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IN DEFENSE OF THE FREE-BANKING STABLECOINS

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Abstract

Stablecoins, a form of crypto-currencies, have come under increasing regulatory scrutiny. The justification for this arises by analogizing the stablecoins to banknotes issued in the early nineteenth century during a period known as the free-banking era. During that era, banks in many states were free to issue their own notes with little supervision. The results, according to the critics, were an unstable banking system that resulted in the federal government printing its own money. In this Article, we examine the history of that era looking at judicial decisions from that time. We conclude that the judiciary had no qualms about free-banking, and if anything, they had concerns about governments printing money. Using the lessons from that era we recommend a slow and steady approach to regulating stablecoins and suggest that any regulation should come at the state level. We speculate that the motivation for the regulatory scrutiny may have more to do with government revenues instead of the public interest.

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INTRODUCTION

This Article addresses the growing concerns relating to stablecoins and evaluates some of the proposals that are being discussed for their regulation, including by the President's Working Group on Financial Markets (PWGFM). Stablecoins, as will be explained below.[1] The concerns emanate from the idea that it is unclear if stablecoins are backed by any tangible assets, and as such can pose a threat to the economy. In expressing these concerns, critics of the stablecoins point to the nineteenth century when banks were free to issue their own notes and circulate them with little supervision and with disastrous results. The era was known as the free-banking era. The results of that era, the fear is, will manifest themselves again in the present, if stablecoins are not brought under regulatory supervision. Or so the critics claim. This Article provides another perspective on the debates surrounding stablecoins and their nineteenth century counterparts. We examine the jurisprudence that

1. See *infra* text accompanying note 48.

emanated from that era to see if the judiciary had any concerns regarding the concept of free-banking, or were the concerns placed elsewhere. We argue that the concerns, insofar they had any, were mostly with unbacked paper money issued by the states or sometimes the federal government. As such, much of the concerns brought today are misplaced. If anything, stablecoins should be left to evolve technically and institutionally before bringing them under any regulatory supervision.

Until recently, Bitcoin has been the most commonly discussed crypto-currency, but relative newcomers such as Dogecoin and Shiba Inu steal the spotlight every now and then.[2] Bitcoin, depending on whom one listens to, is either a worthless asset whose meteoric rise in price is nothing but a bubble that will burst soon,[3] or the future reserve currency of the world.[4] Regardless of the divergence in views, new forms of crypto-currencies have begun to take off in terms of market capitalization. Stablecoins, as they are known, are now valued at around

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2. Ryan Browne, *Dogecoin spikes 20% after Elon Musk says Tesla will accept it as payment for merch* (Dec. 14, 2021, 8:39 AM EST), available at https://www.cnbc.com/2021/12/14/dogecoin-price-surges-after-elon-musk-tweet-about-tesla-merch.html [https://perma.cc/GKA3-KU32]; Taylor Locke, *Shiba inu passes dogecoin in the top 10 cryptocurrencies—here's what drives their growth* (Nov. 1, 2021, 3:04 PM EDT), available at https://www.cnbc.com/2021/11/01/whats-driving-surge-in-meme-cryptocurrencies-shiba-inu-and-dogecoin.html [https://perma.cc/Z3JF-K288].

3. Richard Partington, *Bitcoin could become 'worthless', Bank of England warns* (Dec. 14, 2021, 18.18 GMT), available at https://www.theguardian.com/technology/2021/dec/14/bitcoin-could-become-worthless-bank-of-england-warns [https://perma.cc/WS8W-872N]; Theron Mohamed, *Mark Cuban compares the crypto boom to the dot-com bubble, defends Robinhood, and calls for stablecoin regulation in a new interview. Here are the 10 best quotes* (Oct. 22, 2021, 10:53 AM), available at https://markets.businessinsider.com/news/currencies/mark-cuban-crypto-internet-stock-bubble-robinhood-bitcoin-stablecoin-regulation-2021-10 [https://perma.cc/G9CC-SMZC] ("Crypto reminds me of 1995. It's not so much about all the tokens, and all the trading, and all the frenzy that's going around - that reminds me more of the dot-com stock market. What's interesting to me about crypto is the actual networking platforms themselves, and the ability to connect with smart contracts."; "You're seeing millions and millions of people investing in crypto, because it's far cheaper and simpler than investing in stocks. I don't think we fully understand the impact that crypto has had."); Carla Mozée, *Crypto is not a viable long-term form of private money and stablecoins are equivalent to poker chips at the casino, SEC chief says* (Sept. 21, 2021, 05:05 PM), available at https://markets.businessinsider.com/news/ currencies/sec-crypto-stablecoins-poker-chips-wild-west-sec-gary-gensler-2021-9 [https://perma.cc/3NF9-3SQT].

There are also those who believe that Bitcoin is an illegitimate financial system that poses a threat to national security. Eric Engle, *Is Bitcoin Rat Poison: Cryptocurrency, Crime, and Counterfeiting (CCC)*, 16 J. HIGH TECH. L. 340 (2016).

4. Muchael Schnell, *Rand Paul questioning if crypto could become world reserve currency* (Oct. 25, 2021, 1:03 PM EDT), available at https://thehill.com/homenews/senate/578303-rand-paul-questioning-if-cryptocurrency-could-become-world-reserve-currency [https://perma.cc/8DAX-2UF8] (quoting Senator Rand Paul as stating that "I've started to question now whether or not cryptocurrency could actually become the reserve currency of the world as more and more people lose confidence in government.").

$131 billion, which of course puts the market capitalization of Bitcoin ($1 trillion) seem like a distant horizon.[5] And yet, judging by the latest emanations from financial regulators, whether officially or informally permeating the financial press, it seems that stablecoins pose an existential threat to the stability of the financial system. A brief overview of the flurry of recent developments in the United States concerning the regulation of stablecoins illustrates the urgency and potential impact of stablecoins.

Around the end of 2021, news stories began to cite unnamed sources reporting that "the US Treasury Department and other government agencies [were] expected to publish a report . . . explaining the SEC's authority over stablecoins and urging Congress to pass bills that regulate certain coins similarly to bank deposits."[6] A little while after these stories appeared, the President's Working Group on Financial Markets (PWGFM), along with the Federal Deposit Insurance Corporation (FDIC) and the Office of the Comptroller of the Currency, issued a report on stablecoins, recommending that legislation and regulatory oversight be brought over these digital currencies.[7] A few weeks later, the House of Representatives held a hearing on stablecoins, thereby signaling that Congress, either by explicit action or tacit approval of any action by the SEC, wanted some regulatory oversight of stablecoins. One member of

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5. Camomile Shumba, The founder of DeFi network avalanche says success for crypto will be bitcoin losing its crown to a stablecoin (Oct. 23, 2021, 08:00 AM), available at https://markets.businessinsider.com/news/currencies/avalanche-avax-emin-guen-sirer-founder-bitcoin-stablecoin-tether-usdc-2021-10 [https://perma.cc/KV7Q-ETY5].

6. Jacquelyn Melinek & Liz Coyne, US SEC Set to Crack Down on Stablecoins in New Report (Oct. 25, 2021), available at https://blockworks.co/us-sec-set-to-crack-down-on-stablecoins-in-new-report/ [https://perma.cc/A9MH-FP8Y]. See also Shalini Nagarajan, The SEC is likely to get the green light to target stablecoins this week, report says (Oct. 26, 2021, 06:52 AM), available at https://markets.businessinsider.com/news/currencies/sec-stablecoin-regulation-gary-gensler-biden-crypto-rules-treasury-cftc-2021-10 [https://perma.cc/3WH3-4QPG].

The Chair of the SEC has also been sounding the alarm over cryptocurrencies, generally, even prior to his confirmation. Brian Cheung , Biden's SEC pick: Some crypto markets 'rife with fraud and scams (Mar. 2, 2021, 12:54 PM), available at https://finance.yahoo.com/news/gensler-cryptocurrencies-rife-with-fraud-and-scams-in-some-markets-195434133.html [https://perma.cc/TYT8-AMPM]. His tone post-confirmation hasn't changed. Chris Matthews, Crypto exchanges 'thought they could throw a fastball' by the SEC, but enforcement is coming, Chairs Gensler, Clayton warn: Gensler asks exchanges to collaborate with federal regulators (updated Dec. 1, 2021, 1:02 PM EST), available at https://www.marketwatch.com/story/crypto-exchanges-thought-they-could-throw-a-fastball-by-the-sec-but-enforcement-is-coming-chairs-gensler-clayton-warn-11638380694 [https://perma.cc/5CHD-QYPH].

7. President's Working Group on Financial Markets, the Federal Deposit Insurance Corporation and the Office of the Comptroller of the Currency, Report on Stablecoins (Nov. 2021), available at https://home.treasury.gov/system/files/136/StableCoinReport_Nov1_508.pdf [https://perma.cc/XH8G-2NRP].

Congress, who has previously called for a ban on crypto-currencies,[8] continued to express his skepticism of all digital currencies, stable or otherwise, by stating that: "The number one threat to cryptocurrency is crypto. Bitcoin could be displaced by Ether, which could be displaced by DOGE, which could be displaced by HamsterCoin. And there's CobraCoin, what could MongooseCoin do to CryptoCoin?"[9]

Some regulators are so threatened by the emergence of stablecoins, that they are now looking at issuing their own digital currencies.[10] For instance, in January 2022 the Federal Reserve issued its own report on stablecoins.[11] The Federal Reserve's report addressed several concerns regarding the new coins, including the question of whether the Reserve should issue its own digital dollar.[12] Internationally, the hostility to crypto-currencies, generally, and stablecoins specifically, is no different.[13] Indeed, similar discussions surrounding digital currencies

8. Victor Tangermann, This Congressman Wants to Make All Cryptocurrency Illegal: Should Cryptocurrency Be Outlawed? This Congressman Thinks So (May 10, 2019), available at https://futurism.com/the-byte/congressman-sherman-cryptocurrency-illegal [https://perma.cc/98XA-S2GK]; Marie Huillet, US Rep Sherman Calls for Crypto Ban, Says It Threatens to Diminish American Power: U.S. Congressman Brad Sherman has called on colleagues to outlaw cryptocurrencies (May 10, 2019), available at https://cointelegraph.com/news/us-rep-sherman-calls-for-crypto-ban-says-it-threatens-to-diminish-american-power [https://perma.cc/J2VY-DNKJ].

9. Within hours, Mongoose Coin was created as a reaction to his statement. Connor Sephton, Mongoose Coin Now Exists After Politician Makes It Up (Dec. 11, 2021), available at https://coinmarketcap.com/alexandria/article/mongoose-coin-created-after-congressman-s-joke [https://perma.cc/VS43-D6CV].

10. Charles d'Haussy, What CBDCs Mean for the Future of DeFi and Stablecoins: Central bank-issued digital currencies are an existential threat to permissionless stablecoins and finance. (Oct. 24, 2021, at 6:00 AM MDT; updated Oct. 25, 2021, at 8:34 AM MDT), available at https://www.coindesk.com/policy/2021/10/24/what-cbdcs-mean-for-the-future-of-defi-and-stablecoins/ [https://perma.cc/R8ZX-G3UY]; Andrew Ackerman, Stablecoins in Spotlight as U.S. Begins to Lay Ground for Rules on Cryptocurrencies: Sponsors say stablecoins are safe, but regulators are concerned about potential risks to financial stability (Sept. 25, 2021, 5:30 AM EST), available https://www.wsj.com/articles/stablecoins-in-spotlight-as-u-s-begins-to-lay-ground-for-rules-on-cryptocurrencies-11632562202 [https://perma.cc/9ZY7-EYUX].

11. FEDERAL RESERVE, MONEY AND PAYMENTS: THE U.S. DOLLAR IN THE AGE OF DIGITAL TRANSFORMATION (Jan. 2022), available at https://www.federalreserve.gov/publications/files/money-and-payments-20220120.pdf [https://perma.cc/9DJ2-62DL].

12. The Federal Reserve has an online questionnaire asking the public on their views on the question. https://www.federalreserve.gov/apps/forms/cbdc [https://perma.cc/5SED-R76R]. The Federal Reserve of Boston along with researchers are MIT also released a working paper outlining the results of their research on the question. The Federal Reserve Bank of Boston and Massachusetts Institute of Technology release technological research on a central bank digital currency (Feb. 3, 2022), available at https://www.bostonfed.org/news-and-events/press-releases/2022/frbb-and-mit-open-cbdc-phase-one.aspx [https://perma.cc/LP5Y-3S5L].

13. Nigeria, for example, initially clamped down on Bitcoin, only to see its popularity rise and ultimately the government backed off. Emmanuel Akinwotu, Out of control and rising: why bitcoin has Nigeria's government in a panic, The Guardian (July 31 2021), available at https://www.theguardian.com/technology/2021/jul/31/out-of-control-and-rising-why-bitcoin-has

have taken place around the world as countries are increasingly considering whether to eliminate cash altogether and replace it with digital currencies. With the advent of the Winter Olympics, for example, China unveiled its own digital currency, which seems to be a hit or a dud depending, again, on whom one listens to.[14]

-nigerias-government-in-a-panic [https://perma.cc/J8QY-C2VA]; Shinonbi, As It Embraces Bitcoin, Nigeria offers Developing Lessons To The Developing World (Jan. 28, 2022), available at https://bitcoinmagazine.com/culture/lessons-from-nigeria-bitcoin-adoption [https://perma.cc/W4NY-9PDC]. China also cracked down on Bitcoin mining and transactions only to see the mining move to Thailand, which has benefitted from the influx. Vijitra Duangdee, China's crackdown on cryptocurrencies is fueling a crypto-mining cottage industry in Thailand (Dec. 29, 2021), available at https://www.aljazeera.com/economy/2021/12/29/chinas-crypto-crackdown-sparks-thai-crypto-mining-boom [https://perma.cc/8ERX-QDBN]. India also had originally wanted to ban crypto-currencies, only to back off and examine how to issue its own digital currencies. Jeanette Rodrigues, Suvashree Ghosh, & Bloomberg, Now that India has pulled back from banning crypto, here's how it plans to develop digital currency on its own terms (Feb. 2, 2022, 4:42 AM MST), available at https://fortune.com/2022/02/02/india-crypto-ban-plans-develop-digital-currency-taxes-regulation-bitcoin/ [https://perma.cc/TK5Q-MDFL]. Kazakhstan wants to tax Bitcoin miners as a way to keep electricity prices manageable for the rest of the population and has floated the idea of "into increasing the tax on electricity for cryptocurrency miners from one tenge to five tenge (USD $0.0023 to $0.012)." Kollen Post, Kazakhstan floats 500% tax increase on Bitcoin miners, leading some to eye relocation (Feb. 7, 2022, 5:16 PM EST), available at https://www.theblockcrypto.com/post/133366/kazakhstan-floats-500-tax-increase-on-bitcoin-miners-leading-some-to-eye-relocation [https://perma.cc/N6YU-GE7N].

