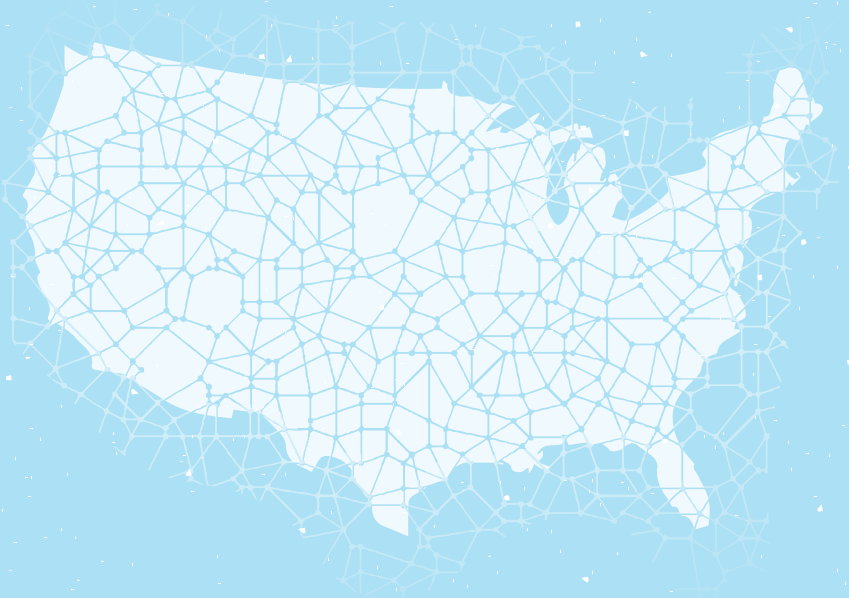


The Need for a Federal Alternative to State Money Transmission Licensing

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Abstract

The several states rather than the federal government are the primary regulators of money transmitters. State-by-state money transmission licensing is inefficient because transmitters provide a networked good that inherently crosses state lines, and because state regulators cannot and do not account for these externalities when they calibrate their regulations. These inefficiencies hinder effective regulatory cooperation, economic growth, American competitiveness in financial technology, effective consumer protection efforts, and financial inclusion. Possible solutions are various and range from least to most extensive: (a) the creation of a license passporting regime resembling the E.U.'s e-money system, (b) the creation of a federally administered alternative license and limited preemption of state law for federal licensees, (c) the creation of a federally administered license and full preemption of all state money transmission licensing, and (d) the creation of a more comprehensive CFTC-run investor protection regime focused on digital currency exchanges that also preempts state licensing. All approaches must also include a safe harbor for novel businesses that do not create the sort of risks to consumers that money transmission licensing is meant to address. Coin Center prefers federal legislation that would create a federal money transmission license as an alternative to state licensing for companies that seek it out.

Author

Peter Van Valkenburgh
Director of Research
Coin Center
peter@coincenter.org

About Coin Center

Coin Center is a non-profit research and advocacy center focused on the public policy issues facing cryptocurrency technologies such as Bitcoin. Our mission is to build a better understanding of these technologies and to promote a regulatory climate that preserves the freedom to innovate using blockchain technologies. We do this by producing and publishing policy research from respected academics and experts, educating policymakers and the media about blockchain technology, and by engaging in advocacy for sound public policy.

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The Need for a Federal Alternative to State Money Transmission Licensing

1. Executive summary

The several states rather than the federal government are the primary regulators of “money transmitters,” a category of businesses including traditional money wire providers but also several new and innovative financial services and technology providers. Those regulations focus on consumer protection. A customer must trust a money transmitter to not lose, steal, or misdirect their money, and every state has, over the years, found ways to police breaches of that trust.

State-by-state money transmission licensing is inefficient because transmitters provide a networked good that inherently crosses state lines, and because state regulators cannot and do not account for these externalities when they calibrate their regulations. The regime is also inefficient because it generates uncertainty for innovative financial services businesses whose novel products and technologies straddle the statutory definitions of money transmission. Critical legal language differs state by state, including the definition for “money transmission.” Unlicensed money transmission carries significant penalties, both state and federal, but the patchwork of state statutes fails to offer clear and justiciable standards eroding the rule of law and hindering innovation.

These inefficiencies prevent effective regulatory cooperation between licensing authorities and anti-money laundering or investor protection regulators. They hinder economic growth because they raise the costs of starting innovative businesses. They hinder American competitiveness in financial technology because regimes internationally eschew overlapping multi-state licensing in favor of a unified approach. They hinder effective consumer protection efforts because regulators calibrate their protections to the activities of a licensee with respect only to customers in the regulator’s state and ignore the risk-profile of the licensee’s national or international business as a whole. And they hinder financial inclusion by stymying the development of new financial tools that can deliver cheaper, safer, or more palatable services to underserved communities. The U.S. is long overdue for a solution to the challenges of state-by-state licensing in the form of a sensible unified national approach to money transmission regulation.

Possible solutions are various and range from least to most extensive: (a) the creation of a license passporting regime resembling the E.U.’s e-money system, (b) the creation of a federally administered alternative license and limited preemption of state law for federal licensees, (c) the creation of a federally administered license and full preemption of all state money transmission licensing, and (d) the creation of a more comprehensive CFTC-run investor protection regime focused on digital currency exchanges that also preempts state licensing. All

approaches must also include a safe harbor for novel businesses that do not create the sort of risks to consumers that money transmission licensing is meant to address (but which may be treated as money transmitters under a loose interpretation of some state statutes). All approaches should also contemplate the creation of a sandbox program where novel businesses that would otherwise qualify and need a full license can negotiate for flexible regulatory treatment.

All things being equal, Coin Center prefers federal legislation that would create a federal money transmission license as an alternative to state licensing for companies that seek it out. The federal legislation would not preempt state licensing except with respect to (a) federally licensed firms, (b) those that fit within a safe-harbor for non-custodial activities, and (c) qualified participants in a federally administered regulatory sandbox.

2. Overview of state-based money transmission licensing

Historically, the several states rather than the federal government have been the primary regulators of “money transmitters.”¹ Those regulations focus on consumer protection.² A customer must trust a money transmitter to not lose, steal, or misdirect their money, and every state has, over the years, found ways to police breaches of that trust.

Today, nearly³ all state money transmission regulation is **permission-based**; a person may not engage in money transmission until they first obtain a license to do so from the state regulator.⁴ With the exception of Montana,⁵ every state now requires businesses performing money transmission as a service for customers in their state to be licensed.⁶ Money transmission regulations are **extraterritorial**; a person must have a license in every state in which they have customers. What matters from a jurisdictional standpoint is the location of the customer, not the location of the transmitter.

¹ Thomas Brown, “50-State Survey: Money Transmitter Licensing Regulations,” *California State Assembly Committee on Banking and Finance* (accessed Jan. 2018) [http://abnk.assembly.ca.gov/sites/abnk.assembly.ca.gov/files/50%20State%20Survey%20-%20MTL%20Licensing%20Requirements\(72986803_4\).pdf](http://abnk.assembly.ca.gov/sites/abnk.assembly.ca.gov/files/50%20State%20Survey%20-%20MTL%20Licensing%20Requirements(72986803_4).pdf).

² Conference of State Bank Supervisors, “State Regulatory Requirements for Virtual Currency Activities CSBS Model Regulatory Framework,” (Sep. 2015) <https://www.csbs.org/sites/default/files/2017-11/CSBS-Model-Regulatory-Framework%28September%2015%202015%29.pdf>.

³ Montana is the sole exception, for which there is no legislation regulating money transmitters. Such firms do not need to be registered with the Division of Banking and Financial Institutions, but must merely be registered as a business with the Montana Secretary of State. See: “Money Transmitters,” *Montana Division of Banking & Financial Institutions* (accessed Jan. 2018) <https://banking.mt.gov/moneytransmitters>.

⁴ See, e.g., No person, as a service or for a fee or other consideration, shall engage in the business of selling, issuing, or otherwise dispensing checks or receiving money as agent for obligors for the purpose of paying such obligors' bills, invoices, or accounts without first obtaining a license from the commission pursuant to the provisions of this chapter.” Code of Alabama 1975, §§ 8-7-1 to 8-7-15.

⁵ See *infra* note 3.

⁶ See *infra* note 1.

Money transmission regulations are prescriptive and **rules-based** rather than flexible and principles-based; the licensee must meet several set compliance obligations rather than honor some generally-specified duty of care to their customers. Money transmission regulations are, on the balance, **non-uniform**. Each state has independently passed a statute that generates the regulatory regime. Only 12 states and territories have thus far adopted a uniform model law developed 18 years ago by the Uniform Law Commission, a non-governmental organization specializing in harmonizing state legislation.⁷ In every other state, key aspects of the law differ, and that non-uniformity extends to fundamental features, such as the definition of money transmission itself (the language which will determine which businesses need a license and which do not).⁸

These four aspects of money transmission regulation—permission-based, extraterritorial, rules-based, and non-uniform—make operating an internet or mobile-phone-based money transmission business with interstate or international customers particularly difficult. For clarity, we can refer to this as an **interstate business**. Regulation is permission-based and applies extraterritorially; therefore, the interstate business cannot offer services to the general public until they first obtain licenses in *every state*.

The situation is even more difficult if the business is engaging in a novel activity that *may possibly* be money transmission depending on the breadth of the definition of money transmission in each state law, or how broadly it is interpreted by the regulator. For clarity, we can refer to these as **novel businesses**. Regulation is rules-based and non-uniform; therefore, novel businesses will need to interpret 53 various statutes, and confirm that interpretation with 53 different state and territorial regulators, merely to determine whether they need to engage in the licensing process at all.⁹

⁷ Uniform Law Commission, “Money Services Act,” *National Conference of Commissioners on Uniform State Laws* (accessed Jan. 2018) <http://www.uniformlaws.org/Act.aspx?title=Money%20Services%20Act>.

⁸ See generally “State-by-State Regulatory Tracker for Digital Currency Policy,” *Coin Center* (last accessed Jan. 2018). Compare, e.g., Utah’s definitions: “(7) ‘Money transmission’ means the sale or issuance of a payment instrument or engaging in the business of receiving money for transmission or transmitting money within the United States or to locations abroad by any and all means, including payment instrument, wire, facsimile, or electronic transfer. . . . 7-25-201. Licensing required. (1) . . . a person may not engage in the business of money transmission without a license.” with Alabama’s definitions (which do not even include a definition of money transmission itself): “(3) Check. Any check, draft, money order, or other instrument for the transmission or payment of money. . . . Section 8-7-3 License — Required. No person, as a service or for a fee or other consideration, shall engage in the business of selling, issuing, or otherwise dispensing checks or receiving money as agent for obligors for the purpose of paying such obligors’ bills, invoices, or accounts without first obtaining a license from the commission pursuant to the provisions of this chapter.” Code of Alabama 1975, §§ 8-7-1 to 8-7-15.

