VIEWPOINTS

MILKEN INSTITUTE
CENTER FOR FINANCIAL MARKETS

FinTech: Who Regulates It and Why It Matters

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Introduction

Financial technology, or "FinTech," refers to the use of technology to facilitate financial services. While technology has complemented finance for millennia (early examples being the introduction of currency, the abacus, and writing materials), this century has seen an explosive proliferation of high technology. Tech-centric competitors seek to disrupt the status quo in areas as far-ranging as investment and retail payments, and the very nature of money itself. Such change holds great promise but may carry significant risks.

This is not the first era of technological disruption to occur in the financial services industry, but people seem unusually excited or, depending upon their perspective, anxious. What is different about this cycle? In 2014, Chris Brummer, a law professor at Georgetown University, and Daniel Gorfine, then director of Financial Markets Policy at the Milken Institute, identified the more disruptive characteristics of FinTech.[1]

- ***Rapid innovation and adoption****:* Financial technologies make it easier to iterate and deploy new financial services broadly.
- ***Increased disintermediation****:* FinTech allows new service providers to bypass traditional intermediaries.
- ***Convergence of industries****:* FinTech allows (or forces) different industries, including traditional finance, technology, and telecommunications, to compete and collaborate as they provide services.

1. Chris Brummer and Daniel Gorfine, "FinTech: Building a 21st-Century Regulator's Toolkit," Milken Institute, October 2014. www.milkeninstitute.org/publications/view/665.

- ***Lower costs/fewer barriers to entry:*** The decreasing costs of technology allow smaller companies to prototype and deploy services that were previously too capital intensive.
- ***Borderless platforms:*** The use of technology, especially the Internet, reduces or eliminates the costs of geographic distance, allowing service providers the capability (if not the legal right) to offer financial services globally.
- ***Democratization of opportunity:*** Lower costs and greater scalability allow for the wide availability of services that were once prohibitively expensive or scarce.

In June 2015, a participant at a Milken Institute roundtable explained the ongoing regulatory uncertainty with the following points:[2]

- Powerful, inexpensive, "customer-facing" technologies, such as those found in smartphones, are expanding potential market size for services that were once prohibitively expensive for all but the very wealthy; groups that previously could not access or afford these products and services may be less sophisticated than traditional customers.
- FinTech innovation is cutting across regulatory jurisdictions because different business models or delivery methods for services do not conform to existing regulatory structures.
- Technology eliminates the distance barrier and allows competitors to offer products to new markets on national and global levels. This can put pressure on regulatory systems that assume a material geographic limitation.
- Regulators are seeing entrants to markets who lack the traditional backgrounds and world views typically associated with incumbents, calling into question regulators' own traditional assumptions about market participants and practices.
- Regulators contend with the increasing pace of innovation as technology enables faster iteration and experimentation of financial services and products.

These themes become evident when one considers some of the most prolific FinTech innovations. Non-bank marketplace lending, for example, disintermediates banks by matching borrowers and lenders worldwide. Mobile payment services accelerate the pace of payments relative to traditional services and allow transactions to take place by means of a phone whose computing power used to be prohibitively expensive for all but large institutions.

In addition, companies can use sophisticated and self-improving algorithms to parse copious amounts of data to inform investment and lending decisions, enabling those who were previously unable to be scored for credit to gain access to it. Perhaps the most potentially disruptive innovation is the rise of virtual currency. While it has uses for traditional financial services, it also presents the potential to compete with government-backed currencies in the global economy.

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2. The roundtable, "FinTech: Innovation and Regulation," was a closed-door session held June 25, 2015, in Washington, DC, and attended by regulators, academics, lawyers, and FinTech companies.

Financial services is not the only industry to see many of these dynamics play out, but it is one of the most comprehensively regulated industries, and technology is straining its existing regulatory framework. For example, the inherent scope of Internet-enabled lending and payment systems is challenging assumptions about whether a company should be regulated primarily at the federal or state level. Likewise, regulators who used to rely on intermediaries, like broker-dealers, as points of control are finding those intermediaries bypassed by new players.[3] Even basic assumptions about the regulatory process, and how quickly the regulatory decision loop takes, are being challenged as financial services change and proliferate far more quickly than new rules are written.

These pressures may necessitate significant changes to financial regulation. While non-bank lending, for example, has been primarily regulated at the state level, the inherently interstate nature of online marketplace lending may justify federal preemption of state regulations in order to provide a consistent regulatory environment. Additionally, if the pace of innovation and complexity of the technology prevent regulators from creating adequate rules-based regulations, they may consider moving to more principles-based rules.[4] Finally, regulators may find that the rules created to benefit consumers are in fact counterproductive if they prevent entry by startups who may lack the resources to meet significant compliance burdens and who, by innovative competition, could serve as an effective means of regulating market participant behavior.

Given the very real potential for significant change in both the financial and regulatory systems, it is important for stakeholders—elected officials, regulators, and market participants—to evaluate whether the current regulatory system is adequate or in need of reform. The Milken Institute Center for Financial Market's FinTech Program, recognizing the vital importance of a financial system that is innovative, dynamic, inclusive, and that provides adequate protection against fraud and misuse, seeks to help inform this discussion through research, analysis, and forums with leading stakeholders in the space. What follows is an analysis on one of the most important questions regarding FinTech regulation: Who should regulate?

This paper seeks to examine the implications of that question, and how the answer may affect both company and consumer use of financial services. Given the scope and diversity of FinTech, the paper's representation of the regulatory environment is by necessity simplified and does not purport to provide specific answers. Instead, it seeks to offer general points that stakeholders may wish to consider. It will briefly discuss the underlying purpose of regulation and then highlight three dynamics that affect the regulation of FinTech—the differences between government, private, and market regulators; the issues surrounding various levels of governmental regulation; and the impacts of having multiple regulatory agencies within a government overseeing different aspects of a transaction. It will close with some general recommendations for how the question should be evaluated.

3. For a thorough treatment of this dynamic in the securities industry, see Chris Brummer, "Disruptive Technology and Securities Regulation," *Fordham Law Review* 84, 977 (2015), http://ir.lawnet.fordham.edu/flr/vol84/iss3/6.
4. For a discussion of the costs and benefits of principle-, rule-, and performance-based regulations, see Brummer and Gorfine, pp. 6–8.

What is Regulation?

It is important, and surprisingly difficult, to explain what we mean by "regulation." While regulation is generally considered the purview of government, with legislatures and administrative agencies establishing statutes or administrative rules that have the force of law, other powerful forces and players are also able to influence the actions of individuals and companies in the FinTech space. For example, non-governmental self-regulatory organizations (SROs) can create rules and enforce discipline in certain industries; companies can be constrained by contract and litigation; and market competition can enforce unwritten standards of service on pain of bankruptcy. Voters and policymakers alike should understand these non-governmental effects, which will be influenced as well by any law, rule, or enforcement action.

This paper uses a broad definition of regulation, and of who or what counts as a regulator:

> *Regulations are rules (whether enshrined in official law, found in private contract, or enforced by the market) that govern how an activity is conducted, and provide a means of redress or enforcement if the rules are violated. Regulators are any actors who enforce those rules.*

Regulation can be roughly divided into two parts—the creation and promulgation of a rule; and the enforcement of a rule. In cases like formal legislation or administrative rulemaking, the creation, promulgation, and enforcement of a rule is highly formalized, with explicit procedures (e.g., a notice-and-comment period, passage of a law by Congress, or formal trial or administrative proceeding). In other cases the creation and enforcement may be more subtle and informal (e.g., the creation of a contract between two private parties or competition forcing certain behavior to maintain customers).

What Purpose Does Regulation Serve?

Having defined (for the purposes of this paper) what regulation is, it is worth asking why regulation is necessary. While opinions among convening participants differed about the scope of regulation, its form, and who should regulate, there was consensus that some amount of regulation is essential to functional markets for financial services. Among the reasons:

- **The need for orderly and reliable markets to attract customers and provide certainty to market actors:** A market that lacks intelligible rules, and fails to provide a reasonable belief that those rules can be relied on and enforced, is unlikely to survive. Likewise, entrepreneurs are less likely to enter a market if they are unsure what the rules are and whether their rights will be enforced.

- **Provision of a means of redress:** The provision of a mechanism for redress, particularly for consumers and/or small businesses to limit the risk they face from bad actors (as opposed to market risk), is also vital to obtaining sufficient buy-in.

- **A level playing field:** Firms want to trust that their competition will be held to similar rules, and that bad actors will be punished, before allocating resources to a market.

- **Systemic security:** Transactions or products that are not threatening in themselves may, in the aggregate, pose a risk to third parties or the broader economy. Regulations help limit the risk and potential spread of such risk.
- **Law enforcement:** Transactions may pose a risk outside the financial system. For example, anti-money-laundering/combating the financing of terrorism (AML/CFT) regulations seek to prevent criminal and terrorist organizations from using the financial system, even if their transactions do not pose risks to the parties to the transactions or to the broader health of the financial system.

Who Regulates, and Why Does It Matter?

The question of who will regulate is both important and challenging. Different types of regulators have different levels of authority, procedures, means of enforcement, and jurisdictions. They also tend to operate at different speeds and may possess different levels of sophistication. Finally, the number of regulators with which a market participant must deal can significantly affect the regulatory burden. These differences of type, speed, and number can be relevant to questions about which regulator is best suited to address a particular issue.

Types of Regulators

Because of the scope, scale, and dynamism of FinTech, the sector is often regulated by multiple regulators, both within certain types (e.g., multiple government regulators) and across types (e.g., governmental, self-regulators, and market regulators).

1. **Government regulators:** The government is what most people think of when they think of a regulator. While elected governments can regulate an industry or activity directly via legislation, they frequently empower a regulatory agency to create and enforce rules. Legislation may set the agency's jurisdiction (though its jurisdiction may be ill or broadly defined), structure, and procedures. A particular agency may have exclusive authority over an industry, or there may be multiple agencies with overlapping authority. The US federal system means there may be state and federal regulators overseeing the same issues at their respective levels. Additionally, government may enter into international agreements to harmonize regulations and create international agencies capable of responding to multinational entities and cross-border transactions. This can provide greater consistency for international markets but add additional layers of cost and complexity.