Of course, some countries like El Salvador not only adopted Bitcoin as legal tender but also have president who actively trades in Bitcoin. This has led the International Monetary Fund (IMF) to pressure El Salvador to rescind the legal tender status or lose access to IMF assistance. Zachary Snowdon Smith, El Salvador Buys $15 Million Worth Of Bitcoin 'Really Cheap,' President Crows, As Selloff Continues (Jan. 21, 2022, 08:51 PM EST), available at https://www.forbes.com/sites/zacharysmith/2022/01/21/el-salvador-buys-15-million-worth-of-bitcoin-really-cheap-president-crows-as-selloff-continues/?sh=c91c07760ed6 [https://perma.cc/4D2P-Z9EQ]; IMF urges El Salvador to remove Bitcoin as legal tender (Jan. 26), available at https://www.bbc.com/news/world-latin-america-60135552 [https://perma.cc/H3RF-8SSM]. The IMF has been launching attacks on crypto-assets for quite a while now. See Tobias Adrian & Rhoda Weeks-Brown, Cryptoassets as National Currency? A Step Too Far (July 26, 2021), available at https://blogs.imf.org/2021/07/26/cryptoassets-as-national-currency-a-step-too-far/ [https://perma.cc/5KW3-9L2T]. Now the IMF is touting digital central bank currencies as alternatives to stablecoins. Cheyenne Ligon, IMF Chief Touts Advantages of CBDCs Over 'Unbacked Crypto Assets' and Stablecoins: Kristalina Georgieva said Wednesday that well-designed CBDCs "can potentially offer more resilience, more safety, greater availability and lower costs" than private cryptocurrencies (Feb. 9, 2022, 9:12 AM MST), available at https://www.coindesk.com/policy/2022/02/09/imf-chief-touts-advantages-of-cbdcs-over-unbacked-crypto-assets-and-stablecoins/ [https://perma.cc/E3HA-MN97]. Palau is another country that has embraced crypto-currencies, specifically Ripple. Michelle Lim, Palau partners Ripple on national stablecoinusing XRP Ledger (Nov. 24, 2021), available at https://forkast.news/ headlines/palau-partners-ripple-stablecoin-xrp-ledger/ [https://perma.cc/C643-7DE3].

14. Emily Parker, China's digital yuan shows why we still need cryptocurrencies like bitcoin (updated 2:09 PM EST, Feb. 4, 2022), available at https://www.cnn.com/2022/02/04/perspectives/china-digital-yuan-cryptocurrency-bitcoin/index.html [https://perma.cc/Z2XR-H6X9].

Other regulatory actions have come in the form of regulatory prosecutions, such as the one launched by the New York Attorney General (NYAG). Letitia James launched a lawsuit against the stablecoin platform, Tether, fining it and banishing it from the Empire State.[15] Her actions created a barrage of stories and further regulatory actions against Tether.[16] The NYAG and other critics' concerns are that Tether claims to be issuing digital currencies that are backed by actual real-world currencies, mostly the U.S. dollar, where in reality, according to the critics, Tether's currencies are backed by very little.[17] The broad concerns stem from a view among regulators that stablecoins pose a threat to the monetary and financial system of the United States and for that matter the world.[18] Concerns are not limited to stablecoins, as there are ongoing regulatory and legal challenges to other crypto-currencies as well.

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15. NY Attorney General Press Release, Attorney General James Ends Virtual Currency Trading Platform Bitfinex's Illegal Activities in New York (Feb. 23, 2021), available at https://ag.ny.gov/press-release/2021/attorney-general-james-ends-virtual-currency-trading-platform-bitfinexs-illegal [https://perma.cc/K4FX-JRXG].

16. See section III *infra* where the NYAG's action against Tether is discussed in detail.

17. Gillian Tett, Stablecoin investors may be due a wake-up call: The critical attention being paid to companies such as Tether is a welcome development (Oct. 14, 2021), available at https://www.ft.com/content/b729cf08-6beb-4d75-b19e-779d2d3a14ce [https://perma.cc/FTJ3-WR6F] (discussing the various concerns regarding Tether and other stablecoins' reserves); Victoria Guida, Federal Reserve fear 'stablecoins' could disrupt financial system: New attention on so-called stablecoins is setting up a clash between the emerging crypto industry and financial regulators (Sept. 20, 2021, 6:54 PM), available at https://www.politico.com/news/2021/09/20/stablecoin-cryptocurrency-regulation-513209 [https://perma.cc/PF55-XNW8]; Stablecoins Could Pose New Short-Term Credit Market Risks (July 1, 2021, 4:15 AM EST) available at https://www.fitchratings.com/research/fund-asset-managers/stablecoins-could-pose-new-short-term-credit-market-risks-01-07-2021 [https://perma.cc/7VY7-PRLX]; Jesse Hamilton & Saleha Mohsin, Stablecoins Face Crackdown as U.S. Discusses Risk Council Review (Sept. 10, 2021, 6:04 PM MDT), available at https://www.bloomberg.com/news/articles/2021-09-11/stablecoins-face-crackdown-as-u-s-discusses-risk-council-review [https://perma.cc/JHF3-D8E9]; Joe Light & Jesse Hamilton, Yellen to Convene U.S. Regulators to Discuss Stablecoins (July 16, 2021, 10:00 AM MDT), available at https://www.bloomberg.com/news/articles/2021-07-16/yellen-to-convene-u-s-regulators-to-discuss-stablecoin-rules [https://perma.cc/4NR6-QAPP]. Ethan Wu, Federal Reserve Chair Jerome Powell says cryptocurrencies are a 'failed' payment mechanism and stablecoins need to be regulated (July 15, 2021, 2:21 PM), available at https://www.businessinsider.in/cryptocurrency/news/fed-chair-jerome-powell-says-cryptocurrencies-are-a-failed-payment-mechanism-and-stablecoins-need-to-be-regulated/articleshow/84454305.cms [https://perma.cc/LE33-AW 45]; Christy Bieber, U.S. Treasury Rushing to Regulate Crypto Markets (Oct. 11, 2021, 9:00 AM EDT), available at https://www.nasdaq.com/articles/u.s.-treasury-rushing-to-regulate-crypto-markets-2021-10-11 [https://perma.cc/VFD9-M5DG]; Michelle Price, *Explainer-How U.S. regulators are cracking down on cryptocurrencies*, REUTERS (Sept. 24, 2021).

18. Tobias Adrian & Rhoda Weeks-Brown, Cryptoassets as National Currency? A Step Too Far (July 26, 2021), available at https://blogs.imf.org/2021/07/26/cryptoassets-as-national-currency-a-step-too-far [https://perma.cc/VF6L-FBKT]/.

The most notable in terms of the size of its target is the SEC's lawsuits against Ripple accusing the platform of raising "over $1.3 billion through an unregistered, ongoing digital asset securities offering."[19] Ripple, a relatively late comer to the cryptocurrency world when considering the standard bearer crypto-currencies Bitcoin and Ethereum, seems to have attracted the regulatory attention of the SEC, while both Bitcoin and Ethereum have escaped its scrutiny.[20]

This Article makes an original contribution to the discussion around the future of stablecoins by examining an untapped yet important source of guidance—early nineteenth century jurisprudence in cases involving banking activities. In this era, sometimes known as the free-banking era, banks were allowed to issue their own notes backed by specie such as gold or silver. Rather than regulatory bodies such as the Federal Reserve and the SEC, the courts were the ones overseeing banks' activities in this regard. By examining cases involving customers who lost money due to the failure of the bank whose notes they held, we see that the judicial attitude at the time—unlike today's regulatory attitude—was not one of hostility to banks being allowed to issue their own notes. If anything, every now and then we see judicial disapproval of states allowing paper money to become the standard currency. This judicial disapproval culminated in a series of three U.S. Supreme Court cases known as the *Legal Tender Cases*.[21] Yet it was rare for a court to ever point the finger

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19. Press Release, SEC, SEC Charges Ripple and Two Executives with Conducting $1.3 Billion Unregistered Securities Offering (Dec. 22, 2020), https://www.sec.gov/news/press-release/2020-338 [https://perma.cc/Z54E-2WSV]. *See also* discussion *infra* Part II (discussing the SEC's lawsuit.).

20. William H. Hinman (Director, Division of Corporation Finance), *Digital Asset Transactions: When Howey Met Gary (Plastic): Remarks at the Yahoo Finance All Markets Summit: Crypto*, U.S. SEC. & EXCH. COMM'N (June 14, 2018), available at https://www.sec.gov/news/speech/speech-hinman-061418 [https://perma.cc/75MB-9A3S].

Sarah Tran, CFTC Commissioner clarifies Ethereum is non-security commodity, ending SEC ambiguity (Aug. 16, 2021), available at https://www.fxstreet.com/cryptocurrencies/news/cftc-commissioner-clarifies-ethereum-is-non-security-commodity-ending-sec-ambiguity-202108160433 [https://perma.cc/5CFP-94LP] (suggesting that for now Ethereum is under CFTC jurisdiction). *See also* Joanna Dreaver, *Consumer Point: Cryptocurrency is a Misnomer*, 40-AUG AM. BANKR. INST. J. 16 (2021) (arguing that Bitcoin and other crypto-currencies should be classified as commodities).

21. In *Hepburn v. Griswold*, 75 U.S. 603 (1870), the Supreme Court held that Congress could not make paper money unbacked by gold or silver legal tender. In other words, it could not force creditors to accept unbacked paper money as satisfaction for debts owed. A few years later, however, when the composition of the Court changed, the Court reversed itself. In *Knox v. Lee* & *Parker v Davis*, 79 U.S. 457 (1871), the Court held that Congress could issue unbacked paper money and declare it legal tender due to the necessity of war. A few years later, the Court held that even in peacetime, Congress could issue unbacked paper money as legal tender. Juilliard v. Greenman, 110 U.S. 421 (1884). Notwithstanding that license to print money, the United States returned to the gold standard, until the Great Depression, when President Roosevelt suspended and then removed the gold standard, with Congress's approval. This was upheld in two companion

at banks being allowed to issue their own notes. This Article adds to the vast existing literature in economic history that has already established that the free-banking era was not the wild-cat banking era that many today proclaim. We link this misperception of the free-banking era to the current intellectual attacks on stablecoins, which tend to warn of a return to the "bad old days of the free-banking wild-cat era."[22]

By examining jurisprudence from the free-banking era, we can also imagine what a future digital currency system might look like. For instance, not only were the various bank notes and other financial instruments circulating as currencies widely at that time, but they were also priced in a manner that shows that customers and bankers were aware of the risks these instruments posed. Applying this experience to today's crypto-world suggests, for instance, that a crypto-currency need not be characterized as "stable" to be accepted as a currency. It may be argued that a putative security such as Ripple's currency, XRP, can be a currency circulating in the crypto-sphere, even while it has the nominal appearance of a security. This Article concludes that the free-banking era teaches us that, while political forces may ultimately give rise to some regulatory oversight over stablecoins and other digital currencies, such oversight should come incrementally and cautiously. We are still in the early era of crypto-currencies, notwithstanding the remarkable and explosive growth in the industry. As such, hurried attempts to impose existing regulatory frameworks over new and innovative payments systems could be counter-productive. Rather, we argue that at this stage in the evolution of the crypto-sphere, regulations and enforcement activities should simply focus on traditional fraud.

This Article proceeds as follows. Part I will provide a basic introduction to crypto-currencies and stablecoins. Part II will discuss the various regulatory actions pending against Tether, a stablecoin, and Ripple, a digital currency not generally considered as a stablecoin. Part III will discuss some of the concerns that have been raised regarding stablecoin from a historic perspective. In Part IV, we use the discussion from Part III to derive lessons that could be applied to the regulation of stablecoins generally speaking, including what appear to be non-stablecoin crypto-currencies such as Ripple's XRP.

I. CRYPTO-CURRENCIES & STABLECOINS: A BASIC INTRODUCTION

Although the idea of electronic payment systems has been around for many decades now, the impetus behind crypto-currencies arose in the

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cases. Perry v United States, 294 U.S. 330 (1935); Norman v. Baltimore & O.R. Co., 294 U.S. 240 (1935). For a full discussion of these cases, see RICHARD H. TIMBERLAKE, CONSTITUTIONAL MONEY (2013).

22. *See infra* Part IV.

aftermath of the 2008 financial meltdown.[23] In the seminal white paper, Satoshi Nakamoto introduced the idea of a financial payment system that has no centralized bookkeeper.[24] Consider a simple transaction where Levi wants to send Eren $1,000, assuming that Levi banks at Bank A and Eren banks at Bank B. Bank B will not credit Eren's account until it knows that Levi's transfer is valid. This presents a database problem. Bank A has a database of its accounts and so does Bank B. However, Bank B does not have access to Bank A's database to verify whether Levi's account has enough money for the transfer to clear. The process of coming to a consensus over the status of accounts takes time. Bitcoin's solution to this issue (and the idea behind all blockchain databases today) was to create a single distributed database, also known as a distributed ledger, that is accessible to everyone and not controlled by any single entity.[25]

On the Bitcoin platform, for instance, consider the following example. Mikasa has 20 Bitcoins that she intends to send to Hange. Mikasa has a unique password called a "private key" that is assigned to a message. The message in effect declares "Mikasa wants to send 20 bitcoins to Hange." The signed message is sent to all the computers that run a copy of the updated database, also called the "Bitcoin Network."[26] Computers in the Bitcoin Network will confirm that Mikasa has 20 bitcoins (the unit of currency on the Bitcoin network) to send because they each have a copy of the current database or ledger. At this point, the transaction has only been proposed.[27] No computer has updated its copy of the ledger yet. Transactions are lined up awaiting their turn to be processed and verified.[28] To carry out the verification, the "bitcoin miners" in the network play their role.[29] Miners are computers all over the world, and their role is to take a batch of verified new transactions (known as blocks), such as Mikasa's, and "propose them for settlement."[30]

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23. PAUL VIGNA & MICHAEL J. CASEY, THE AGE OF CRYPTO CURRENCY: HOW BITCOIN AND DIGITAL MONEY ARE CHALLENGING THE GLOBAL ECONOMIC ORDER, 41–68 (2015) (discussing the precursors to Bitcoin and the development of cryptocurrencies).

24. Satoshi Nakamoto, *Bitcoin: A Peer-to-Peer Electronic Cash System*, BITCOIN.ORG (Oct. 31, 2008), available at https://bitcoin.org/bitcoin.pdf [https://perma.cc/KAV4-WX8Z]. For a good overview, see MATT HOUGAN AND DAVID LAWANT, CRYPTOASSETS: THE GUIDE TO BITCOIN, BLOCKCHAIN, AND CRYPTOCURRENCY FOR INVESTMENT PROFESSIONALS, 1–11 (2021), available at https://www.cfainstitute.org/-/media/documents/article/rf-brief/rfbr-cryptoassets.ashx [https://perma.cc/D5HP-U2SL]; ANTHONY LEWIS, THE BASICS OF BITCOINS AND BLOCKCHAINS AN INTRODUCTION TO CRYPTOCURRENCIES AND THE TECHNOLOGY THAT POWERS THEM (2018).