⁹ See, e.g., Marco Santori, “What is Money Transmission and Why Does it Matter?” *Coin Center* (Apr. 2015) <https://coincenter.org/entry/what-is-money-transmission-and-why-does-it-matter>; and Peter Van Valkenburgh, “When does a company actually control customer bitcoins?” *Coin Center* (Mar. 2016) <https://coincenter.org/entry/when-does-a-company-actually-control-customer-bitcoins>.

In the case of a novel business, the nature of state money transmission regulation will create a particularly unsavory choice: play it fast and loose, or else sink hundreds of thousands or even millions of dollars into legal and regulatory strategy before starting a business.¹⁰

In both cases, interstate and novel businesses face very high barriers to entry in the form of legal and compliance costs. These are barriers that are not present in foreign jurisdictions that have a unified and flexible money transmission regulator (e.g. the U.K.)¹¹ or a passporting system where one license is reciprocally honored by other jurisdictions (e.g. the E.U.).¹² These barriers also do not result in increased consumer protection; they are red tape rather than justifiable under various theories of optimal regulation, which we will discuss later in the report.

The primary goal of state money transmission regulation is consumer protection. Money transmitters are, at least momentarily, custodians of consumer valuables. A chief objective of money transmission regulation is to guarantee the continued solvency of the transmitter, to ensure that they do not lose these valuables. In the banking context, this guarantee of solvency is often understood as prudential regulation and deals with minimum capital requirements and responsible risk tolerances. Unlike banks, however, money transmitters do not engage in fractional reserve lending. The regulated entity is not supposed to engage in *any* risk-taking behavior, they are supposed to hold consumer funds 1:1 in a liquid form such that even if every customer suddenly wanted their money back, they would easily be able to oblige.¹³

This report is not advocating for the availability of bank charters for money transmitters. Rather, it advocates for a federal licensing alternative that would (as with existing state licenses) not permit lending or fractional reserves. This federal alternative would more simply protect customers from the risks inherent in handing custody over valuables to a business that seeks only to hold them in trust or move them to another person.

Money transmitters are also regulated at the federal level by the Financial Crimes Enforcement Network (FinCEN). FinCEN's objective, however, is to stop money laundering and terrorist financing rather than protect consumers. FinCEN achieves this objective by deputizing money services businesses (or "MSBs," of which money transmitters are one type) as arms of a

¹⁰ Marco Santori, "What is Money Transmission and Why Does it Matter?" *Coin Center* (Apr. 2015) <https://coincenter.org/entry/what-is-money-transmission-and-why-does-it-matter>.

¹¹ See Financial Conduct Authority, *Innovator businesses: Project Innovate* (last accessed Jan. 2018), <https://innovate.fca.org.uk/>.

¹² "On the taking up, pursuit of and prudential supervision of the business of electronic money institutions," *European Parliament* (Sep. 2000) <http://eur-lex.europa.eu/legal-content/EN/ALL/?uri=CELEX%3A32000L0046>.

¹³ Many states include "maintenance of permissible investments" requirements to accomplish these ends. For example, Alaska requires that "a money services licensee shall maintain at all times permissible investments that have a market value computed under generally accepted accounting principles of not less than the aggregate amount of all of its outstanding payment instruments and stored value obligations issued or sold in all states and money transmitted from all states by the money services licensee." AK Stat § 06.55.501 (2016), <https://law.justia.com/codes/alaska/2016/title-06/chapter-06.55/article-05/section-06.55.501>.

financial surveillance regime. MSBs must register with FinCEN and collect and keep customer information (“Know Your Customer” requirements), report suspicious transactions (by filing “Suspicious Activity Reports”) and have a risk-calibrated program to stop the flow of illicit funds (by adhering to an anti-money-laundering program).

This report is not advocating for any change to these federal anti-money laundering policies, but rather is focused on the question of consumer protection and licensing. Although, as discussed, a national approach to consumer protection could lead to enhanced regulatory cooperation between agencies focused on consumer protection and anti-money-laundering.

3. Emerging payment technologies, business models, and customer preferences.

To best characterize emerging payment technologies, we begin by offering a brief overview of the history of consumer-facing financial services and a description of the nature of innovation generally. To simplify that story, we can start by identifying two discernable categories of consumer-facing money institution: retail banks and payments businesses.

What we call “payments businesses” are a loose assemblage of traditional brick-and-mortar service providers including money order sellers, check cashers, money transmitters, remittance providers, foreign currency exchangers, and prepaid card providers, as well as a growing number of new, predominantly online service providers including e-commerce checkout providers, person-to-person internet and mobile device payments providers, digital currency exchanges and wallet providers, and various other website or mobile app developers who incorporate or would like to incorporate user payments into their non-financial services.

To a disinterested consumer, these businesses may be somewhat indistinguishable. Be it a bank debit card, a credit card, a prepaid card, a PayPal account, or a Western Union wire, each is just another way to pay people. Both Bank of America and Venmo allow a customer to store money in an account with an online dashboard for keeping track of their balances and making or receiving payments. Debit cards, credit cards, and prepaid cards each connect to a very different sort of institution (respectively an FDIC-insured deposit account, a line of credit provided by a credit card network’s partner bank, and a reloadable custodial account held by a non-bank card provider). However, to the card-user, these distinctions may be inconsequential. The user wants to be able to swipe a piece of plastic and receive their goods and services with minimal fuss. As interest rates on depository accounts have fallen and remained very low for the last 20 some years, the rate of return on money stored (or debts accrued) in these accounts has similarly become less distinguishable or meaningful to the consumer.

Taking a more academic view, of course, banks are truly unique beasts amongst these institutions because of their role in the creation of money. To a retail consumer, a bank may look like little more than a vault for their valuables and a dispenser of deposited cash or provider of loans. Banking, however, due to the nature of fractional reserve lending, plays a

much more weighty role extending beyond mere consumer services and deep into the heart of national economies and the global economic system as a whole.

It has long been understood that “banking was an exercise of ‘public powers,’ and that ‘public powers are never granted without some public object in view.’”¹⁴ As told by the Office of the Comptroller of the Currency, the federal regulator of nationally chartered banks, “especially is this true, in respect to banking corporations, whose operations affect the currency, and thus the whole community.”¹⁵ Thus, banks have been historically created through a government grant of a limited charter. That charter is explicitly designed to cabin the activities of the bank, a cost and safeguard imposed in exchange for permission to wield a public power (money creation). For better or worse, this limitation makes banks supremely risk averse, unlikely to pioneer new technologies or business models, and potentially unable to do so if those activities were found to be outside of the narrow scope of their operating charter.

Banks have therefore traditionally ceded payments innovation to non-bank entities who can focus on innovative technologies and practices that would not fit well into a risk-averse corporate culture or a limited corporate charter and regulatory regime.

These payments innovators have historically included early telecommunication pioneers (e.g. telegram or wire providers), credit card networks, standards bodies (e.g. SWIFT, FedWire), and more recently internet businesses (e.g. PayPal, Venmo, Coinbase). While these businesses and institutions may seem like a hodgepodge, they all have one common theme. They specialize in building standardized and interoperable networks for data about payments. By creating these networks for banks, these innovators allow otherwise siloed data (the bank’s ledger of customer accounts) to be interwoven into a global network of transactions. I pay you, and our respective banks reconcile the new balances in our respective accounts via SWIFT, American Express, or Venmo. These payment innovators gain that line of business from the banks but do not gain the public powers of new money creation.

Payments are easy to effectuate when you are the common connection between many persons in a network. The traditional business model for a payment provider was to have a physical location on as many street corners as possible (e.g. Western Union or Moneygram). The business with these geographical network effects would then become the most convenient payment provider and the de facto choice of customers. The new model is focused on *digital* network effects: to be the internet-related business with as many active and engaged users as possible. Thus, the company that builds a network of used and bespoke goods buyers and sellers (eBay) becomes the payment processor for that network (PayPal). The dominant web portal and search engine for Chinese internet browsers (Alibaba) becomes the electronic payments provider for China (Alipay). The manufacturers of the dominant mobile phone operating systems (Apple and Google) become the dominant mobile payment processors for their users

¹⁴ Bernard Shull, “The Separation of Banking and Commerce in the United States: an Examination of Principal Issues,” *Office of the Comptroller of the Currency of the US Treasury Department* (1999) <https://www.occ.gov/publications/publications-by-type/occ-working-papers/1999-1993/wp99-1.pdf>.

¹⁵ *Id.*

(Android Pay and Apple Pay). And even Airbnb and Uber (seemingly not payments providers at all) begin processing payments amongst the several home and car renters and rentees on their respective platforms.

Simultaneously, new internet-based innovations revive the possibility of doing payments efficiently with cash. Electronic cash systems or digital currencies (as they are commonly known)¹⁶ recreate the utility of fungible bearer instruments (e.g. dollar bills) but allow those instruments to be sent and received electronically. Now rather than needing a trusted party in between the sender and recipient, an electronic payment can be made the same way cash payments have been made for centuries: peer-to-peer. In these systems, there may be no need for a custodial and regulated party whatsoever—users can simply be their own bank and pay other users directly.

With larger amounts of digital cash, however, this becomes a risky proposition, not unlike stuffing a mattress full of hundred-dollar bills. In the electronic cash world, we increasingly see persons setting up shop as reliable custodians who can also help users exchange their digital cash for other forms of digital cash or for traditional currency.¹⁷ Effectively, these custodians are like banks that happen to have currency exchange windows and ATMs anywhere where there is an internet-connected device. These digital currency exchanges, however, do not engage in the public powers that historically have justified bank-like regulation. They do not control or affect the supply of the underlying digital currency that they exchange or custody. The supply and scarcity of these new digital currencies is governed by physical realities of mathematics and cryptography rather than the lending behaviors of public institutions.¹⁸ Accordingly, these custodial exchanges are better suited to regulation as money transmitters or trust companies rather than as banks or lenders, and that is how the bulk of these company are, in fact, currently regulated.¹⁹

Internet businesses will typically be both interstate and novel businesses as we described those terms earlier. This can be the case regardless of whether they facilitate dollar-denominated payments for any purpose (such as Venmo and PayPal), dollar-denominated payments for a specific application (such as Uber and Airbnb), or digital currency payments (such as Coinbase and Kraken). All of these businesses expect to have a global customer base and must therefore

¹⁶ In other literature, this term is used interchangeably with “virtual currencies,” a term created by FinCEN, the division of Treasury Department that enforces anti-money laundering law. See “Application of FinCEN’s Regulations to Persons Administering, Exchanging, or Using Virtual Currencies,” *Financial Crimes Enforcement Network of the US Department of the Treasury* (March 2013) <https://www.fincen.gov/sites/default/files/shared/FIN-2013-G001.pdf>. Cryptocurrencies are a subset of digital or virtual currencies, which rely on cryptography, peer-to-peer networks, and economic incentives for their operation rather than trust in a centralized administrator of the currency.

