invalid under the Commerce Clause."); Edgar v. Mite Corp., 457 U.S. 624, 642–43 (1982) ("The Commerce Clause also precludes the application of a state statute to commerce that takes place wholly outside of the State's borders, whether or not the commerce has effects within the State."); Cotto Waxo Co. v. Williams, 46 F.3d 790, 794 (8th Cir. 1995) ("[A] statute has extraterritorial reach when it necessarily requires out-of-state commerce to be conducted according to in-state terms.").

location of the lender should be controlling, in part because the lender's state bore the deepest and most consistent relationship to every transaction.[478] The NBA's solution to this quandary is akin to a choice-of-law provision that resolves the question in favor of the state law that the lender and borrower agreed to.[479] The NBA thus facilitates interstate contracts.[480] Contrast this experience with the experience of marketplace lenders post-*Madden*, where uncertainty about the legality of loans has crippled access to lending for certain borrowers.[481]

State-by-state regulation may also impede the securitization markets. As Mason, Kulick, and Singer point out, inconsistency in allowable interest rates, finance charges, and terms can hamper securitization of loans.[482] Securitization can be an important source of funds for loans,[483] especially for small businesses. However, inconsistencies in loan terms (often driven by regulatory requirements) have kept the loan securitization markets for small businesses relatively underdeveloped.[484]

Finally, the lack of consistent regulation may require more complex financial engineering to make products compliant. The change in structure of loans by marketplace lenders provides an example. Banks are restructuring their products to retain an interest for the purposes of regulatory protection rather than economic efficiency.[485] This change is not driven by competitive pressure or customer-oriented innovation, but rather to avoid regulatory uncertainty. The result is greater complexity and higher costs, with the additional cost being passed on to borrowers and investors.

B. Competitive Equity

There is much wisdom to Senator Dale Bumpers's (D-AR) reaffirmation of the principle that "institutions offering similar

478. Marquette Nat'l Bank of Minneapolis v. First of Omaha Serv. Corp., 439 U.S. 299, 310–11 (1978).

479. Smith, *supra* note 51, at 1672.

480. *Id.*

481. *See* TREASURY REPORT, *supra* note 72, at 25.

482. Mason, Kulick & Singer, *supra* note 464, at 797–98.

483. *Id.* at 798.

484. DAVID BROWN & EMILY LINER, TO GROW NEW BUSINESSES, IMPROVE ACCESS TO CREDIT 18–19 (2016), http://s3.amazonaws.com/content.thirdway.org/publishing/documents/pdfs/000/002/037/to-grow-new-businesses-improve-access-to-credit.pdf?1474321861 [https://perma.cc/4ABB-VZYL].

485. Smith, *supra* note 51, at 1677–80.

products should be subject to similar rules."[486] In the realm of fintech, that is often not the case. Instead, competing institutions offering similar products on a nationwide basis are often subject to different regulations, depending on whether they are a bank.[487]

Marketplace lending presents an obvious, but not exclusive, example. Marketplace lenders offering bank-like loan products compete with banks. Although they are governed by many of the same consumer protection laws as banks, marketplace lenders lack banks' interest export capability.[488] Banks are able to offer a consistent product nationwide, but marketplace lenders are subject to state-by-state rules.[489] Some lenders have sought to minimize this competitive disadvantage by partnering with banks, but those partnerships are under legal threat.

Policymakers should ask if it should matter whether a loan is made by a bank or a nonbank lender. Perhaps, instead, the characteristics of the loan and the facts surrounding the negotiation and agreement to its entry should be determinative. The plaintiff's argument in *Bethune* is striking in how much it relies on technicalities.[490] The plaintiff does not allege that Lending Club misled him as to the terms of the loan, hid fees, or coerced him. Indeed, he appears to have gotten exactly the type of loan he expected. Despite the lack of fraud or coercion, the plaintiff alleges that because Lending Club was the true lender, and the bank only a sham lender, the loan was illegal under New York law.[491]

Although the *Bethune* plaintiff points to the more regulated status of banks as a justification for their exemption from usury laws, he does not explain which regulations serve to justify the exemption

---

486. 126 CONG. REC. 6907 (1980) (statement of Sen. Bumper).

487. *See, e.g.*, *supra* Parts III.A.3 (discussing differences in ability to export laws governing interest between banks and nonbank lenders), III.B.1 (discussing general exemption from money transmission licensing requirements for banks).

488. *See supra* Part III.A.3.

489. *See, e.g.*, Telis Demos, *Venture Capitalists Get Radical and Invest in a . . . Bank*, WALL ST. J. (Nov. 1, 2016, 8:53 AM), http://www.wsj.com/articles/the-new-banking-approach-for-silicon-valley-is-a-bank-1478004624 [https://perma.cc/32MZ-GPAQ] ("Cross River uses its position as a chartered and Federal Deposit Insurance Corp.-member bank to do things that are tougher for nonbank firms under U.S. rules. That includes originating loans in any state and moving funds over the banking system's rails on behalf of its partners or customers."); *see also* Wack, *supra* note 2 ("Banks that are getting into the online lending business have one additional edge over the startups—greater regulatory certainty. Firms like Lending Club and Prosper issue their loans through partner banks in a somewhat byzantine effort, which has attracted judicial scrutiny, to get around state-by-state interest rate caps.").

490. *See supra* notes 120–24 and accompanying text.