   Regulatory agencies generally promulgate regulations via a notice-and-comment process that allows the public to review a proposed rule for a period of time and provide feedback. Agencies may hold open meetings on a proposed regulation to receive additional public (including industry) input. The agency is required to consider the feedback as it finalizes the rule. This process provides broad democratic access but can be time consuming and taxing on regulator resources.[5] Additionally, the

5. For example, it took the Securities and Exchange Commission three and a half years to finalize Title III, Regulation Crowdfunding, after the passage of the Jumpstart Our Business Startups (JOBS) Act in April 2012.

regulation may be at risk of becoming obsolete due to rapidly innovating technologies or changing market conditions.[6]

Once regulations are finalized, agencies can provide guidance to market participants on areas of ambiguity via various formal and informal means, including no-action letters (negotiated letters that lay out a set of facts where the agency staff would not recommend an enforcement action); "frequently asked questions" guidance; and public statements. Additionally, regulators can create specific programs in which they make themselves available for questions from companies and provide non-binding guidance, or even create regulatory "sandboxes," where entrepreneurs can try innovative business models under the regulator's guidance. Examples include the Consumer Financial Protection Bureau's (CFPB) Project Catalyst[7] and the Financial Conduct Authority's (FCA) Project Innovate in the United Kingdom.[8]

In some cases, such as bank regulation, regulators may conduct ongoing inspections of market participants to ensure compliance and prevent problems from developing. These inspections are not in response to alleged violations but are designed to protect the stability of the market and ensure compliance by regulated entities.[9]

Government regulatory enforcement actions can involve administrative or judicial proceedings, and require set processes, usually including the ability to present evidence and a right to appeal a decision. In some cases, the government may pursue criminal convictions. These proceedings tend to be relatively slow-moving, although agencies will often enter into agreements with the party against whom they have brought the enforcement action, and will assess some sort of penalty stipulating that the targeted party will change its behavior.

Enforcement actions may serve as an example to firms in the same industry. While these enforcement actions can provide necessary correctives, there is also a concern that agencies may use them to coerce changes in behavior that should properly stem from formal changes in the rules.[10]

While regulation via agency is the most obvious version of government regulation, the government also serves as a regulator via the judicial system, which allows private parties to assert claims against each other and enforce the resulting judgments.

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6. Rule 504 of Regulation D under the Securities Act of 1933, for example, limits the size of an offering a company can raise annually to $1 million. Inflation has eroded that value, leading the SEC to propose raising the amount to $5 million. Because this change requires a modification to Regulation D, the SEC must undertake a new notice-and-comment period.
7. Consumer Financial Protection Bureau, www.consumerfinance.gov/projectcatalyst/.
8. Financial Conduct Authority, https://innovate.fca.org.uk/.
9. See, for example, Federal Deposit Insurance Corporation, "Basic Examination Concepts and Guidelines," *RMS Manual of Examination Policies*, Section 1.1, p. 2. www.fdic.gov/regulations/safety/manual/section1-1.pdf.
10. See, for example, Rachel Witkowski, "How CFPB Reshapes Market with Enforcement Actions—Not Rules," *American Banker*, posted online February 1, 2016. www.americanbanker.com/news/law-regulation/how-cfpb-reshapes-market-with-enforcement-actions-not-rules-1079137-1.html.

Private actors also serve as significant regulators via contracts, as will be discussed later. These contracts are ultimately adjudicated and enforced through the judicial system. Likewise, common-law obligations, like the duty of care, are enforced via the courts.

Benefits and costs of government regulation: Government regulation can be the most powerful form of regulation. First, it can invoke the power of the state and impose penalties ranging from monetary fines on up to imprisonment. Second, it has the ability to regulate an entire industry directly and proactively, while many forms of private regulation tend to be responsive and firm specific. Finally, it incorporates the views of the broadest spectrum of stakeholders, both directly, through the solicitation and consideration of public comment, and indirectly, through elections. This transparency and inclusiveness can provide a broad foundation for legitimacy.

Government regulation is not without costs, however. It tends to be the slowest model to adapt to changes in the market and among regulated actors because of process requirements, leading to a higher risk of rules becoming obsolete. In the need to address new developments, governments may fail to make changes to old rulemaking, thus leaving in place legacy regulatory frameworks that are insufficient or incompatible with the products and services offered by firms in the 21st century.

Additionally, regulators' broad jurisdictions, budget constraints, and limited ability to hire and fire employees may lead to a lack of specialization in new and emerging methods of providing financial services. Finally, government regulations may reflect political preferences—including overreaction to crises, protectionism, or regulatory capture by special interests or market participants—instead of the best interests of citizens.

2. **Private regulators:** There is also a significant amount of private regulation by which market participants regulate each other's behavior. Private regulation can include formal self-regulatory organizations (SROs) empowered by statute to serve a regulator function; sophisticated contractual regimes among market partners; and private litigation by consumers or competitors for the enforcement of common law rules.

   (a) *Self-regulatory organizations:* SROs are private organizations that regulate part of a given market. The organizations' members are largely or exclusively drawn from the industry being regulated, and frequently have a more narrow focus than that of their comparable government regulators,[11] which can result in greater specialization.

   Membership in an SRO can be compulsory by law or rule; the SEC, for example, requires certain securities industry participants to become members of the Financial Industry Regulatory Authority (FINRA). Membership may also be voluntary; for example, membership in NACHA, the SRO that co-manages the Automated Clearing House, or ACH, system with the Federal Reserve is voluntary, but only members may vote on system rules.

11. For example, while NACHA oversees ACH payment system rules, and FINRA oversees certain securities market participants, the Federal Reserve and the SEC have broad responsibility for the banking system and securities markets generally.

While SROs generally have formal procedures for creating or changing rules, and disciplining members, these procedures can be less time consuming and onerous than governmental procedures. This can allow SROs to move more quickly than government regulators in certain circumstances. Additionally, while SROs generally have more limited jurisdictions than do the relevant government regulators (e.g., jurisdiction only over their members or over a particular system), to the extent that the SRO can effectively discipline its members, this can free up governmental regulatory resources.

(b) *Partner regulation:* Market participants may also have their conduct regulated by their peers, either because they are obligated to do so, have a financial interest in doing so, or wish to protect their reputations. Partner regulation may relate to formal requirements (such as compliance with anti-money-laundering laws) or informal business norms (e.g., prompt response to customer complaints), and take the form of (sometimes quite sophisticated) contractual regimes, the use of market power, or litigation.

In some cases, market participants are under an affirmative legal obligation to police their partners. Banks, for example, are obligated by their regulators to perform significant "vendor management" on firms they partner with to ensure that the banks' customers are protected.[12] Likewise, broker-dealers are required by the SEC and FINRA to perform due diligence and monitoring of the companies that use their platforms to sell private securities.[13]

In those cases, market participants may utilize contracts to grant them the ability to stipulate certain behaviors and monitor their partners to ensure that the terms are complied with, or they may also refuse to do business with the potential partner firm, denying it access to a pool of customers. For example, broker-dealers can control what issuers they recommend to clients, or what issuers have access to the broker-dealers' sales platforms. If a broker-dealer does not feel comfortable with an issuer because the issuer is not conducting itself properly or providing sufficient transparency, it can deny the issuer access.

In other cases, the partner regulation may be driven by regulatory or economic incentives that fall short of a legal mandate. For example, the Truth in Lending Act (TILA)[14] and Electronic Funds Transfer Act[15] limit consumer liability for fraudulent activity in credit card[16]

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12. See Office of the Comptroller of the Currency, Bulletin 2013-29, available at www.occ.gov/news-issuances/bulletins/2013/bulletin-2013-29.html; and Federal Deposit Insurance Corporation (FDIC), Financial Institution Letter 44-2008, available at www.fdic.gov/news/news/financial/2008/fil08044a.html.
13. Broker-dealers that recommend a security can be found liable under rule 10b-5 if they fail to perform a reasonable investigation of the issuing company and the company's representations to potential investors. See FINRA Regulatory Notice 10-22, available at www.finra.org/sites/default/files/NoticeDocument/p121304.pdf.
14. Public Law No. 91-508.
15. Public Law No. 95-630.
16. 15 USC §1643.

and electronic fund transactions.[17] This liability shift away from the customer and to the market participants (banks, card networks, and merchants) has led market participants to create a network of private law to allocate risk and police behavior to minimize the risk of fraud.[18]

Private regulation can be enforced formally via SRO enforcement proceedings or through litigation for breach of contract and common law tort claims, and informally via moral suasion and the threat of damaging business relationships. However, given the nature of private regulation, the effectiveness of informal regulation may depend on the relative market power of the participants.

(c) *Regulation by litigation*: In addition to litigation by partners, litigation by customers and competitors may enforce contractual requirements and control behavior. Companies that violate a regulatory requirement (e.g., customer data security) may find themselves sued by the consumers they harmed. Likewise, competitors may sue in cases where a company's activities violate a law or regulation that governs competition, including antitrust, and unfair and deceptive trade practice legislation.

Even if there is no specific statute or regulation proscribing a company's activities, the firm may still be sued under common law principles; for example, one company that through negligence harms another may be liable in tort, even if there is no statute or regulation prohibiting the action.

Benefits and costs of private regulation: Private regulation can be more responsive than governmental regulation because it is not as bound to formal processes.[19] It may also be more efficient because the private stakeholders could have more specific knowledge and information regarding the market, technology, and services than regulators with broader jurisdictions.[20] It can also target bad acts and bad actors more precisely than can industry-wide regulators. For example, a lawsuit against a specific company would only target that company (although the results of that suit will likely influence similarly situated market participants to change their behaviors), rather than create a regulation that may sweep too broadly.[21]

Yet there is also concern that incentives may not result in optimal regulation. For example, to the extent that SROs fund themselves via fines, there is a risk that they will over-regulate to boost their budgets.[22] There is also a risk that they will under-regulate to please their constituents.[23] There is yet

17. 15 USC §1693g.
18. Mark Edwin Burge, "Apple Pay, Bitcoin, and Consumers: The ABCs of Future Public Payments Law," 67 *Hastings Law Journal*, 2016, forthcoming. Available at SSRN: http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2702101 (accessed December 10, 2015).
19. Id. at 45.
20. Id. at 46.
21. For an argument in favor of tort law as a means of pro-innovation regulation in the broader technology context, see Adam Thierer, *Permissionless Innovation* (Virginia: Mercatus Center 2016) 122-124.
22. Hester Peirce. "The Financial Industry Regulatory Authority: Not Self-Regulation after All."

another risk, that SROs could become captured by incumbents and create rules that benefit those firms at the expense of new entrants. Finally, private regulation holds less certainty. For example, meritorious suits may not be brought due to a lack of resources by the aggrieved party and may not prevail. Likewise, individual suits may be less effective at changing industry behavior than broad preemptive rules.