¹⁷ See, e.g., Coinbase (<https://www.coinbase.com>) or Xapo (<https://xapo.com/>).

¹⁸ Peter Van Valkenburgh, “What is Bitcoin Mining, and Why is it Necessary?” *Coin Center* (December 2014) <https://coincenter.org/entry/what-is-bitcoin-mining-and-why-is-it-necessary>.

¹⁹ See, e.g., “Licenses,” Coinbase (accessed Jan. 2018), <https://www.coinbase.com/legal/licenses?locale=en-US>; and “NYDFS Grants Charter to ‘Gemini’ Bitcoin Exchange Founded by Cameron and Tyler Winklevoss” NYDFS (Oct. 2015) <http://www.dfs.ny.gov/about/press/pr1510051.htm>

seek licenses from all 53 state and territorial (as well as international) regulators. All of these businesses are novel and therefore may inconsistently fit into the definition of money transmission depending on the breadth of that definition in any particular jurisdiction. They will therefore need to engage in significant legal-interpretive efforts and regulatory outreach to understand and obey their compliance obligations. It may be cheap to start a website, but it definitely isn't a bargain to start an online payments business.

As discussed earlier, these are substantial barriers to entry for payments businesses. These barriers are not present in regions that have a unified money transmission regulator (e.g. the U.K.)²⁰ or a passporting system where one license suffices for multiple polities (e.g. the E.U.).²¹ These barriers are also not productive of any increased consumer protection; they are red tape rather than justifiable under various theories of optimal regulation. In the following section, we will discuss why counter arguments to this claim are not rational.

4. Problems with the current regime

a. States as laboratories

In *New State Ice Co. v. Liebmann*, Supreme Court Justice Louis Brandeis described how a “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.”²² The premise of using states as contained experiments and laboratories for testing alternative policies has since become a dominant argument in favor of state rather than federal regulation, as well as for federalist systems generally.

A related argument claims that states will compete with each other to have friendly policies for a given interest group and that this will trigger migration of those groups into the state, thus bolstering the economy of the state and promoting smarter policies with promises of increased tax revenue. The migratory phenomenon is known as “voting-with-your-feet,” and the resultant model for good policy is called Tiebout competition.²³

Critics of Tiebout competition suggest that it results not so much in a race to the top (promoting good policy that on-net creates optimal social and economic outcomes) but rather a race to the bottom (promoting policies that favor special interests and generate negative externalities for residents of other states).²⁴ This debate is most visible in the context of

²⁰ See Financial Conduct Authority, *Innovator businesses: Project Innovate* (last accessed Jan. 2018), <https://innovate.fca.org.uk/>.

²¹ “On the taking up, pursuit of and prudential supervision of the business of electronic money institutions,” *European Parliament* (Sept. 2000) <http://eur-lex.europa.eu/legal-content/EN/ALL/?uri=CELEX%3A32000L0046>.

²² *New State Ice Co. v. Liebmann*, 285 U.S. 262 (1932).

²³ Charles M. Tiebout, “A Pure Theory of Local Expenditures,” *Journal of Political Economy*, Vol. 64, No. 5 (Oct. 1956) <http://www.jstor.org/stable/1826343>.

²⁴ Dennis Epple and Allan Zelenitz, “The Implications of Competition among Jurisdictions: Does Tiebout Need Politics?” *Journal of Political Economy*, Vol. 89, No. 6 (Dec. 1981) <http://www.jstor.org/stable/1837190>.

Delaware corporate law, which, depending on your politics, is either exemplary in its efficiency²⁵ or a scourge on society.²⁶

No matter one's position on the relative merits of using states as laboratories, voting with your feet, Tiebout competition, or Delaware corporate law, these arguments are not applicable to the state-by-state money transmission regime.

Internet money transmission is not a local business and does not limit itself to local customers, and money transmission regulations are extraterritorial. That is to say, they are applied based on the location of the customer, not the location of the business. All major online money transmitters have customers in every state and will therefore need to comply with the regulatory policies of every state. As a result, businesses will rationally adopt compliance measures commensurate with the most strict of all of their several state regulators.

We could imagine some businesses skimping on these measures towards customers residing in a laxer state, but the fixed costs of adopting a new compliance program, or satisfying a given regulatory requirement in one state, will substantially outweigh the marginal costs of extending that policy (once developed) to every customer. Indeed, the administrative costs of discriminating between customers, identifying each with a particular compliance program, and then tailoring the business's website, terms of use, and policies to each specific customer based on their location likely outweighs any savings that might result from lowering compliance standards for only certain customers. As economist Thomas Hazlett has found in his extensive study of the telecommunications industry and regulatory preemption:

[F]irms adjust to diverse regulations by conforming to those rules that allow for the best aggregate operations. When integrated national networks are key both to suppliers, who seek scale economies, and to consumers, who desire nationwide coverage, the competition between the states results not in diverse standards but "winner take all"—the "winner" being the state with the most restrictive regulations. In situations where state regulations contradict each other, even this effort to smooth out differences in state laws will be stymied, and the costs of balkanization further increased.²⁷

The end result is not an array of petri dishes, each with divergent variables and diverse strains of regulation. Instead, it is one giant petri dish wherein the most aggressive strain has festered and crowded out every other. The result is a monoculture that flourishes irrespective of whether it is optimal. The experiment didn't work.

²⁵ Lewis S. Black, Jr., "Why Corporations Choose Delaware," *Delaware Department of State Division of Corporations* (2007) https://corp.delaware.gov/whycorporations_web.pdf.

²⁶ William L. Cary, "Federalism and Corporate Law: Reflections upon Delaware," *Yale Law Journal*, Vol. 83, No. 4 (Mar. 1974) <http://www.jstor.org/stable/795524>.

²⁷ Thomas Hazlett, "Is Federal Preemption Efficient in Cellular Phone Regulation?" *Federal Communications Law Journal*, Vol. 56, No. 1 (2003). <http://www.repository.law.indiana.edu/fclj/vol56/iss1/5>.

Neither is there an incentive for a state to improve its licensing policies to become (via Tiebout competition²⁸) the future hub for money transmission, online payments, or blockchain technology as Delaware has become the home for corporations. This is because an improved licensing policy would not create an attendant incentive for a business to move its headquarters to that state. An out-of-state money transmitter benefits from the improved licensing process just as much as one that decides to relocate to that state. Similarly, out-of-state money transmitters suffer any costs attendant a particular state's bad policies as much as in-state providers. In economics, the failure to internalize the benefits or costs of one's actions is referred to as an "externality," and can be positive or negative. As Hazlett writes with respect to the economics of a state-by-state approach:

[S]tate regulators have no reason to take into account what ripples across state borders. States can overconsume regulation by dumping costs on others, or they can underconsume because benefits are too widely distributed. As a general rule, the lowest level of government that can accurately determine costs and benefits is the jurisdiction logically selected to make regulatory decisions: Economic federalism prefers the most decentralized structure of government capable of internalizing all economic externalities.²⁹

As we have already discussed, money transmission is a networked good just like telecommunications. The value of the service is dependent on national (and even global) scale. No one wants to sign up for money transmission services that only allow transmissions to residents in three out of fifty states. If transmitters must be national to deliver the best service, then the lowest level of government capable of determining costs and benefits of regulation (and avoiding externalities) is the national government.

Finally, we might ask whether diverse state-by-state approaches have, in fact, been taken in regulating money transmission and whether diversity would be a virtue in this arena. Again, the answer is no and no. While nearly every state has a unique money transmission statute, the differences are not substantial with respect to creating different consumer protection policies. All effectively do the following: require licensing before one can engage in business, only grant licenses after background checks and proof of some level of minimum capitalization, require that customer funds are held 1:1 in liquid permissible investments, and conduct semi-regular examinations to confirm compliance.³⁰

²⁸ Charles M. Tiebout, "A Pure Theory of Local Expenditures," *Journal of Political Economy*, Vol. 64, No. 5 (Oct. 1956) <http://www.jstor.org/stable/1826343>.

²⁹ Thomas Hazlett, "Is Federal Preemption Efficient in Cellular Phone Regulation?" *Federal Communications Law Journal*, Vol. 56, No. 1 (2003). <http://www.repository.law.indiana.edu/fclj/vol56/iss1/5>.

³⁰ Thomas Brown, "50-State Survey: Money Transmitter Licensing Regulations," *California State Assembly Committee on Banking and Finance* (accessed January 2018) [http://abnk.assembly.ca.gov/sites/abnk.assembly.ca.gov/files/50%20State%20Survey%20-%20MTL%20Licensing%20Requirements\(72986803_4\).pdf](http://abnk.assembly.ca.gov/sites/abnk.assembly.ca.gov/files/50%20State%20Survey%20-%20MTL%20Licensing%20Requirements(72986803_4).pdf).

Where there is “experimentation,” it is in determining exactly (A) how to describe those requirements in the legal language of the statute or regulations,³¹ (B) who to send to do examinations, (C) in what precise form records should be kept, and (D) how much to demand in the way of minimum capital and in what form it can be held (e.g. cash, short term treasury bonds, etc.).³² The varying approach to drafting the requirements has left a minefield of confusing legal analysis for novel businesses (e.g. “I seem to be a money transmitter in Iowa but not in Alabama, can that be right?”). The experimentation with respect to examinations and recordkeeping means that the business will have to welcome onto their premises several different teams of state agents to conduct effectively the same examination using subtly different forms (while also typically paying for their travel and accommodations). And the resultant heterogeneity of minimum capital requirements means that an interstate business will need to have capital on hand equivalent to the largest of the several state requirements. These are not carefully calibrated additional consumer protections, they are by and large redundant bureaucratic costs from a regulatory system that organically emerged without careful consideration or national planning.

b. Local tailoring

The “states as laboratories” approach may make more sense in policy arenas where unique localities have idiosyncratic policy problems. A state with more unbanked residents might need better policies with respect to payday lenders. A state with a more extreme climate might need stricter negligence standards for heating and cooling service providers. Money transmission, however, is essentially the same service whether the customer is in Alaska or Alabama. Why should some citizens have more or less protections, and do we really think that PayPal needs to treat some U.S. citizens differently than others based purely on their state of residence?

Should we even be experimenting with the hard-earned money of various state citizens? Money transmission regulation does not have a complicated purpose. The goal is to make sure that when a business says it will hold and transmit money for a resident, it will follow through without any funny business. This geographic uniformity is even more pronounced for money transmitters than it is for banks who may lend or hypothecate custodied funds to potentially heterogeneous regional populations with varying levels of default risk. Money transmitters do not lend; they have a 1:1 reserve requirement. All things considered, this is not a nuanced, geographic, or culturally sensitive policy issue.

The origins of money transmission licensing were haphazard state-by-state responses to predatory corner shops that would fleece vulnerable populations when selling a money order.³³

³¹ See *infra* note 8.