491. Bethune v. LendingClub Corp., No. 16 CIV. 2578 (NRB), 2017 WL 462287, at *1 (S.D.N.Y. Jan. 30, 2017).

that do not apply to marketplace lenders.[492] Marketplace lenders are subject to consumer protection laws—including the Equal Credit Opportunity Act,[493] the Fair Housing Act,[494] the Truth in Lending Act,[495] Dodd-Frank's prohibition on unfair, deceptive, or abusive acts or practices,[496] and the Gramm-Leach-Bliley Act[497]—that are similar to those governing banks.[498] Additionally, marketplace lenders that work with banks are "regulated" by their bank partners.[499] Further, under the Bank Service Company Act, these lenders may fall under the direct regulation of the federal regulator of their partner banks for the services they perform for those banks (including loan servicing and lead generation).[500] As such, it is unclear what regulatory discrepancy justifies prohibiting a marketplace lender from making a loan that a bank can make. This question is important for borrowers. Rules that place certain providers at a competitive disadvantage—by depriving them of the regulatory consistency enjoyed by banks—limit competition and innovation. As seen in the history of interest rate regulation, this limitation can favor incumbents at the expense of

---

492. *Id.*

493. Equal Credit Opportunity Act, Pub. L. No. 93-495, §§ 501–03, 88 Stat. 1500, 1521 (1974) (codified as amended at 15 U.S.C. §§ 1691–91f (2012)).

494. Fair Housing Act, Pub. L. No. 90-284, §§ 801–19, 82 Stat. 73, 81–89 (1968) (codified as amended at 42 U.S.C. §§ 3601–19 (2012)).

495. Truth in Lending Act of 1968, Pub. L. No. 90-321, §§ 101–45, 82 Stat. 146, 146–59 (1968) (codified as amended at 15 U.S.C. §§ 1601–67f (2012)).

496. Consumer Financial Protection Act, Pub. L. No. 111-203, § 1031, 124 Stat. 1376, 2005–06 (2010) (codified as amended at 12 U.S.C. § 5531 (2012)). The CFPB also collects consumer complaints about marketplace lenders. *See* Press Release, Consumer Fin. Prot. Bureau, CFPB Now Accepting Complaints on Consumer Loans from Online Marketplace Lender (Mar. 7, 2016), http://www.consumerfinance.gov/about-us/newsroom/cfpb-now-accepting-complaints-on-consumer-loans-from-online-marketplace-lender [https://perma.cc/3QZA-JS5M].

497. Gramm-Leach-Bliley Act, Pub. L. No. 106-102, 113 Stat. 1338 (1999) (codified as amended in scattered sections of 12 U.S.C.). Note, however, that the exact scope of the rules may differ somewhat.

498. TREASURY REPORT, *supra* note 72, at 10.

499. OFFICE OF THE COMPTROLLER OF THE CURRENCY, OCC BULL. NO. 2013-29, RISK MANAGEMENT GUIDANCE (2013), https://www.occ.gov/news-issuances/bulletins/2013/bulletin-2013-29.html [https://perma.cc/HF4H-B96S]; FED. DEPOSIT INS. CORP., FIL-44-2008, GUIDANCE FOR MANAGING THIRD-PARTY RISK (2008), https://www.fdic.gov/news/news/financial/2008/fil08044.html [https://perma.cc/H856-PWUA]. *See also* FED. DEPOSIT INS. CORP., FIL-50-2016, FDIC SEEKING COMMENT ON PROPOSED GUIDANCE FOR THIRD-PARTY LENDING (2016), https://www.fdic.gov/news/news/financial/2016/fil16050.html [https://perma.cc/X4HL-38VF].

500. *See* Bank Service Company Act, Pub. L. No. 104-208, § 2613, 110 Stat. 3009, 3485–87 (codified as amended at 12 U.S.C. §§ 1861, 1867(c) (2012)); Sawyer v. Bill Me Later, Inc., 23 F. Supp. 3d 1359, 1368 (D. Utah 2014).

higher-than-necessary prices and unnecessarily limited access for consumers.[501]

Regulation should follow the risk created, and similar products should be regulated similarly. Although it is true that banks have regulatory requirements not shared by marketplace lenders, such as obligations under the Community Reinvestment Act and safety-and-soundness inspection to protect the federal deposit insurance fund, those requirements are tied to aspects of banks' business—such as deposit taking—that marketplace lenders do not share.[502] Hence, differential regulation may be justified. To the extent that marketplace lenders present the same risks as banks, however, they should be regulated similarly; on the other hand, regulation should be adjusted according to the extent to which models present different or lesser risks. Regulating marketplace lenders similarly to banks would equalize the rulebook for market participants and encourage competition from new players, which would ultimately benefit consumers.

C. Political Equity Between Citizens of the Several States

It is a well-worn saying from Justice Brandeis that "a single courageous state may, if its citizens choose, serve as a laboratory; and try novel social and economic experiments."[503] Professors Samuel Issacharoff and Catherine Sharkey wryly note: "While Justice Brandeis's aphorism . . . is oft repeated, the tail end of his claim tends to get lost."[504] In full, his saying reads: "[A] single courageous State may, if its citizens choose, serve as a laboratory; and try novel social and economic experiments *without risk to the rest of the country*."[505] There is always the risk that the state as laboratory will have an accident or that it will create a policy that benefits itself but sends pollutants downstream[506] (often called a "spillover").[507] This risk is

501. *See supra* notes 33, 34, 42, 468, 469, and 471, and accompanying text.

502. *See* Letter from John W. Ryan, President and CEO, Conference of State Bank Supervisors, to Thomas Curry, Comptroller of the Currency, Office of the Comptroller (Apr. 13, 2017), https://www.csbs.org/regulatory/resources/Documents/Attached%20Exhibits%20-%20OCC%20Complaint.pdf [https://perma.cc/CJ2C-E44D] (listing areas of federal banking law that only apply to FDIC-insured deposit-taking banks).

503. New State Ice Co. v. Liebmann, 285 U.S. 262, 311 (1932) (Brandeis, J., dissenting).

504. Issacharoff & Sharkey, *supra* note 13, at 1355.

505. *New State*, 285 U.S. at 311 (Brandeis, J., dissenting) (emphasis added).

