CHAPTER 22:
Federalism and FinTech

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Americans are currently seeing a period of potentially significant change as financial technology (FinTech) companies seek to harness advances in communications, data processing, and cryptography to compete with traditional providers across a host of services. FinTech is changing how financial services are provided in a host of ways that make it possible for new competitors to compete with incumbents.[1] Some of the most powerful are removing geographic limitations on where a company can offer its services, and lowering barriers to entry. This newly competitive landscape is exposing weaknesses, inefficiencies, and inequities in the United States' financial regulatory structure.

Many of these problems stem from the awkward way in which the federal and state governments share regulatory power over FinTech. The uneven application of state and federal law places some competitors at a disadvantage. In some situations, the application of state law subjects the citizens of some states to regulation by other states. The changing economic and business realities wrought by technology frequently (though not universally) argue in favor of the federal government replacing state-by-state regulation with consistent national regulation. Considerations of efficiency, competitive parity, and political equity should drive decisions about whether federal or state regulation is appropriate.

FinTech is a very broad area; this chapter uses a few select examples to explore the interaction between federalism and financial technology. This chapter focuses on "marketplace lending,"[2] virtual currencies, and Internet securities sales. While these three examples occur in different markets and are governed by different laws, they share certain common attributes. Each innovation has been governed by a regulatory framework focused on retail customers, has drawn both state and federal regulatory attention, and has been characterized by significant, technologically driven change.

This chapter briefly describes each innovation and how technology is changing the relevant market. For each innovation, the chapter outlines the allocation of state and federal regulation, how competition is regulated, and the problems created by the divide of responsibility between the federal and state governments. Finally, the chapter briefly discusses options to make regulation of each innovation fairer and more efficient.

Marketplace Lending. Marketplace lending is a broad term that encompasses new non-bank lenders with certain traits. First, marketplace lenders use the Internet to advertise and interact with borrowers, and in some cases capital sources, nationwide. This allows lenders to match borrowers to capital suppliers from across the country.[3] Second, marketplace lenders fund loans through a combination of their own balance sheet, securitizations of loans into asset-backed securities, or the sale of loans (either whole or fractionalized) to individual and institutional investors. This differentiates them from banks, which frequently fund loans with capital from insured deposits. Third, marketplace lenders frequently use non-traditional data sources and proprietary algorithms to underwrite borrowers in addition to, or to the exclusion of, traditional methods, such as scores from credit bureaus.

Marketplace lenders often are able to make lending decisions more quickly than traditional banks.[4] There is also some evidence that they can provide some borrowers with better prices than traditional lenders[5] or make loans to borrowers who are unlikely to obtain credit from traditional sources.[6] This may be the result of the lenders enjoying a lower cost-structure than banks because of the lack of branches.[7]

Marketplace lenders make money through several different channels. The most obvious is collecting the interest payments for loans they hold on their books. Lenders also collect servicing fees from investors who purchase the loans (or securities backed by the loans) for maintaining the loan and providing the conduit for the borrower to repay. Marketplace lenders also earn origination fees charged to the borrower at the inception of the loan.

Many marketplace lenders make their loans through one of two methods: directly or through a bank partnership.[8] The direct model requires the lender to be licensed in every state into which it extends credit.[9] The bank-partnership model, by contrast, allows the lender to leverage banks that have a federally granted right to lend nationwide, subject primarily to the law of its home state.[10] The bank-partnership model has recently come under judicial and regulatory scrutiny that may call its continued viability into question.