3. **Market regulators:** Companies operate in and rely on a market for their survival. As such, other market participants, including competitors and potential customers, have some ability to regulate a company's behavior via commercial channels.

   If a company provides a poor product or service, it invites competitors to offer its customers better terms in an effort to win them over. This in turn should incentivize the company to improve its product or risk losing business. A possible example of this is the creation of the Investors' Exchange (IEX) alternative trading system[24] as a response to the rise of certain high-speed trading techniques and their allegedly anti-consumer effects.[25]

   The IEX exists to serve what it perceives to be a market need for consumers who are ill served by market incumbents and the preexisting market.[26] Many (though by no means all) investors[27] and academics[28] agree with IEX that consumer interests can be better served by IEX than its competition. If IEX (and subsequent entrants) will in fact serve the needs of customers better, it is likely that competitors will adapt their products and services in order to compete lest they lose customers, effectively minimizing the scope of impact for suboptimal offerings.

   The effectiveness of market regulation depends on the nature of the market and whether competitors can, given the market's limits (e.g., regulations, market size, and profit margins) provide a better product or service—or if the unsatisfactory level of service is the market's "natural state." The answer is not static; changes to regulation, such as lowering or raising barriers to entry, and

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Mercatus Working Paper, Mercatus Center at George Mason University, Arlington, VA, December 2014. http://mercatus.org/publication/financial-industry-regulatory-authority-finra-not-self-regulation-after-all at Pg. 22 n.109.

23. Burge at 46.

24. IEX, www.iextrading.com/.

25. The Milken Institute takes no position on the merits of high-speed trading.

26. Letter to the SEC from Sophia Lee, general counsel of Investors' Exchange LLC re: Investors' Exchange LLC Form 1 application (Release No. 34-75925; File 10-222) November 23, 2015, www.sec.gov/comments/10-222/10222-26.pdf.

27. Letter to the SEC from Britt Harris, chief investment officer and Bernie Bozzelli, managing director, trading, of the Teacher Retirement System of Texas re: Investors' Exchange LLC Form 1 application, undated, www.sec.gov/comments/10-222/10222-320.pdf; letter to the SEC from O. Mason Hawkins, chairman and CEO of Southeastern Asset Management Inc. et al., re: Investors' Exchange LLC Exchange Application (File No: 10-222), September 30, 2015, www.sec.gov/comments/10-222/10222-3.pdf.

28. Letter to the SEC from Prof. Eric Budish, professor of economics, University of Chicago Booth School of Business, re: Investors' Exchange LLC Form 1 application (Release No. 34-75925; File No. 10-222), dated February 5, 2016, https://www.sec.gov/comments/10-222/10222-371.pdf; Letter to the SEC from Prof. James E. Upson, Associate Professor of Finance, University of Texas at El Paso re: Investors' Exchange LLC Exchange Application (File No: 10-222), dated January 14, 2016, www.sec.gov/comments/10-222/10222-324.pdf.

changes in technology allowing for new competitors or substitute services, can change the competitiveness of the market and, with it, the effectiveness of market regulation.[29]

Benefits and costs of market regulation: Market regulation is ever present and constantly applied, which may allow it to be the most adaptable. It also provides a clear incentive for improved behavior among legitimate market participants. Finally, it is pro-innovation because it does not prohibit or place direct barriers in front of new products or services.

Unfortunately, market regulation can be limited in its effectiveness. The less competition-friendly a market is—whether because of limited room for innovation, inherently limited economics, or high regulatory barriers to entry—the less any market competition can affect the behavior of incumbents.

Additionally, while legitimate companies may be highly susceptible to market regulation, outright frauds are likely to be much less so. It is unlikely that a sham company seeking to bilk the public and run will care that it is being outcompeted. Further, while market regulation can regulate behavior over time, it cannot provide the retributive justice and disgorgement of ill-gotten profit that government or more formal private regulation can provide.

How Does the Level of Government Regulation Matter?

In addition to the types of regulators, the "level" of government regulation can also have significant effects on market participants. In the United States, government regulation of financial transactions is primarily exercised at the federal or state level. Additionally, regulation can be the product of international agreement between national governments.[30]

Government regulators, who may be elected or appointed, are accountable to different constituencies. Generally speaking, the "lower" the level, the fewer people are subject to a rule set and the greater the number of "equal" rule makers there will be. For example, each of the 50 state governments, as well as the governments of the District of Columbia and various US territories, has equal authority to regulate markets within its jurisdiction, and no legal authority to regulate it beyond that jurisdiction.

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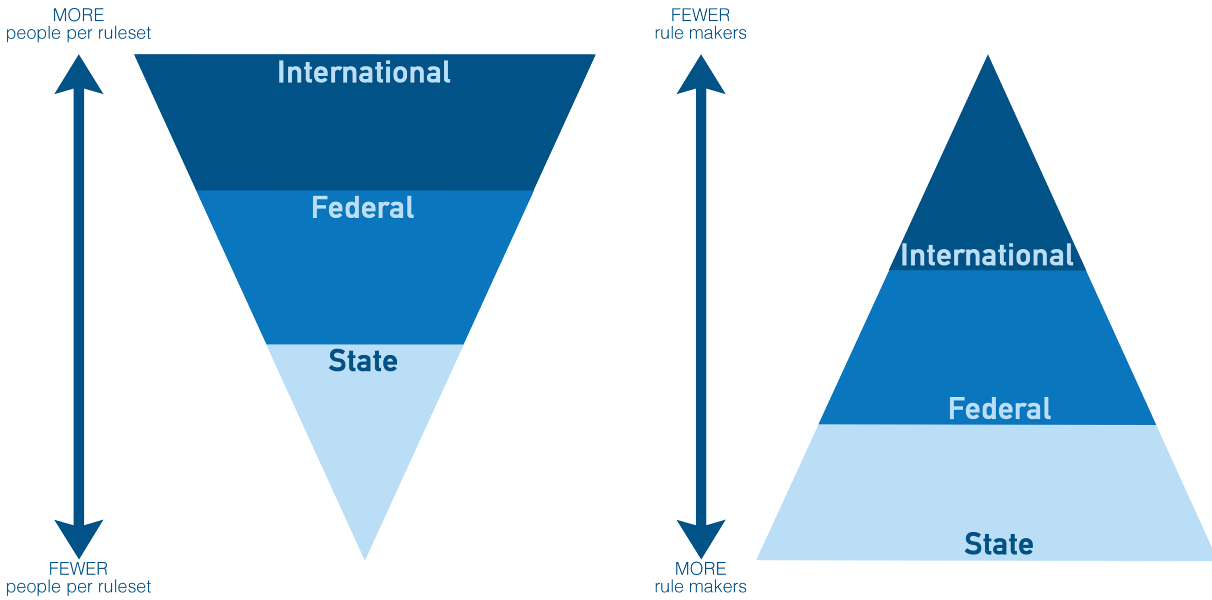
29. Arguably the most dramatic current example of competition that regulates market participant behavior can be seen, albeit outside of FinTech, in the transportation market, where the rise of apps like Uber have changed the service level of taxis. While taxis generally do not control their rates, there is evidence that after the introduction of Uber and similar services to a market, the quality of the service (as measured by customer complaints) has improved. See, generally, Scott Wallstein, *The Competitive Effects of the Sharing Economy: How Is Uber Changing Taxis?* June 2015, www.ftc.gov/system/files/documents/public_comments/2015/06/01912-96334.pdf.

30. While this section primarily discusses the topic from a US perspective, the European Union and its member states also have a system that presents a somewhat similar dynamic.

FIGURE 1. Regulatory levels vary in their scale and number of rule makers



These governments are elected by, and accountable to, the citizens of the individual states. The federal government represents and is (to varying degrees) accountable to all citizens and has the authority, subject to constitutional limitations, to regulate markets across the country and to preempt conflicting state regulations. But it cannot legally impose regulatory requirements on other countries or, in certain cases, on purely intrastate markets. International agreements reflect the work of and bind multiple national governments and are negotiated by governments accountable to the populations of those countries.