25. HOUGAN AND LAWANT, *supra* note 24.

26. *Id.* at 4.

27. *Id*.

28. *Id.*at 5.

29. *Id*.

30. *Id*.

The miners have to compete to "settle the next block."[31] The competition involves solving a challenging mathematical puzzle called a cryptographic puzzle.[32] The miner that finds the solution first is rewarded with newly minted bitcoins and possible transaction fees, which have been paid by the party who initiated the transaction. This reward serves as "proof-of-work"—it gives miners an incentive to perform the work necessary to verify transactions and maintain the database.[33] All network participants must reach a "consensus" before the new block of proposed transactions are accepted.[34] Once a consensus is reached, their ledgers are updated and synchronized.[35] However, the computational power needed to "mine" Bitcoin entails significant costs, including depreciation of computer equipment, electricity costs to run the computers, and the cost of cooling the heat generated by the computers.[36] This means that only a relatively small number of miners can be players on the Bitcoin platform, which defeats the objective of decentralization. As such, a new protocol, known as the "Proof-of-Stake" was developed to address these concerns.[37]

According to the "Proof-of-Stake" protocol, instead of miners, "validators" verify transactions and maintain the database of accounts. Validators are paid strictly in transactions fees, but they must have some stake in the system. Hence, validators must own tokens, or the digital currency of the platform, in order to be chosen to validate the blocks.[38] In other words, the odds of being the rewarded validator who creates the next block depends on how many tokens in the system the validator owns, and not who has the most expensive, i.e. fastest, equipment. Although Peercoin was the first crypto-currency to implement Proof-of-Stake,[39] Ethereum, which currently relies on Proof-of-work, is working on moving to a Proof-of-Stake consensus mechanism.[40]

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31. *Id*.

32. Amy Castor, *A (Short) Guide to Blockchain Consensus Protocols*, COINDESK, available at https://www.coindesk.com/markets/2017/03/04/a-short-guide-to-blockchain-consensus-protocols/ [https://perma.cc/977G-QNB3].

33. *Id.*; HOUGAN AND LAWANT, *supra* note 24, at 5.

34. Castor, *supra* note 32; HOUGAN AND LAWANT, *supra* note 24, at 5 (2021).

35. Castor, *supra* note 32; HOUGAN AND LAWANT, *supra* note 24, at 5. *See also* Hossein Nabilou, *Bitcoin Governance as a Decentralized Financial Market Infrastructure*, 4 STAN. J. BLOCKCHAIN L. & POL'Y 1 (2020–2021) (discussing the governance and operation of the Bitcoin system).

36. Shlomit Azgad-Tromer, *Crypto Securities: On the Risks of Investments in Blockchain-Based Assets and the Dilemmas of Securities Regulation*, 68 AM. U.L. REV. 69, 80 (2018).

37. Castor, *supra* note 32.

38. *Id.*

39. *Id*.

40. Paul Wackerow, *Proof-of-Stake (POS)*, ETHEREUM.ORG (Sept. 26, 2022), https://ethereum.org/en/developers/docs/consensus-mechanisms/pos/ [https://perma.cc/P9WR-3GS2].

Like Bitcoin, Ethereum is also a blockchain-based platform that has its own currency or token called Ether (or ether), but it also supports other digital assets.[41] The Ethereum network is considered the "world's most programable blockchain."[42] As discussed above, the idea behind Bitcoin was to replace traditional fiat money and day-to-day transactions. The idea behind Ethereum was to use its platform not only as a basic payment system, but also to enable more sophisticated transactions, known as "smart contracts," to be executed without a central third-party. Rather, these contracts would be verified using the same blockchain concepts that allow miners to verify transfers of currency.[43] The Ethereum platform allows users of smart contracts to transact using complex processes, which condition the completion of one transaction on the verifiable performance of another transaction in return.[44] This feature allows parties who conduct large transactions and who rely on escrow services to mitigate the risk of fraud, non-payment, or non-delivery. As such, Ethereum's technology allows for transactions such as transferring mortgages and keeping track of complex financial instruments.[45] Additionally, the Ethereum platform has enabled other types of virtual currencies to emerge, most notable the stablecoins. Indeed, by one estimate, almost three-quarters of all stablecoins are issued on the Ethereum platform.[46]

While the idea of crypto-currencies as an alternative to traditional currency seems to have taken off, as evidenced by the success of Bitcoin and Ethereum, most users of these platforms' currencies are holding them as a store of value rather than as a medium of exchange.[47] The volatility

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41. Alyssa Hertig, *"Ethereum 101"* (3 December 2020), *coindesk* https://old.coindesk.com/learn/ethereum-101/what-is-ethereum [https://perma.cc/VZ8J-BY4Z]; *See also* HOUGAN AND LAWANT, *supra* note 24; LEWIS, *supra* note 24.

42. *What is Ethereum?*, ETHEREUM.ORG, https://ethereum.org/en/what-is-ethereum/ [https://perma.cc/2Y4G-EJJ7].

43. Hertig, *supra* note 41.

44. *Id*. Another notable feature of the Ethereum platform is the "Ethereum Virtual Machine" (EVM). Smart contract developers create smart contracts by writing in a programming language called "Solidity," which is then converted into bytecode—language that a computer can understand but not humans. This is then compiled to low-level machine instructions called "opcodes." Then the EVM takes over and executes the opcodes. Luit Hollander, *The Ethereum Virtual Machine—How does it work?*, MYCRYPTO (Jan. 29, 2019), https://medium.com/mycrypto/the-ethereum-virtual-machine-how-does-it-work-9abac2b7c9e [https://perma.cc/8VXW-QRT2]>.

45. Hertig, *supra* note 41.

46. Michelle Lim, *74% of stablecoins are issued on Ethereum, according to new report: ConsenSys Codefi's 4Q 2020 report on DeFi trends also predicts more 'wrapped' tokens, tranche lending products and Ethereum 2.0 derivatives in 2021*, FORKAST.NEWS (Jan. 28, 2021), https://forkast.news/stablecoin-ethereum-consensys-defi-usdt-nft/ [https://perma.cc/PK4T-R5 WS].

47. *See, e.g.*, Dirk G. Bauer & Thomas Dimpfl, *The Volatility of Bitcoin and its Role as a Medium of Exchange and a Store of Value*, EMPIRICAL ECON. (2021) (empirically finding that "Bitcoin cannot function as a medium of exchange and has only limited use as a risk-diversifier,"

of the price of these currencies makes them less likely to be a unit of exchange. Indeed, the spectacular, albeit volatile, rise in prices of crypto-currencies induces those who own bitcoins or ethers to hold them rather than transact in them. In order to avoid the volatility of the prices that Bitcoin and other crypto-currencies have displayed, a new category of crypto-currencies has emerged, known as stablecoins.[48] As the name suggested, this type of crypto-currency was designed to be more "stable" so that it may serve as a unit of exchange.

Stablecoins are digital assets that derive their value from an underlying asset, such as the U.S. dollar. The aim is for their value to be directly tied to the value of the asset.[49] Those who possess units of the stablecoins will see minimal fluctuations in the price of their digital assets.[50] The idea is no different than foreign governments' central banks pegging the value of their currencies to the U.S. dollar or other currencies. This ensures stability in the foreign currency and certainty for those wishing to engage in commercial transactions with the foreign country's economy. Examples of these stablecoins include Tether, which is pegged to the U.S. dollar. The price of one unit of Tether's currency, USDT, is supposed to equal 1 U.S. dollar.[51] Another example is Globcoin, whose

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as well as demonstrating that "Bitcoin displays store of value characteristics over long horizons."); *see also* Dirk G. Bauer et al., *Bitcoin: Medium of Exchange or Speculative Assets?*, 54 J. INT'L. FIN. MKTS., INSTS. & MONEY 177 (2018) (analyzing the "transaction data of Bitcoin accounts" to show "that Bitcoins are mainly used as a speculative investment and not as an alternative currency and medium of exchange").

48. *See President's Working Group on Financial Markets, the Federal Deposit Insurance Corporation and the Office of the Comptroller of the Currency*, REP. ON STABLECOINS 4–11 (Nov. 2021) (providing an overview of how stablecoins operate), https://home.treasury.gov/system/files/136/StableCoinReport_Nov1_508.pdf [https://perma.cc/T7UA-M5E9].

49. See Bank of International Settlements, Committee on Payments and Market Infrastructures Board of the International Organization of Securities Commissions Consultative report, Application of the Principles for Financial Market Infrastructures to Stablecoin Arrangements, October, 2021, available at https://www.bis.org/cpmi/publ/d198.pdf [https://perma.cc/9N2W-FK8K]; Douglas Arner, Raphael Auer and Jon Frost, BIS Working Papers No 905, Stablecoins: risks, potential and regulation (Monetary and Economic Department, Nov. 2020), available at https://www.bis.org/publ/work905.pdf [https://perma.cc/QS6U-B8SV]; Dirk Bullmann, Jonas Klemm & Andrea Pinna, In search for stability in crypto-assets: are stablecoins the solution? European Central Bank (ECB) Occasional Paper Series No. 230 (Aug. 2019), available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3444847 [https://perma.cc/5GFF-SV57]; Kimberly Houser & Colleen Baker, Sovereign Digital Currencies: Parachute Pants or the Continuing Evolution of Money, forthcoming NYU J.L. BUS. available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3922314 [https://perma.cc/EEU7-TQJX].

50. Bullman, *supra* note 49. Kimberly Houser & Colleen Baker, Sovereign Digital Currencies: Parachute Pants or the Continuing Evolution of Money, forthcoming NYU J.L. BUS. 9, available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3922314 [https://perma.cc/PUQ6-UQNL].

51. Bullman, *supra* note 49. Kimberly Houser & Colleen Baker, Sovereign Digital Currencies: Parachute Pants or the Continuing Evolution of Money, forthcoming NYU J.L. BUS.

currency is GLX. It is a stablecoin whose price is created by an index linked to 15 global currencies plus gold.[52] As such, the price of a GLX is the weighted average of the price of 15 currencies plus gold. These currencies include the U.S. dollar, British pound, the Euro, and the Turkish Lira.

In addition to the stability of the price of crypto-currency stablecoins, another key advantage is the speed of transacting using these digital currencies. After all, one could ask why do we need a stablecoin if we already have the U.S. dollar? The answer is twofold. If one wanted to buy 1 bitcoin today, use it to buy some ether, sell some of the ether for U.S. dollars, the process can be complicated. The individual would have to first deposit U.S. dollars into the account of a crypto-exchange where they could purchase bitcoins.[53] That would take some time. Then they would be issued the bitcoins that they purchased, which would be held on the exchange's account. They could then buy some ethers, which would also be held on the exchange's account. If they wished to move the bitcoins or ethers to their personal account, or digital wallet, that transaction would also take some time. Finally, if they wanted to cash some of their bitcoins or ethers, that would take additional time and transactional costs.

In contrast, using a stablecoin, such as USDT, cuts down on the time and effort. The individual would exchange some U.S. dollars for the equivalent units in USDT, say $1,000 USD for 1,000 USDT. This process can be done either on Tether's end or even on any crypto-exchange that allows its user to purchase USDT. Once the user owns some USDT, the speed at which it can be used to purchase other digital currencies or assets is much faster. Now if the individual wants to purchase bitcoins or ethers, they can do so with the USDT they own. They can later sell their ethers, bitcoins, or USDT. Redeeming the USDT for U.S. dollars is also seamless and quick, according to Tether.[54]

Platforms such as Tether assure their customers of this quick and seamless ability to convert back and forth between their digital currencies and official currencies, such as U.S. dollars, by claiming to have enough currency reserves on hand to meet any demands for redemption. Indeed, Tether originally claimed when it was launched that it had a 1:1 ratio of U.S. dollars for any USDT it issued. Similar claims have been made by other stablecoin platforms, such as Globcoin. It is this claim of 100%

16, available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3922314 [https://perma.cc/Z3LR-XBAF]; https://tether.to/ [https://perma.cc/23KS-CWEZ].

52. https://globcoin.io/howitworks.html [https://perma.cc/CWW9-NFDA].

53. They could purchase bitcoins directly from someone who owned bitcoins, but then they would have to somehow transfer the U.S. dollars to the seller's bank account.

54. https://tether.to/ [https://perma.cc/23KS-CWEZ].

reserves that has landed some stablecoins, such as Tether, in legal hot water as we will explain below.[55]

Given that the purpose of stablecoins is to keep the price of digital currencies stable with respect to a specified national currency or basket of currencies, there are several mechanisms by which crypto-platforms maintain price stability. For example, the idea behind Tether is that for every $1 a customer pays Tether, Tether will issue 1 USDT. When the customer wishes to redeem its USDT, Tether will pay out the amount of USDT in dollars and the redeemed USDT will cease to exist. Hence, if there are 1 million USDT circulating, there should be $1 million in reserves held by Tether. This type of stablecoin is known as a "backed by funds" or "tokenized funds" stablecoin.[56] The issuer of the tokens or digital currency or a custodian that the issuer chooses holds the reserves to ensure that the tokens can be redeemed on demand. If the redemption is done through a custodian of the reserves who guards them, then these stablecoins are known as "off-chain collateralized stablecoins."[57] However, if the assets that are used as reserves for redemption of the currency are other crypto-assets, then these stablecoins are known as "on-chain collateralized stablecoins."[58] These stablecoins require no third party custodian or even the issuer to be the custodian of the assets, as the redemption is handled in a decentralized manner on the blockchain. There are also completely uncollateralized stablecoins that maintain the price stability in a manner similar to the way central banks that peg their currencies to the U.S. dollar to maintain the stability of their currency. These stablecoins maintain a number of tokens, or units of currency, in circulation that will see the price stay stable. If the price starts to fall, the platform's algorithm will try to buy up units to lower the supply, and if the price rises the algorithm will issue more tokens. These are known as "algorithmic stablecoins."[59]

Of course, there are many other types of crypto-currencies, some of which are closer to Bitcoin and Ethereum, others are closer to the stablecoin variety, and others in some sense are a hybrid. One such

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55. See discussion of NYAG's suit against Tether Section III.1 *infra*.

56. European Central Bank, Stablecoins – no coins, but are they stable, In Focus Issue no. 3, (Nov. 2019), available at https://www.ecb.europa.eu/paym/intro/publications/pdf/ecb.mipinfocus191128.en.pdf [https://perma.cc/C7BF-RF34].

57. *Id*.

58. *Id*. Examples of this include LUSD and USD. There are also mixed stablecoins that are partially on-chain and partially off-chain. These include TUSD and PAX.