The bank-partnership method reflects an important difference in how marketplace lenders and banks are regulated. Banks enjoy the ability to, among other things, extend credit to borrowers subject to the higher of the limit allowed under the state law of the bank's home state or the borrower's home state. The 1864 National Bank Act[11] originally granted this power to banks to end discrimination by states seeking to protect their own state-chartered banks. The National Bank Act created a national charter that was arguably designed to replace state banks that had previously dominated the United States banking sector.[12] The newly created national banks were "National favorites," in the words of the Supreme Court in *Tiffany v. National Bank of Missouri*,[13] which merited protection from "ruinous competition with State banks."[14]

The interest-rate-export provision took on a new importance in the 1970s as credit cards changed how financial services were provided. Credit cards allowed banks to compete for customers across state lines without having to open branches, which was legally difficult at the time.[15] This development again raised the question of whether the law of the bank's home state or the borrower's home state should control the rate of interest the issuing bank was allowed to charge.

The Supreme Court took up this question in *Marquette National Bank v. First of Omaha Corp*.[16] The court held that under section 85 of the National Bank Act, a nationally chartered bank was able to charge the interest rate allowed by its home state, even if that rate exceeded what was allowed by the laws of the borrower's state. The court also found that the bank's home state was the state listed on its organizational certificate, even if the bank extended credit in another state.

In the wake of *Marquette,* state banks found themselves at a competitive disadvantage because they could not export interest rates. Congress provided state-chartered banks with parity through section 521 of the 1980 Depository Institutions Deregulation Act (DIDA),[17] which effectively copied the language of the National Bank Act to "prevent discrimination against State-chartered depository institutions."[18] This provision was, as its proponents pointed out, intended to "allow [] competitive equity among financial institutions, and reaffirm[] the principle that institutions offering similar products should be subject to similar rules."[19]

The definition of "interest" for the purposes of banks exporting interest rates is broader than just the numerical rate. The Office of the Comptroller of the Currency (OCC) and the Federal Deposit Insurance Corporation (FDIC) have interpreted interest to include "any payment compensating a creditor or prospective creditor for an extension of credit, making available of a line of credit, or any default or breach by a borrower of a condition upon which credit was extended,"[20] an interpretation that was embraced by the Supreme Court in *Smiley v. Citibank (South Dakota)*.[21] This means that not only can banks export the numerical interest rate from their home state, they can also export the structure of interest charges.

The ability to export interest rates allows banks to offer consistent prices on loans nationwide without regard for the variance in state interest-rate limits, thereby providing greater efficiency. Conversely, non-banks that are regulated on a state-by-state basis are subject to different limits on what they can charge borrowers and what type of fees they can collect.[22]

This limitation is part of the reason why many (though not all) marketplace lenders partner with banks. By partnering with a bank that originates and then sells the loan, either directly to the marketplace lender or to an investor, the marketplace lender is able to leverage the bank's ability to charge consistent prices and have a consistent fee structure nationwide. This allows marketplace lenders to enjoy economies of scale and compete on a more similar regulatory footing to that of their bank competition. It does not provide perfect parity, because the marketplace lender must bear the cost of compensating its bank partner.

Recent legal and regulatory developments have called the long-term viability of the bank-partnership model into doubt. The United States Court of Appeals for the Second Circuit's recent decision in *Madden v. Midland Funding, LLC*[23] has cast a pall on the ability of non-banks to buy loans from banks and continue to charge the same rate of interest, if that rate of interest exceeds the limits of the borrower's state. While not directly involving marketplace lenders, the case does implicate the bank-partnership model.

In *Madden,* a nationally chartered bank located in Delaware offered a credit card to a borrower in New York at an interest rate of 27 percent. This rate was consistent with Delaware law, but exceeded New York's 25 percent limit. However, the National Bank Act allowed the bank to export its home state rate. After the borrower defaulted on her account, it was sold to Midland Funding LLC, a non-bank debt-collection agency. Midland Funding attempted to collect on the loan, including not only the money owed while the loan was held by a bank, but also the interest due on an ongoing basis at the original 27 percent annual rate.

The borrower sued, arguing that the loan was usurious under New York law and that Midland Funding was not entitled to National Bank Act pre-emption. While the trial court held that Delaware law might apply, the borrower appealed this decision to the Court of Appeals for the Second Circuit. The Second Circuit decided in favor of the borrower, finding that Midland Funding was not entitled to state law pre-emption. It reached this conclusion after finding that extending the pre-emption was not necessary to protect the powers of the national bank. Limiting the ability to sell debt to non-banks on the same terms the bank enjoyed did not "significantly interfere" with the powers of the national bank.