³² See *infra* note 30 for a comparison of various minimum capital requirements.

³³ See Andrea Lee Negroni, “Risky Business: State Regulation of Money Transmitters,” *CLEAR News* (Spring 2003)

https://www.goodwinlaw.com/~media/Files/Publications/Attorney%20Articles/2003/Risky_Business_State_Regulation_of_Money_Transmitters.ashx (“In an article entitled ‘Money Wire Transfers: How to Help Immigrants Avoid Fraud and Save Money,’ the National Consumer Law Center focuses on the risks to immigrants of using money transmission services. Principally, these risks include high fees and the

State and local regulation was more sensible back then because these brick and mortar businesses were typically based in and only had customers in that state. Today's internet businesses are orders of magnitude larger than those corner stores.³⁴ They will not have offices in every state and they assuredly will have customers in every state (who will, in turn, want to send money to persons in every other state or internationally).

Even legal scholar Richard Epstein, one of legal academia's most ardent defenders of federalism, argues against state-by-state regulation in the context of such highly networked and geographically dispersed businesses. Epstein explains that "there are certain transactions in which an individual or firm cannot choose among states, but must enlist the cooperation of all states in order to carry on its business," and that these transactions are one of "three types of situations in which federalism provides insufficient protection for market institutions."³⁵ In this context, writes Epstein, "[i]t is quite possible that the sum total of the [regulatory] demands will exceed the gains from running the business, so that the competition of federalism becomes the destroyer and not the protector of markets."³⁶

Nor is this only a challenge facing businesses or free market advocates; consumer advocates should also be concerned with the current state of play. Rather than improving consumer protection, local state-by-state regulations likely leave customers at increased risk. Each individual state will generally be concerned only with the activities of licensed firms that touch their own citizens, rather than the systemic health and risk profile of the licensee as a whole. This is a particularly odd regulatory approach for businesses that, by virtue of the internet, are almost assuredly global in the scope of their operations. For example, in Alabama, a money transmission licensee need only prove a minimum net worth of \$5,000 and obtain a surety bond of \$10,000 in order to satisfy the capital protections mandated by that state's money transmission laws.³⁷ At best, this may be barely sufficient to protect customers in Alabama, and in general it appears severely disjointed from the realities of the modern payments and financial services industry.

possibility of fraud (i.e., that the transmitted funds may never be received by the intended recipients). . . Greg Gonzales of the Tennessee Department of Financial Institutions said that a failure of a regional money order issuer in the 1980s was the precipitating event for the growth of regulation of money transmitters.").

³⁴ By some estimates Coinbase, a digital currency exchange and licensed money transmitter, has as many as 11.7 Million users as of October 2017. Evelyn Cheng, "Bitcoin exchange Coinbase has more users than stock brokerage Schwab" *CNBC* (Nov. 2017) <https://www.cnbc.com/2017/11/27/bitcoin-exchange-coinbase-has-more-users-than-stock-brokerage-schwab.html>.

³⁵ Richard Epstein, "Exit Rights Under Federalism," *Law and Contemporary Problems*, Vol. 55, No 1 (1992) <https://scholarship.law.duke.edu/lcp/vol55/iss1/8/>.

³⁶ *Id.*

³⁷ Code of Alabama 1975, §§ 8-7-1 to 8-7-15 available at http://asc.alabama.gov/Acts/Chapter%207_SOC.aspx#Section 8-7-7.

c. Discretion can be a safety valve

Novel businesses are those that may or may not be money transmitters. These businesses will also often engender different consumer risk profiles than a traditional money order provider. For example, Uber or Airbnb may only be processing payments between reputable parties on their services and ecommerce platforms. A company like Coinbase may deal only in digital currencies whose balances are fully auditable via global public ledgers known as blockchains. A firm such as Google may be able to limit consumer payments risks by baking in cybersecurity protections into their mobile device software and hardware. In all these cases, there are two apparent questions worth asking: (1) do these businesses pose the kinds of consumer risk that should qualify them as money transmitters? And (2) should the licensing requirements be flexible to accommodate varying risk profiles of the novel business?

Today, these questions are addressed by offering discretion to every individual state regulator with respect to whether a business needs a license and whether any licensing requirements can be waived or strengthened. Effectively all state money transmission statutes afford the regulator with some level of discretion.³⁸ While this is occasionally touted as evidence of how the state-by-state system can be pro-innovation, it is evidence of the contrary.

When 53 independent regulators each have discretionary power to fine-tune the regulatory requirements of your business, the result is not flexibility and a light-touch regime. It is chaos. Discretion and a flexible, rather than rules-based, approach to regulation are, without a doubt, beneficial to innovation, but only in a situation where the innovator need rely on the flexibility of one or maybe a handful of regulators working together. Without coordination they are at the whim of 53 fickle and flexible overseers.

Debates over so-called “agent of the payee” exemptions from money transmission licensing are a notable case of discretion-driven confusion and non-uniformity.³⁹ An agent of a payee is a payment processor, usually for a merchant. This is a business or person who transmits money only by virtue of receiving payments on behalf of a client with whom they have a longstanding contractual arrangement for payment processing services, and not as a retail service to consumers. An example would be Square, which allows merchants at a flea market to accept credit cards with their smartphones. The nature of the relationship, business-to-business and long-term, means that the relative risks and potential for consumer harms are distinct from the typical consumer-facing money-wire provider. In short, there is a reasonable policy argument for differential treatment between agents of the payee and typical money transmitters, and possibly even a full-blown exemption from licensing for agents.

³⁸ See *infra* note 30.

³⁹ Peter Luce, “California Adds Limited Agent of A Payee Exemption to Its Money Transmitter Licensing Requirement; Relaxes Right To Refund Disclosure Requirement for Online Transactions,” *Davis Wright Tremaine LLP* (Oct. 2014) <https://www.paymentlawadvisor.com/2014/10/08/california-agent-of-payee-exemptio/>.

The merits of this policy argument aside, every state has taken a different approach to either granting or denying this exemption, usually by exercising regulator discretion. The result has been chaos. Some states, like North Carolina, for example, have used discretion to issue a declaratory ruling exempting agents of the payees.⁴⁰ In other states, like California, the regulator has refused to utilize discretion to craft the exemption, and new legislation has been passed to grant the exemption.⁴¹ Others have refused to grant an exemption either via discretion or legislation.⁴² Finally, Texas took an extremely lawyerly approach to its discretionary rulings that puts the legitimacy of this entire policy discussion into doubt. Agents, argues the Texas regulator, are not legal actors independent of the principal (so long as their behavior conforms to the original principal-agent agreement). Therefore, an agent of the payee is, from the point of view of the regulator, just the payee. As has been long understood in the English common law, “Whatever a servant is permitted to do in the usual course of his business is equivalent to a general command [from the master].”⁴³ If the agent is acting according to the general instructions of the payee, then she is indistinguishable from the payee, and, argues Texas, she needs no license.⁴⁴ She is not a money transmitter, she is just the recipient of a transmission.

In this case, regulator discretion, a purported safety valve for innovation, has made a mess of an entire business model. In some states, you are a money transmitter but exempted; in others, you are a money transmitter and not exempted; and in still other states, you never were a transmitter to begin with, you were just the recipient of a transmission. Each discretionary ruling has or has not modified an already unique statute in a unique way and some borrow from other sources of law to craft entirely new outcomes. Lawyers able to keep track are gainfully employed, but at what cost?

Discretion and non-uniformity amplify very real risks to innovators. Profound criminal penalties await an innovator whose business ends up on the wrong side of one regulator’s discretion. Similar penalties await an innovator who tries to ignore the states, or who wishes to hazard a liberal interpretation of when an activity is not money transmission, or who, stated

⁴⁰ Ray Grace, “RE: Declaratory Ruling 2017-01, concerning the agent-of-payee exemption in the N.C. Money Transmitters Act, N.C. Gen. Stat. § 53-208.44(a)(8)” *State of North Carolina Office of the Commissioner of Banks* (Jul. 2017) <http://www.nccob.org/Public/docs/Financial%20Institutions/Money%20Transmitters/Declaratory%20Ruling%202017-01%20Agent-of-Payee%20Exemption%20in%20the%20MTA.pdf>.

⁴¹ Assembly Bill 2209: Money Transmission Act §3(l), 2013-2014 Reg. Sess. (Cal. 2014), https://leginfo.ca.gov/faces/billTextClient.xhtml?bill_id=201320140AB2209AB2209.

⁴² See Benjamin Lo, “Fatal Fragments: The Effect Of Money Transmission Regulation On Payments Innovation” *Yale Journal of Law and Technology*, Volume 18 Issue 1 (2016) <http://digitalcommons.law.yale.edu/cgi/viewcontent.cgi?article=1121&context=yjolt>.

⁴³ William Blackstone, *Commentaries on the Laws of England*, Volume 1 (1765).

⁴⁴ See “A Person Providing Bill Payment Services as An Agent of the Payee Is Not Engaged in the Business of Money Transmission and Does Not Need A License Under the Texas Money Services Act, Law and Guidance Manual Opinion No. 14-01,” *Texas Department of Banking* (May 9, 2014), <http://z2policy.ctspublish.com/texas/Z2Browser2.html?showset=txdobset&collection=texas&documentid=512> [<https://perma.cc/HM69-3XHW>].

plainly, chooses to seek forgiveness rather than permission. These penalties include not just the civil or criminal consequences a state's statute imposes on unlicensed money transmitters, but also include federal criminal liability under the Bank Secrecy Act (BSA). The BSA creates criminal liability for "whoever knowingly conducts, controls, manages, supervises, directs, or owns all or part of an unlicensed money transmitting business."⁴⁵ The innovator need not even have knowledge that what she has built will be construed as unlicensed money transmission in one or more of the several states to be convicted under the BSA. The PATRIOT Act amendments to the BSA stripped that law of all scienter (knowledge) requirements, effectively creating a strict liability regime.⁴⁶ If one of the several state regulators uses her discretion to deem your business a money transmitter after you've been operating, you will have, by consequence, instantly violated a very serious federal law. BSA liabilities can even pierce the corporate veil and extend to a firm's investors, managers, or employees, generating a culture of knee-jerk caution likely to chill experimentation, or send it to safer, simpler shores.⁴⁷

d. Sandboxes

Many have recognized the issues inherent in state-by-state regulation of financial services, or, at least, the general problem of inefficient regulations stifling financial innovation. The solution du jour is to build a "sandbox."⁴⁸ Magical or bizarre as that may seem to those unfamiliar with the financial regulatory space, there are real and productive sandboxing initiatives globally. For example, the Financial Conduct Authority (FCA), the financial regulatory body in the U.K., has created a financial technology sandbox to offer innovative financial technology companies greater guidance and clarity with respect to the regulatory landscape.⁴⁹ The Monetary Authority of Singapore has taken a similar fruitful approach.⁵⁰

A sandbox allows a firm with an innovative product or service (our novel businesses) to petition a regulator to be exempt from the standard set of rules that would otherwise apply and instead enter into an enforceable compliance agreement tailored to the specific firm, its product, and the risks it generates (and doesn't generate) for consumers. This provides some real benefits to companies: for one, they can find more flexible paths toward financial regulatory compliance. Companies can work with regulators to sensibly tailor their compliance obligations. For

⁴⁵ 18 U.S.C. § 1960(a)

⁴⁶ 18 U.S.C. § 1960 at (b)(1) ("the term "unlicensed money transmitting business" means a money transmitting business which affects interstate or foreign commerce in any manner or degree and—(A) is operated without an appropriate money transmitting license in a State where such operation is punishable as a misdemeanor or a felony under State law, **whether or not the defendant knew that the operation was required to be licensed or that the operation was so punishable.**" [emphasis added]).