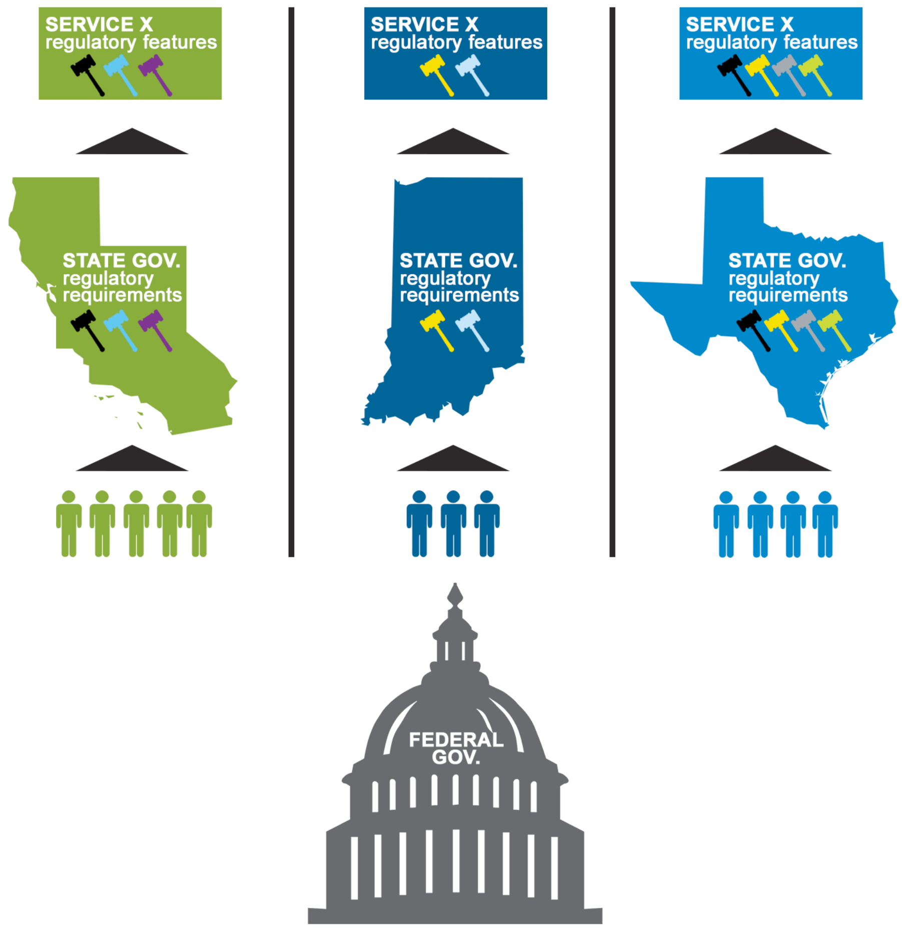
This dynamic can lead to tradeoffs between the "fit" and consistency of regulations. State regulators frequently create rules that reflect the unique characteristics of a state's market and the preferences of its citizens, while federal (or international) regulators represent the interests of a larger group of people and more diverse markets. Conversely, federal regulation offers the potential for greater consistency, while state regulations can vary significantly.

The level at which regulation is made can have important implications for the impact of a regulation on the market, as well as the democratic legitimacy of the regulation.

Intrastate Regulation

Markets or transactions limited to a single state are generally regulated by that state exclusively. In cases where all the parties to a transaction, including the citizens to whom the regulator is ultimately accountable, are within a single state, the state regulators can create regulations that match the needs and preferences of those citizens and provide companies with a single set of requirements.

FIGURE 2. Pure Intrastate Market



In a truly intrastate market, transactions are kept purely within a state (note solid lines between states), usually because it is not economically feasible to expand beyond the state market. The federal authority does not regulate the market (either because it lacks jurisdiction or elects not to). The citizens of a state, through the democratic methods of the state government, create regulatory requirements, which are enforced against companies providing a particular service. The service as offered in that state complies with and conforms to those requirements.

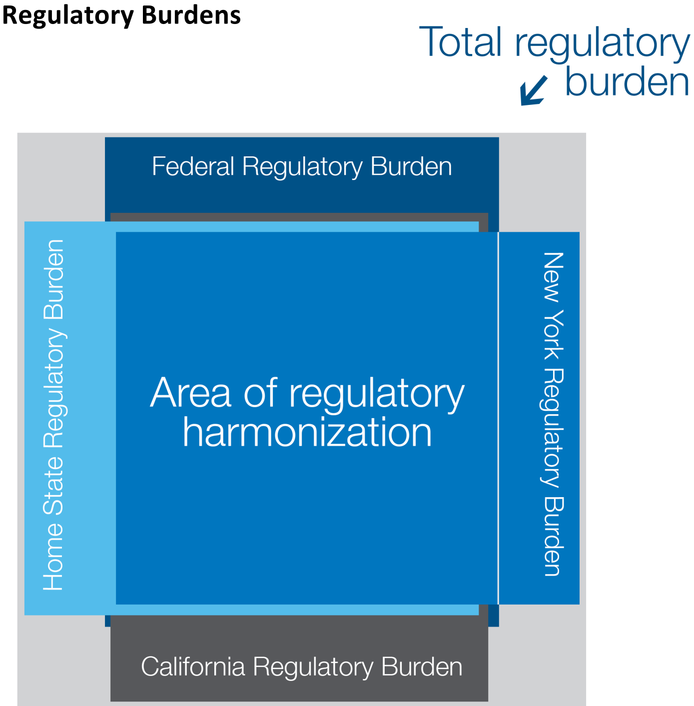
Multi-State State-Level Regulation

However, even if a transaction is inherently intrastate, many market participants may operate in multiple states and must comply with different state laws. Thus larger states with market hubs may distort the regulatory environment. For example, because of the size of its market and its role as a financial center, New York holds significant power over the conduct of firms that want to work with banks and other financial services firms. This power can force companies to comply with New York regulations, regardless of whether those regulations are consistent with other states.[31] Consumers may

31. There is concern, for example, that possible new regulations on cybersecurity proposed by the New York Department of Financial Services (DFS) will force companies to make significant structural and process changes that will impact the national market. See "Bankers Fear NY's Tough Stance Will Dictate Cyber Rules for All," *American Banker*, November 18, 2015, www.americanbanker.com/news/law-regulation/bankers-fear-nys-tough-stance-will-dictate-cyber-rules-for-all-1077897-

find themselves de facto regulated by the governments of other states as companies comply with the requirements of all the states whose markets they wish to enter.

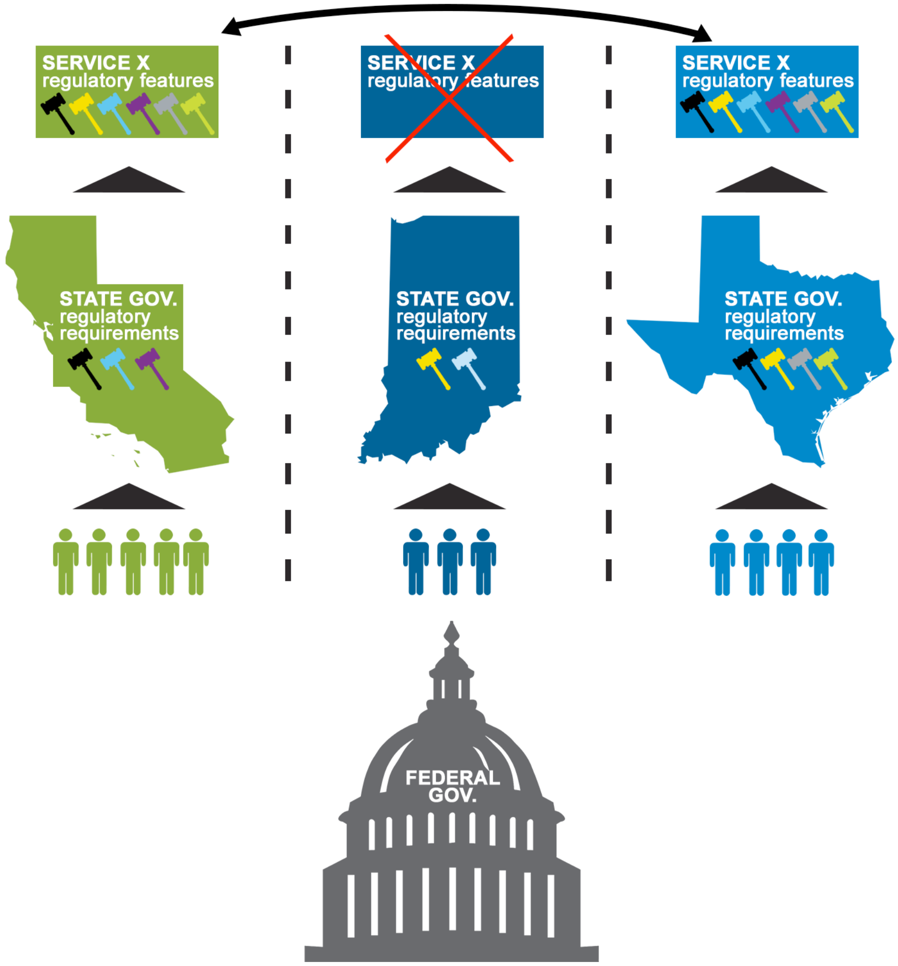
FIGURE 3. Overlapping Regulatory Burdens



Having to comply with multiple states' laws can distort the markets as well, by preventing companies, especially startups that may lack the resources for such compliance, from entering states whose smaller markets do not justify the additional regulatory burden. It may also lead companies to structure activities to alter their regulatory profiles. Some non-bank lenders, for example, partner with banks to originate loans in order to avoid having to register with, and adhere to, the lending law requirements of every state. This arrangement is an artificiality, which while not pernicious, has little competitive benefit beyond easing regulatory compliance.

1.html. Likewise, virtual currency companies will need to perform state-specific activities under New York's BitLicense regime for certain transactions, including a New York-specific anti-money-laundering regime that will affect their services nationwide. NY Comp. Codes R. & Regs. tit. 23, §200.15(a)(2-3), available at www.dfs.ny.gov/legal/regulations/adoptions/dfsp200t.pdf.