59. *Id*. Examples include FEI, USDN and CUSD. *See also* Ryan Clements, *Built to Fail: The Inherent Fragility of Algorithmic Stablecoins*, 11 WAKE FOREST L. REV. ONLINE 131 (2021) (arguing that algorithmic stablecoins "currently lacks transparency, prudential safeguards, and supervisory oversight … [and] are also built on a fragile foundation of relying on uncertain historical variables: they need a support level of baseline demand, they need participation of willing arbitrageurs, and they need an environment of informational efficiency.").

hybrid, although it does not market itself as such, is Ripple. Ripple's platform utilizes blockchain to allow for quick inexpensive transactions and is used by financial institutions.[60] Its currency is called XRP. It is also decentralized, but its key advantage over other blockchain currencies is the speed at which the transactions settle. Indeed, transactions can settle in less than five seconds. This has made Ripple attractive to banks and financial institutions that need to transfer large amounts of cash and deposits around the world.[61] While the old-fashioned way of sending payments across borders was slow and expensive, Ripple allows these banks to make these transfers fast and cheap.[62] There are over 100 financial institutions that use Ripple, including American Express, and the number of users is expected to grow.[63] On the Ripple system, there is a ledger, known as the XRP Ledger, which is a software code that operates as a peer-to-peer database. It is spread across a network of computers and records data respecting transactions, among other things.[64] The XRP Ledger allows the system to keep track of all the units of currency that are transferred back and forth between various parties. The currency is XRP, which is also software code, and is the digital asset or native token on the XRP Ledger.

With this background, we can now proceed to explain the legal and regulatory challenges that have increasingly faced stablecoins and other crypto-currencies such as Ripple, before turning to examine the legal and regulatory landscape during the free-banking era.

II. LEGAL AND REGULATORY CHALLENGES TO STABLECOINS & RIPPLE

In this Part, we will discuss some of the regulatory measures taken with respect to stablecoins and Ripple. We will present these measures in chronological order to illustrate the regulatory evolution. The first measure we will discuss is the New York Attorney General's lawsuit against Tether and the ensuing settlement. The second measure is a class action lawsuit launched against Tether. While this lawsuit by itself is not a regulatory measure, it does exemplify some of the concerns regulators have regarding stablecoins and other digital currencies and their impact on the market. The third measure is the President's task force on stablecoins and its recent proposals. The fourth measure that we will

60. *See Ethereum vs. Ripple: Which one should be in your Portfolio* (last updated Oct. 15, 2021), available at https://trading-education.com/ethereum-vs-ripple-which-one-should-be-in-your-portfolio [https://perma.cc/VPE9-HETX].

61. ALAN T. NORMAN, BLOCKCHAIN TECHNOLOGY EXPLAINED: THE ULTIMATE BEGINNER'S GUIDE ABOUT BLOCKCHAIN WALLET, MINING, BITCOIN, ETHEREUM, LITECOIN, ZCASH, MONERO, RIPPLE, DASH, IOTA AND SMART CONTRACTS 110–11 (2017).

62. *Id*.

63. *Id*.

64. XRPL Ledger, https://xrpl.org/index.html [https://perma.cc/V7T8-9HMN].

discuss is the SEC's lawsuit against Ripple. The discussion of these measures will serve as background for our subsequent discussion in Part V of the merits of the proposed regulation of stablecoins and Ripple.

A. *The Tether Actions by the NYAG and the Class Action Lawsuit*

USDT, Tether's currency, is a blockchain-based crypto-currency that belongs to a class of crypto-currencies called "stablecoins," which are also sometimes known as "asset-backed" tokens or coins. This is because the underlying crypto-currency derives its value from another asset. In the case of the USDT, it is the U.S. dollar. The purpose of these tokens or coins is to keep crypto-currency prices stable, as opposed to the volatility seen in prices of popular non-stable crypto-currencies such as Bitcoin and Ether.[65] Tether's white paper's abstract explains that

> Asset-backed token issuers and other market participants can take advantage of blockchain technology, along with embedded consensus systems, to transact in familiar, less volatile currencies and assets. In order to maintain accountability and to ensure stability in exchange price, we propose a method to maintain a one-to-one reserve ratio between a cryptocurrency token, called tethers, and its associated real-world asset, fiat currency.[66]

In theory, stablecoins maintain their prices because the value of the coins are backed by an underlying fiat currency and their value is pegged at a pre-determined rate. In Tether's case, USDT is pegged at a one-to-one ratio with the U.S. dollar and claims to be 100% backed by Tether's reserves.[67] According to crypto-currency market data, Bitcoin to Tether trading represents the majority of bitcoin traded into fiat currency.[68] In July 2021, USDT represented 63.1% of all Bitcoin exchanged into fiat or stablecoins.[69] This illustrates how Tether remains a major source of liquidity for the crypto-currency market. Tether customers, as well as other stablecoin customers, presumably use these stablecoins instead of regular dollars, or other assets, because of the ease and speed of crypto-currency trades on the various crypto-exchanges. The various algorithms that are used to verify transactions, whether it be proof of work or proof

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65. Tether's white paper provides more details on this. https://tether.to/wp-content/uploads/2016/06/TetherWhitePaper.pdf [https://perma.cc/NHN3-Y7JV].

66. https://tether.to/wp-content/uploads/2016/06/TetherWhitePaper.pdf [https://perma.cc/Z5T2-ZH9L] (abstract).

67. https://tether.to/ [https://perma.cc/U4GC-3BWC]

68. Jake Frankenfield, "Tether (USDT)" (Apr. 12, 2021), online *Investopia* https://www.investopedia.com/terms/t/tether-usdt.asp#citation-4 [https://perma.cc/VE5C-A4UF].

69. CryptoCompare Exchange Review July 2021 (Aug. 5, 2021), https://www.cryptocompare.com/media/38553118/cryptocompare_exchange_review_2021_07.pdf [https://perma.cc/ED9N-B5K3].

of stake, act as an assurance that the crypto-transactions have taken place in a safe, secure, and speedy manner. This eliminates the need for a centralized third-party verifier, such as the banks and the central bank clearing house. This also means that Tether customers expect the price of one USDT to be equivalent to one U.S. dollar at every moment, and not to be subject to wild swings other crypto-currencies have been subject to.[70] The stability of value is a key social benefit that USDT could offer users, given the speed and accuracy of blockchain transactions. This was also a key feature in Ripple's setup, and it is a key feature in all crypto-platforms.

In theory when a Tether customer who owns 100 USDT wishes to exchange them for $100 USD, this should pose no problem for the Tether platform, as there should be as many dollars in reserves as there are USDT outstanding. Otherwise, the amount of USDT being redeemed for U.S. dollars might exceed the amount of dollars actually held by Tether, leading the system to collapse, at least temporarily. Tether would have to either turn away the holders of USDT that it could not redeem, which, of course, would generate panic among all USDT holders. The result would be the equivalent of a 'run on the bank,' which happens when word gets out that there is not enough cash on hand at one's local bank.

Tether's customers might feel deceived if it emerged that there were insufficient dollars on reserve with Tether. They may also not care, as long as at any point those wishing to redeem their USDT for U.S. dollars were able to. Regardless, the New York Attorney General (NYAG), Letitia James, fell into the former camp. Her office began an investigation of the trading platforms associated with Tether, following its publication of a report on integrity in the virtual currency market.[71] During her investigation, the NYAG discovered that Tether was lending another company associated with Tether, Bitfinex, millions of dollars due to losses that Bitfinex had incurred.[72] The NYAG filed a proceeding in the

70. Vildana Hajric and Katherine Greifeld, Bitcoin Went Mainstream in 2021. It's Just as Volatile as Ever (Dec. 21, 2021, 5:30 AM MST), available at https://www.bloomberg.com/graphics/2021-bitcoin-volitility/ [https://perma.cc/PE76-WAUF]: And yet by some measures, the world's largest cryptocurrency is nearly as untamed at nearly $50,000 as it was at $5,000. Based on the past five years of price movements, Bitcoin moved more than two standard deviations from its average in either direction 23 times in 2017. So far in 2021—a year many see as its major mainstream breakout moment—Bitcoin has recorded 19 such moves, data compiled by Bloomberg show. In other words, still quite volatile.

71. Barbara D. Underwood (NY Attorney General), Virtual Markets Integrity Initiative Report (Sept. 18, 2018), available at https://virtualmarkets.ag.ny.gov/ [https://perma.cc/NS37-85XF]; Letitia James NY Attorney General, Attorney General James Ends Virtual Currency Trading Platform Bitfinex's Illegal Activities in New York (Feb. 23, 2021), available at https://ag.ny.gov/press-release/2021/attorney-general-james-ends-virtual-currency-trading-platform-bitfinexs-illegal [https://perma.cc/C7XZ-UQRS].

72. Attorney General of The State of New York Investor Protection Bureau, Settlement Agreement *In the Matter of Investigation by Letitia James, Attorney General of the State of New*

New York Supreme Court (trial court) on April 24, 2019 seeking to enjoin certain conduct by Bitfinex and various Tether companies to prevent the transfer of funds. The Court granted that injunction, and the Appellate Division affirmed.[73] The courts also affirmed the NYAG's jurisdiction over both Bitfinex and Tether, as well as other virtual currency trading platforms and crypto-currencies operating from various locations around the world, given that these entities were doing business in New York.[74] The courts further held that the stablecoin USDT and other virtual currencies were commodities for the purposes of the (New York State's) Martin Act, and noted that virtual currencies may also constitute securities under that Act.[75] Ultimately, the NYAG signed a settlement agreement with Tether and Bitfinex, in which they agreed to refrain from doing business in New York, as well as paying a fine.[76]

In the process of her investigation, the NYAG claims to have found misrepresentations of Tether with respect to the amount of dollars in reserve backing the amount of USDT issued.[77] Her findings were that there were insufficient funds. As such, most of the USDT were simply backed by nothing more than a promise to redeem. The NYAG claimed that Tether did not even have access to banking, which would mean that it really had no way of redeeming USDT for dollars in the event that customers tried to redeem more USDT than what Tether had access to in reserve.[78] As for having a verification process for the amount of cash in reserve, what was really taking place was that cash would be moved into Tether's account for verification purposes, and then moved back out to Bitfinex's account after Tether's reserves were verified by an auditor.[79] The NYAG argued that, as of April 26, 2019, approximately $850 million had gone missing from Bitfinex's account, something which both

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York of iFinex Inc. (Feb. 17, 2021) at para. 21, https://ag.ny.gov/sites/default/files/2021.02.17_-_settlement_agreement_-_execution_version.b-t_signed-c2_oag_signed.pdf [https://perma.cc/29QM-RELP].

73. Settlement Agreement *In the Matter of Investigation by Letitia James, Attorney General of the State of New York of iFinex Inc.*, ATTORNEY GENERAL OF THE STATE OF NEW YORK INVESTOR PROTECTION BUREAU (Feb. 17, 2021) at para 50; James v. IFinex Inc., 185 A.D.3d 22 (127 N.Y.S. 3d 456, July 9, 2020).

74. James, *supra* note 71.

75. *Id.* at para 4.

76. Settlement Agreement, *In the Matter of Investigation by Letitia James, Attorney General of the State of New York of iFinex Inc.*, ATTORNEY GENERAL OF THE STATE OF NEW YORK INVESTOR PROTECTION BUREAU (Feb. 17, 2021) at para. 57, https://ag.ny.gov/sites/default/files/2021.02.17_-_settlement_agreement_-_execution_version.b-t_signed-c2_oag_signed.pdf [https://perma.cc/4HK7-GLWY].

77. *Id*. at para 45.

78. *Id.* at para 52.

79. *Id.* at para 29.

companies reassured customers about even though they did not know where the money was.[80]

In the settlement agreement, the parties agreed to various factual findings and legal remedies. The agreement stipulated that Tether had represented that every Tether coin (USDT) was backed 100% by 1 U.S. dollar, which should ensure a one-to-one exchange rate. In March 2017, the U.S. dollar backing started to fall apart when Wells Fargo, the bank Tether was doing business with, decided not to process U.S. dollar wire transfers from Bitfinex and Tether. This left the latter scrambling to find alternative arrangements. The companies continued to issue USDT. In fact, Bitfinex opened accounts with another bank, Noble Bank, but Tether did not. Most of the cash holdings that were supposed to back USDT were deposited into a trust account under the name of its General Counsel. Tether, itself, did not have a significant bank relationship in its name from March to September 2017, and as such, it could not directly process any fiat deposits for purchases of USDT by customers. Bitfinex, on the other hand, allowed customers to exchange U.S. dollars with other virtual currencies. Because Tether could not conduct significant banking activities during this time period, it did not have sufficient dollars to back the hundreds of millions of new USDT that had entered the market.

The settlement agreement then turns to the time between June 1, 2017 and September 15, 2017. During that period, Bitfinex held approximately $382 million of Tether's funds in a comingled account.[81] These funds should have been held by Tether in reserve for redemption of USDT in circulation but were not. However, on September 15, 2017, Bitfinex transferred the funds from its account at Noble Bank into Tether's account at Noble Bank.[82] This allowed for the verification of Tether's assets that day, which then allowed Tether to release a "Transparency Update" by an auditor. The update stated that the auditor had audited Tether's account and verified the one to one USDT backed by U.S. dollars from June 1 to September 15, 2017.[83] This could not have been true, as Tether did not have the $382 million in its account until the morning of the audit.[84] Later, in the summer of 2018, Bitfinex borrowed $400 million from Tether.[85] On November 1, 2018, Tether made a public announcement that it had established a new relationship with Deltec Bank.[86] Furthermore, they represented in the announcement that USDT

80. *Id.* at para 49.
81. *Id.* at para 21.
82. *Id.* at para 26.
83. *Id.* at para 27.
84. *Id.* at para 29.
85. *Id.* at para 38.
86. *Id.* at para 38.

was fully backed by U.S. dollars.[87] This also was not true just a few days later, because much of the dollars in Tether's account were transferred to Bitfinex, which disproved any claims of a one to one ration backing the USDT in circulation.[88]

As a result of the settlement agreement, Bitfinex and Tether paid an $18.5 million penalty.[89] Furthermore, Bitfinex and Tether were barred from any trading activities with any residents of New York state. Tether was also required to disclose on a quarterly basis the amount of U.S. dollar reserves backing their USDT in circulation.[90]

Around the time the NYAG was taking its legal actions against Tether, two finance academics published an article proclaiming that Tether was able to inflate Bitcoin's price through its unbacked issuances of USDT. The study examined two competing hypothesis for the dramatic rise in Bitcoin's price during the 2017 boom. The first is a pull hypothesis, according to which the demand for Tether arises from legitimate investors who want to use USDT as a means of exchange on various crypto-exchanges. The second hypothesis is a push hypothesis, according to which Bitfinex prints unbacked USDT, which are then used to make purchases of assets such as Bitcoin on the various exchanges.[91] The extra unbacked USDT are created for free. This allows the holders of the newly minted USDT to profitably sell bitcoins, whose price has risen due to the extra demand by the unbacked USDT, for U.S. dollars or other currencies.[92] If the holders of the unbacked USDT have large holdings of bitcoins, which they may have purchased earlier for a much lower price, they can profitably sell these bitcoins when they push up their price.[93] If the price of bitcoin falls, then unbacked USDT can be used to purchase the cheaper bitcoins, which in turn either halts the price drop or even pushes the price back up.[94] Either way, Bitfinex can sell some inflated bitcoins for U.S. dollars, which will allow it to then replenish the dollar reserves Tether claims to have backing their USDT.