⁴⁷ *Id.* at (a) ("whoever knowingly **conducts, controls, manages, supervises, directs, or owns** all or part of an unlicensed money transmitting business" [emphasis added]).

⁴⁸ See Sara Merken, "States Embrace Fintech Sandbox Concept as Federal Action Stalls" *Bloomberg BNA* (Sept. 2017) <https://www.bna.com/states-embrace-fintech-n73014464317/>.

⁴⁹ See Financial Conduct Authority, *Innovator businesses: Project Innovate* (accessed Jan. 2018), <https://innovate.fca.org.uk/>.

⁵⁰ "FinTech Regulatory Sandbox," *Monetary Authority of Singapore* (accessed Jan. 2018) <http://www.mas.gov.sg/Singapore-Financial-Centre/Smart-Financial-Centre/FinTech-Regulatory-Sandbox.aspx>.

example, a company that does payments or asset management but does not do lending could work with the regulator to avoid unnecessary compliance with lending-oriented rules that might otherwise apply if they simply sought a traditional, one-size-fits-all banking charter. Sandboxes also give innovative companies a single point of contact; not just a single agency to deal with, but a dedicated contact person in that agency to focus on their particular regulatory issues.

The sandbox metaphor suggests that an innovative business is like a child, valuable and worth protecting because of its creativity and long term promise, but also clumsy and prone to hurting itself or others if left unsupervised. The child should be able to play freely in a safe, stimulating environment that the regulator has created through an enforceable compliance agreement, *i.e.* the four walls of the sandbox.

If every state had its own sandbox, however, and the agreements were different and idiosyncratic, then compliance costs and uncertainty would be magnified rather than ameliorated. The only way to avoid those compliance costs would be to knit all 53 state and territorial programs together into one while preserving and homogenizing the agreements between the states and various sandbox participants. Barring an enormously complicated and controversial multi-state compact, this approach is doomed. The US federal system has a solution to destructively fragmented regulatory regimes, and it is preemption, not multi-state negotiations.

5. The need for meaningful federal reforms

Our overbroad and haphazard style of payments regulation carries real costs for Americans, among them: stifled economic growth, the loss of American competitiveness in financial technology, fewer approaches toward fostering financial inclusion, inconsistent or sub-optimal consumer protections, and inefficient bureaucratic coordination that results in taxpayer waste and impediments to law enforcement and other regulatory efforts beyond consumer protection.

a. Enhanced supervisory structure and regulatory coordination

If the costs of becoming regulated in the U.S. are unreasonably high, some service providers will choose to base their operations outside of U.S. jurisdiction. Some may even choose to continue servicing U.S. customers and that may be difficult to prevent, given the global and censorship resistant nature of the internet. In some cases, these service providers may fail to protect their consumers, but they may also fail to undertake steps related to other public policy goals, such as AML, counter-terrorism, sanctions law, or securities and commodities regulation. If companies are based here and have a reasonable and unified regulatory framework, cooperation between consumer protection regulators and these other regulators will be more likely to flourish and other policy objectives beyond consumer protection may be more achievable.

The Center for a New American Security (CNAS) recently released a report studying the risk of terrorist use of digital currencies.⁵¹ Their conclusion is that current usage is anecdotal and limited to small amounts, but they suggest this is an area to monitor.⁵² In offering policy recommendations to address the challenge, CNAS argued that the fragmented, state-by-state approach to regulation is actively hindering our counter-terrorism efforts. They suggest a unified approach to improve cooperation and law enforcement efficacy:

At present, certain kinds of financial technology companies must seek separate licenses in each state in which they operate. State and federal banking regulators should think about ways to harmonize the financial supervision landscape.⁵³

In a similar vein, Chairman Clayton and Chairman Giancarlo, respectively of the Securities and Exchange Commission and the Commodities Futures Trading Commission, have also identified potential inefficiencies in state-by-state money transmission regulation of internet businesses:

Check-cashing and money-transmission services that operate in the U.S. are primarily regulated by states. Many of the internet-based cryptocurrency-trading platforms have registered as payment services and are not subject to direct oversight by the SEC or the CFTC. We would support policy efforts to revisit these frameworks and ensure they are effective and efficient for the digital era.⁵⁴

The SEC and CFTC focus on investor protection. The rise of digital currencies has raised investor-protection-motivated questions over transparency and safety in spot-markets for digital currencies and other open blockchain tokens. Given that these spot markets are, predominantly, exchanges presently regulated as money transmitters, a federal licensing regime could simplify collaboration and information-sharing between consumer protection and investor protection regulators.

b. Economic growth

The growth of the internet technology industry over the last 20 years stands unparalleled with respect to new jobs created and new companies in the Fortune 500. Most of these firms have been focused either on media and content creation or e-commerce, utilizing technologies and infrastructure born of the World Wide Web to address a host of old school inefficiencies. Among these: ridesharing, hotel and real estate markets, retail goods sellers, used goods markets,

⁵¹ Zachary G. Goldman, et al., “Terrorist Use of Virtual Currencies: Containing the Potential Threat,” *Center for a New American Security* (May 2017) <https://www.cnas.org/publications/reports/terrorist-use-of-virtual-currencies>.

⁵² *Id.*

⁵³ *Id.*

⁵⁴ Jay Clayton and J. Christopher Giancarlo, “Regulators Are Looking at Cryptocurrency,” *Wall Street Journal*, January 24, 2018, <https://www.wsj.com/articles/regulators-are-looking-at-cryptocurrency-1516836363>.

restaurant delivery and more. Comparatively little effort has been expended applying these technologies to solve problems or improve service in banking, payments, and finance.⁵⁵

This deficit can be explained by many different potential causes. There are real computer science and cybersecurity challenges inherent in providing financial services over internet technologies (e.g. the double spending problem,⁵⁶ secure communications,⁵⁷ verifiable transactions with privacy⁵⁸), and while technological solutions have emerged (e.g. open blockchain networks,⁵⁹ asymmetric key encryption,⁶⁰ zero-knowledge proofs⁶¹) these are young and exotic fields of research as compared with the fundamental innovations that enabled the first wave of internet businesses decades ago (e.g. packet-switching networks, graphical user interfaces).

Internet businesses have also flourished primarily within market sectors that deliver *consumer-facing* products or services like entertainment, retail, and transportation. Finance and banking are highly intermediated services where the bulk of the industry is focused on large-scale institutional clients rather than retail- or consumer-level clients. Perhaps the conservative, risk-averse institutional market naturally discourages some level of experimentation and innovation, and maybe that's not even a bad thing.

Aside from these plausible explanations, however, there is the not unlikely possibility that financial innovation and its attendant economic growth have lagged because of heightened and irrational regulatory costs associated with operating in these sectors.

The paradigmatic approach to regulatory risk for an internet-based start-up is “seek forgiveness, not permission.”⁶² That motto may be rewarding in an area like ridesharing where the cost of permission is exorbitant (e.g. integrating one's global internet-based product with

⁵⁵ Rory Van Loo, “Making Innovation More Competitive: The Case of Fintech,” *UCLA Law Review*, Vol. 65 (2017) http://scholarship.law.bu.edu/faculty_scholarship/50.

⁵⁶ Ivan Osipkov, et al, “Combating Double-Spending Using Cooperative P2P Systems” *Proceedings - International Conference on Distributed Computing Systems* (2007) <https://experts.umn.edu/en/publications/combating-double-spending-using-cooperative-p2p-systems>.

⁵⁷ Ralph C. Merkle, “Secure communications over insecure channels,” *Communications of the ACM*, Vol. 21, No. 4 (Apr. 1978) <https://doi.org/10.1145%2F359460.359473>.

⁵⁸ David Chaum, Amos Fiat, and Moni Naor, “Untraceable Electronic Cash,” *Advances in Cryptology — CRYPTO' 88: Lecture Notes in Computer Science*, Vol. 403 (1990) https://doi.org/10.1007/0-387-34799-2_25.

⁵⁹ Satoshi Nakamoto, “Bitcoin: A Peer-to-Peer Electronic Cash System” (Oct. 2008) <https://bitcoin.org/bitcoin.pdf>.

⁶⁰ Whitfield Diffie and Martin E. Hellman, “New Directions in Cryptography,” *IEEE Transactions on Information Theory*, Vol. 22, No. 6 (Nov. 1976) <https://www-ee.stanford.edu/~hellman/publications/24.pdf>.

⁶¹ Shafi Goldwasser, Silvio Micali, and Charles Rackoff, “The Knowledge Complexity of Interactive Proof Systems,” *Society for Industrial and Applied Mathematics Journal on Computing*, Vol. 18, No. 1 (Feb. 1989) <http://crypto.cs.mcgill.ca/~crepeau/COMP647/2007/TOPIC02/GMR89.pdf>.

⁶² Adam Thierer, “Innovation Arbitrage, Technological Civil Disobedience & Spontaneous Deregulation,” *Technology Liberation Front* (Dec. 2016) <https://techliberation.com/2016/12/05/innovation-arbitrage-technological-civil-disobedience-spontaneous-deregulation/>.

fragmented and local regulated taxi and limousine services) but the costs of non-forgiveness are, nonetheless, tolerable given that the penalties are borne primarily by drivers for violating taxi and limousine rules, not the ridesharing network provider itself, and the costs of shutting down services near airports or in certain cities are manageable and do not threaten the viability of the service as a whole.

The costs of permission are similarly exorbitant in the financial sector (*e.g.* similar state-by-state licensing, a suite of federal regulators with possible overlapping jurisdiction, and non-cooperative incumbents) but the costs of non-forgiveness are less manageable than in other industries. A single foreign sanctions violation or incidence of unlicensed money transmission can carry fines in the hundreds of thousands or even millions of dollars, as well as felony criminal liability, and lasting reputational damage that may doom a startup and sully its founders for life.⁶³

These heightened costs are, at times, sensibly calibrated—the risks inherent in a single \$10 million payment to a terrorist are plainly more significant than the risks inherent in a single unlicensed cabbie making pickups across New York. However, rational calibration is not always what is at work. A business that is licensed to transmit money in 49 out of 50 states will still suffer mightily if they transact in the one jurisdiction where they are unlicensed, even though the likelihood that one additional license would have created meaningful improvements in consumer protection is effectively nil.⁶⁴

No data can prove that a unified national approach to money transmission regulation would assuredly deliver economic growth. We can't turn back the clock and run an experiment where the burgeoning U.S. fintech sector could escape the unnecessary costs of state-by-state regulation. Nor are international comparisons perfect evidence of any causal link between a unified approach (*e.g.* the e-money license passporting regime in the E.U. discussed in the next section) and growth, since too many exogenous variables confound the analysis.