FIGURE 4. Interstate Markets with No Federal Regulation

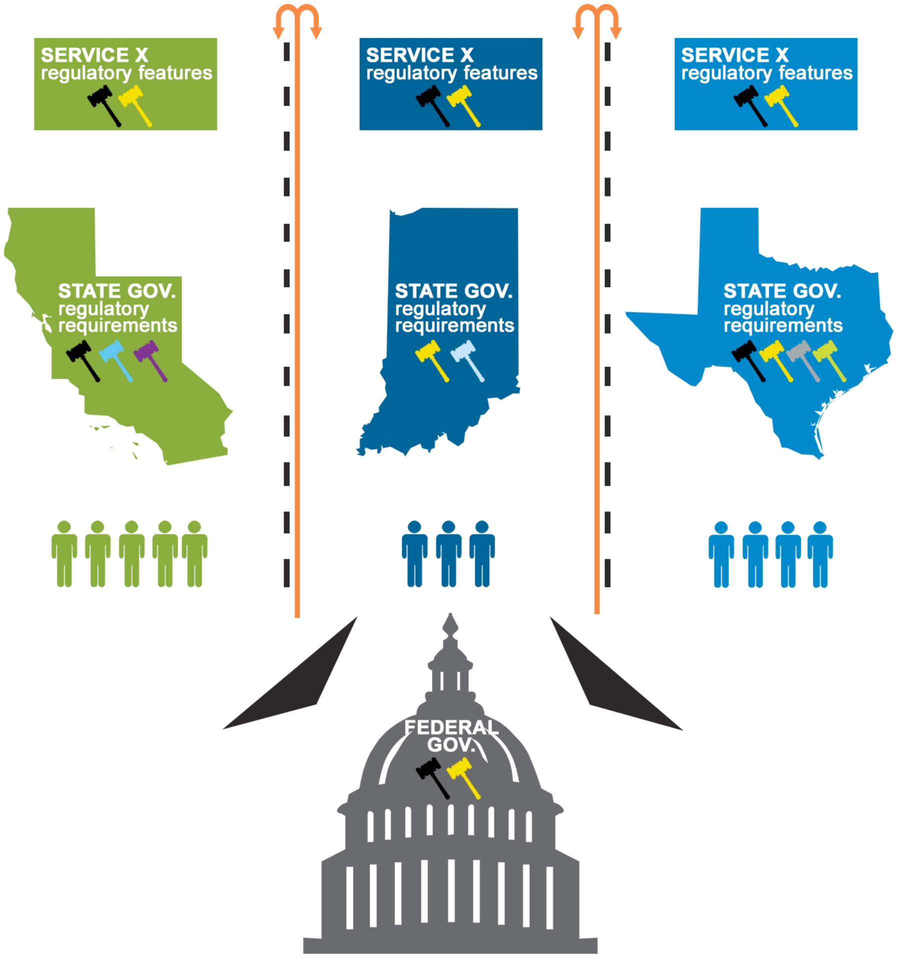


In an interstate market (note dashed lines between states), the ultimate parties to a transaction involving goods or services are located in different state. Interstate commerce is defined broadly for the purposes of granting the federal government the ability to regulate, although the federal government is not required to regulate in every case it has the ability to. In a case where citizens prefer state to federal regulation, they will, through the democratic methods of the state government, create regulatory requirements, which are enforced against companies providing the service. Service providers who want to access multiple states will need to comply with the requirements of all the states they want to access and may not enter state markets that are insufficiently large or lucrative to justify complying with those states' specific requirements.

Full Federal Preemption

Federal regulation can also exist as the sole set of rules that govern a market or transaction. Here Congress creates requirements, or empowers federal regulatory agencies to create requirements, that apply to all market participants nationwide. These requirements may be de novo if the market or transaction is new, but can also preempt existing state regulation.

FIGURE 5. Interstate Markets with Full Federal Preemption



In some cases the citizens may want federal law to completely preempt state law. In that case the regulatory requirements will be created at the federal level based upon what can get sufficient consensus among all the citizens and will apply across state lines.

Federal preemption usually occurs when there are enough economies of scale to allow for a single set of rules. This can occur where the market is naturally unconstrained by geography, or where barriers to entry, or regulatory complexities created by multiple state regulations, are high. For example, Title III of the JOBS Act[32] created a new crowdfunding exemption that substantially preempts state securities law to allow businesses to leverage the Internet to attract investors without having to comply with the laws of every state where these businesses offer securities. The Internet's capability to overcome distance has made small-dollar, multi-state offerings feasible, but the costs of compliance with each state's requirements would have defeated this goal.

32. 15 USC 77d(a)(6).

Full preemption may also be appropriate where some states exercise disproportionate influence on the market through market concentration. Federal regulation provides almost everyone[33] with some representation.

While exclusive federal regulation has the virtue of providing a consistent set of rules and broader input, it is not without its weaknesses. First, it creates a "one size fits all" rule set that may work better for, or reflect the preferences of, some states over others. State legislatures and regulators will often have a better understanding of their local markets and may be able to craft more apt regulations. Second, it may take longer for federal rules to adapt to changes (though changes at the aggregate state level can also take considerable time). Third, state-level regulation can provide for experimentation and competition, allowing for the testing of new ideas and approaches on a smaller scale before broader adoption. Federal preemption can prevent this. Finally, federal preemption may place significant strain on federal regulators to address issues via enforcement that might be better left to the states.

Hybrid Regulation

In hybrid regulation an interstate market or transaction is governed by both federal and state law. How the responsibilities are split can have a significant effect on how the regulation impacts the market.

COEXTENSIVE REGULATION

Hybrid regulation can take the form of the federal government regulating some aspects of the transaction and the states regulating others, or with both the states and federal government exercising coextensive jurisdiction. Frequently, the federal government serves as a "floor" (which preempts state laws to the extent that they are less restrictive than that floor) and allows the states to create additional restrictions.

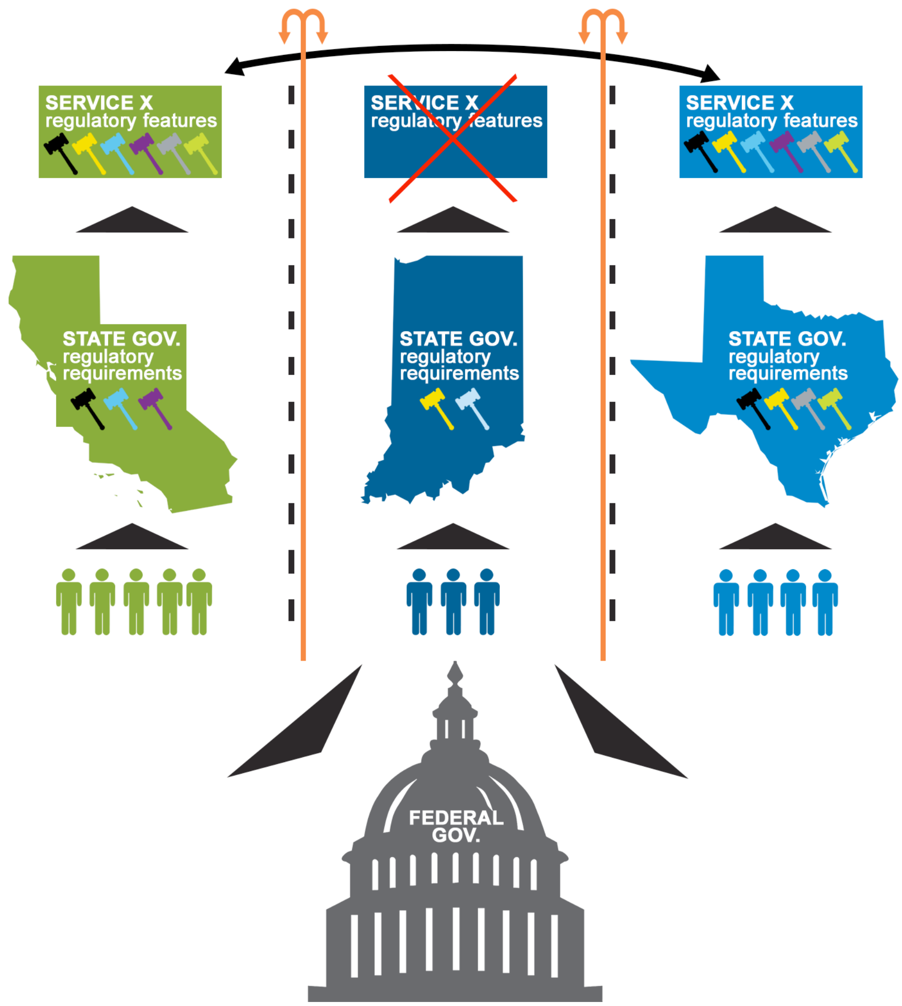
In the United States, for example, while money transmitters must comply with federal anti-money-laundering (AML) rules, money transmittal is primarily regulated at the state level, with state regulations requiring state licensing and determining most of the substantive requirements. As such, to enter the market a company must be licensed by and comply with the laws of 48 states and the District of Columbia.[34] Likewise, New York's BitLicense places state-specific AML requirements on digital currency businesses operating in New York, in addition to the federal requirements.[35]

While coextensive regulation provides for voter input on both the state and federal levels, and may allow for more precise regulation by the states within a broader federal construct, it also risks creating a system that suffers from many of the flaws of state-by-state regulation. First, states may create conflicting or redundant requirements, forcing market participants to solve the same problem several

33. In the United States, six non-voting members of Congress represent, respectively, the District of Columbia, Puerto Rico, the US Virgin Islands, American Samoa, Guam, and the Northern Mariana Islands.
34. South Carolina and Montana do not currently regulate money transmittal. See Thomas Brown, "50-State Survey: Money Transmitter Licensing Requirements," http://abnk.assembly.ca.gov/sites/abnk.assembly.ca.gov/files/50%20State%20Survey%20-%20MTL%20Licensing%20Requirements(72986803_4).pdf.
35. NY Comp. Codes R. $ Regs. tit. 23, §200.15(a)(2-3).

different ways under multiple regulators, thus increasing their compliance costs and raising barriers to entry.[36]