Another way to understand the authors' claims is to envisage three scenarios. In the first scenario, when the crypto-currencies (say Bitcoin) are inflated in price, the creators and holders of unbacked USDT can exchange unbacked USDT for bitcoins. This is possible because investors believe 1 USDT = 1 USD but, 1 USDT may not be worth as much in

87. *Id.* at para 42.

88. *Id.* at para 43.

89. *Id.* at para 55.

90. *Id.* at para 55.

91. John M. Griffin & Amin Shams, *Is Bitcoin Really Un-Tethered?*, SSRN 3 (Oct. 28, 2019), available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3195066 [https://perma.cc/CBZ2-WJK7].

92. *Id.* at 3.

93. *Id.*

94. *Id.* 4.

reality. They then can sell the inflated Bitcoin (BTC) for USD to replenish the USDT reserve or keep the cash for themselves. In the second scenario, if crypto-currency prices are falling, the creators of Tether can artificially inflate the price of BTC by selling unbacked USDT for bitcoins. This inflates the demand for bitcoins, thus increasing its price. The creators can then sell their holdings of bitcoins (which they likely purchased at a lower price) at the inflated price for USD to replenish USDT reserves or keep the cash for themselves. Finally, in the third scenario, if there is a crash in the crypto-currency market, then other investors may want to redeem USDT. The creators essentially have a put option to default on Tether. This is probably the scenario that the NYAG was worried about, a sort of moral hazard situation. The creators of the unbacked USDT, or any other stablecoin, have insurance for any fall in the price of Bitcoin. But the insurance was free to purchase, because the cost of issuing of the stablecoins was less than the true cost, i.e. one U.S. dollar for one USDT.

The authors of the study tested the two hypotheses, i.e. the push or pull hypothesis, using data on bitcoin prices and trading volumes of Bitcoin and Tether. They found that timing of the flow of bitcoins on the Bitcoin platform matched the timing of the flow of USDT on the Tether platform.[95] This, the authors suggested, showed that USDT were being used to purchase bitcoins.[96] They found that when there were positive flows of USDT from the Bitfinex to other exchanges where bitcoins could be purchased with USDT, the price of bitcoin would rise over the next three hours from the initiation of the purchases.[97] This led to high returns from investing in Bitcoin. They also found that the rise in Bitcoin's price was a result of trading by one large player.[98] They concluded that the evidence suggested that the rise in Bitcoin's price was a result of the newly issued USDT.[99] They also found that the returns to investing in Bitcoin were not random, or, in other words, the result of deliberate actions.[100] The authors concluded that their analysis of the data was consistent with the push hypothesis, namely that the unbacked USDT were being issued and used to purchase assets resulting in their price inflation.[101] The authors' results also found little evidence for the pull hypothesis.[102] As such, they concluded that their findings suggested that

95. *Id.* at 7.
96. *Id.* at 5.
97. *Id.* at 5.
98. *Id.*
99. *Id.*
100. *Id.* at 6.
101. *Id.* at 8.
102. *Id.*

Bitcoin's prices were being affected by a small group of market players.[103]

Although the study contradicted an earlier study finding that Tether had no impact on Bitcoin,[104] at least four class action lawsuits were filed against Tether. These lawsuits allege that Tether manipulated the market for Bitcoin and brought various claims under various statutes seeking a variety of remedies. The lawsuits have been consolidated. The basic claims against Tether center around the findings of the study mentioned above. We have provided some of the details in Appendix A. The study (and the resulting lawsuit) display some of the other concerns that some have expressed regarding the role of stablecoins in the crypto-sphere. The lawsuits are still outstanding (as of the writing of this Article), and we do not address the merits of the lawsuit in this Article.

B. *The President's Working Group on Financial Markets Report*

In November 2021, the President's Working Group on Financial Markets (PWGFM), along with the Federal Deposit Insurance Corporation (FDIC) and the Office of the Comptroller of the Currency, issued a report on Stablecoins.[105] The report, after explaining the basic operation of stablecoins, proceeds to identify the risks associated with the current state of stablecoins.[106] It starts with the premise that such financial instruments can only "serve as a reliable means of payment or store of value . . . when there is confidence in its value, particularly in periods of stress."[107] As such, confidence is these stablecoins may be undermined when the reserve assets fall in price, become illiquid, or are improperly safeguarded.[108] Additionally, the lack of clarity regarding when and how stablecoin holders can redeem their coins as well as security concerns about the storage and handling of data may also be factors undermining confidence in the coins.[109]

The report then argues that if stablecoins fail to "perform according to expectations," this could harm the users of stablecoins and create

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103. *Id.* at 7.

104. Wang Chun Wei, The impact of Tether grants on Bitcoin, 171 ECON. LETTERS 19 (2018) (finding that although the issuance of USDT by Tether is correlated with the rise in Bitcoin's price, the issuances do not have a statistical causal impact on Bitcoin's returns, although they found an increase in USDT trading after declines in Bitcoin's price).

105. PRESIDENT'S WORKING GROUP ON FINANCIAL MARKETS, THE FEDERAL DEPOSIT INSURANCE CORPORATION AND THE OFFICE OF THE COMPTROLLER OF THE CURRENCY, REPORT ON STABLECOINS (Nov. 2021), https://home.treasury.gov/system/files/136/StableCoinReport_Nov1_508.pdf [https://perma.cc/6TAQ-WVAU].

106. *Id.*

107. *Id.* at 12.

108. *Id.*

109. *Id.*

systemic risk.[110] Indeed, if one stablecoin were to be suspected of not being able to adequately perform, this could result in a run the coin, i.e. the reserves backing that coin could be depleted. The run on the first coin could then also spread to other coins, and eventually collapse the system.[111] The nature of any such a run and its impact on the economy will ultimately be a function of "the volume and liquidity characteristics of reserve assets sold, as well as on broader economic and financial conditions."[112] The report noted that many of the risks that stablecoins can face are similar to the ones that traditional payments systems face, such as "credit risk, liquidity risk, operational risk, risks arising from improper or ineffective system governance, and settlement risk."[113] However, the report notes that there are other operational risks that are specific to stablecoins due to the decentralized nature of its decision-making.[114] As such, if there is a breakdown in the technology or governance underlying the payment mechanisms of a stablecoin, this could "disrupt the ability of users to make payments," or in other words "lose their money," which can in turn disrupt economic activity."[115] These risks may arise because the blockchain does not provide adequate incentives to verify payments or because the payments are not properly recorded on the ledger.[116] Additionally, the users may not be able to redeem their stablecoins for cash (or whatever is backing the coins) in a timely manner, which can cause its own disruptions in the economy.[117]

These risks can have real consequences, because of the growth in the size of stablecoins.[118] As more and more businesses and individuals use stablecoins to transact, the link between the crypto-world and the real-world becomes stronger, the report argues.[119] Worse, the report posits, if more stablecoin users switch their funds from currently insured financial institutions this can lead to pressure to create more reserves that might "not support credit creation," which would mean that the stablecoin issuers would have to borrow more to have adequate reserves on hand.[120] This would "increase borrowing costs and impair credit availability in the real economy."[121] The report concludes that a "consistent and

110. *Id.*
111. *Id.*
112. *Id.*
113. *Id.*
114. *Id.* at 13.
115. *Id.*
116. *Id.*
117. *Id.*
118. *Id.* at 14.
119. *Id.* The report also notes concerns about economic concentration and anti-competitive effects this may have on the payments sector. *Id.*
120. *Id.*
121. *Id.*

comprehensive regulatory framework is needed both to increase transparency into key aspects of stablecoin arrangements and to ensure that stablecoins function in both normal times and in stressed market conditions."[122]

The report observes that a stablecoin could be considered, depending on the facts, "a security, commodity, and/or derivative."[123] As such, this implicates the jurisdiction of the SEC and/or the Commodity Futures Trading Commission (CFTC), especially given their role in both investor protection and ensuring market integrity.[124] But stablecoins also have features of payment and banking systems with all their attached risks.[125] This, in turn, implicates the jurisdiction of so many dispersed agencies, which means that the oversight of the coins can fall between the cracks.[126] For this reason, the report recommended legislation to be enacted to ensure comprehensive regulation of the coins.[127]

The report calls for legislation that will both regulate stablecoin but also provide access to safety nets such as deposit insurance.[128] Of course this would mean that only stablecoin issuers who comply with the requirements of deposit insurance regulations would be permitted to issue stablecoins that can be used for payments.[129] Furthermore, such stablecoin issuers would be required to have standards that "promote interoperability among stablecoins."[130] This would allow stablecoin issues to have access to deposit insurance and "emergency liquidity[,] and Federal Reserve services."[131] Once they are subject to deposit insurance regulations, issuers would also be subject to "capital and liquidity standards" as well as "enhanced prudential standards that address financial stability concerns."[132]

One of the report's concerns was that current stablecoin platforms and payment systems may be too decentralized.[133] There are several stages in the stablecoin ecosystem, namely the creation or issuance of the coins, the transfer of the coins between parties, and the storage of the coins by the various users in different locations, and these stages can be carried out by different entities.[134] As such, the potential for error multiplies. The

122. *Id.* at 15.
123. *Id.*
124. *Id.*
125. *Id.*
126. *Id.*
127. *Id.* at 16–18.
128. *Id.* at 16.
129. *Id.*
130. *Id.*
131. *Id.*
132. *Id.*
133. *Id.*
134. *Id.*

report recommended comprehensive regulatory oversight that encompasses all these stages.

The report made some specific recommendations with respect to each of these stages. For example, it suggested that those entities that stored the coins should be prohibited from lending stablecoins as well as complying with liquidity and capital requirements.[135] The report also recommended limiting stablecoin platforms with commercial entities.[136] We note that these recommendations are set out with very little economic or legal analysis. Perhaps, future legislative or regulatory hearings will conduct the necessary analysis prior to any regulations being enacted. In the interim, the report recommended that existing agencies look into regulating stablecoins under the existing patchwork of legislation.[137] This includes Section 21(a)(2) of the *Glass-Steagall Act*, the *Electronic Fund Transfer Act*, the *Gramm-Leach-Bliley Act*, the *Bank Secrecy Act*, and the *Consumer Financial Protection Act*.[138]

1. The Ripple Lawsuit

The SEC's complaint against Ripple is, in one sense, a plain vanilla securities complaint about an entity offering securities without the appropriate paperwork. In another sense, it is about the SEC, and perhaps other regulatory agencies, taking aim at an emerging currency system that has the potential to upend the traditional monetary and financial order.[139] The details of the lawsuit are presented in Appendix B, but in a nutshell the complaint is as follows. The SEC alleges that Ripple raised $1.38 billion in cash from investors through the sale of units of XRP, the currency that is hosted on the Ripple platform, without registering their sales with the SEC.[140] Ripple never provided investors with the required material information when soliciting public investment and used the money to fund its operations without disclosing how it was doing so.

The focus of this Article, of course, is stablecoins, and we will put aside the discussion of Ripple until the end of this Article. For now, the reader should understand the basic dispute between the SEC and Ripple is one of classifying what seems to be another crypto-currency as a security. Of course, there are implications for all crypto-currencies,

135. *Id.* at 17.

136. *Id.*

137. *Id.* at 18.

138. *Id.*

139. There have been several lawsuits similar to the Ripple lawsuit, some of which has resulted in reported opinions. Carol R. Goforth, *Regulation of Crypto: Who Is the Securities and Exchange Commission Protecting?*, 58 AM. BUS. L. J. 643 (2021); Peter J. Henning, *A Taxonomy of Cryptocurrency Enforcement Actions*, 14 BROOK. J. CORP. FIN. & COM. L. 227 (2019–2020).

140. Complaint ¶ 1, S.E.C. v. Ripple Labs, Inc., No. 20 Civ. 10832 (S.D.N.Y. 2021) https://www.sec.gov/litigation/complaints/2020/comp-pr2020-338.pdf [https://perma.cc/EYY7-ZJZ3].

including Bitcoin and Ethereum, if the SEC prevails in this case, but for the purposes of this Article, there are implications more relevant to stablecoins. We will refer to these concerns in the next section and later in this Article.

III. STABLECOINS VS. WILDCAT BANKING: ARGUMENTS AND RESPONSES

A. *Stablecoins: The Critics*

In addition to the regulatory actions mentioned in the previous section, there have also been concerns about stablecoins expressed by policymakers and academics alike. For example, a few weeks before the PWGFM's report was released, Federal Reserve Governor Lael Brainard delivered a speech at the Consensus by CoinDesk 2021 Conference, in which she outlined her, and presumably the Federal Reserve's, thinking regarding digital currencies.[141] While Governor Brainard acknowledged the great technological advances that have been made in the crypto-currency sphere, and especially stablecoins, she expressed several concerns regarding their proliferation. At the outset, Governor Brainard explained that stablecoins were digital assets "whose value is tied in some way to traditional stores of value, such as government-issued, or fiat, currencies or gold."[142] Governor Brainard went on to note that stablecoins did not "have legal tender status," and then further noted that these coins "may expose consumers and businesses to risk."[143] Governor Brainard then fretted that if stablecoins were widely adopted, an alternate payment system centered around "private forms of money" would emerge.[144] This, Governor Brainard argued, because the "network externalities associated with achieving scale in payments," would fragment the existing payment systems and impose costs and burdens on households and businesses. Additionally, Governor Brainard argued that the dominance of private monies could "introduce consumer protection and financial stability risks because of their potential volatility and the risk of run-like behavior."[145] For this claim Governor Brainard referred to the nineteenth century free banking era, when banks could issue their own banknotes, and which she characterized as being "notorious for inefficiency, fraud, and instability in the payments system."[146] These

141. Governor Lael Brainard, *Private Money and Central Bank Money as Payments Go Digital: an Update on CBDCs*, available at https://www.federalreserve.gov/newsevents/speech/brainard20210524a.htm [https://perma.cc/DS75-NH9H].

142. *Id.* at 1.

143. *Id.* at 2.