While the Office of the Solicitor General and the OCC criticized the Second Circuit's decision to the Supreme Court,[24] the Solicitor General also argued that the Supreme Court should not take up the case for procedural and judicial economy reasons. The Supreme Court agreed with the Solicitor General and opted not to grant certiorari. It is unclear whether other circuits will follow the Second Circuit's lead. They may instead defer to the OCC's rejection of the Second Circuit's interpretation of the National Bank Act. However, the decision remains good law in the Second Circuit.

While the *Madden* decision does not directly involve marketplace lenders, it appears to be negatively affecting access to marketplace loans for borrowers with lower credit, as funding for loans with interest rates in excess of the state limit has declined significantly in the Second Circuit.[25] It has also contributed to at least one court case arguing that a marketplace lender is using its bank relationship as a sham to avoid state usury law. However, in that case, unlike in *Madden*, the question raised is whether the bank is the lender at all.

The plaintiff in *Bethune v. Lending Club Corp. et al.*[26] is a borrower who took out a loan with Lending Club at a 29.97 percent annual percentage rate (APR) and later alleged that the loan violated New York's usury law.[27] The borrower argued that the loan violated New York's usury law because Lending Club was the "true lender" and used a Utah bank simply as a "sham pass through" to take advantage of Utah's lack of an interest rate cap. The borrower argues that because Lending Club is the true lender and not a bank New York law should apply. This would render the loan invalid as usurious.

The question of who is the true lender is an important one for marketplace lenders that partner with banks. If the bank partner was never the actual lender, the interest rate exportation would not attach, and the loan would be subject to the borrower's state regulations that apply to non-bank lenders. The scope of the true lender doctrine is unclear. Some courts follow the contracts to determine the lender,[28] while others claim to look beyond the contract to the economic reality of the transaction.[29] It remains unclear how courts will treat marketplace lenders.

Marketplace lenders' true-lender troubles may not be limited to private civil litigation. The Bureau of Consumer Financial Protection (CFPB) has successfully invoked the true-lender doctrine to argue that the use of a tribal partnership (which operates somewhat similarly to a bank partnership) does not shield a lender from state usury laws.[30] The CFPB argued that attempting to collect on loans that were invalid because they were usurious under the state law of the borrower was a violation of the Dodd–Frank Wall Street Reform and Consumer Protection Act of 2010.[31] Additionally, regulators in several states, including New York and California, are beginning to look at marketplace lending business models with a possible eye to true-lender issues.[32] These inquiries may mean that the states are looking to assert substantive jurisdiction over marketplace loans because the true lender is a non-bank and therefore subject to significant state control, as opposed to banks who enjoy broad federal pre-emption.

Federal banking regulators have sent mixed messages regarding marketplace lending and bank partnerships. The OCC has expressed openness to the idea of allowing marketplace lenders (and other types of FinTech firms) to become special-purpose banks, which would provide them with the same relevant powers as traditional banks.[33] Both the OCC and FDIC have also cautioned banks about the risks inherent in partnering with non-bank lenders. It is unclear whether there will be any meaningful movement toward a new charter, or if the regulators' cautioning of banks will be interpreted by banks as a warning shot against partnerships.

MONEY TRANSMISSION

Like lending, money transmission operates in a system where both federal and state actors regulate. It is currently undergoing a potentially significant shift thanks to technology, including the use of distributed ledgers and virtual currencies. Regulatory fractures between the states and federal government and among the states themselves may unduly hamper these new technologies, and citizens find themselves subject to regulations over which they have no control.