FIGURE 6. Interstate Markets with Hybrid State and Federal Regulation



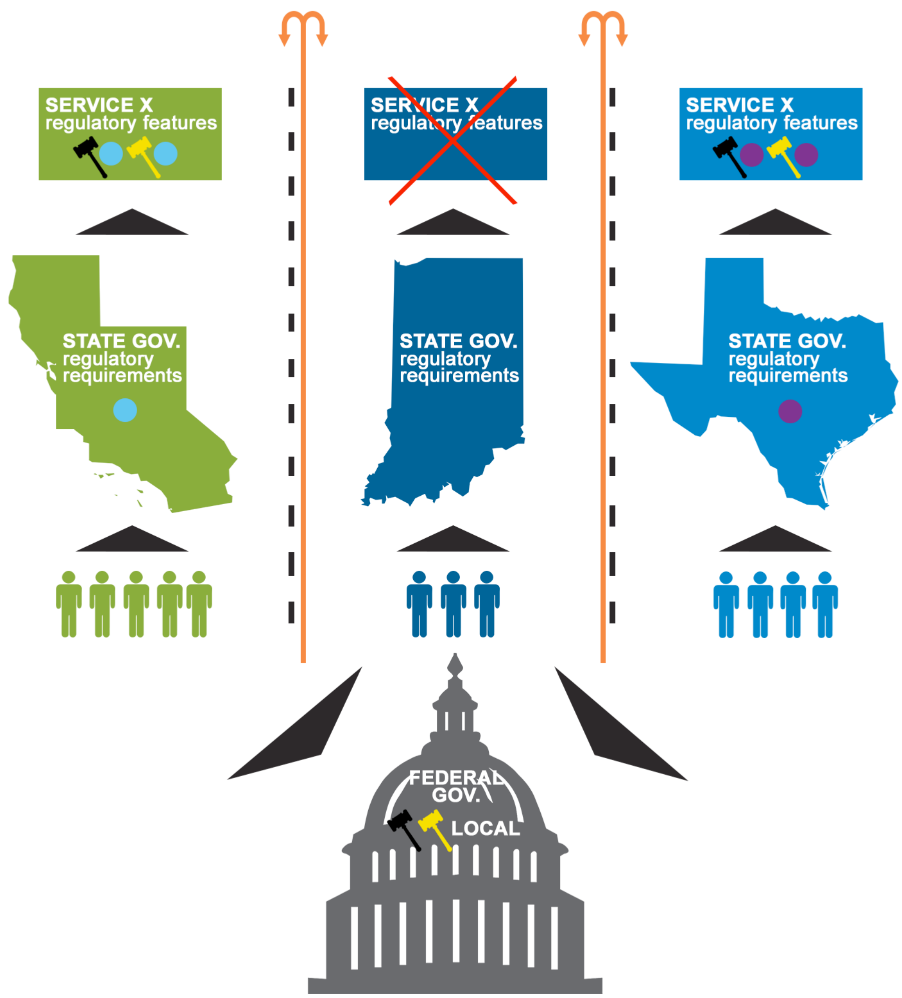
A mix of federal and state law can also regulate interstate markets. In these cases the citizens, through the democratic methods of federal government, create regulatory requirements at the federal level that apply to the service nationwide and are enforced by federal regulators. (Note that among the three states a majority of citizens want regulatory requirements, which is why those provisions are in the federal requirements). Citizens also utilize the democratic methods of state government to create regulatory requirements that are enforced against the company providing the service by state regulators. Service providers who want to access multiple states will need to comply with the requirements of all the states they wish to access, as well as the federal requirements and may not enter state markets that are insufficiently large or lucrative to justify complying with those states' specific requirements.

36. The complexity and cost of complying with different state requirements, in addition to the federal requirements, was cited as a potential reason for the under-use of Regulation A offerings by US businesses. Government Accountability Office. *Factors that May Affect Trends in Regulation A Offerings*, GAO-12-839, July 2012, www.gao.gov/assets/600/592113.pdf.

Second, while state regulators may be more responsive than the federal government, in the aggregate it may be harder for them to adapt, which can slow regulatory progress. Finally, differences in market influence among the states may mean that some states can de facto impose their preferences, while other states may not have the market significance for companies to take on the necessary compliance to do business there.

In addition to formal coextensive regulation, there may also be cases where federal preemption technically exists, but where state governments have sufficient leeway in the application of the rules that this amounts to state modification. This so-called "gold-plating" can reflect good-faith efforts to make federal rules work in a state's unique environment, or it can serve to undermine the preemption and actually raise the barriers to entry for external firms, protecting local incumbents from competition.

FIGURE 7. Interstate Markets with Federal Preemption but Local Modification

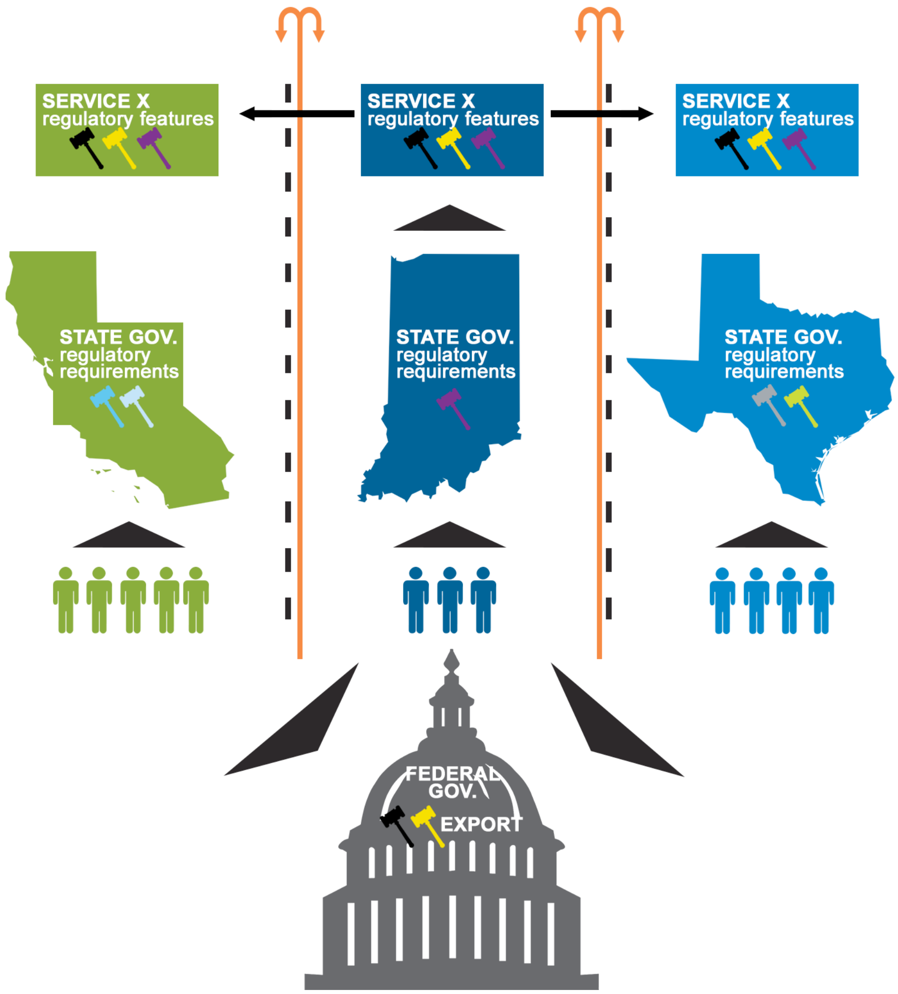


Federal preemption can sometimes take the form of federal laws that allow states some control over implementation to suit the needs of the local environment. This allows citizens to create federal requirements that apply to all states. Citizens can also use the democratic methods of state government to create local implementation requirements that influence how companies must comply with those requirements to operate in the state. While this can be beneficial, excessive local requirements can frustrate the purpose of preemption if *compliance is too costly relative to the market. Excessive local implementation (sometimes called "gold plating") may be used as a form of protectionism to prevent national competition for local markets.*

REGULATORY EXPORT

Another form of hybrid regulation is regulatory export (or "passporting"). Federal rules can require a state to permit a company to operate, either in whole or in part, under the rules of the company's home state. This allows for states to compete and experiment to create optimal rules and increased consistency of rules as companies relocate to the states with those rules. However, there is a risk that this dynamic will create a "race to the bottom" as some states create rules perceived to be overly permissive or insufficiently protective.

FIGURE 8. Interstate Markets with Federal Law and State Law Export



In some cases there exist both federal requirements and the ability to export certain state law requirements. In these cases the regulatory requirements agreed to at the federal level apply across state lines, while the regulatory requirements not covered at the federal level are determined at the state level by the citizens of the respective states. Because of the exporting provisions of the federal law, however, companies may move to the state with the least onerous regulatory requirements and export those requirements to the other states.

An example of regulatory export is the ability of nationally chartered banks to export the interest rate they are allowed to charge by the laws of their home state to other states under the National Bank Act.[37] This ability was put in place in part to help facilitate a consistent national market for credit.[38]

The provision has resulted in banks that operate at a national level basing themselves in states without a limit on interest rates, such as Delaware and South Dakota.[39] This allows them to offer credit nationally without regard for the usury laws of states they enter and operate in. While this may help the development of a robust national consumer credit market, it also arguably frustrates the desires of voters in states that maintain usury laws to limit the interest rates on credit offered in their state.

Does the Number of Regulators Matter?

In addition to the different levels of government involvement, multiple regulators with overlapping jurisdictions at the same level may have oversight over transactions and market participants. This can frequently occur in cases where some regulators have jurisdiction over specific actors, while others have jurisdiction over specific consumers or their property, such as the Department of Labor's (DOL) authority over workplace retirement accounts[40]; overarching issues (e.g., the US Treasury's Financial Crimes Enforcement Network's (FinCEN) responsibility to prevent criminals using the financial system); or the authority to regulate how transactions occur (e.g., the Federal Trade Commission's authority to prevent "unfair and deceptive acts or practices"[41] and the CFPB's authority to prevent "unfair, deceptive, or abusive acts or practices"[42]).