506. A clear example is product liability regulation, where, as Issacharoff and Sharkey note: "Products liability law raises the specter of spillover effects, whereby a state uses its liability regime to benefit in-state residents with larger compensation payments, or exports the costs of its regulation to out-of-state manufacturers and product consumers in the rest of the nation." Issacharoff & Sharkey, *supra* note 13, at 1386.

particularly acute in national markets that are regulated on a state-by-state basis.[508] Many innovative fintech markets, including lending and money transmission, fall into the category of national markets regulated state by state.

Although the courts and many scholars view the need to prevent or at least minimize encroachments by one state's citizens on another's to be a core component of American federalism,[509] others have a more sanguine view of spillovers. Professors Heather K. Gerken and Ari Holtzblatt, for example, argue that in some cases—especially those where an issue has high political salience among the public—benefits to spillovers also exist, including increasing political engagement and forcing reform.[510] To Gerken and Holtzblatt, federalism is not an end in itself but rather a means to encourage a "well-functioning democracy"[511] and to push the political process to a national consensus[512] which, while it can include disuniformity, is driven by a national "choice, not an accident."[513] This view also does not consider some states effectively controlling other states as a positive good. The point is not to have California's boot on Wyoming's throat for all time, but to push the public and politicians into engagement and compromise.[514]

Many of the spillovers arising from inconsistent state-by-state regulation discussed in this Section likely fall into the quadrant of high economic cost but low political salience, as envisioned by Gerken

---

507. Heather K. Gerken & Ari Holtzblatt, *The Political Safeguards of Horizontal Federalism*, 113 MICH L. REV. 57, 61–62 (2014).

508. Issacharoff & Sharkey, *supra* note 13, at 1359.

509. *See, e.g.*, State Farm Mut. Auto. Ins. Co. v. Campbell, 538 U.S. 408, 422 (2003) ("A basic principle of federalism is that each State may make its own reasoned judgment about what conduct is permitted or proscribed within its borders."); BMW of N. Am., Inc. v. Gore, 517 U.S. 559, 571–73 (1996); Healy v. Beer Inst., 491 U.S. 324, 335–36 (1989) ("The principles guiding this assessment . . . reflect the Constitution's special concern both with the maintenance of a national economic union unfettered by state-imposed limitations on interstate commerce and with the autonomy of the individual States within their respective spheres." (footnotes omitted)); *see also* Katherine Florey, *State Courts, State Territory, State Power: Reflections on the Extraterritoriality Principle in Choice of Law and Legislation*, 84 NOTRE DAME L. REV. 1057, 1115 (2009) ("[T]he idea that states are entitled to some autonomous sphere in which to make policy free of interference from other sovereigns [is an 'ideological principle[]' of federalism]."); Michael S. Greve, *Choice and the Constitution* 7 (Am. Enter. Inst., Federalist Outlook No. 16, 2003), https://www.aei.org/publication/choice-and-the-constitution [https://perma.cc/53D2-PZ47] ("States must govern themselves, not one another.").

510. Gerken & Holtzblatt, *supra* note 507, at 62–63.

511. *Id.* at 67–68.

512. *Id.* at 86.

513. *Id.* at 98.

514. *Id.* at 63.

and Holtzblatt.[515] After all, the specifics of how much capital money transmitters must retain or what forms a company must file to make a securities offering, though ultimately important to questions of access and opportunity, are unlikely to motivate people to march in the streets. Regulation A provides such an example, where the issue was important to businesses seeking capital and had subsidiary effects on workers and local economies but never prompted mass political movements. Federalizing interventions to address those problems of high cost and low salience are likely justified given the economic burden that they impose compared to the minimal benefits of maintaining inconsistency.[516]

Some of the issues discussed in this Article, however, may have relatively high political salience, such as interest rate and (potentially) virtual currency regulation (see Table 1 below). Even if one subscribes to Gerken and Holtzblatt's view of spillovers as not anathema per se, in most of the examples discussed here, moving to a national consensus is appropriate.

515. *Id.* at 83.

516. *Id.* at 85 ("We think the case for regulating low-salience, economically costly spillovers . . . is easy. The democratic benefits are small, and the economic costs are high.").

Table 1. High Economic Cost and High vs. Low Political Salience of Fintech Issues Discussed[517]

	High political salience	**Low political salience**
High economic cost	Interest rate regulation Virtual currency regulation (potentially)	Intrastate securities offerings Regulation A securities offerings Money-transmitter regulation

An example of this move toward a national consensus is the regulation of the interest banks can charge. Critics often point to the interest rate export provisions as unconstitutional[518] "sister-state preemption"[519] that gives "Delaware or South Dakota supremacy over [other states]."[520] That criticism ignores that the extension of interest rate export to both state-chartered and nationally chartered banks was in furtherance of a federal policy and done under federal law. The NBA represents a "federal law [that] completely defines what constitutes the taking of usury by a national bank, referring to the state law only to determine the maximum permitted rate."[521] Likewise, DIDA represents a national decision to extend competitive parity to state-chartered banks.[522] Congress, a body that draws membership from all states, provided a venue for citizens to come to a national consensus,[523] which includes some amount of intentional disunity. To the extent that citizens change their views, they have a

517. This Table follows the pattern of the table created by Gerken & Holtzblatt, *supra* note 507, at 61–62. However, given the relatively high economic costs of all the topics, it contains only a high economic cost row.