There is, however, good data indicating pronounced economic growth and enhanced consumer welfare within other industries that have enjoyed a movement from a patchwork regime to a unified national approach.⁶⁵ When the Supreme Court struck down discriminatory state-by-state wine regulations in 2005, the average price of wine in brick and mortar retailers declined 40% as compared with online retailers.⁶⁶ Similarly, when the Federal Communications Commission preempted state-by-state cellular rate regulation in 1994, the young wireless

⁶³ 18 U.S.C. § 1960.

⁶⁴ Note that a money transmitter will still need to do know your customer and anti-money laundering compliance for customers in states where they are not licensed. These AML and counter-terrorism laws are administered federally and not by the states.

⁶⁵ Joseph R. Mason, Robert Kulick, and Hal J. Singer, "The Economic Impact of Eliminating Preemption of State Consumer Protection Laws," *University of Pennsylvania Journal of Business Law*, Vol. 12 (2010) <http://scholarship.law.upenn.edu/jbl/vol12/iss3/4/>.

⁶⁶ *Id.*

telephony industry enjoyed an explosion of competition that ultimately benefited wireless consumers above all else. As economist Thomas Hazlett found,

This rivalry has resulted in a sharp decline in wireless telephone charges, with the average price per minute of use declining seventy-nine percent between 1993 and 2002. In response, total minutes of use have increased more than twenty-fold during this period. Intense competitive pressure has made profits elusive, a situation investment analysts describe as "Profitless Prosperity," and efficiency gains are apparent.⁶⁷

As we've discussed, money transmission—especially when performed online—is a highly networked service much like wireless telephony. If the patchwork state-by-state approach to regulation could be addressed, we might reasonably expect similar booms in competition, efficiency, and consumer well-being.

c. U.S. competitiveness

Because of the internet and global communications technologies, payments are now a global business and firms will make decisions to locate based, in part, on the potential for regulatory arbitrage. The U.S. is, speaking generally, at the rear of the pack when it comes to regulatory costs for starting a financial services business.

The E.U. and e-Money license passporting

In September of 2000, the European Parliament adopted a directive on electronic money (e-money).⁶⁸ A primary goal within the directive was the creation of a common minimum set of prudential regulatory rules for payments businesses across the entire European single market. Once compliant with this minimum standard and licensed in one E.U. member state, a payments business can operate across the entire E.U. with customers in any member nation. Member states cannot impose stricter standards on businesses originating from other member states, nor can they conduct independent or redundant examinations for compliance.⁶⁹

This sensible passporting scheme makes the E.U. a significantly more rational, predictable, and cost-efficient home for an innovative payments company. At its inception, some wrongly identified the e-money directive as an effort to impose stricter, more burdensome regulations on fintech businesses as compared with the "unregulated" U.S. market. That misapprehension

⁶⁷ Thomas Hazlett, "Is Federal Preemption Efficient in Cellular Phone Regulation?" *Federal Communications Law Journal*, Vol. 56, No. 1 (2003)
<http://www.repository.law.indiana.edu/fclj/vol56/iss1/5>.

⁶⁸ "On the taking up, pursuit of and prudential supervision of the business of electronic money institutions," *European Parliament* (Sept. 2000)
<http://eur-lex.europa.eu/legal-content/EN/ALL/?uri=CELEX%3A32000L0046>.

⁶⁹ *Id.*

stems from the fact that there is no comprehensive regulatory scheme for issuers of e-money (e.g. non-credit payments) from the U.S. Federal Reserve.⁷⁰

However, as has been discussed in this report and elsewhere,⁷¹ the U.S. payments industry is very far from being unregulated. There are several overlapping activities-based regulations issued by multiple federal regulators (OCC, FDIC, Federal Reserve, FinCEN, CFPB) and 53 state and territorial money transmission regulators that all may apply to a payments company in the U.S. The U.S. has no unified e-money style regulation, but the result is not hands-off; it's 53 and more hands-on.

The U.K. and fintech-friendly regulation

Although Brexit has begun to complicate matters for U.K.-based e-money providers, Her Majesty's government has been extremely progressive with respect to a different area of fintech innovation: digital currencies. In March of 2015, Her Majesty's Treasury, seeking to "create a world-leading environment for the development of innovative payments and financial technology" crafted a plan for digital currency regulation that included public funding, standard setting, and regulatory clarifications.⁷²

Specifically the plan called for: (1) clarification and application of anti-money laundering regulation to digital currency exchanges to prevent criminal use, (2) training, resources, and legislation to ensure that law enforcement bodies can effectively address criminal activity conducted with digital currency, (3) cooperation from the British Standards Institute and the digital currency industry to develop a set of best practices for consumer protection that does not impose an extreme regulatory burden on players in the space, and (4) the creation of a research initiative with leading institutions within the U.K. to study digital currencies and increase public funding for digital currency research to £10 million.⁷³

Within the year, U.K. authorities matched that encouraging talk with real action. The U.K. Financial Conduct Authority ("FCA") launched an "Innovation Hub" designed to make it easy and quick for innovative startups and entrepreneurs to comply with appropriate consumer protection regulations and safely enter the market. Among other things, participants in the Hub receive from the regulator, "A dedicated team and contact for innovator businesses, help for these businesses to understand the regulatory framework and how it applies to them, assistance in preparing and making an application for authorisation, to ensure the business

⁷⁰ See Anastasiia Burau, "Electronic Money: Comparative Analysis Of Regulation In The European Union, The United States And Ukraine" *Central European University* (Apr. 2014).

⁷¹ Lee Hudson Teslik, "The U.S. Financial Regulatory System," *Council on Foreign Relations* (Oct. 2008) <https://www.cfr.org/background/us-financial-regulatory-system>.

⁷² See HM Treasury, *Digital currencies: response to the call for information* (Mar. 2015) available at https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/414040/digital_currencies_response_to_call_for_information_final_changes.pdf

⁷³ *Id.*

understands the regulatory regime and what it means for them, and a dedicated contact for up to a year after an innovator business is authorised.”⁷⁴

While some U.S. regulators have issued similarly encouraging statements—among them the Chairman of the CFTC⁷⁵ and the Comptroller of the Currency⁷⁶—little in the way of ameliorative action has materialized. Many in the press have identified the gap and warned of a coming exodus of innovative companies into the U.K.⁷⁷

The FCA Innovation Hub exemplifies a principles-based approach that forgoes the rigid, often obsolete, and check-the-box requirements found in U.S. money transmission regulation. Instead, the Hub is designed to foster a cooperative dialog between innovators and regulators, a dialog aimed at achieving a set of principles—adequate protection of consumer funds, prevention of systemic risks to the economy, and effective transparency for law enforcement—considering the fresh opportunities and limitations of some new technology or business model.

d. Consistent standard for consumer protection and safety/soundness

Without a national alternative, our patchwork approach to regulation may not optimally protect consumers. For one, it may drive service providers overseas to jurisdictions that do not sufficiently protect U.S. consumers. Companies that choose to locate overseas because of the costs or uncertainties associated with a state-by-state licensing approach may choose to continue offering services to U.S. customers via the internet. The architecture of the internet makes it extremely difficult to prevent a foreign service provider who is willing to play it fast and loose from accessing U.S. consumer markets. Innovation may be a foregone conclusion in the financial services industry. Whether it is, on balance, responsible and regulated innovation may come down to offering incentives (in the form of commonsense and uniform regulations) that will make more innovative companies choose nations with adequate regulatory protections, like the U.S., as their home.

Even for companies that do locate within the U.S., the current regulatory landscape may be sub-optimal in protecting their customers from harm. Again, this can be the case because each

⁷⁴ See Financial Conduct Authority, *Innovator businesses: Project Innovate* (last accessed Jan. 2018), <https://innovate.fca.org.uk/>.

⁷⁵ For example, a 2016 special address, then CFTC Commissioner J. Christopher Giancarlo articulated “The Need for a “Do No Harm” Regulatory Approach to Distributed Ledger Technology.” J. Christopher Giancarlo, *Special Address Before the Depository Trust & Clearing Corporation 2016 Blockchain Symposium* (Mar. 2016) available at <http://www.cftc.gov/PressRoom/SpeechesTestimony/opagiancarlo-13>.

⁷⁶ With regard to virtual currencies and blockchain technology, the Comptroller has said that “[t]hese innovations are potentially revolutionary in their impact, and are advancing at a breakneck pace. The current regulatory regime, which is rooted in 20th century concepts and approaches, will need to change and adapt in order to remain relevant into the 21st century.” Thomas J. Curry, *Remarks Before the Institute of International Bankers Washington, D.C.* (Mar. 2015) available at <http://www.occ.treas.gov/news-issuances/speeches/2015/pub-speech-2015-32.pdf>.

⁷⁷ See generally, Jeff Lynn, “Why Britain is beating the U.S. at financial innovation” *TechCrunch* (May 2016) <http://techcrunch.com/2016/05/13/why-britain-is-beating-the-us-at-financial-innovation/>.

individual state will generally be concerned only with the activities of licensed firms that touch their own citizens, rather than the systemic health and risk profile of the licensee as a whole.⁷⁸

e. Financial inclusion

New business models and technologies are the key to financial inclusion. Presently underserved and disadvantaged populations will only access financial services if costs can be reduced and if the convenience, appeal, and trustworthiness of financial products can be enhanced. Technology holds the key to these improvements. As the Center for Global Development has reported, “Use of innovative communication tools is widespread within the most disadvantaged populations and this has come to be seen as a fitting tool to provide financial services.”⁷⁹

And while many immediately think of lending as the key to financial inclusion, payments, and particularly mobile payments, have increasingly been at the fore of innovation and enhanced inclusion. As the World Bank has commented, “Where most financial inclusion models have employed either ‘credit-led’ or ‘savings-led’ approaches, the M-PESA experience suggests that there may be a third approach—focusing on building the payment ‘rails’ on which a broader set of financial services can ride.”⁸⁰ Mobile money and digital payments, by virtue of liquidity, ease of use, and relative security to cash ultimately provides underserved populations with an essential gateway to several diverse and competitive financial products.