While many countries have relatively few regulators with broad and largely exclusive jurisdictions,[43] the United States has multiple federal regulators with overlapping jurisdictions. These include eight pure federal financial regulators,[44] with other government organizations, including the DOL, FTC, and FinCEN, exercising some regulatory function over financial services. The result is a complex environment for a particular transaction in which actions by the relevant regulators may be unpredictable.[45]

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37. 12 USC §85. State-chartered banks and credit unions have similar powers under the Federal Deposit Insurance Act 12 USC §1831(d)(a) and Federal Credit Union Act 12 USC §1785(g), respectively.
38. *Tiffany v. National Bank of Missouri*, 85 US 409, 413 (1874).
39. For example, Chase and PNC Bank are based in Delaware (http://www.ibanknet.com/scripts/callreports/fiList.aspx?type=statebank&state=10) and Citibank and Wells Fargo are based in South Dakota (http://www.ibanknet.com/scripts/callreports/fiList.aspx?type=statebank&state=46).
40. Karen Damato, "Why Labor Department Gets a Say on IRA Advice," *Wall Street Journal* blog "Total Return," April 23, 2015, http://blogs.wsj.com/totalreturn/2015/04/23/why-labor-department-gets-a-say-on-ira-advice/ (accessed February 2, 2016).
41. 15 USC §45(a)(1).
42. 12 USC §5511(b)(2).
43. For example, the United Kingdom has three financial services regulators: the Prudential Regulatory Authority (PRA), an agency within the Bank of England that serves as the prudential regulator for banks, insurers, and other large financial institutions; the Financial Conduct Authority (FCA), which regulates financial institutions' conduct to protect customers; and the new Payment System's Regulator (PSR), which regulates the conduct of payment systems participants.
44. Congressional Research Service, "Who Regulates Whom and How? An Overview of U.S. Financial Regulatory Policy for Banking and Securities Markets," p. 2, January 30, 2015, www.fas.org/sgp/crs/misc/R43087.pdf.
45. For example, the Government Accountability Office has found that the fragmentation and complexity of the US financial regulatory regime "does not always ensure (1) efficient and effective oversight, (2) consistent financial

For example, the Federal Reserve Bank of Boston has identified eight federal regulators that may have authority over mobile payments, depending on the details of a particular transaction, in addition to possible state-level regulatory jurisdiction—and no single regulator serves as the lead regulator for the market.[46]

Like multileveled regulation, multiple overlapping regulators can affect the regulation of a market in significant ways. Having multiple regulators at a single level of government may provide for competition and experimentation among these regulators, as well as transparency and increased opportunities for democratic engagement, but it may also create confusion, frustrate regulatory innovation, shackle market participants with inefficient processes, and lead to forum shopping.

Advantages of Multiple Regulators

- **Competition among regulators:** Regulators have incentives to compete to be the most efficient and effective at regulating a market. This is particularly true in cases where the regulated entities have some choice as to their regulator (such as bank chartering regulators), yet even in cases where market participants have no choice, regulators want to avoid the political costs of a reputation for inefficiency. These incentives can lead regulators to try new and innovative processes.

- **Transparency:** Multiple regulators operating in a market may allow for greater transparency by exposing disagreements about the regulatory process and philosophies that might otherwise have been submerged within a unitary regulator. This transparency can help voters and policymakers evaluate policies, and regulators can adapt them if necessary.

- **Broader democratic engagement:** There is a persistent concern that regulators may become captured by the industry they regulate, either consciously or inadvertently, since they frequently have had similar experiences, education, and culture to the industry they regulate. The capture may lead to policy choices, including a refusal to act, that benefits the industry over the public. Having multiple regulators with control over a market may mitigate the risk of capture and could allow elements of the public who lack appropriate influence with one regulator to be heard by another.

  An arguable example of this is the DOL's fiduciary duty rule for financial advisors. Section 913 of the Dodd-Frank Act tasked the SEC with studying whether the legal standard of care applicable to broker-dealers and investment advisors was appropriate, but it did not require that the SEC change the standard.[47] While the SEC refused to change the standard, the DOL, which has

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oversight, and (3) consistent consumer protections. As a result, negative effects of fragmented and overlapping authorities persist throughout the system" Government Accountability Office. *Complex and Fragmented Structure Could Be Streamlined to Improve Effectiveness*, GAO-16-175, February 2016, executive summary, http://www.gao.gov/assets/680/675400.pdf.

46. Federal Reserve Bank of Boston, "Evolving Mobile Payments Landscape: An MPIW Update," December 4, 2013, slide 19, www.bostonfed.org/bankinfo/payment-strategies/presentations/2013/pandy12-04-2013.pdf; see also Pew Charitable Trusts, "Mobile Payments: Regulatory gaps, ambiguities, and overlap," issue brief, finding that the regulatory environment for mobile payments is fractured and inconsistent. www.pewtrusts.org/en/research-and-analysis/issue-briefs/2016/02/mobile-payments.

47. Public Law No. 111-513, § 913 (2010).

authority over retirement accounts governed by the Employee Retirement Income Security Act (ERISA), proposed changing the standard for advisers to those accounts, making them a fiduciary. While this change is broadly opposed by the financial services industry, it is supported by investor advocates who feel that the SEC has been dilatory in acting in the public's interest.

Disadvantages of Multiple Regulators

- **Inconsistent philosophy or methods:** Varying levels of expertise, regulatory philosophies, and preferred methods among regulators may lead to inconsistent or suboptimal outcomes. Regulators tasked with overseeing a specific industry (e.g., the SEC) may develop a nuanced understanding of the market that is not shared by regulators who interact with the market in a more limited or infrequent manner. Likewise, regulators may view their roles and responsibilities in different ways and set different priorities to consumer protection, structural concerns, and access to services.[48] Finally, different regulators may use different methods, such as rulemaking vs. regulation by enforcement action. This inconsistency can create discrepancies in how market participants are regulated.

- **Uncertainty:** One major potential downside to the fragmentation of regulatory responsibility is uncertainty. This uncertainty can affect market participants by making it harder for them to know exactly who their regulators are or which one (if any) has the final word. This problem can be particularly acute in cases in which multiple regulators have concurrent jurisdiction and different interpretations of the rules. Additionally, smaller, younger, and less sophisticated companies may be least able to cope with identifying and working with multiple regulators.

  Likewise, multiple regulators may create uncertainty as to which agency has responsibility and accountability for monitoring certain markets and behaviors, leading to gaps, loopholes, and struggles for turf. As former Federal Reserve Chairman Paul Volker noted in the context of the implementation of Dodd-Frank, the number of regulatory agencies at the federal level "is a recipe for indecision, neglect, and stalemate, adding up to ineffectiveness."[49]

- **Control by the most restrictive regulator:** While multiple regulators may lead to competition, it may also lead to stagnation as market participants would need to comply with the most restrictive regulator or risk an enforcement action. This would prevent market participants from having a "one-stop shop" for compliance and can negate some of the value provided by pro-innovation regulatory tools like no-action letters because the letter only applies to the agency that granted it.

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48. Adam J. Levitin, *The Consumer Financial Protection Bureau: An Introduction* (April 26, 2013). Georgetown Law and Economics Research Paper (forthcoming); see also *Review of Banking and Financial Law*, Vol. 32, pp. 321−369, 330 2013; Georgetown Public Law Research Paper No. 13-006. Available at: http://ssrn.com/abstract=2199678 or http://dx.doi.org/10.2139/ssrn.2199678 (arguing that prudential bank regulators prioritized the safety and stability of the banking system over consumer protection).
49. Liz Moyer, "Volcker: U.S. Should Have Fewer Financial Regulatory Agencies," *Wall Street Journal* "MoneyBeat" blog, May 29, 2013, available at: http://blogs.wsj.com/moneybeat/2013/05/29/volcker-u-s-should-have-fewer-financial-regulatory-agencies/?mod=wsj_nview_latest.

- **Lack of specialization and ill-suited processes:** While there is a risk that regulators may become captured by their industries, there is also the benefit that regulators can develop specialized expertise and build processes that better match the legitimate needs of the market they regulate. Other regulators who may have a more tangential relationship to the market may lack that expertise and process, creating needless inefficiencies. These efficiencies can be especially damaging for newer or smaller companies that may lack the resources or existing streams of revenue to weather the delay.

- **Forum shopping:** A framework of multiple regulators may provide more avenues of democratic engagement, but it may also allow for forum shopping as activists frustrated by a failure to achieve a policy goal with the primary regulator seek to influence a market through a secondary regulator. This can lead to inconsistent or suboptimal regulation if the primary regulator's initial decision was correct or if the secondary regulator has incomplete jurisdiction or insufficient expertise. It may also result in a regulator taking action that was not contemplated or supported by the legislature when it drafted the enabling legislation.

  The DOL's fiduciary duty rule arguably represents this dynamic. Brokers and dealers who sell securities to investors in discreet transactions were required to have a reasonable basis to believe a security they recommend for purchase is suitable for the potential buyer.[50] Registered Investment Advisors (RIAs), who advise clients and manage their assets on an ongoing basis, are required to avoid potential conflicts of interest and act in the best interests of their clients.[51] The SEC has authority over both broker-dealers and RIAs as members of the securities market, but the DOL has overlapping authority with regard to certain employer-sponsored retirement accounts serviced by both broker-dealers and RIAs.

  While the Dodd-Frank Act directed the SEC to conduct a study to evaluate the obligations of brokers, dealers, and investment advisers, it did not direct the SEC to change the standard or contemplate that DOL would make a change pursuant to its own authority under ERISA.[52]

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50. Financial Industry Regulatory Authority (FINRA) Recommendations.
http://finra.complinet.com/en/display/display_viewall.html?rbid=2403&element_id=9859&print=1.

51. *Regulation of Investment Advisers by the U.S. Securities and Exchange Commission*, staff of the Investment Adviser Regulation Office, Division of Investment Management, US Securities and Exchange Commission, March 2013, p. 22, www.sec.gov/about/offices/oia/oia_investman/rplaze-042012.pdf.

52. For example, the following exchange occurred between Rep. David Scott (D-Ga.) and SEC Chair Mary Jo White at a House Financial Services Hearing on Nov. 18, 2015:

SCOTT: Thank you very much over here, Chairlady. Chairlady, are you aware, when we wrote Dodd-Frank, that in Section 913, we gave exclusive responsibility to the Securities and Exchange Commission if there came a time when we needed to—to put together a best-interest standard for the fiduciary? You're aware of that, aren't you?

WHITE: I— I'm certainly aware that 913 gives the SEC authority to proceed. Doesn't mandate it. Yes.

SCOTT: Well, let me ask you this: why are you allowing the Labor Department to take over your territory that we put in Dodd- Frank, that was approved by the House, approved by the Senate, and signed by the president of the United States?

WHITE: Well, I—I don't view it—and I've heard the comments before—I don't view it that way. I mean, I think that—again, we are separate agencies. They do have responsibility in the—and statutory authority in the ERISA space. I mean, even as we sit here...

SCOTT: Let me...