518. Irwin v. Citibank (S.D.), N.A., No. 2557, 1993 WL 837921, at *2 (Pa. Com. Pl. Dec. 9, 1993).

519. *See, e.g.*, Yolanda D. McGill & Kathleen E. Keest, Comment on Petition for Rule-Making to Permit Preemption of State Laws with Respect to the Interstate Activities of State Banks (May 16, 2005), https://www.fdic.gov/news/conferences/agency/public_mcgill_test.html [https://perma.cc/RQ62-JS7D].

520. *Id.*

521. Beneficial Nat'l Bank v. Anderson, 539 U.S. 1, 10 (2003) (quoting Evans v. Nat'l Bank of Savannah, 251 U.S. 108, 114 (1919)).

522. *See* Greenwood Tr. Co. v. Massachusetts, 971 F.2d 818, 827 (1st Cir. 1992).

523. *See* Gerken & Holtzblatt, *supra* note 507, at 108.

mechanism to pressure their representatives in Congress to change the law.

Contrast this with much of the state-by-state regulation described previously.[524] One state's regulations can distort the entire national market, especially if the state is large and economically important. For example, given New York's important position within the financial sector, the inherent power of the NYDFS, and the broad scope of New York's BitLicense,[525] it is unclear whether Bitcoin companies actually could avoid New York jurisdiction and remain competitive. Even if the scope of the law is uncertain, companies will have a strong incentive to comply to avoid being the target of the NYDFS testing its authority. A court battle with the NYDFS over its authority—even if successful—could bankrupt a small company. A consumer in a state where a product would be legal, but is de facto banned because of New York, has no recourse in Albany or with the NYDFS. Thus, Americans everywhere may have their options constrained by New York (or California, or Texas) because either certain products may not be offered (if one large state prohibits them) or state compliance costs will be passed on to customers nationwide, requiring products that *are* offered to cost more.

State legislators and regulators have incentives and obligations to create policy that they believe benefits their state without much regard for its effect on others.[526] Policies that internalize benefits and export costs are a likely consequence.[527] For example, New York's BitLicense is designed to respond to the internal policy preferences and political bargains that affect New York, its citizens, and its policymakers.[528] The NYDFS did not wait for other states to come to a general agreement, nor did it adopt any of the previous paths used by states to that point (ignoring virtual currencies, fitting them under existing regulations, or modifying existing regulations). Of course, New York is not unique in this respect: each state reacts in its own way on the basis of political and policy preferences within the state. Such reactions, however, can result in a muddle—multiple conflicting regimes effectively regulate people without providing them with any meaningful recourse.[529] Contrast this situation with federal

524. *See supra* Parts III.A.1, III.A.3, III.B.2, III.C.1, and III.D.3.

525. *See* Hughes & Middlebrook, *supra* note 241, at 511–12.

526. *Cf.* Int'l Paper Co. v. Ouellette, 479 U.S. 481, 494–95 (1987) (contrasting the cost-benefit analysis that a federal regulator, the state where an activity occurs, and a state downstream are likely to perform in the context of regulating water pollution).

527. Issacharoff & Sharkey, *supra* note 13, at 1387–88.

528. *See* N.Y. COMP. CODES R. & REGS. tit. 23, §§ 200.1–.22 (2017); Hughes & Middlebrook, *supra* note 241, at 542.

529. Issacharoff & Sharkey, *supra* note 13, at 1355.

regulation, which gives far more people at least the opportunity to participate in the decision-making, even if the ultimate outcome is not what everyone desires.[530]

Thus, even in cases of high political salience, federal action to address spillovers can be appropriate. Such action allows for democratic input from, and accountability to, all the citizens who have their autonomy limited by the regulation. Federal regulation is also not per se deregulatory, because it will likely reflect a compromise between citizens of more restrictive states and those of less restrictive states, resulting in a rule that is too restrictive for some states and not restrictive enough for others.[531] Furthermore, although costs and benefits may not be spread exactly evenly because state economies differ, it will not be as simple for policymakers to export the costs of regulations to outsiders. Better, more responsive policy will likely result, however, because the country is not held hostage by a handful of states that are effectively avoiding the full costs of their regulations.

Critics of laws that allow a company to export its home state's law, such as laws governing interest rates, worry about a "race to the bottom."[532] That concern is also commonly cited in discussions of state corporate chartering, with a long line of scholars worrying that states (most notably Delaware) race to the bottom of investor protection to attract corporations and the fees that come with them.[533] Other scholars believe that competitive federalism in corporate charters is a race to the top, leading to more efficient corporate law.[534]

When considering the risk of a race to the bottom, one must remember that consumers are not powerless and can choose to avoid bad products. Consumer choice gives companies an incentive to (1) seek out legislation that is attractive enough to the customers and investors they want to do business with, and (2) avoid exploiting such legislation to disadvantage consumers. Likewise, states have an incentive to pass laws that attract customers and to avoid passing laws seen as undesirable. States also have an incentive to avoid laws that are seen as so exploitive that they mobilize the public or interest

---

530. *See supra* notes 510–16 and accompanying text.

531. Issacharoff & Sharkey, *supra* note 13, at 1373.

532. Lalita Clozel, *State Regulators Balk at OCC Fintech Charter*, AM. BANKER (Aug. 19, 2016, 5:08 PM), https://www.americanbanker.com/news/state-regulators-balk-at-occ-fintech-charter [https://perma.cc/SK7Z-3SVK] ("Massachusetts Commissioner of Banks David Cotney also said a federal charter [which would grant interest rate and money transmission home-state export] could trump state consumer protection and licensing rules, which would be 'the beginning of a race to the bottom.'").

533. *See, e.g.*, Mark J. Roe, *Delaware's Competition*, 117 HARV. L. REV. 588, 594–95 (2003) (describing the "race to the bottom" theory).

534. *Id.* at 596 (describing the "race to the top" theory).

groups to appeal to the federal government for preemption. By contrast, in a world where certain states de facto regulate a national market and prevent products with certain characteristics from being viable, consumers have their choices limited without their input or consent.