Money transmission regulation occurs at both the federal and state levels. The nature of the regulation depends on whether the entity in question is a bank or a stand-alone money transmitter. Generally, federal regulation is primarily concerned with preventing money laundering and other criminal activities. The Bank Secrecy Act[34] requires, *inter alia*, that money-services businesses (which it defines broadly) register with the Treasury Department's Financial Crimes Enforcement Network (FinCEN) and provide it with reports of suspicious activities. Federal law also criminalizes the unlicensed provision of money transmission services if a state's law would make it a crime to provide a service without a license.[35]

Congress has not passed a uniform money transmission law, but it has called on the states to create more uniform laws[36] to help prevent money laundering. Through the Dodd–Frank Act, Congress has added a layer of regulation and created a new federal regulator—the CFPB. The CFPB has asserted jurisdiction in actions against two players in the payments system on the grounds they are covered persons under Dodd–Frank.[37] It is unclear whether this represents the beginning of a concerted "consumer protection" effort at the federal level, or if the federal government will remain primarily focused on preventing criminal activity.

Conversely, money-transmitter regulation at the state level is heavily focused on consumer protection.[38] State laws frequently restrict who may own a money-transmitter business based on character, fitness, and criminal history.[39] They also frequently have provisions, such as minimum-worth requirements, and demand a surety bond to help protect consumers from transmitter insolvency.[40] Requirements can vary significantly from state to state[41] and while banks are frequently exempted, the scope of state money-transmission law is otherwise frequently quite broad.[42]

In response to Congress' request, the Uniform Law Commission drafted a uniform money-transmitter statute[43] that has been adopted by seven states. Additionally, the Money Transmitter Regulators Association and the Conference of State Bank Supervisors have created agreements to facilitate multistate reviews and examinations of money transmitters. Despite this, the state regulatory environment for money transmission still has significant inconsistencies.

Virtual currencies, the largest and most famous of which is bitcoin, have become entangled with money-transmission regulation. However, given the potential non-monetary uses for virtual currencies, including recording ownership of non-monetary assets, the impact of money-transmitter regulation may extend beyond money.

Briefly, Bitcoin, is a protocol that runs on computers, creating a common network.[44] This protocol involves a token (bitcoin) that can represent value. These tokens can be transferred between users of the protocol, with the transfer being recorded on a generally accessible distributed ledger (the bitcoin ledger is called "the blockchain"). Different protocols use different methods to ensure that the record created is accurate. In bitcoin, for example, computers perform cryptographic work to maintain the accuracy of the records. These "miners" are rewarded with bitcoins, which creates an incentive for users to police the system. While some proposed virtual currency systems are designed to be "permissioned" in that access to the protocol is gated by an entity that decides who can use it, the Bitcoin blockchain is a permission-less and open-source system that can be used by anyone.

Users can transfer tokens to other users, which can be used for payment if the tokens have a value. Some virtual currencies, especially Bitcoin, compete with traditional government-sponsored currencies as a store of value and means of payment.

As part of the transfer of value, additional information can be recorded on the distributed ledger. This capability is what has led industries, including real estate, banking, and corporate securities, to investigate distributed currencies, and Bitcoin specifically, as a better way to record and disseminate records of ownership and transfer of property. These recording and transfer functions necessitate the transfer of a small amount of virtual currency. In permissioned systems the transfer of a token may have no monetary value because there is no "market" for the tokens, but in open systems like Bitcoin the tokens have value, which makes it more likely that transfers may be considered money transmission.

Virtual currencies are subject to overlapping and diverse regulation at the federal level. FinCEN has provided guidance stating that parties that maintain virtual currencies exchanges (where people exchange virtual currencies for other stores of value including government-backed money) and "administrators" (parties who create virtual currencies, place them in circulation, and can remove them from circulation) are money-services businesses and subject to Bank Secrecy Act requirements. Conversely, users (people who use the virtual currency to buy things) and miners are not.[45]