And while financial inclusion via mobile money and non-bank payments has been primarily discussed in the context of developments abroad, such as M-PESA in sub-Saharan Africa, the story domestically focuses even more tightly on the non-banking financial services sector. As the World Bank’s Consultative Group to Assist the Poor (CGAP) reports,

In much of our global branchless banking work, we focus on large banks and MNOs as the actors with the greatest potential to ‘move the needle’ on financial inclusion. But in the U.S., startups and nonbank players are leading the charge to build businesses targeting the underserved. In particular, a number of players in the prepaid, payments, and savings ecosystems have managed to prove business models.⁸¹

Notably, the CGAP also points to the our labyrinthine regulatory landscape as a primary impediment to financial inclusion at home.

⁷⁸ See *infra* note 37.

⁷⁹ Maria Chiara Malaguti, “Payment System Regulation for Improving Financial Inclusion,” *Center for Global Development* (Dec. 2015). <https://www.cgdev.org/sites/default/files/CGD-Policy-Paper-70-Malaguti-Payment-Systems-Financial-Inclusion.pdf>.

⁸⁰ Ignacio Mas and Daniel Radcliffe, “Mobile Payments Go Viral: M-PESA in Kenya,” *World Bank* (Mar. 2010) <https://ssrn.com/abstract=1593388>.

⁸¹ Paul Breloff and Sarah Rotman Parker, “Financial Inclusion in the U.S.: Spending Time In Our Own Backyard,” *Consultative Group to Assist the Poor* (Aug. 2011) <http://www.cgap.org/blog/financial-inclusion-usspending-time-our-own-backyard>.

In an international context, we are accustomed to dealing with a single (or small number) of regulatory/supervisory bodies relevant to branchless banking. However, in the U.S., financial services are regulated at both federal and state levels amid a complex interplay of congressional/legislative action and a number of regulators/supervisors (Treasury, Federal Reserve, Office of Thrift Supervision, etc.). Even within the same state or city, it's common for different companies engaged in the same activity (say, transaction accounts or credit) to be subject to completely different rules and regulatory/supervisory regimes based on their entity form or charter.⁸²

New rails or platforms for cheaper and more inclusive financial ecosystems include not only mobile payments but also digital currencies. Speaking generally, International Monetary Fund (IMF) staff recently found that “[digital currency] schemes and distributed ledger technologies can strengthen financial efficiency by facilitating peer-to-peer exchange while reducing transaction times and costs, especially across borders. In the longer term, these technologies have the potential to deepen financial inclusion by offering secure and lower-cost payments options.”⁸³

An area of promise is the remittances industry, which may presently lack the competitive pressures necessary to drive down fees and guarantee reasonable and transparent currency exchange rates. Digital currency technologies spur competition in this industry by providing new and alternative cross-border payment plumbing, thereby lowering the fixed costs of starting a competitive remittances business. As reported by the CGAP, the emergence of digital currencies “opens new possibilities for customers as well as alternative payment channels for providers, who have traditionally had to work through a highly intermediated correspondent bank network.”⁸⁴

While large scale use of digital currencies for remittances (*i.e.* “rebittances”) has yet to materialize, the emergence of many rebittance startups is indicative of a remittance landscape that is growing more and more competitive by the day. If we believe that providers facing increased competitive pressure will be more responsive to the needs of customers and better proxies for their interests, then this is good news regardless of the ultimate success or failure of any particular firm.

Globally, digital currencies are emerging as invaluable tools for those who face financial exclusion because of disastrous monetary policy or unfortunate regulatory consequences in their home nations. In India, where anti-corruption motivated de-monetization has limited poorer populations' access to cash, and Venezuela, where hyperinflation has made cash useless,

⁸² *Id.*

⁸³ Dong He, et al., “Virtual Currencies and Beyond: Initial Considerations,” *International Monetary Fund* (Jan. 2016) <https://www.imf.org/external/pubs/ft/sdn/2016/sdn1603.pdf>.

⁸⁴ Paul Breloff and Jeff Bond, “Picking Winners in the Great Remittance Disruption,” *Consultative Group to Assist the Poor* (Apr. 2015) <http://www.cgap.org/blog/picking-winners-great-remittance-disruption>.

Bitcoin usage is on the rise as a store of value that does not require access to the legacy financial system or reliance upon the questionable regulatory policies of the state.

Finally, the transparency of financial activities committed to open, public ledgers (such as Bitcoin's blockchain) can also be a positive force for fairness as well as access in the financial industry. Much as ridesharing apps such as Uber and Lyft use technology to reduce information asymmetries between drivers and riders with ratings and recordkeeping, open blockchain networks can enable users to directly verify that payments have been made and that fees were as advertised.⁸⁵ The single source of truth in these systems is a blockchain, an unforgeable cryptographic log of all activities, rather than the good-word and reputation of any particular financial services provider.⁸⁶

6. What could federal money transmission licensing look like?

The need for a federal alternative is palpable and should, at least from an economic reasoning standpoint, be uncontroversial. What would a federal alternative look like? In this section we will sketch four alternative federal approaches that would address the inefficiencies of state money transmission licensing.

As a perfunctory matter, no existing law grants authority to a federal regulator to create and administer a money transmission licensing scheme via rulemaking. Regardless of the approach taken, new legislation will be necessary. Such legislation would be well within the bounds of Congress's constitutional authority to regulate commerce among the several states. As discussed throughout, money transmission is almost always interstate, and the creation of barriers to competition through fragmented regulation of interstate services (e.g. ferry service between New Jersey and New York) is the exact ill the Commerce Clause was intended to allow Congress to address.⁸⁷

a. Passporting

A federal approach could mirror the E.U.'s e-money directive and reconfigure state licensing to work on a passporting basis. Federal legislation could impose a common set of prudential regulatory rules for money transmitters and direct the states to offer licenses under these standards.

These common standards do not need to be innovative. The Uniform Law Commission's Model Uniform Money Services Act (UMSA)⁸⁸ and Uniform Regulation of Virtual Currency Businesses

⁸⁵ Juan Llanos, "Will Bitcoin Change How We Think About Regulation?" *Coin Center* (March 2015) <https://coincenter.org/entry/will-bitcoin-change-how-we-think-about-regulation>.

⁸⁶ *Id.*

⁸⁷ *Gibbons v. Ogden*, 22 U.S. (9 Wheat.) 1 (1824).

⁸⁸ Uniform Law Commission, "Money Services Act," *National Conference of Commissioners on Uniform State Laws* (accessed Jan. 2018) <http://www.uniformlaws.org/Act.aspx?title=Money%20Services%20Act>.

Act (URVCBA)⁸⁹ together should form their basis. Both need to be considered because a federal approach should promote innovation in both the dollar-denominated payments as well as digital currency arenas.

With common prudential rules established, the legislation must also direct states to honor the licenses granted by other states and prohibit states from imposing additional, incompatible, or redundant conditions, rules, or regulations on out-of-state businesses with a conforming license from another state. The legislation must also forbid the states from conducting independent examinations on out-of-state licensees.

Such a passporting regime would be a boon to interstate businesses but it may not address issues faced by novel businesses that do not create the kinds of risks to consumers typically addressed through licensing. To address novel business issues, any federal legislation must also:

- (A) Clearly limit the definition of money transmission to include only activities wherein the licensed business takes actual custody over customer money and/or control over customer digital currency. The terms “custody” and “control” should have crisp and intuitive definitions that are sensitive to new technologies in this space.⁹⁰
- (B) Create a safe harbor that spares non-custodial businesses (those that do not take custody or control of funds, and thus do not pose a direct risk to consumers) from any state or federal licensing requirement.⁹¹
- (C) Offer a sandbox modeled after the U.K. initiative described earlier.⁹² The sandbox effort should provide a single point of contact for applicants seeking clarity from their regulator. A money transmitting business exhibiting innovative qualities that warrant individually calibrated regulations should be able to apply for the sandbox and, if certain negotiated conditions are met, they should be regulated under different and specifically tailored, negotiated standards. The sandbox could be federally administered or, alternatively, administered by the states. States would be directed to honor these sandbox agreements and to not interfere with sandbox participants.

⁸⁹ Uniform Law Commission, “Regulation of Virtual Currency Businesses Act,” *National Conference of Commissioners on Uniform State Laws* (accessed Jan. 2018) <http://www.uniformlaws.org/Committee.aspx?title=Regulation%20of%20Virtual%20Currency%20Businesses%20Act>.

⁹⁰ The URVCBA has a particularly lucid definition of “control” with respect to digital currencies: “‘Control’ means: (A) When used in reference to a transaction or relationship involving virtual currency, power to execute unilaterally or prevent indefinitely a virtual-currency transaction; ...” This definition clearly specifies that those with the ability to move or lose customer funds must be licensed but it also clearly excludes those playing a lesser role with respect to customer digital currency (e.g. they store some keys or credentials related to customer digital currency but not a sufficient number of keys or credentials to transact on the customer’s behalf.).

⁹¹ Peter Van Valkenburg, “Bitcoin innovators need legal safe harbors,” *Coin Center* (January 2017) <https://coincenter.org/entry/bitcoin-innovators-need-legal-safe-harbors>.

⁹² See *infra* (4)(d) Sandboxes.

The passporting approach requires the least *de novo* regulatory infrastructure, choosing instead to simply harmonize the existing efforts and resources of the several states. Some, however, may argue that this approach is vulnerable to a “race to the bottom.” All states would necessarily enforce the same minimum regulatory standards, however, some may be more relaxed with examinations or enforcement against bad actors, and these may become the preferred home of licensees to the detriment of consumers. While this is conceptually plausible, no such phenomenon has doomed consumers in the E.U. where this approach has been in operation for almost 20 years.

Another potential pitfall in this approach is that it may not be constitutional given the anti-commandeering doctrine established by the Supreme court in *Printz v. United States*.⁹³ Under *Printz*, the federal government is prohibited from imposing targeted and affirmative duties upon state legislators and executive officials. The passporting approach may violate the anti-commandeering doctrine in that it directs state money transmission regulators to offer, honor, and enforce a federally-specified license. This issue of constitutionality may be avoided if the federal initiative is voluntary for the states to adopt but tied to federal funding of state programs related to financial services. A full anti-commandeering analysis is, however, beyond the scope of this report.

b. An alternative federal license for custodial payment companies

Another option would be to have the federally created prudential standards administered by a federal regulator via an *alternative* federal money transmission license. That is, a business could choose to seek licenses in those states in which it will have customers, or it could alternatively choose to seek a federal license. As a result, the federal licensing program need not preempt the ability of the several states to continue granting licenses. A federal license can simply be an alternative to state licensing and federally licensed businesses can be absolved, under the federal statute, from any liability or obligations under state licensing laws (limited preemption). This is no different than the dual nature of state and federal banking regulation that exists today.⁹⁴ The logical seat for the program is a newly created division for money transmission in the Treasury Department, although other existing divisions might be considered.

⁹³ *Printz v. United States*, 521 U.S. 898 (1997).