States have strong competitive incentives to create good laws, and they also have strong incentives to avoid creating bad laws that prompt federal intervention. The threat of federal preemption can be a powerful check on any potential race to the bottom. As Professor Mark Roe points out in the context of state chartering of corporations, corporate law is a product not only of the states but also of the federal government.[535] As Roe says, "all corporate law could be federal law."[536] This means state action, especially for a dominant state like Delaware, is done with the threat of federal intervention in mind.[537] In the corporate context, the federal government has intervened through direct action[538] and through threat of action.[539] It is not that states cannot compete; rather, (1) the bounds placed by the federal government, or by the areas in which it hesitates to enter, limit the scope of competition[540] and (2) that competition can end in federal displacement of state law if things go awry.[541]

Concerns about a race to the bottom in fintech can be answered in a similar way. Creating a regime akin to that found in bank interest rate export requires a consensus at the federal level, and if such a regime is more harmful than helpful, the federal government can either displace the problematic state laws or remove the exporting capability.[542] States, for their part, have an incentive to avoid becoming too aggressive for fear they will lose their ability to regulate (and collect the attendant fees). The expansion of the CFPB into the interest rate debate, in the context of both the *CashCall* case and the Payday Rule, indicates federal policing of consumer issues is a very

535. *Id.* at 598.

536. *Id.* at 597.

537. *Id.* at 598, 639–40.

538. *Id.* at 610, 633 (discussing various direct federal interventions into corporate governance).

539. *Id.* at 601–07 (discussing incidents where the threat of federal action affected Delaware's positions). A clear example provided by Professor Roe is the debate around Delaware's 1988 anti-corporate takeover law. *Id.* at 605. Roe points to comments by the head of the Delaware State Bar Association's corporate law committee arguing for a law that was not maximally restrictive (which would be best for incumbent corporations) because such a law might risk federalization of the issue. *Id.*

540. *Id.* at 639.

541. *Id.* at 624 (discussing the preemptive effect of NSMIA).

542. *See* discussion *supra* Part III.A.2.

real possibility in the long term, making the threat of federal intervention credible.

D. Let's Not (Always) Make a Federal Case out of It

Many of the circumstances previously discussed involve companies operating at a national level while dealing with state regulation. The proposed changes to Rule 147 reflected the opposite concern. Rule 147 offerings are, by their nature, intrastate,[543] but the SEC considered imposing substantive regulations on those offerings.[544] The SEC's regulatory hook was issuers' use of an instrumentality of interstate commerce—the Internet.[545] That hook is likely sufficient under current jurisprudence,[546] but the SEC ultimately chose (wisely) not to use its authority to impose substantive requirements, instead deferring to the states.[547] Unlike the other examples—as this Section explains—efficiency, competitive equity, and political equity could not support federal regulation.

Intrastate offerings are inherently limited to a single state, use of the Internet notwithstanding. Hence, conflicting state laws are consistent with efficiency. The costs of monitoring legislative and regulatory developments are limited because there is only one state with jurisdiction over a particular issuer. Ironically, the injection of substantive federal regulation would decrease efficiency by increasing the number of applicable rule sets and the number of regulators that need to be monitored. Also important, adding the SEC to the regulatory mix could delay regulatory adaptation because the federal government is likely to be less responsive to local concerns than the states would be.[548] Likewise, intrastate offerings do not need federal regulation to provide competitive equity because every company conducting a Rule 147 offering in a given state will be regulated by that state.[549]

Finally, political equity would not justify federal regulation because Rule 147 offerings are, by their terms, limited to cases where the company is effectively linked to the state and the investors are residents of the same state. All the parties affected by the regulation have some amount of democratic access and means of promoting

543. *See supra* note 430–34 and accompanying text.
544. *See supra* notes 442–43 and accompanying text.
545. *See supra* note 435 and accompanying text.
546. *See supra* note 463 and accompanying text.
547. *See supra* notes 456–60 and accompanying text.
548. Letter from author & Staci Warden to Brent J. Fields, *supra* note 440, at 6.
549. *See supra* note 452 and accompanying text.

accountability.[550] Accordingly, the relevant state legislature and regulators have a strong incentive to create properly balanced regulations and enforcement because both the costs and the benefits will be felt within the state.[551]

One question that Rule 147 does present concerns the resales of securities initially offered under Rule 147 by the original purchaser to out-of-state parties.[552] Such resales reintroduce an interstate element to the transaction. Thus, it is appropriate that federal rules govern the resale. First, under Rule 147, the securities cannot be sold across state lines for the first six months after the initial purchase.[553] After that period, if the offering were public under the state's laws, the securities would presumptively be eligible to use the resale exemption found in Section 4(a)(1) of the Securities Act of 1933.[554] Private securities resales can rely on the provisions of Rule 144.[555] Although the exemption found in Section 4(a)(1) is broad, it represents a choice made at the federal level to exempt such offerings. If public policy needs dictated, Congress could change the rule.

Given the above considerations, although the federal government *can* impose substantive requirements on Rule 147 initial offerings or on other intrastate transactions with similar characteristics, it should not. The mere presence of an instrumentality of interstate commerce does not overcome the fact that the economic and political realities of the transactions place them within the individual states without the "leaking"[556] found in the other cited markets.

V. WHAT SHOULD BE DONE?

As this Article demonstrates, the allocation of regulation for certain fintech transactions is frequently harmful to efficiency, competition, and political equity. What should be done to mitigate these issues and create greater regulatory consistency? Change can come from federal regulators, Congress, the states themselves, or the courts, although these routes may vary in their effectiveness.