Other federal agencies have begun to regulate transactions involving virtual currencies. The IRS has provided guidance holding that virtual currencies are property for tax purposes.[46] The Commodity Futures Trading Commission has brought at least one enforcement action related to virtual currency futures.[47] The Securities and Exchange Commission (SEC) has brought enforcement actions around virtual-currency-based securities trading[48] and a Ponzi scheme involving virtual currencies.[49] The Federal Trade Commission has brought an enforcement action against a company that sold computers used to mine bitcoins.[50] The CFPB and bank regulators have provided guidance regarding the potential risks of virtual currencies to consumers and banks.[51]

States have taken different tacks on regulating virtual currencies. Virtual currencies are fully covered under some states' existing money-transmission laws. Other states, such as Kansas and Texas, consider exchanges to be covered if they offer to exchange virtual currency for real currency.[52] A Florida trial court found that Florida's money-transmitter law does not cover virtual currencies, throwing out a case brought against an individual who sold bitcoins to an undercover agent without a money-transmitter license.[53] Other states have amended, or are attempting to amend, their money-transmission laws to cover virtual currency.

So far, New York is the only state to create a specific virtual-currency regulatory regime with its "BitLicense."[54] The scope of the license is quite broad, covering a wide swath of activities, and applies to any transaction that involves New York residents or the state itself. It exempts non-money-transmissions that involve the transfer of a de minimis amount of virtual currency as well as end use and software development.

The BitLicense regime imposes requirements that largely mirror those placed on traditional money transmitters. However, it also creates a New York-specific anti-money-laundering-reporting requirement that overlaps with FinCEN's requirements, but applies even if the licensee is not subject to FinCEN reporting. It also requires that licensees employ a Chief Information Security Officer and maintain a cybersecurity program. BitLicense has been met with mixed reviews. Some firms argue that it is too onerous and claim they will boycott New York.[55] Given the importance of New York for financial services it is unclear how effective or feasible such a boycott would be. So far only two firms, Circle and Ripple, have obtained the licenses.

SECURITIES

Regulation A. The sale of corporate securities is another area where technology has outstripped regulatory assumptions, including assumptions about whether federal or state law should apply. The first major federal securities laws, the Securities Act of 1933 and the Securities and Exchange Act of 1934, did not generally pre-empt concurrent state regulation.[56] However, as the securities market became more national, in part because of changes in technology, Congress began to feel that state regulation of certain offerings and securities was "redundant, costly, and ineffective."[57] This belief resulted in the National Securities Markets Improvement Act (NSMIA) of 1996,[58] which pre-empted state regulations over many securities transactions.

The NSMIA displaces state registration requirements and most substantive regulations for "covered securities," which include securities issued pursuant to an exemption from registration, sold to "qualified purchasers" or traded on certain exchanges. The NSMIA also allowed the SEC to change the definition of qualified purchaser by rulemaking. While the NSMIA limited the powers of the states considerably, it did not completely remove them. The states retained the ability to enforce state anti-fraud laws and require notice filings by companies that were offering securities in the state. The states also maintained their authority over securities not covered by the NSMIA.

Among the securities not covered were those offered under Regulation A,[59] an exemption from full SEC registration that allowed companies to offer and sell up to $5 million of securities to the general public per year. Even though offerings under Regulation A were exempt from the full registration process, they were considered public offerings and therefore not covered by the NSMIA. As such, companies that made Regulation A offerings were required to comply with both the federal and state requirements.

Regulation A saw peak use in the late 1990s, with 116 initial offerings in 1997, and 57 "qualified" offerings (offerings that had successfully made it through SEC review) in 1998.[60] However, over time, the use of Regulation A declined in favor of offerings made under Rule 506 of Regulation D.[61] Although these offerings were limited mostly to accredited investors (generally wealthy individuals or institutions), Rule 506 offerings had several advantages over Regulation A offerings. Unlike Regulation A—which did not have state law pre-emption, required qualification by the SEC, and imposed a limit on how much a company could raise—Rule 506 offerings were covered by the NSMIA, required only notice filings with the SEC, and had no offering limit. Thus, Rule 506 came to be considered the more efficient means of accessing capital. In 2011, there were only 19 initial Regulation A offerings, only one of which was qualified.[62]