⁹⁴ Office of the Comptroller of the Currency, “National Banks and The Dual Banking System” (Sep. 2013) <https://www OCC.treas.gov/publications/publications-by-type/other-publications-reports/national-banks-and-the-dual-banking-system.pdf> (“The ‘dual banking system’ refers to the parallel state and federal banking systems that co-exist in the United States. The federal system is based on a federal bank charter, powers defined under federal law, operation under federal standards, and oversight by a federal supervisor. The state system is characterized by state chartering, bank powers established under state law, and operation under state standards, including oversight by state supervisors. It has been a bedrock precept of our constitutional law for more than 180 years, since the Supreme Court’s decision in *M’Culloch v. Maryland* in 1819, that states cannot constitutionally control the powers of entities created under federal law.”).

The need to clarify issues for novel businesses would remain. Therefore, federal legislation creating such an alternative licensing scheme must contain a safe harbor provision that would create limited preemption of state money transmission regulations in any case where businesses either: (a) do not fit the federal definition, (b) are not custodial, or (c) are operating under a sandbox agreement with the federal regulator.

c. Full preemption and a federal money transmission license

Alternatively, federal legislation could explicitly preempt all state money transmission licensing regulation. A federally administered license would become the one and only path to running a money transmission business in the U.S. Such a step, while much more drastic, is fully within the constitutional powers of Congress under the Commerce Clause and 10th Amendment. That said, there would be complicated questions inherent in any such regime: How do companies with existing state licenses transition to a federal license? How will a new division within the Treasury Department tasked with enforcing a new law rapidly develop the resources and expertise to effectively regulate alone?

d. Targeted preemption for digital currency companies

This report has focused on money transmission, in general, rather than looking specifically at any particular business model or affected technology. Nonetheless, discussion of a unified national approach has been in part motivated by the significant complications and opportunities that emerge at the intersection of digital currency businesses and financial services regulations. Rather than upend the field of money transmission regulation as a whole, a new federal regime could be crafted for digital currency businesses alone.

Momentum for such an approach is new but rapidly building. The Office of the Comptroller of the Currency has at times suggested that digital currency custodians and exchanges may be ripe candidates for a federal Fintech Charter.⁹⁵ The fintech chartering process has, however, slowed—at least for the time being—and no charters have yet been granted.⁹⁶ It also remains to be seen whether digital currency custody or exchange are bank-permissible activities under the National Bank Act.⁹⁷ If these were not deemed to be bank-permissible activities, then a bank

⁹⁵ Michael del Castillo, “US Bank Regulator Opens Door to National License for Bitcoin Firms” *Coindesk* (Sep. 2017) <https://www.coindesk.com/us-currency-boss-opens-door-licensed-bitcoin-banks/> (quoting Acting Comptroller Keith Noreika: “I wouldn’t be adverse to those people coming in and talking to the [Office of the Comptroller of the Currency] about how a charter could make sense for them. But that is a long process they’d have to go through, and just because you get in the door doesn’t mean you’re going to get out the door on the other side.”).

⁹⁶ Michelle Price, “U.S. regulator plays down bitcoin fears, backs fintech charter” *Reuters* (Dec. 2017) <https://www.reuters.com/article/us-usa-occ-bitcoin/u-s-regulator-plays-down-bitcoin-fears-backs-fintech-charter-idUSKBN1EE25C> (quoting Comptroller Joseph Otting: “I’m not sure what it looks like and how it’s funded, but I do think there’s a space there that a technology solution can solve. Then the question is what is the requirement on that fintech to get that charter.”).

⁹⁷ See generally, Peter Van Valkenburgh, “Comments to the Office of the Comptroller of the Currency on Exploring Special Purpose National Bank Charters for Fintech Companies” *Coin Center* (Jan. 2017)

charter would be out of the question. Additionally, a national bank charter (even one limited to fintech activities) is overkill as a regulatory regime given that these companies play no role in lending, currency creation or other public banking functions.

Recently, the Chairmen of the CFTC and the SEC have, together, called for a “revisit” of the policy behind our state-by-state approach to regulating digital currency exchanges.⁹⁸ The SEC has found that some cryptocurrency token sales fit their definition of securities issuance and has begun to bring enforcement actions against token sellers for unregistered securities issuance.⁹⁹ The SEC has also said, in no uncertain terms, that digital currency exchanges trading tokens deemed to be securities must be registered National Securities Exchanges or Alternative Trading Systems.¹⁰⁰ The SEC has not, however, deemed *all* cryptocurrencies to be securities and there are compelling legal and policy reasons why such sweeping classification is unreasonable.¹⁰¹ Who, after all is the issuer of Bitcoin? The miners? The software developers? This is rather like asking who amongst the gold industry is the issuer of gold as a security? Gold, a valuable asset that exists in the world independent of any promises from a third party issuer or promoter, is rightly classified and regulated as a commodity, just like Bitcoin and similar cryptocurrencies.

The CFTC has, sensibly, deemed Bitcoin and other digital currencies to be commodities.¹⁰² This places derivative financial products where the underlying is a digital currency (e.g. Bitcoin swaps and futures) under their jurisdiction. Marketplaces trading in digital currency derivatives must conform with the same regulatory standards as traditional commodities derivatives trading platforms and register appropriately as, potentially, Swap Execution Facilities or Derivatives Clearing Organizations. The CFTC has existing authority to police market manipulation and insider trading on commodities spot markets (i.e. digital currency exchanges that enable spot trading but don’t offer swaps or futures),¹⁰³ but under existing law it does not require registration or licensing from these platforms.

<https://coincenter.org/entry/comments-to-the-office-of-the-comptroller-of-the-currency-on-exploring-special-purpose-national-bank-charters-for-fintech-compan>.

⁹⁸ Jay Clayton and J. Christopher Giancarlo, “Regulators Are Looking at Cryptocurrency” *Wall Street Journal* (Jan. 2018) <https://www.wsj.com/articles/regulators-are-looking-at-cryptocurrency-1516836363>.

⁹⁹ Securities and Exchange Commission, “Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934: The DAO” (Jul. 2017) <https://www.sec.gov/litigation/investreport/34-81207.pdf>. See also Securities and Exchange Commission, “In The Matter Of Munchee Inc.,” (Dec. 2017) <https://www.sec.gov/litigation/admin/2017/33-10445.pdf>.

¹⁰⁰ Securities and Exchange Commission, “Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934: The DAO” (Jul. 2017) <https://www.sec.gov/litigation/investreport/34-81207.pdf>. See also Securities and Exchange Commission.

¹⁰¹ Peter Van Valkenburgh, “Framework for Securities Regulation of Cryptocurrencies,” *Coin Center* (Jan. 2016) <https://coincenter.org/entry/framework-for-securities-regulation-of-cryptocurrencies>.

¹⁰² See *In the Matter of: Coinflip, Inc., d/b/a Derivabit, and Francisco Riordan*, CFTC Docket No. 15-29, <http://www.cftc.gov/idc/groups/public/@lrenforcementactions/documents/legalpleading/enfcoinfliprder09172015.pdf>.

¹⁰³ Dodd Frank Wall Street Reform and Customer Protection Act, Pub. L. No. 111-2031, § 753 (2010).

The public policy goal that animates state money transmission licensing is consumer protection. When a customer hands over funds to a money transmitter, they have to trust it to not lose, steal, or misdirect their money. The relatively simple issue of ensuring the solvency of digital currency exchanges aside, state money transmission regulations were never intended to deal with emergent investor protection issues inherent in high-volume marketplaces facilitating trading of a variety of speculative new digital assets amongst hundreds of thousands or even millions of active traders.

These emergent investor protection issues are similar to those addressed by the SEC and CFTC with respect to securities exchanges and commodities futures exchanges. But, a digital currency is not a security and therefore it makes no sense to regulate digital currency exchanges as National Security Exchanges. Digital currencies are commodities, but the CFTC only regulates commodities futures markets, not commodities spot markets.¹⁰⁴ All told, should investor protection issues in digital currency spot markets need to be addressed, they would be best addressed through a *de novo* regime crafted in legislation and seated within the CFTC. Much of that regime would be focused on investor disclosures, market transparency, and guardrails to prevent and police fraud, market manipulation, and insider trading (issues beyond the scope of this report), but the legislation should also deal with the more straightforward issue of licensing for exchanges that play a role as custodians and payment providers. The public policy goals of state money transmission regulators could thus be subsumed within a larger CFTC-administered investor protection regime. State money transmission laws would then be fully preempted for newly CFTC-regulated digital currency exchanges.

7. Conclusion and Recommendations

State by state money transmission licensing is inefficient because transmitters provide a networked good that inherently crosses state lines, and because state regulators cannot and do not account for these externalities when they calibrate their regulations. This regime is also inefficient because the plurality of state statutory definitions for “money transmission” offer little to no certainty for innovators who are building a product that may or may not fit into a definition, depending on how it is drafted in a particular state and how a regulator in a particular state chooses to interpret their definition in light of novel products and technologies.

These inefficiencies prevent effective regulatory cooperation between licensing authorities and anti-money laundering or investor protection regulators. They hinder economic growth because they raise the costs of starting innovative businesses. They hinder American competitiveness in financial technology because regimes internationally eschew overlapping multi-state licensing in favor of a unified approach. They hinder effective consumer protection efforts because regulators calibrate their protections to the activities of a licensee with respect only to customers in the regulator’s state and ignore the risk-profile of the licensee’s national or international business as a whole. And they hinder financial inclusion by stymying the development of new financial tools that can deliver cheaper, safer, or more palatable services to

¹⁰⁴ Aside from CFTC authority to police market manipulation, fraud, and insider trader.

underserved communities. The U.S. is long overdue for a solution to the challenges of state-by-state licensing in the form of a sensible unified national approach to money transmission regulation.

Possible solutions are various and range from least to most extensive: (a) the creation of a license passporting regime resembling the E.U.'s e-money system, (b) the creation of a federally administered alternative license and limited preemption of state law for federal licensees, (c) the creation of a federally administered license and full preemption of all state money transmission licensing, and (d) the creation of a more comprehensive CFTC-run investor protection regime focused on digital currency exchanges that also preempts state licensing. All approaches must also include a safe harbor for novel businesses that do not create the sort of risks to consumers that money transmission licensing is meant to address (but which may be treated as money transmitters under a loose interpretation of some state statutes). All approaches should also contemplate the creation of a sandbox program where novel businesses that would otherwise qualify and need a full license can negotiate for flexible regulatory treatment.

All things being equal, Coin Center prefers federal legislation that would create a federal money transmission license as an alternative to state licensing for companies that seek it out. The federal legislation would not preempt state licensing except with respect to (a) federally licensed firms, (b) those that fit within a safe-harbor for non-custodial activities, and (c) qualified participants in a federally administered regulatory sandbox.

However, should investor protection concerns over digital currency exchanges necessitate a change to existing SEC or CFTC jurisdiction, Congress should create a CFTC-administered supervisory regime for digital currency exchanges and that regime must fully preempt state money transmission licensing.