---

550. Letter from author & Staci Warden to Brent J. Fields, *supra* note 440, at 6.

551. *Id.*

552. The Author is indebted to an anonymous reviewer who raised this question.

553. 17 C.F.R. § 230.147(e) (2017).

554. 15 U.S.C. § 77d(a)(1**)** **(**2012).

555. *See* 17 C.F.R. § 230.144 (allowing the public resale of restricted securities in some cases); *see also Rule 144: Selling Restricted and Control Securities*, SEC (Jan. 16, 2013), https://www.sec.gov/reportspubs/investor-publications/investorpubsrule144htm.html [https://perma.cc/95N5-PWWC].

556. Letter from author & Staci Warden to Brent J. Fields, *supra* note 440, at 6.

A. Who Should Write the Rules?

Who writes the rules, and to whom the writers are answerable, are the core questions posed by the previous examples and by many fintech issues more broadly. Rules can come from numerous sources and can conflict, complement one another, or exist on parallel tracks. Among the parties that may write rules are federal regulators, Congress, and the states themselves. All have a potential role to play in providing more consistent and equitable regulation, though they may not all have the same chance of success.

Federal regulators already possess considerable power to impact fintech regulation. For example, consider a special-purpose bank charter for fintech firms, such as the one being pursued by the OCC.[557] This charter, though not without controversy,[558] could help address the competitive disadvantage fintech faces. It is unclear, however, whether the charter will help anyone but the largest fintech firms that focus on affluent customers. If the OCC's charter simply applies regulations built for universal banks to much more limited companies, or if it otherwise imposes significant costs,[559] it may be of little value to new entrants that lack the resources to manage the associated regulatory burden. Likewise, if the OCC regulates fintech firms, which rely on speed and nimbleness to survive, in the same way that it regulates banks, the fintech firms—especially newer, smaller firms that are still finding their way—may not remain viable. Given that many fintech lenders offer higher-interest products, the informal regulatory pressure against high rates may make the charter unworkable. Even if the charter is viable only for larger players that serve prime customers, it would allow those firms to compete on a more even playing field. In that case, the charter would benefit some

---

557. OFFICE OF THE COMPTROLLER OF THE CURRENCY, SUPPORTING RESPONSIBLE INNOVATION IN THE FEDERAL BANKING SYSTEM: AN OCC PERSPECTIVE 2 (2016).

558. *See, e.g.*, Letter from Sens. Sherrod Brown & Jeffrey A. Merkley, to Thomas Curry, Comptroller of the Currency, Office of the Comptroller (Jan. 9, 2017), http://brown.senate.gov/download/occ-fintech [https://perma.cc/ETV2-PNBV] (expressing concern over the special-purpose bank charter and questioning the OCC's legal authority to offer one); Letter from John W. Ryan to Thomas Curry, *supra* note 502 (opposing the special-purpose bank charter and raising questions as to whether the OCC has the necessary statutory authority to issue a "fintech" charter).

559. For example, the OCC is considering imposing enhanced capital requirements and CRA-like obligations, and potentially requiring more onerous small-business borrower "protections" as a condition of granting a fintech charter. *See* OFFICE OF THE COMPTROLLER OF THE CURRENCY, EXPLORING SPECIAL PURPOSE NATIONAL BANK CHARTERS FOR FINTECH COMPANIES 12 (2016), https://www.occ.gov/topics/bank-operations/innovation/comments/special-purpose-national-bank-charters-for-fintech.pdf [https://perma.cc/QDW2-Y2XH].

consumers, but it nevertheless would miss an opportunity to serve a broader population.

The bank regulators could also seek to address the harm and uncertainty done by the *Madden* decision to marketplace lending[560] via regulation.[561] Promulgating a rule holding that under federal law a valid loan made by a bank does not become invalid once sold to a nonbank would preempt state laws to the contrary[562] and be consistent with the OCC's previously stated position on the power of banks.[563] Such a rule could also potentially address the "true lender" question[564] if it holds that a bank is not required to retain a "predominant economic interest" in a loan in order to exercise its power to lend. Such a rule would no doubt be controversial, and it would only treat a symptom caused by the unfair and inefficient regulatory system currently facing fintech firms—rather than the underlying cause—but it would help address at least some of the practical harms to credit access caused by inapt state regulation.

Congress has even more flexibility. Congress could create a regime that provides consistency, avoids unnecessary duplication, and is accessible to new firms that may not be large enough to benefit from a bank charter. Hughes and Middlebrook advocate a bifurcation of responsibility between the states and federal government.[565] This division would be based on which level of government has the most experience regulating the different aspects of a cryptocurrency transaction (for example, anti-money-laundering issues would be left to the federal government and payment execution regulation to the states).[566] Similarly, Congress could federalize certain aspects of regulation in which state-by-state differences are most harmful, while leaving other aspects to the states, such as allowing a state lending or money transmission license to serve as a passport between states. That approach would be similar to the regulation of state banks, for which federal action permits interest rate export, but much of the rest

560. *See supra* notes 100–22 and accompanying text.

561. BRIAN KNIGHT, MERCATUS ON POLICY: RISKS TO INNOVATIVE CREDIT POSED BY EMERGIN REGULATORY AND LITIGATION TRENDS 4 (2017) https://www.mercatus.org/system/files/knight-risks-innovative-credit-mop-v1.pdf [https://perma.cc/GV45-2SBV]; Brian Knight, Comment Letter on Examination Guidance for Third-Party Lending 2 (Oct. 17, 2016), https://www.mercatus.org/system/files/mercatus-fdic-guidance-third-party-lending.pdf [https://perma.cc/MX2Y-9BLU]; *see also* Alan S. Kaplinsky, *OCC Must Stand up for Preemption*, AM. BANKER (Mar. 20, 2017, 12:00 PM), https://www.americanbanker.com/opinion/occ-must-stand-up-for-preemption [https://perma.cc/MXR9-4S37].