In response to the economic crisis of 2007–2009, Congress passed the Jumpstart Our Business Startups (JOBS) Act.[63] The JOBS Act made several changes to the securities laws in order to ease companies' ability to obtain capital, including amending Regulation A to allow companies to offer up to $50 million of securities per year. While the act did not explicitly pre-empt state regulation, it allowed the SEC to include purchasers of Regulation A securities as qualified purchasers under the NSMIA. It also directed the Government Accountability Office (GAO) to perform a study on the causes of the decline in Regulation A offerings.

The GAO study found evidence that both the low offering limit and the costs and difficulty of complying with state-by-state regulation limited the appeal of Regulation A.[64] While state regulators acknowledged that technology may have outstripped regulation and that state regulation may have added to the burden of using Regulation A, they argued that state regulation protects consumers from fraud.[65] The states also pointed out that they were adapting, including by creating a new coordinated review process to help reduce regulatory friction. Finally, they maintained that it was premature for the federal government to consider pre-emption because the market and regulators had not yet adapted to the increased offering size.[66]

State protestations notwithstanding, the SEC's proposal for an amended Regulation A included two tiers of offerings. The first defined purchasers as qualified purchasers, thereby pre-empting the states, but required companies to provide ongoing reporting on a regular basis after the offering closed. The second tier retained state regulation and did not require ongoing reporting by the company.

These proposed changes were controversial. State regulators, some Members of Congress, some consumer advocacy organizations, and others opposed the pre-emption. Supporters, including business groups and other Members of Congress, countered that pre-emption was necessary for Regulation A's viability. Pre-emption made it into the final rule and was promptly met with law suits from Massachusetts and Montana.[67] These states argued that the SEC's expansion of the definition of "qualified purchaser" exceeded the SEC's authority and was arbitrary and capricious. The court did not agree, finding that the SEC had the authority to change the definition and that the change was not arbitrary and capricious.

Regulation A in its amended form became effective on June 19, 2015. Uptake does seem to have improved, at least relative to the low-water mark, with 108 offerings filed with, and 48 qualified by, the SEC as of July 19, 2016. There is a roughly even mix between the two tiers.

Rule 147. Rule 147[68] is a safe harbor for intrastate offerings that are exempt from the requirements of the Securities Act. If an offering meets the rule's criteria, a company can feel comfortable being exempt from registration. Many states condition their laws regarding small-scale offerings on compliance with Rule 147. Over time, companies expressed concern that Rule 147 compliance was becoming more difficult, in part because of technology. The SEC Advisory Committee on Small and Emerging Companies, for example, noted that a company advertising its offering of securities via the Internet could violate the rules by "offering" securities to out-of-state investors, even if the offer was legally open only to residents of the same state.[69]

In response, the SEC proposed several changes to Rule 147.[70] Most fundamentally, the proposal would change Rule 147 from a safe harbor to an exemption under the SEC's general exemptive authority. The proposal contains several modernizing changes, including allowing general solicitation (and therefore the use of the Internet). The proposal also would impose substantive requirements for offerings to qualify under Rule 147, including a $5 million annual offering limit, a requirement that the relevant state place a limit of its choosing on the amount investors can purchase.

States, practitioners, policy professionals, and other commenters argue that the proposal would unnecessarily impose federal requirements on transactions that are, for all practical purposes, located within a single state and therefore better suited to state control. These commenters argue that, unlike interstate offerings, Rule 147 offerings are limited to one state and that all the potentially affected participants have a means of influencing policy and seeking redress in that state. They also argue that state regulation of Rule 147 offerings lacks the potential to "leak" into other states. Rule 147 offerings are a perfect candidate for experimentation in what Justice Brandies termed "laboratories of democracy"; the states can experiment with how to best protect investors without constraining their fellow states. At the time of this writing the SEC's proposed rule is still pending.