144. *Id.*

145. *Id.*

146. *Id.* (citing JOSHUA R. GREENBERG, BANK NOTES AND SHINPLASTERS: THE RAGE FOR PAPER MONEY IN THE EARLY REPUBLIC (2020).

concerns underlay "the need for a uniform form of money backed by the national government."[147]

Governor Brainard noted that the Federal Reserve was committed to digital payments, generally speaking, but was also concerned about the public having access to "safe, reliable, and secure means of payment, including cash."[148] As part of this commitment, we must explore—and try to anticipate—the extent to which households' and businesses' needs and preferences may migrate further to digital payments over time. Given that other countries are also creating and developing their digital currencies, it is important that the United States monitor and be part of the situation.[149] In her opinion, there were several important policy considerations that the Federal Reserve would take into account when developing rules around digital currencies. These included, preserving "general access to safe central bank money,"[150] improving efficiency,[151] promoting "competition and diversity and lower transactions costs,"[152] reducing cross-border frictions,[153] preserving "financial stability and monetary policy transmission,"[154] protecting privacy and safeguarding financial integrity,[155] and increasing "financial inclusion."[156] Governor Brainard outlined some other policy considerations that the Federal Reserve would be looking at regarding digital currencies, but the tone of her remarks suggested that the Federal Reserve would want to subsume these stablecoins into their control. Indeed, a little while later, the President's working group on stablecoins issued its report discussed above, which echoed these sentiments.

On the academic side, the influential macro and monetary economist Gary Gorton co-authored an article with attorney Jefferey Zhang on the question of stablecoins.[157] In their article, they present a legal and economic analysis of stablecoins like Tether. Their article starts by explaining that what differentiates stablecoins from regular crypto-

147. *Id.*
148. *Id.* at 3.
149. *Id.*
150. *Id.* at 4.
151. *Id.* at 5.
152. *Id.*
153. *Id.* at 6.
154. *Id.* at 7.
155. *Id.*
156. *Id.* at 8.
157. Gary B. Gorton & Jefferey Y. Zhang, *Taming Wildcat Stablecoins*, available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3888752 [https://perma.cc/8VKD-5CMM]. For a quick summary of their article, see Izabella Kaminska, *Gorton turns his attention to stablecoins: The academic thinks we're seeing the revival of the era of free banking and regulators should act pre-emptively to manage the risks*, FIN. TIMES (July 20, 2021), https://www.ft.com/content/32b85446-0f56-43d8-a278-52afff303369 [https://perma.cc/76HR-8FK6].

currencies is that stablecoins' value is meant to be stable and tied to an external item such as a currency, e.g. the U.S. dollar.[158] These stablecoins will pledge to transparently posses enough reserves, either in actual U.S. dollars or in other assets that are sufficiently stable in value to cash such as Treasury bills, so that customers who want to redeem their coins for cash can successfully do so.[159] The authors then turn to the question of whether stablecoins can be considered money in the traditional sense.[160] From an economist's perspective, they posit, "money has three important properties[:] It must be a store of value, a unit of account, and a medium of exchange."[161]

They qualify the 'medium of exchange' condition by specifying that this means that there should be no questions asked when using what purports to be money in exchange for a good or service.[162] In other words, for something to qualify as money, they argue, the parties to the transaction need not waste time and effort verifying that the purported money is authentic and properly backed by an asset of value.[163] This means that stablecoins need to credibly commit to its users, including parties that will be thinking about accepting them as payments for a good or service, that its value is properly backed and can be redeemed.[164] The idea that the stablecoin can be redeemed on demand for an asset such a U.S. dollar then raises the question of whether stablecoins should be considered demand deposits.[165]

The authors look at the terms and conditions of the various stablecoins and conclude that most, but interestingly not Tether, of the major stablecoin agreements in the market were essentially debt contracts between the customers and the issuers of the stablecoins.[166] In other words, because the various entities that issue stablecoins undertake to redeem the coins at face value of the coin in dollars upon presentment, this is akin to a debt contract.[167] Their reading of Tether's terms and

158. Gorton & Zhang, *supra* note 157, at 6–8.

159. *Id.* The article also discusses the NY OAG's lawsuit against Tether for not having enough reserves, which we discuss above.

160. *Id.* at 8.

161. *Id.*

162. *Id.*

163. *Id.*

164. *Id.* at 8–9.

165. *Id.* at 10. Demand deposits are basically checking accounts or anything similar to them. In other words, when a person deposits cash at the bank into a checking account, although the bank does not commit to keep the cash on hand at all times, the bank does commit to allowing the depositor to retrieve their cash at any point. Of course, there may be a notice requirement if the notice is sufficiently large. Generally speaking, however, every time one of us goes to the bank to withdraw cash, we do so without any fear or thought of the bank not having enough cash to satisfy our withdrawal request.

166. *Id.* at 12.

167. *Id.* at 10–12.

conditions led them to argue that Tether's customers were shareholders.[168] This matters, because if the agreement is more of a debt contract then the stablecoins are legally speaking demand deposits and are subject to their own special banking regulations.[169] If they are equity contracts, as they argued for Tether, then they are the equivalent of money market funds,[170] which are not demand deposits under various legal interpretations that have been rendered over the past forty years.[171]

The authors also examine whether redemption for U.S. dollars is quick and costless for various stablecoins,[172] and engage with the question of whether stablecoin issuers should be considered banks.[173] They start with the premise that banks today are in the business of "(1) deposit taking, (2) commercial lending, and (3) payments."[174] Although stablecoin issuers do take deposits and engage in payment services, at present they do not seem to be engaging in commercial lending, the authors note.[175] But, they could soon, they also note.[176] This raises the possibility that such stablecoin issuers could become major financial players akin to the money market funds prevalent today. Money market funds have their own set of regulations that they must comply with. They are subject to oversight by the Federal Reserve, because on more than one occasion, the Federal Reserve has had to step in and rescue these funds when the

168. *Id.* at 12.

169. *Id.* at 10–11.

170. Money market funds are funds where the investors give an intermediary, usually the investment company or the bank that contracts with an investment company, their money. The money is then invested in short-term instruments such as Treasury bills and other short-term debt that has very low risk and predictable yield. The investment company will usually keep some cash on hand, and as such the investors can cash in their investment at anytime, usually at par, i.e. for the original amount they put in. As such, money market funds become similar to traditional bank accounts but with higher interest rates. Of course, there would be restrictions on how much can be cashed out, especially if the market is not performing well, which may affect the value of the investments. There are also money market fund accounts, which are similar to the money market funds, but are essentially checking accounts with slightly higher interest rates than traditional checking accounts. See Gorton & Zhang, *Taming Wildcat Stablecoins*, *supra* note 157, at 10–11.SECURITIES AND EXCHANGE COMMISSION, FACT SHEET: REFORMING MONEY MARKET FUNDS (June 5, 2013), https://www.sec.gov/opa/Article/press-release-2013-101---related-materials.html [https://perma.cc/VN55-646T].

171. Gorton & Zhang, *supra* note 157, at 10–13. The authors cite a letter from the United States Department of Justice on the question of money market funds as well as the United States Supreme Court's case on the question of what is a demand deposit in *Board of Governors of the Federal Reserve System v. Dimension Financial Corporation*, 474 U.S. 361 (1986).

172. Gorton & Zhang, *supra* note 157, at 15.

173. *Id.* at 16.

174. *Id.*

175. *Id.* at 18.

176. *Id.* at 18–19. They note that some states are in the process of allowing crypto-companies to become state-regulated banks or financial institutions.

financial markets imploded.[177] Investors who suddenly need cash will try to cash in their investments in money market funds, as these purport to be safer and more stable than the stock-market. But such a run on the funds, akin to a run on a bank, can cause its own problems.[178] As such, the Federal Reserve steps in to bail out the funds and assist with their liquidity problems.

The authors then take an interesting historical turn to the past to look for further guidance on the status of stablecoins. They argue that the modern-day phenomenon of multiple issues generating, and essentially printing, their own currency is analogous in historic terms to the free banking era. That era, which roughly lasted from 1837 to 1860, was an era when some states allowed banks chartered within them to issue their own notes. These notes were usually backed by state bonds, which were held as security for the circulating notes.[179] The authors note that due to the large number of notes circulating from different banks, although they all claimed to represent the same U.S. dollar amount as printed on their face, the notes did not necessarily trade at par.[180] In other words, a note issued by Bank A that displayed $10 on its face may only command $8 worth of good or services in another location, especially if the location was far away from the note issuer's location. Location mattered, because reputation and costs of verification that the issuing bank had sufficient reserves to honor the bank notes would mean that someone accepting this note was taking a risk. The risk would be that eventually one day the person, or someone else who accepted the note from this person, would show up at the issuing bank's office and ask for the note to be redeemed in gold or some other asset. At that point, the bank may either have sufficient assets to redeem the notes or not. That was the risk that was associated with what was also known as the wildcat banking era.[181] Sometimes banks sprung up, issued a bunch of notes with little backing, and then failed. This left the noteholders with no recourse and usage for the notes. Hence, the discounting of the notes. So, while hundreds of

177. *Id.* at 20–23.

178. A run on the bank usually takes place when there is a hint of the bank not having enough cash. Then every depositor wants to be the first one to cash out their deposits. For the money market funds, the investment company usually only has little cash on hand to satisfy the routine cashing outs by its investors. When a run on the funds takes place, the company will have to sell off or liquidate its investments. This, if it happens all at once by several investment companies, will depress the money markets and cause the prices of the various Treasury bills and short-term debt to fall (which will also raise short-term interest rates). As such, there will be even less cash to satisfy the investors seeking to cash their investments.

179. *Id.* at 23–27. The authors provide several references for their claims in these pages. We will refer to some of these later in the discussion, but in this section, the reader can refer to the article.

180. *Id.* at 25–26.

181. *Id.* at 26.

notes from many issuers circulated, there were real costs involved in verifying whether the notes were legitimate in the first place and whether they were issued by a bank with sufficient reserves. This meant that the notes were not readily accepted as cash with no questions asked, an important principle, the authors argue, is needed for something to be deemed money.[182] The authors then explain how the National Bank Act of 1863 and subsequent legislation facilitated the rise of a national uniform currency.[183] Ultimately, the federal government was able to legally and practically drive out state-issued private bank notes, and impose a unform fiat currency on the entire country.[184]

From this brief overview of the history of banknotes, the authors then conclude that what is needed for the future of stablecoins is one of the following options:

> (1) transform stablecoins into the equivalent of public money by (a) requiring stablecoins to be issued through FDIC-insured banks or (b) requiring stablecoins to be backed one-for-one with Treasuries or reserves at the central bank; or (2) introduce a central bank digital currency and tax private stablecoins out of existence.[185]

In other words, they argue that the stablecoins should meet the same fate as the free-banking era, or wildcat banking era as they characterize it, banknotes. They cite various existing laws and regulations and propose new ones that could bring about their proposed options.[186] They argue that given that there are benefits from digital currencies,[187] but that also the history of western central banking has been the replacement of private currencies with government currencies,[188] this leads one to conclude that only government issued currencies, including digital ones, should exist.[189]

In his article, Professor Wilmarth echoed his support for the various recommendations of the PWGFM's report, and added some nuance to their recommendations.[190] Specifically, he supports the SEC using its

182. *Id.* at 27.
183. *Id.* at 29.
184. *Id.* at 29–31
185. *Id.* at 31.
186. *Id.* at 31–36.
187. These include the lower costs, speed, and efficiency of financial transfers. *Id.* at 36–37.
188. *Id.* at 37–39.
189. *Id.* at 39–42.
190. Arthur E. Wilmarth, *It's Time to Regulate Stablecoins as Deposits and Require Their Issuers to Be FDIC Insured Banks*, 3–4, GW Law School Public Law and Legal Theory Paper No. 2022-01, available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=4000795 [https://perma.cc/BGG3-YKEE]. We focus on Professor Wilmarth's paper, because of (1) his influence and stature as a scholar; (2) the cogency of his arguments; and (3) his arguments are representative of most of the arguments made in favor of stablecoin regulation.

powers to regulate stablecoins as "securities" in order to protect investors and the markets.[191] He also recommended that the Department of Justice (DOJ) designate stablecoins as "deposits," which would then bring them under the jurisdiction of Section 21(a) of the Glass-Steagall Act.[192] Furthermore, he recommends that Congress require issuers and distributors of stablecoins to be FDIC-insured banks.[193] This would force issuers and distributors of stablecoins to comply with laws that "protect the safety, soundness, and stability of our banking system and obligate banks to operate in a manner consistent with the public interest."[194]

This would also maintain, he argues, "the longstanding U.S. policy of separating banking and commerce" and would keep the Facebooks of the world from creating "shadow banking" empires.[195] These empires pose a threat to consumers, competition, and the health of the financial sector as a whole.[196]

Professor Wilmarth points out that the explosive growth in the size of stablecoins, there are several laws that the issues, distributors, and users of these coins can skirt. For example, because of the high degree of anonymity of users, market participants using stablecoins can "avoid complying with "Know Your Customer" (KYC) requirements, anti-money laundering (AML) laws, tax laws, and sanctions against terrorist financing."[197] In addition to Tether, and the doubts surrounding the adequacy of its reserves, he also points to plans by Facebook, via its payment system Novi and its currency Diem, to create new ways to pay for goods and services regardless of location around the world.[198] These developments all point to looming dangers, Professor Wilmarth argues. These dangers are similar to the ones identified by the PWGFM report. These dangers include the risk that a loss of confidence in the adequacy of reserves could cause a run on the stablecoin issuers, similar to the 2008 and 2020 runs on money market funds.[199] He also cited the dangers that the collapse of one stablecoin could inflict on the financial system. Indeed, he also cited as another example the private banknotes that were issued prior to the civil war and that created instability in the banking system.[200] For this and throughout his paper, he also cites the Gorton and

191. *Id.* at 3–4.
192. *Id.*
193. *Id.*
194. *Id.*
195. *Id.*
196. *Id.* at 4.
197. *Id.* at 5.
198. *Id.* at 6–7.
199. *Id.* at 9.
200. *Id.* at 9.

Zhang article cited by Governor Lael Brainard in her speech and discussed above.[201]

Arguably, the hardest part of Wilamrth's recommendations, which he recognizes,[202] is the claim that stablecoins can be regulated as securities by the SEC. To do so, stablecoins would have to fall under the various definitions of securities such as "investment contracts" or notes, i.e. debt obligations.[203] He discusses three leading cases on the question of defining a security, *Howey*,[204] *Edwards*,[205] and *Reves*.[206] The classic *Howey* test defines an investment contract as a "scheme [that] involves an investment of money in a common enterprise with profits to come solely from the efforts of others."[207] He then transitioned to *Edwards* where the court explained that profits can include "dividends, other periodic payments, or the increased value of the investment."[208] Furthermore, the court in *Edwards* stated that "fixed returns on investments pitched as low-risk would satisfy the Howey test, and the ability of investors to redeem their investments would not affect that outcome."[209] Then, Professor Wilmarth turned to *Reves*, where the Supreme Court held that every promissory "note" is presumptively a "security,"[210] but that presumption can "be rebutted based on several factors" including whether the purchaser of the note is motivated by profits or using the note to "facilitate the purchase and sale of a minor asset or consumer good."[211] He further cites other federal court cases where crypto-currencies were found to be securities under securities laws, because the sellers of these currencies promised a rise in the value of the crypto-currencies. Of course, he conceded, none of these cases involved stablecoins.[212]

Indeed, the commonly used stablecoins are created with the idea of maintaining a one-to-one value with a currency, such as the U.S. dollar. These stablecoins do not pay interest either. Rather, they assure the

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201. *Id.* at 9. Two other dangers that Professor Wilmarth pointed out were the potential for stabelcoins to create a shadow banking system, which could lead to the intermingling of banking and commerce. *Id.*

202. *Id.* at 11.