WHITE: ... sit here now, you know, brokers have to comply, if they're in the ERISA space, with the

Frustration with SEC inaction led to lobbying for the DOL to act where it could, but this created an inconsistent standard. Additionally, the SEC will likely move forward with its own fiduciary duty rule, potentially further complicating the process.[53] A fiduciary standard may or may not be appropriate, but the inconsistency and confusion are likely harmful to innovation and access.

Recommendations

Who regulates an industry can be as important as what the regulation is or how it is put together. As such, it behooves legislatures, regulators, and market actors to structure regulation so that it is undertaken by the regulator (or regulators) that can best maximize the benefits of it, while minimizing the costs. Unfortunately, the answer is rarely obvious and will vary according to the unique needs of the market. It will also change as innovation occurs, and will often depend on weighing competing values. Given the diversity and scope of FinTech's impact, this section contains general recommendations to be considered when crafting regulatory structures and regulations, and in considering how rules should be enforced.

Legislatures

(1) Legislators should understand that government regulation is not always necessary—it is a powerful tool but can be costly, cumbersome, and slow to adapt. If other actors, such as market competitors, are able to sufficiently police market participants, government action may not be called for.

 (a) If government regulation is necessary, try to structure it in a way that best harnesses the other actors. They can help you leverage their strengths and avoid duplicative or burdensome regulation.

 (b) Where possible, regulations that assign liability, rather than stipulate how a process is done, may provide the correct incentives to market participants to minimize risks to consumers, without subjecting innovation to the relatively slow and inefficient government regulatory process.

 (c) Self-regulatory organizations can be quicker to respond to emerging issues in a market, but they must be policed to prevent them from becoming tools of incumbents against competition or innovation.

 (d) Consider whether regulation is preventing entry to new competitors who could improve service for consumers. It is possible that some consumer-protection regulations are

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Department of Labor rules and ours.
SCOTT: Let me respond to that, please. I was here. I helped write Section 913. There was a reason
why the Securities and Exchange Commission came to set and let us do this—because they were the regulatory agency. Now, you mention ERISA. Not once—not one time—did the Labor Department come over and said, "Hold on, let us handle the retirement." No. There was no discussion of that. That is just happening now. …

53. *Investment News*. "SEC's Mary Jo White says agency will develop fiduciary rule for brokers," May 17, 2015. www.investmentnews.com/article/20150317/FREE/150319919/secs-mary-jo-white-says-agency-will-develop-fiduciary-rule-for.

counterproductive, and that consumers would be better served by having more options, instead of having choices limited by regulation.

(2) Where they have the appropriate constitutional authority, federal regulators should consider whether markets have evolved sufficiently that the current divisions of regulation between states and the national government, or between national law and international treaty, are no longer optimal. While each circumstance will be different, the following list offers some criteria to consider:

   (a) Is the current division of regulatory responsibility preventing beneficial transactions from being completed or undertaken?

   (b) Are people being de facto regulated by rules they had no representation in creating?

   (c) Are market participants resorting to economic fictions to move from one regulatory regime to another in order to pursue regulatory consistency?

   (d) Is there an unjustified difference in regulation between two types of competitors based on regulatory status?

   (e) Would nationalizing regulation deprive consumers of appropriate protections at the state level?

   (f) Would nationalizing regulation prevent beneficial experimentation among state regulators?

   (g) Can regulatory jurisdiction be split between state and federal regulators in a way that avoids unnecessary or burdensome duplication?

   (h) Can state harmonization be effectively encouraged, and could it realistically address any problems created by inconsistency?

   (i) Will allowing for a regulation export regime provide necessary consistency, or would it create an inappropriate weakening of regulation?

   (j) Will permitting state regulators to add to regulations, or to create their own unique interpretations of federal laws and rules, allow for appropriate tailoring to meet local needs, or will it prevent consistency and foster protectionism?

(3) If an evaluation of the relevant factors indicates that the current allocation of responsibilities creates an undue burden, and the legislature is constitutionally empowered to act, the legislature should consider a clear and transparent reallocation of authority. This could include:

   (a) *Full federal preemption:* in cases where the economic reality of the market is truly interstate, and where state-level regulation leads to distortions, unjustified inefficiency, inconsistent regulation of competitors based on charter status, or de facto regulation of people under rules they had no representation in creating.

For example, online lenders are regulated at the state level or utilize a bank partnership model to take advantage of the federal interest rate export provisions that banks enjoy. Given the interstate nature of online lending and the inconsistencies and artificialities of the current model, a federal charter may be more appropriate.

(b) *The use of export regimes:* for matters where state competition and experimentation are valuable but where consistency of rules is necessary for efficient and inclusive markets, or where protectionism thrives under the guise of legitimate regulatory concern. However, this should be monitored to prevent an unduly harmful race to the bottom.

(c) *The judicious use of local authority:* to adapt general requirements while limiting the use of "gold-plating" to erect barriers to external competition.

(4) However, while reallocation of authority may be appropriate, legislatures should also resist the temptation to impose "one size fits all" rules in cases where the effects of regulation are really limited to the jurisdiction that creates the regulation. This will avoid unnecessary costs, inapt regulation, and dilution of representation.

(5) Likewise, legislatures should consider whether the division of responsibilities between regulators is unnecessarily hampering growth, innovation, and access in a market. While the creation or removal of regulatory agencies, or the changing of jurisdiction, is a politically difficult action, it can be justified and should be considered when the regulatory structure becomes an undue impediment to innovation and market function.

Additionally, legislatures may want to create structures that require formal coordination between regulators in cases where such coordination would help market participants. For example, legislatures may consider:

(a) Rationalizing the regulatory structure to create fewer regulators with clear and distinct jurisdictions.

(b) Designating a primary regulator for particular industries or activities, with clearly delineated powers, whose regulations supersede those of other regulators. This can prevent conflict or prevent the most conservative regulator having a de facto veto.[54]

While a primary regulator could provide consistency and clarity, it would also have to be monitored to avoid regulatory capture that results in suboptimal regulation.

(c) Creating formal mechanisms to force regulators to coordinate in the creation and application of regulations to prevent inconsistency or uncertainty.

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54. The Dodd-Frank Act transfers consumer financial protection functions from many, but not all, financial regulators to the CFPB (12 USC §5581). However, there are still overlaps between the CFPB with its focus on consumer protection, and other regulators responsible for overseeing markets that may result in confusion or inconsistent government action.

i. For example, the Dodd-Frank Act requires the CFPB and FTC to coordinate on rulemaking[55] and enter into an agreement regarding enforcement efforts.[56]

ii. A no-action letter clearinghouse—where market participants request no-action relief from their primary regulator and the request is circulated for coordination with other regulators who can engage with the market participant and sign off on the letter—could help provide regulatory certainty.

Regulatory Agencies

(1) While legislatures have more power to create or modify structures de novo*,* regulatory agencies may have some ability to create a regulatory structure that addresses the potential pitfalls of who regulates. In some cases, this may be formal and derived from regulator's enabling legislation; in others it may be informal and consensus driven. Regulators should consider the following options when assessing regulation:

(a) If the federal regulator has the appropriate authority, consider preempting state regulations where it is necessary and appropriate to do so to remove undue barriers, inconsistencies, and distortions.

(b) Seek regulatory harmony among different regulators to the greatest extent possible, including compromising in cases where compromise both provides sufficient protection and is necessary for greater consistency and clarity.

(c) Resist creating a regulatory split within a market unless such a split is unavoidable to further an essential policy goal.

(2) Regulators in a multiple-regulator environment should act to avoid creating unnecessary confusion or delay, including:

(a) Working with fellow regulators to coordinate rulemakings, guidance, and enforcement actions to provide as much consistency and transparency as possible.

(b) Developing adequate processes to address the needs of market participants given the economic reality they operate in, even if they are not the primary regulator for a market.

(3) Regulators should also be mindful of their relationships with the entities they regulate, including both SROs and market participants, including:

(a) Leveraging SROs and market participants where possible and appropriate to provide appropriate regulation of market actors, but monitoring the SROs to prevent capture by incumbents.

55. 12 USC §5514(a)(2).
56. 12 USC §5514(c)(3).

(b) Clearly communicating the scope and limitations of the regulator's authority to market participants so they can avoid being blindsided by unexpected regulators.

(c) Engaging with stakeholders on an ongoing basis to better understand the impact of the regulatory structure on them, even if there isn't a relevant rulemaking ongoing.

Private Regulators

Private regulators (SROs and market participants) may have the most limited ability to change the regulatory structure directly, but that does not mean that their actions do not impact who regulates their industries. First, they themselves regulate their industries through formal and informal means. Second, the real and perceived consequences of their regulation (or lack thereof) can impact legislatures, regulators, and the voters who influence government regulators via elections. Finally, they can directly influence government regulators by educating them on the effects of regulatory structure. As such, private regulators should consider the following to help create a durable regulatory environment that encourages innovation and competition while also providing certainty.

(1) Market participants should effectively self-police. Internal policing, whether via SROs, contractual relationships, or competition, is vital to the continued viability of private regulation. If government regulators, customers, or voters perceive that the market has become predatory, or that its participants are unable or unwilling to appropriately protect customers, there will be increased pressure for formal governmental regulation. This could result in regulations based on a limited understanding of market reality or overcorrection to reflect the politics of the moment.

(2) Market participants should also avoid regulating in a way that prevents competition and innovation, unless such regulation is absolutely necessary to accomplish an essential and legitimate regulatory function. While it may be tempting to try to erect regulatory moats around an industry, such efforts may ultimately prove self-defeating:

(a) These efforts may antagonize customers, creating political pressure that could result in adverse regulation and deplete customer goodwill that may be necessary when change does finally come.

(b) Regulatory protectionism may dull a company or industry's competitive edge and encourage overinvestment in the status quo, leaving companies less able to compete when technology or political pressure finally disrupt the market environment.

In conclusion, it is important to engage and educate legislators, regulators, and the public on the costs and benefits of "who" the regulator is, in addition to "how" regulation works. The impacts of regulatory structure are likely best understood by market participants and may be less obvious or intuitive to other stakeholders.

Education about why some arrangements may be better or worse than others is vital to help inform the debate and counter arguments that market participants are simply seeking a regulatory race to the bottom or, in the case of SROs, protecting their prerogatives and funding sources.

About the Author

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