WHAT DOES IT MEAN?

Lending, money transmission, and the securities markets are all seeing significant changes due to technology. In particular, the ability of technology to facilitate communications nationwide (and worldwide) and the increased competition due to lower barriers to entry have significantly affected how people's needs can be met. These changes in technology and markets are pressuring the existing division of regulatory responsibility between states and the federal government.

The existing structure, which is showing signs of obsolescence, may be causing harm to consumers and citizens. Specifically, the current structure may be harming the efficiency of the markets, the interests of competitive equity, and the political equality of the citizens of different states. While much of this is driven by the state-by-state nature of regulation for certain market participants, Rule 147 provides an illustration of where unnecessary federalization has the potential to cause harm.

Efficiency. Redundant regulations can harm the very groups that regulation seeks to help. To use Regulation A as an example: Businesses were harmed because it was harder to access capital via the methods they believe will work best for them. Investors, particularly retail investors, were also harmed by being deprived of investment opportunities that instead went almost exclusively to the wealthy. (Regulation D strongly encourages selling only to accredited investors.) Further, there were likely additional cascading harms to employees and communities. When businesses are unable to effectively access capital, economic growth, consumer options, and job opportunities suffer, too.

Likewise, the state-by-state regulation of non-bank money transmitters and lenders increases the regulatory burden faced by those firms (but not their bank competition), making it more difficult and expensive for firms to comply with regulations or offer uniform products nationwide. Multiple overlapping regulations and regulators increase the burden on firms to investigate and determine the requirements, comply with them, and thereafter constantly monitor all of the rule makers for changes.[71] Redundant but inconsistent regulation may also prevent firms from harnessing economies of scale, making services more expensive and possibly making them economically non-viable.

While concerns about consumer protection are often cited to justify inefficient state-by-state regulation, redundant regulation can harm consumers. If the burden of the overlapping regulations is so great that it impedes legitimate transactions, there is a real possibility that the redundancy does more harm than good. Inefficient overlapping regulations can create a barrier to entry, making markets less competitive and depriving consumers of choice.

Further, the burden of complying with multiple, redundant regulations falls especially hard on start-ups and smaller firms that lack the resources to employ large legal teams. Where technology allows new competitors, overlapping regulatory requirements may stand in the way. As such, inefficient redundancy can harm the dynamism of the market, as incumbents, who perhaps could not outcompete new firms, can "out-comply" them. This would deprive consumers of beneficial innovations and contribute to market ossification.[72]

Competitive Parity. Regulation should contribute to consumer protection, but it should not needlessly distort the competitive landscape. Unfortunately, the division of state and federal responsibility can provide some firms with an advantage over others offering similar services based not on the service provided or risks created, but on charter status.

The example of marketplace lenders and interest-rate exportation is illuminating. Marketplace lenders compete directly with banks and are subject to the same federal consumer protection laws, but are not able to export their home state interest rate nationally the way banks can. This places them at a very clear disadvantage to banks because they cannot price their products consistently nationwide. To address this disadvantage, many marketplace lenders partner with banks—which, by necessity, adds cost and inefficiency compared to allowing marketplace lenders to compete on an even playing field.

This inefficiency and the lack of a fully competitive market harms not only firms that seek to compete with regulation-advantaged incumbents, it also hurts consumers by depriving them of the benefits of competition. Consumers may face higher than necessary costs and reduced access because the incumbents are not as disciplined by competition as they would be if they were regulated equally. This is not to say that equal regulation always means identical regulation. Different business models may pose different risks, and regulation should acknowledge such differences. However, in the cases presented above there does not appear to be a difference that would justify allowing banks to enjoy federal pre-emption while non-banks do not.

Political Equity. State regulatory decisions can spill over into other states, and the citizens of those states may lack a means of political redress. State legislators and regulators may create policies that benefit them or their home state at the expense of others,[73] such as imposing significant restrictions on services that are politically popular within the state but limit the range of services available to others. This distorting, de facto regulation of the national market by some states at the expense of others can serve as another justification for pre-emption.