203. *Id.* (citing 15 U.S.C. §§ 77b(a)(1), 78c(a)(10), 80a-2(a)(36)).

204. SEC v. W.J. Howey & Co., 328 U.S. 293 (1946).

205. SEC v. Edwards, 540 U.S. 389 (2004).

206. Reves v. Ernst & Young, 494 U.S. 56 (1990).

207. Arthur E. Wilmarth, *It's Time to Regulate Stablecoins as Deposits and Require Their Issuers to Be FDIC Insured Banks*, page 11, GW Law School Public Law and Legal Theory Paper No. 2022-01, available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=4000795 [https://perma.cc/BF8S-6FGH] (citing SEC v. W.J. Howey & Co., 328 U.S. 293, 301 (1946)).

208. *Id.* at 12 (citing SEC v. Edwards, 540 U.S. 389, 394–97 (2004)).

209. *Id.* at 12 (citing SEC v. Edwards, 540 U.S. 389, 394–97 (2004)) (quotations omitted).

210. *Id.* at 12 (citing Reves v. Ernst & Young, 494 U.S. 56, 64–67 (1990)).

211. *Id.*

212. *Id.* at 12.

purchasers that they will not suffer any losses.[213] This leaves Professor Wilmarth in a conundrum regarding how he can conclude that the SEC has jurisdiction over these stablecoins. He gets around the conundrum by arguing that the SEC should argue that stablecoins are "investment contracts" or "notes" because

> (1) issuers and distributors offer and sell stablecoins to investors with the shared understanding that stablecoins are the most widely-used form of payment for speculating in cryptocurrencies and other digital assets; and (2) issuers and distributors expect that most buyers of stablecoins will use their coins to pursue speculative profits by trading in digital assets or by lending their coins to other traders. [214]

In other words, he argues that stablecoins are nothing more than "poker chips" being used to engage in speculation in the crypto-sphere. Indeed, because there are no stablecoins issued for only purchasing goods and services, he concludes that these coins have only one motivation, namely the use for speculative investments in other crypto-assets.[215] In this regard, he is echoing SEC Chairman Gensler's accusations against the stablecoins as well as the spirit of the private lawsuits against Tether alleging manipulation of Bitcoin's prices discussed above.[216]

1. Wildcats and Wildcat Banking: A Jurisprudential View

The crux of the concerns regarding stablecoins comes from invoking the free-banking era and the supposed chaos that ensued. There are many ways to evaluate the veracity of these concerns. Economists, especially economic historians, have evaluated many of these claims.[217]

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213. *Id.* at 13.

214. *Id.* at 14.

215. *Id.*

216. Carla Mozée, Crypto is not a viable long-term form of private money and stablecoins are equivalent to poker chips at the casino, SEC chief says (Sept. 21, 2021, 05:05 PM), available at https://markets.businessinsider.com/news/currencies/sec-crypto-stablecoins-poker-chips-wild-west-sec-gary-gensler-2021-9 [https://perma.cc/GE5S-YXTL].

217. With respect to the Gorton & Zhang article as well as general criticisms of free-banking, two eminent economists Professors Larry H. White and George Selgin have been at the forefront of defending the free-banking era. Their comments on the issue of stablecoins as well as their work on the question of monetary regimes will infuse parts of our analysis. In this Article, we will not refer to their Twitter discussions given that Twitter threads can be very non-centralized and can be laced with comments that can distract from the original poster's message. However, their online replies can be nicely summed up in two articles, Selgin and White discuss some of the issues expressed by Gorton and Zhang as well as others. George Selgin, *The Fable of the Cats*, ALT-M (July 6, 2021), https://www.alt-m.org/2021/07/06/the-fable-of-the-cats/ [https://perma.cc/3QNA-KE4P]; Larry White, *Should We Fear Stablecoins?*, ALT-M (June 24, 2021), https://www.alt-m.org/2021/06/24/should-we-fear-stablecoins/ [https://perma.cc/M2TA-H2MD]; Larry White, *What You Should Know About Free Banking History*, ALT-M (Apr. 28, 2015),

Additionally, it is instructive to also look at the caselaw during the early nineteenth century in the United States.[218] The tone of the judicial opinions, as well as sometimes the arguments by counsel as reported in the decisions, can reflect the prevailing attitude towards banks issuing their own notes. After all, these were the eminent jurists of their day sitting in judgment over disputes concerning banks and their notes. It would seem obvious that if the system was in shambles, we would see quite a bit of discussion regarding the stability of banking and the need for legislative action. During this era, banks would issue their notes backed by specie, i.e. gold or silver, or other financial instruments. Some of these banks were unable to redeem all their notes, and litigation ensued. Federal regulation of banking was minimal. Most of these regulations were done at the state level either by state legislation or by judicial enforcement of the legislation and the commercial common law.

The demeanor and tone of the judges adjudicating these cases in the early to mid-nineteenth century does not indicate any revulsion at the idea of free banking, specifically, or even the idea of banks issuing notes backed by specie or otherwise. When courts mentioned free-banking statutes, they almost never mentioned them disapprovingly.[219] For example, when deciding whether the State of Louisiana could impose a tax on bank capital, the Supreme Court of Louisiana observed that "[i]t may be true . . . that under the constitution of 1852 and act of 1853 the free banks were not liable to a license tax. . . . But in 1868 a new constitution was adopted, and in 1870 the free banking law was

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https://www.alt-m.org/2015/04/28/what-you-should-know-about-free-banking-history/print/ [https://perma.cc/2FJ4-EU8V]. There are also various other discussions, especially by George Selgin, at https://www.mercatus.org/bridge/podcasts/01242022/george-selgin-future-cbdc-Federal Reserve-accounts-and-stablecoins [https://perma.cc/DQ6A-5EVK]; https://onthebrink-podcast .com/selgin/ [https://perma.cc/7M5X-GHYJ]; https://www.cato.org/multimedia/media-high lights-radio/g-eorge-selgin-discusses-stablecoins-bitcoins-free-banking-brink [https://perma.cc/ 7244-86JD]. Their academic work, some of which is referenced here, is also the source of much of this section.

218. This is, admittedly, not a common method of evaluation economic or policy history, but it has been done before. A pioneering article in this regard is Daniel W. Levy, *A Legal History of Irrational Exuberance*, 48 CASE W. RES. L. REV. 799 (1998). In the article, Mr. Levy examines five historical eras of financial panics and the associated judicial reactions to them.

219. The term "wildcat banking" seldom appeared in judicial opinions at the time. The one opinion we found from 1866 discussed the role of the legislature when it came to banking laws. The Supreme Court of Wisconsin explained that the "legislature might pass such laws as experience might prove necessary and essential to carry out the principles of the original banking law, and which should more effectually guard the public against a system of unsound and wildcat banking." That being said, the Court held that the legislature could not "pass any law which would injuriously affect the securities given by the banking law." As such, "[i]t might pass laws to support and enforce the banking law; laws which should afford greater protection and security to bill-holders; laws which would render the original law more efficient, more stringent, less liable to be evaded, and which should give more effectual remedies to enforce its provisions." Rusk v. Van Norstrand, 21 Wis. 159, 165–66 (1866).

reenacted, and in the same year other laws were passed upon the subject of taxation of banks and banking."[220] The court provided no commentary on the old law or the new law, other than to observe that the banks could now be compelled to pay the tax in question.

The absence of any historical context for why there was a new banking law, while by itself does not prove the lack of concerns with free-banking, is nonetheless telling. While we do not discuss every case in that era, we do provide representative cases that illustrate by explicit refence to the banking environment or by the absence of any discussion the prevailing judicial attitude towards free-banking. These attitudes can be broken into nine main rubrics, which we present as follows.

2. Free-banking as a Check on Corruption

The absence of discussion of free banking in the previous case can be contrasted with those cases where the courts spoke favorably of the free banking statutes. For example, a trial judge in New York observed that prior to the enactment of free banking laws in 1838, banking could only be conducted by a charter granted by the legislature. As such, these banks were "a chartered monopoly," which meant that only those banks authorized by "successive legislatures to successive political or personal favorites" could operate. Over time, the "granting of these charters . . . became a great abuse," and a constitutional convention was convened in 1821 to resolve the issue. It seems that failed too, as "[f]avoritism . . . still continued, with its attendant corruption, until public dissatisfaction became so strong and so universal that the legislature were at length compelled to extirpate the root of the evil." Finally, in 1838, the banking system was overhauled and free banking was allowed.[221] The new laws contained provisions to "secur[e] the community, by proper safeguards, from losses which might arise, as they had too often arisen, out of a vicious paper currency." Furthermore, any "notes intended for circulation as money were to be engraved under the direction of the comptroller, and countersigned in his office with a uniform signature, and secured by a deposit, with him, of public stocks, or of mortgages on real estate."[222]

With the benefit of hindsight in 1908, a trial court in Ohio, was still quite uncritical of the free-banking era.[223] The court observed that Ohio's free-banking statute passed in 1851, was also passed eleven days after the new Ohio Constitution was enacted.[224] The court noted that the power of

220. State v. Southern Bank, 31 La. Ann. 519, 519 (1879).

221. Tracy v. Talmage, 1854 WL 5794 (N.Y. Gen. Term. 1854), modified, 14 N.Y. 162 (1856).

222. *Id.*

224. State v. Laning, 18 Ohio Dec. 681, 682 (Com. Pl. 1908).

225. *Id.* at 686.

legislatures to charter banks had been removed, as the old banking system "had been bitterly assailed in the constitutional convention."[225] This was because the old system

> . . . had emanated the paper currency to which was attributed a great amount of the financial troubles . . . and an effort was made to have inserted in the constitution a provision to deny to the general assembly power to create banking institutions or to authorize the issuing of paper currency.[226]

The court observed that the constitutional committee tasked with examining banks and currency reported that "the business of loaning and dealing in money shall be left free to all," and also reported against special privileges and paper currency.[227]

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226. *Id.* at 685.

227. *Id.*

227. *Id. See also In re* Bachtel, 1905 WL 717 (Ohio Cir. Ct. June 18, 1905), *aff'd sub nom.* Bachtel v. Wilson, 74 Ohio St. 524, 78 N.E. 1116 (1906) (providing a similar perspective).

These observations regarding the political interferences with the banking system can explain much of the failures that created some of the banking failures that critics of the free-banking era point to. *See, e.g.*, the discussion between Hugh Rockoff and Richard Timberlake in Hugh Rockoff, *Institutional Requirements For Stable Free Banking*, 6 CATO J. 617 (1986); Richard H. Timberlake, Jr., *The Feasibility Of Free Banking Institutions*, 6 CATO J. 635 (1986).

While it is true that there were episodes of runs on American banks in that era that resulted in losses to customers, one must be cognizant of a few facts. The first is that American banks were more heavily regulated than their free-banking counterparts around the world. The amount of truly free-banking banks in the grand scheme of American banking system was very small. George Selgin, *The Fable of the Cats* (July 6, 2021), https://www.alt-m.org/2021/07/06/the-fable-of-the-cats/ [https://perma.cc/BGR2-7U6W]; *Real and Pseudo Free Banking* (July 23, 2015), available at https://www.alt-m.org/2015/07/23/real-pseudo-free-banking/print/ [https://perma.cc/5CUB-R7U6].

Second, there were bans, in many states, on branch banking. Many states did not allow banks from another state to operate within their borders. Also, many state governments required their banks to issue notes backed primarily by government debt. As such, the supply of currency was tied to the size of the state government's debt. George A. Selgin, THE THEORY OF FREE BANKING: MONEY SUPPLY UNDER COMPETITIVE NOTE ISSUE 13–14 (1988). We note that this created many problems for the banks. A bank that had to use the value of government debt as the backing for its outstanding notes was at the mercy of the government debt. For example, banks in the Midwest that held Southern states' government debt as assets to back their notes saw the value of those bonds drop on the eve of and during the Civil War. On the other hand, the banks in New York and many New England states, where those state governments' bonds were stable in value, did not suffer any major failures. As such, many researchers concluded, the problem with the so-called wildcat banking was not the wildcats but the falling prices of assets that the banks were forced to hold to back their notes. John A. Dove, Gary M. Pecquet & Clifford F. Thies, *The Michigan Free Bank Experience:Wild Cat Banking Or Interference With Contract?*, 32 ESSAYS IN ECON. BUS. HIST. 47 (2014); Matthew Jaremski, *Free Bank Failures: Risky Bonds versus Undiversified Portfolios*, 42 J. MONEY, CREDIT & BANKING 1565 (2010); Richard Sylla, *U.S. Securities Markets and the Banking System, 1790-1840*, FED. RSRV. BANK OF ST. LOUIS REV. (May/June 1998) 83 (1998); Michael J. Haupert, *Investment in Name Brand Capital: Evidence from the Free banking Era*, 35 AM. ECONOMIST 73 (1991); Howard Bodenhorn, *Entry, Rivalry*

3. Nothing Wrong with Different Notes Circulating at a Different Prices

The judicial discussions of the banking system also demonstrated a sophisticated network of banking and their customers. Consider the case of *Edmunds v. Digges*.[228] In that case, the plaintiff had exchanged large denominations of Virginia banknotes, that were acceptable for official business, i.e. legal tender in the Commonwealth of Virginia. He took the notes to the capital Richmond to make a payment to the state treasury. He agreed to exchange these notes for smaller denominations of a soon-to-be-defunct bank, the Mechanics Bank of Alexandria offered by the defendant. The defendant wanted the larger denominations to make it easier and safer to send by mail to his brother. He assured the plaintiff that his notes would be exchangeable for officially accepted Virginia bank notes closer to Richmond.[229]

Although the notes were exchangeable at banks in their location, by the time the plaintiff was getting close to Richmond, news spread that the Mechanics Bank of Alexandria had suspended payment on its notes, and its notes were no longer being accepted by other banks. He tried to get his large bills back from the defendant, who refused to return them. The bank never resumed payment, and the notes eventually became worthless.[230] There was no evidence that the defendant knew or suspected that the bank would become insolvent or that its notes would be unexchangeable. Indeed, they were circulating at par on the day he exchanged the notes with the plaintiff in place they were both at.[231] The plaintiff sued and won at a jury trial.[232] The defendant appealed to the Supreme Court of Appeals, then the highest court in Virginia. The court reversed and remanded for another trial.[233]

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and Free Banking in Antebellum America, 72 REV. ECON. STAT. 682 (1990); Andrew J. Economopoulos, *Free Banking Failures in New York and Wisconsin: A Portfolio Analysis*, 27 EXPLORATIONS IN ECON. HIST. 41 (1991); *Illinois Free Banking Experience*, 20 J. OF MONEY CREDIT & BANKING 249 (1988); Arthur Rolnick & Warren Weber, *Explaining the Demand for Free Bank Notes*, 12 FED. RSRV. BANK OF MINN. 21 (1988); Arthur J. Rolnick & Warren E. Weber, *Banking Instability and Regulation in the U.S. Free Banking Era*, 9 FED. RSRV. BANK OF MINN. Q. REV. 2 (1985); Arthur J. Rolnick & Warren E. Weber, *New Evidence on the Free Banking Era*, 73 AM. ECON. REV. 1080 (1983); James Kahn, *Another Look at Free Banking in the United States*, 75 AM. ECON. REV. 881 (1985); Robert G. King, *On the Economics of Private Money*, 12 J. MON. ECON. 127 (1983); Hugh Rockoff, *New Evidence on Free Banking in the United States*, 75 AM. ECON. REV. 886 (1985); Hugh Rockoff, *The Free Banking Era: A Reexamination*, 6 J. OF MONEY, CREDIT & BANKING 141 (1974).