562. *See* Smiley v. Citibank (S.D.), N.A., 517 U.S. 735, 744 (1996).

563. *See supra* notes 112–13 and accompanying text.

564. *See supra* notes 147–51 and accompanying text.

565. Hughes & Middlebrook, *supra* note 241, at 549.

566. *Id.*

of the regulation remains at the state level.[567] The challenge is determining which functions or criteria should be federalized and which should remain under state control.

The states themselves can also harmonize their requirements, as they have done with Article 4A of the Uniform Commercial Code, which governs the transfer of funds.[568] It is unclear whether any of the fintech-related model laws discussed here will ultimately matter, however. Those laws not only need to gain sufficient traction to be widely adopted, but they must remain sufficiently consistent over time. Only then can fintech firms have confidence in their regulatory environment and avoid expensive monitoring costs. Experience to date suggests that success is unlikely. The states have not harmonized their lending and money transmission laws, even ignoring Congress's call to harmonize such laws.[569] Future harmonization is unlikely without federal government action.

Another option, advocated by Professor J.W. Verret, would be to allow for home-state charter recognition akin to how states respect the corporate law of other states.[570] There is a long history of state corporate charter recognition,[571] but the same tradition of political comity does not exist for financial firm charters.[572] States are unable to compete with one another to offer the best legal regime because firms need to comply with every state's law. As Verret acknowledges, somewhat akin to state banks, it is likely the federal government will need to compel that recognition if it is to occur at all.[573]

It may make sense to allow companies to opt into federal fintech regulation that overlaps with state law. Companies that operate in only a single state or a few states may be able to comply with those state laws more efficiently than with an overarching federal regime, and providing opt-in will allow companies to avoid regulatory regimes that are inefficient or that put them at a competitive disadvantage. That approach would ensure regulatory

---

567. *See supra* note 60 and accompanying text.

568. Hughes & Middlebrook, *supra* note 241, at 519; *see also* Gerken & Holtzblatt, *supra* note 507, at 94 (citing the UCC as an example of an effective solution to inconsistent laws among states).

569. *See supra* notes 191–95 and accompanying text.

570. Verret, *supra* note 11, at 35–36.

571. *Id.* at 13–14.

572. *Id.* at 36.

573. *Id.* at 36–37. The current dual banking system is considered by some to encourage this sort of salutary regulatory competition. *See, e.g.*, Kenneth E. Scott, *The Dual Banking System: A Model of Competition in Regulation*, 30 STAN. L. REV. 1, 32 (1977). *But see* Henry N. Butler & Jonathan R. Macey, *The Myth of Competition in the Dual Banking System*, 73 CORNELL L. REV. 677, 683–93 (1988) (arguing that the dual banking system does not encourage competition so much as rent splitting between federal and state governments).

coverage, but it would allow companies that operate only in a single state or a few states to avoid a federal regime that may not be appropriate for them. The opt-in method might encourage competition between the states and federal government. However, it is possible an opt-in regime could negate the benefits of a federal system if state regulation created sufficiently costly spillovers for which the companies did not pay, giving companies insufficient incentive to move to the federal system.[574]

Policymakers may also consider whether hybrid regulation, in which the states' and federal government's regulatory regimes overlap or coexist, is appropriate. Even in areas of significant federal preemption, states are able to enforce laws that are not explicitly preempted.[575] It may make sense to explicitly federalize only those elements of regulation where the state-by-state model impinges on efficiency, competitive equity, and political equity, while leaving other issues to the states. Determining which is which, however, would be the challenge.

Hybrid regulation can also include coextensive regulation, which may be more problematic. For example, Section 1041 of Dodd-Frank precludes preemption of state laws that offer "greater" consumer protection.[576] As a result, states that embrace "greater" consumer protection are able to set policy for themselves and potentially for other states. Other states that favor less "protective" rules (as defined by the CFPB) are precluded from exercising sovereignty.[577] This arrangement denies certain states political equality without providing offsetting efficiency benefits. As Professor Michael Greve points out, hybrid regulation, in which the federal government sets a floor but not a ceiling, does not create consistency, but rather can serve as a jumping-off point for further idiosyncratic state regulation.[578] Although commentators have raised concerns that preempting state law will weaken consumer protections,[579] the better

574. The Author is grateful to one of the anonymous peer-reviewers for raising this concern.

575. *See, e.g.*, 12 U.S.C. § 25b (2012) (narrowing the scope of federal preemption of state consumer financial laws).

576. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 1041(a)(2), 124 Stat. 1376, 2011–12 (2010) (codified as amended at 12 U.S.C. § 5551(a)(2) (2012)).

577. *Id.* (deeming that Dodd-Frank only preempts state law to the degree it is inconsistent, but that state "statutes, regulations, orders, or interpretations" that provide consumers with "greater" protection, as determined by the Bureau, is not inconsistent).

578. Michael S. Greve, *Business, the States, and Federalism's Political Economy*, 25 HARV. J.L. & PUB. POL'Y 895, 903 (2005).

579. *See, e.g.*, Bar-Gill & Warren, *supra* note 32, at 81–82.

answer may be to create uniform rules adequate to provide appropriate protection to govern the national market.[580]

B. Who Should Enforce the Rules?

The previous Section focused on the rules to which market actors are subject. However, the question of who enforces those rules—or threatens to enforce them—is also important. The question can arise in cases where state laws or rules are so broad that they may allow a regulator to bring enforcement actions against companies that have weak or tangential ties, and in cases where there is a common rule but multiple regulators share jurisdiction—situations that can lead to a consistent rule in theory becoming an inconsistent rule in practice.