The problem of regulatory spillover is particularly acute if large and economically important states seek to regulate in a way that imposes significant limitations, obligations, and costs, such as the New York's BitLicense. The requirements imposed by New York are sufficiently onerous that multiple firms have stated they will simply avoid New York. Given New York's importance to the financial system, the broad scope of its law, and the difficulty in being able to confidently exclude customers based on geography, it is unclear whether firms will be able to remove themselves from New York's jurisdiction.

The cost of such extraterritorial regulation is borne not only by firms, but also the residents of other states who may not even agree with New York's policy. If firms feel they need to comply with New York law, that will affect how they structure their products and services and what they choose to offer (or not). At a minimum, the costs of complying with New York law will likely be priced into services nationwide. Non-New Yorkers lack democratic representation in Albany and cannot influence New York state policy.

As more states regulate, this problem may compound, especially if other large states regulate inconsistently, imposing multiple overlapping regulatory regimes on the national market. Further, some residents in smaller states may find that companies are less likely to offer services if the additional burden of complying with the small state's rules is not considered cost-effective by firms already complying with multiple large-state rules.

Efforts to restrict state-by-state regulation and provide consistency are not hostile to consumer protection. First, a national policy is likely to be a compromise between the extremes found in the states, providing some significant measure of protection.[74] For example, while the SEC pre-empted the states in some Regulation A offerings, it also mandated significant and ongoing disclosure that was not required for offerings that included state regulation. Second, protecting consumers also involves protecting their right to have a say in the rules that bind them, a right that is eviscerated by state regulations that de facto regulate national markets. By contrast, the federal government provides broad democratic representation and accountability. Even in cases like the National Bank Act's interest rate exportation provision, which references state laws, the regulatory system is still a federal law that was voted on by representatives of all of the states and could be repealed by those same representatives if their constituents demanded it.

As such, federal pre-emption can be appropriate if state regulation is distorting the market. It would not only provide redress to the population that is being regulated but would also better balance the costs and benefits of regulation by internalizing both, instead of allowing states to create rules that capture benefits while passing the costs to others.

Rule 147: An Example of Why Not Everything Should Be a Federal Issue. Much of this chapter deals with cases in which technology has moved the economic reality of markets from the local level to the national level, but regulation has struggled to keep up. The SEC's current Rule 147 proposals, by contrast, present a case where, technically, federal transactions are at their core inherently local. In such a case, the federal government should not regulate substantively, even if it legally could, because the states are better able to create rules that meet their citizens' needs without creating problems in the national market.

Unlike Regulation A offerings, marketplace loans, or money transmissions, Rule 147 offerings are by their very nature limited to a single state. This means that state regulation does not create inefficiency because only one state is involved. It also means that there are no competitive equity concerns because every company pursuing a Rule 147 offering in a given state is subject to the same laws. Finally, there are no political equity concerns; in state-specific markets, the affected investors and issuers have a means of democratic redress within the state.

The federal government can allow the states to experiment without imposing substantive restrictions. The states are in the best position to adopt rules that suit local needs and preferences and are more likely to be responsive to their constituents without unduly distorting the market in other states. Intrastate offerings can work as a true "laboratory of democracy" without the risk of lab spills.

CONCLUSION

Financial technology's ability to allow small firms to operate instantly on a nationwide basis is calling into question the current allocation of regulatory responsibility between the states and the federal government. While universal federalization is not appropriate, wise, or constitutional, in matters of interstate commerce, the federal government can take action. While the mere ability to act does not serve as a justification, in cases where state-by-state regulations hamper efficiency, competitive parity, and political equity, the federal government should consider pre-emption to provide consistent national rules. Conversely, in cases where the states are able to regulate without imperiling those values because the economic reality of the transaction is *intra*state, the federal government should defer.

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ENDNOTES

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