The enforcers of regulations, such as the states' attorneys general and banking commissioners, are not immune to the temptation to capture benefits while exporting costs.[581] Although attorneys general and commissioners may be sensitive to the political preferences of their state, they are less concerned with the perception of out-of-state residents, who lack a direct means of applying political pressure to check the enforcers' actions.[582] That situation might encourage regulators to stretch their authority over companies without political means of redress.

For example, given the scope of the BitLicense,[583] the NYDFS could use its virtual currency regulations to bring an enforcement action against a company that may have only tangential or incidental ties to New York (if any at all). The NYDFS may wish to bring an action because it feels it is justified on the basis of a company's conduct, but it may also be motivated by political factors such as wishing to appear tough or making an example of a foreign firm to change licensed firms' behavior. The NYDFS may also be motivated to pursue foreign firms because those firms lack the means of political response that domestic firms possess. The threat of litigation could chill activity outside New York for fear of an enforcement action that could bankrupt a company even if that company successfully resisted.[584]

---

580. *See supra* note 464 and accompanying text.

581. PAUL NOLETTE, FEDERALISM ON TRIAL 210–11 (2015) (looking at the impact of state attorneys general and their litigation on national markets).

582. *Id.* at 211.

583. *See supra* note 275 and accompanying text.

584. A related example, albeit one with limited chance of bankruptcy, is the New York Attorney General's use of New York's Martin Act, N.Y. GEN. BUS. LAW §§ 352–353 (McKinney 2017), a law that empowers the New York Attorney General to launch sweeping investigations

Even in areas with robust federalization, such as bank regulation, the states are not completely excluded.[585] In fact, Dodd-Frank goes even further in Section 1042,[586] which empowers state attorneys general and regulators to bring civil suits to enforce Dodd-Frank's consumer protection provisions (though they are limited to enforcing CFPB regulations against banks).[587] That provision places state regulators in a position to enforce not only their states' non-preempted laws, but also federal law. Arguably, this nonexclusive approach to enforcement invites disparate treatment, depending on how the various attorneys general interpret the law. The approach risks creating fifty or more different interpretations of the same law. It could, in turn, lead to inefficient inconsistency, usurpation of authority by states with aggressive attorneys general, and the imposition of externalities on other states without democratic redress.[588]

Considering the unpredictability of state-by-state regulations for particularly sensitive transactional elements, federal enforcement should provide more consistency and allow real—albeit imperfect—redress to those affected. This is not to say that federal enforcement is guaranteed to be good enforcement.[589] However, federal enforcement may be able to provide consistent application of the rules nationwide, as well as among competitors, and may be subject to broad political accountability. These attributes recommend it for cases where the true nature of a transaction is interstate.

---

into possible financial fraud, to investigate ExxonMobil for failing to write down the value of its oil reserves as a means to facilitate an investigation driven by concerns about climate change, rather than securities fraud. *See, e.g.*, Christopher M. Matthews, *New York AG Employs Powerful Law in Exxon Probe*, WALL ST. J. (Sept. 16, 2016, 5:38 PM), https://www.wsj.com/articles/new-york-ag-employs-powerful-law-in-exxon-probe-1474061881 [https://perma.cc/5JXS-C72G].

585. *See, e.g.*, Cuomo v. Clearing House Ass'n, LLC, 557 U.S. 519, 536 (2009) (holding that federal banking regulations did not preempt a state's ability to enforce state lending law).

586. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 1042(a)(1), 124 Stat. 1376, 2012 (2010) (codified as amended at 12 U.S.C. § 5552(a)(1) (2012)).

587. *Id.* § 5552(a)(2).

588. NOLETTE, *supra* note 581, at 211.

589. Examples of flawed enforcement abound. For those on the right, Operation Choke Point and the FDIC's treatments of financial institutions that offered refund-anticipation loans are examples of federal regulatory abuse. *See supra* notes 70, 224–27 and accompanying text. For those on the left, the perceived capture of financial regulators in the run-up to the 2007–2009 financial crisis shows how federal regulators can fall down on the job. Adam J. Levitin, *The Politics of Financial Regulation and the Regulation of Financial Politics: A Review Essay*, 127 HARV. L. REV. 1991, 2049 (2014) ("While the financial regulatory system [pre-2008 crisis] was undoubtedly outdated in many ways, it is hard to deny that capture [of financial regulators by regulated entities] played some role, if not the leading role, in the crisis.").

Determining who should enforce is difficult given the variables and trade-offs that encumber every example. In many of the areas previously discussed, the interests of efficiency, competitive equity, and political equity argue for more federalization of enforcement, though the states are likely in the best position in cases of intrastate transactions.

C. What About the Courts?

Finally, the courts have a role to play. As the jumble that is "true lender" law demonstrates, uncertainty imposed by litigation can harm efficiency and competition, and it can privilege some citizens over others. Providing clarity on who has the right to write the rules—and consistency on questions such as whether a lending contract applies—will help both market participants and citizens, who, to the extent that they are displeased with the courts' consensus, can lobby Congress to make a change.

VI. CONCLUSION

Financial technology is changing how people access financial services and who provides those services. The dramatic and rapid changes are placing significant stress on the regulatory and legal framework for financial services, including the balance of authority between the federal government and the states. Often, the current allocation leads to harmful inefficiency and a lack of competitive and political parity. In those cases, federal policymakers should consider federalizing fintech regulation and displacing state-by-state rules to an appropriate degree. However, in cases where the transaction is truly intrastate, the federal government should defer to the states, even if the Constitution would allow federalization. Harmonizing the level at which the markets are regulated with their economic, competitive, and political reality will lead to a more competitive, efficient, and just result. Such harmonization will help consumers, market participants, and the country as a whole flourish.