228. Edmunds v. Digges, 42 Va. 359 (1845).

230. *Id.* at 360–61.

231. *Id.*

232. *Id.*

233. *Id.*

234. *Id.*

Justice Baldwin, for the majority, made some observations regarding the nature of notes. First, he observed that the there was "no implied warranty of the value of current money of the country, passing from hand to hand, in the course of trade, commerce and other business."[234] Indeed, this 'no implied warranty for money' rule held not only for "money made by law a good tender in the payment of debts and performance of contracts" but also "equally so in regard to the notes of banks and bankers, payable to bearer, and circulated by delivery."[235] In other words, cash and cash equivalents, i.e. banknotes and even negotiable instruments such as checks that could be indorsed, were functionally equivalent and should be treated by the law as such.

He stated this by observing that these financial instruments were "not merely the representative of money, but in the course of business, and by common usage, [were] substantially employed and treated . . . as actual money or cash."[236] But he also observed that in order for these cash equivalents to circulate properly, both parties had a role in maintaining the orderliness of the market.[237] In other words, the circulation depended not only "upon the responsibility of those who pass them, but upon the opinion and estimate of those who receive them."[238] Those who pass these banknotes or checks along were not seen to be giving any assurances regarding the "the credit, punctuality or solvency of the makers [of the notes]" and those who received the notes could "exercise[] [their] own judgment" or rely on the opinion of others' whom they trusted regarding the value of the notes.[239]

4. Forgery is the Main Concern of Free-Banking Jurisprudence

Continuing with the *Edmunds* case, the court noted that the only guarantee that those who passed the notes along were held by law to be making the notes "genuine and not counterfeit."[240] Other than the note being a forgery, "in the absence of express warranty, or fraudulent misrepresentation or concealment, the receiver takes it at his own risk."[241] In other words, there was "no implied warranty, whether of title or value" for banknotes any more than there was for legal tender cash.[242] The reason is that both parties are "equally innocent" and there is no justice in having the loss caused by a third party, namely the insolvency of the

235. *Id.* at 361–62.
236. *Id.* at 361.
237. *Id.*
238. *Id.*
239. *Id.*
240. *Id.* at 361–62.
241. *Id.* at 362.
242. *Id.*
243. *Id.*

Mechanics Bank of Alexandria, thrust upon the last person to circulate the notes.[243] This would cause a chain of litigation and would further hinder the circulation of banknotes overall.

Only forged notes required the vigilance of all involved, because forged notes were no note to begin with. If the defendant expressly warranted that the notes were perfectly acceptable for exchange, then would the defendant then be liable for the loss in value. Indeed, the concurring judge was of the opinion that the defendant had warranted the soundness of his banknotes, and as such would have upheld the finding of liability at trial.[244]

5. Notes from Different Issuers Circulated all Over at Different Prices Based on the Issuer's Risk

The public, back then, traded notes of one bank for another, even when they were taking a risk that one of the banks may suspend payment on the notes. Additionally, people would issue promissory notes whereby they would promise to pay the promise in specific notes. For example, in the case of *Hixon v. Hixon*,[245] the defendant had promised to pay the plaintiff $100 via a sealed negotiable instrument. The payments were to be in a $100 "in Georgia, or Alabama, or Tennessee bank-notes, or notes on any good men."[246] While it is not clear what the latter refers to, what is clear is that the acceptable payment would be $100 drawn on a bank in one of the three adjacent states mentioned.[247]

Many similar cases from the nineteenth century are replete with examples of contracts whereby payments were promised in various choice of notes or valuable items, presumably with the party being promised the payment.[248] In *Gray v. Donahue*,[249] the court also saw nothing wrong with bank notes circulating above or below the par value. The court stated that "bank notes are not money, in the legal sense of the word," as they are "not a legal tender as money, either in the ordinary

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244. *Id.*

245. *Id.* at 363.

245. Hixon v. Hixon, 26 Tenn. 33 (1846).

247. *Id.* at 34.

247. The issue in the case was one of quantum of damages since the defendant did not pay the plaintiff on time. The court held that since the defendant was obliged in $100 notes drawn on any one of the three states' banks, this meant that the defendant could pay in any banks' notes, which would also mean that the defendant could possibly pay in lower valued notes. Since it was up to the defendant to choose, there could be a banknote that was worth less than $100 in specie, and there could be another bank whose notes were worth more or even the full $100. As such, the quantum of damages was "the specie value of such notes, in which payment might have been made, and in which it would have been most to the interest of the [defendant] to have paid."

248. *See, e.g.*, Heywood v. Heywood, 42 Me. 229 (1856).

249. Gray v. Donahue, 4 Watts 400 (Pa. 1835).

transactions of business, or in the collection of debts by legal process."[250] Only coins legally minted were the only true legal tender, at the time, and they possessed "a fixed and permanent value."[251] As such, bank notes were "merely promissory notes for the payment of money . . . convertible into coin on demand at the bank where they are issued."[252]

The court cautioned that these bank notes'

> value is fluctuating and precarious; different at different distances from their place of issue, and even there, at particular periods, depreciated below the par of gold and silver, though they may continue to pass current from hand to hand, and constitute a part of the circulating medium of the country.[253]

As such, the court observed that promissory notes denominated in bank notes were

> an engagement to pay in a kind of property, consisting of promissory notes or choses in action which the parties have chosen specifically to contract for, but which may or may not be equivalent to money, and cannot be … considered a promise to pay money in its legal or commercial sense.[254]

The creditor, therefore, can only expect to be paid in bank notes, and not necessarily specie, however inferior the bank notes are to specie.[255] Curiously, despite this caution here and elsewhere, it is obvious from the multitude of cases litigating the question of how much debtors owed their creditors that they continued to accept promises to pay in banknotes instead of insisting on being paid in specie, despite their ability to legally do so.[256]

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251. *Id.* at 400.

252. *Id.*

253. *Id.* at 401.

254. *Id.*

255. *Id.*

255. *See also* State Bank v. Ford, 27 N.C. 692 (1845) (holding that when a lender lent discounted notes, the borrower was not obligated to repay the debt at par value of the notes, as this would violate usury laws); Bondurant v. Commercial Bank of Natchez, 16 Miss. 533 (1847) (finding that banks could not use discounted notes to pay for debts at par without running afoul of anti-usury laws.).

256. Specie had always been the main currency of the USA with the exception of the Civil War and up until the early 1930s when President FDR suspended the gold standard. *See* RICHARD H. TIMBERLAKE, CONSTITUTIONAL MONEY (2013) (discussing the monetary history of United States in terms of various cases challenging the authority of the government to suspend gold redeemability); Russell L. Post and Charles H. Willard , *The Power of Congress to Nullify Gold Clauses*, 46 HARV. L. REV. 1225 (1933) (describing the events and the supreme court decisions that allowed the effective ending of the gold standard). We note that it is still illegal to mint one's own gold coins, as one individual found out the hard way about ten years ago. U.S. Attorney's

The courts noted different approaches when notes from different banks were being used. For example, in *Balch v. Colman*,[257] the court dealt with the question of a promissory note "payable at the Lafayette Bank [Indiana], with the rate of exchange between the place of payment and the city of New York."[258] At the time the note was given, banks were redeeming their notes in specie, but when the note was due, banks in Indiana had suspended redemption in specie. As such the question was

> what shall be the rate of exchange which the plaintiff has a right to demand? Shall it be the present rate of difference between the depreciated currency of the state and funds in New York; or, shall it be the ordinary rate of exchange between specie, or its equivalent, at Lafayette, and funds in the city of New York?[259]

The court noted that although the parties when making the contract for the promissory note anticipated payment in "sound circulating medium, convertible into specie, and, of course, of value equal to specie."[260] In ascertaining the equivalent value of such specie in paper notes in Indiana, the court noted that in addition to the price of specie, "other ingredients . . . must be looked to in making an estimate."[261] For example, specie is "not transported at the same rate as other merchantable commodities."[262] There is also "the risk, the insurance, the delays, and other contingencies, which are taken into the account; and, not unfrequently, the scarcity or abundance of specie at the place of remittance,"[263] all of which affects the rate of exchange.[264]

Office (Charlotte Division), Defendant Convicted of Minting His Own Currency (Mar. 18, 2011), https://archives.fbi.gov/archives/charlotte/press-releases/2011/defendant-convicted-of-minting-his-own-currency [https://perma.cc/K5KQ-2PYR].

257. Balch v. Colman, 2 F. Cas. 504 (C.C.D. Ind. 1840).

259. *Id.* at 504.

260. *Id.*

261. *Id.*

262. *Id.*

263. *Id.*

264. *Id.*

264. *See also* Mitchell v. Waring, 27 Ky. 233 (1830)(discussing various terms that can be included in debt contracts and what that means in terms of recovery in specie or bank notes); Pierson v. Wallace, 7 Ark. 282 (1847)(explaining that although there may bank notes circulating at discounts of 50%, generally speaking when a contract specifies payment in bank notes, it means notes that are circulating at par with specie.).

We note that during this period, there emerged an industry of note brokers who would accept notes from banks from all over the United States and trade them for local notes that were easier to redeem, sometimes at par and sometimes at a discount. GEORGE A. SELGIN, THE THEORY OF FREE BANKING: MONEY SUPPLY UNDER COMPETITIVE NOTE ISSUE 25–34 (1988). One economist, for example, found that individual banks' notes circulated in the secondary market at a discount depending on the probability of default, which shows that the "secondary market reduced losses by accurately discounting notes based on their individual risk of default" and that note "discounts

6. Shareholder Liability was a way to Ensure Redemption of Notes

In *Johnston v. Southwestern Railroad Bank*,[265] the court noted that the act governing banking in Georgia, where one of the defendant banks was incorporated, required that "the persons and property of the stockholders . . . shall be pledged . . . over and above the amount of said stock . . . for the ultimate redemption of the bills or notes issued by or from said Bank. . . ."[266] In other words, Georgia required shareholders to be liable for any excess notes that could not be redeemed in gold or silver by the bank itself. This meant that Georgia banks were practically unlimited liability banks. In fact, some states had unlimited shareholder liability, while others required double or triple liability for shareholders, something that many have argued contributed to the stability of banking during the free banking era.[267]

The court noted that normally the liability of shareholders was limited by the amount they paid into a company for their shares.[268] However, the Georgia legislature, "with a view to the protection of her citizens from a spurious currency"[269] only allowed certain banks that complied with various regulatory requirements from issuing notes to circulate as currency. The court noted that there were usually three kinds of banks: banks of deposit, banks of discount, and banks of circulation.[270] The court made it clear that the liability of the shareholders, while unlimited, was only for the redemption of the bank's circulating notes that the banks were unable to pay off in specie.[271] In other words, the liability was not for all debts incurred by the bank, say a debt from hiring a contractor to build the bank's headquarters, but only for debts arising from problems with note redemption. This is because when it came to regular non-

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were almost exclusively sensitive to those factors which increased a bank's probability of default: specie suspensions, falling bond prices, and undiversified portfolios." This allowed an "accounting for a bank's composition and environment", and in turn, the market protected noteholders and allowed notes to circulate throughout the economy. Matthew Jaremski, *Bank-Specific Default Risk in the Pricing of Bank Note Discounts*, 71 J. ECON. HIST. 950 (2011).

265. Johnston v. Sw. R.R. Bank, 22 S.C. Eq. 263 (S.C. App. Eq. 1849).

267. *Id.* at 323.

267. Alexander W. Salter, Vipin Veetil & Lawrence H. White, *Extended Shareholder Liability as a Means to Constrain Moral Hazard in Insured Banks*, 63 Q. REV. ECON. & FIN. 153 (2017) (canvassing the history and theory of bank shareholder liability as a means to ensure the proper security of bank deposits); Howard Bodenhorn, *Double Liability at Early American Banks* (2015) (discussing the economic impacts of double liability for shareholders), available at http://papers.nber.org/papers/w21494.pdf [https://perma.cc/2Y22-BNVS]; Jack L. Carr and G. Frank Mathewson, *Unlimited Liability as a Barrier to Entry*, 96 J. POL. ECON. 766 (1988) (discussing the Scottish free-banking experience, and noting that none of the unlimited liability Scottish banks at the time failed).

269. Johnston, 22 S.C. Eq. at 323.

270. *Id.*

271. *Id.*

272. *Id.*

banknote debts, the legislature "left every one to the protection of [their] own sagacity or vigilance."[272]

However, when it came to protecting the community from the general effects of over-circulating unbacked currency, the legislature required those who "asked for the privilege of [] supplying the circulating medium" to be "personally responsible for the ultimate redemption of the bills."[273] Furthermore, while shareholders would not normally be liable for the misdeeds of the directors of a bank beyond their initial capital contributions, when it came to "creating a fictitious currency," i.e. "putting in circulation Bank bills to an amount which [the banks] have not the means of redeeming, the misconduct of the directors is visited upon the stockholders in their persons and property."[274]

In *McDougald v. Bellamy*,[275] the Supreme Court of Georgia held that the shareholders were liable for the outstanding unredeemed banknotes that had been put into circulation. Even though the notes were erroneously put into circulation, that fraud or error on the part of the bank's president did not insulate the shareholders from liability.[276] The bank's stock was $1 million, of which $250,000 in specie was supposed to be held as reserves but was never actually paid up by the shareholders.[277] The case stands for the liability of corporations for the frauds and torts of their agents, as well as the question of limited lability of ordinary shareholders versus unlimited lability of bank shareholders.

The case is, for our purposes, also instructive for other aspects. The court applying basic principles of agency held that the bank was liable for the banknotes issued by the bank's director even though they had not complied with the rules, which would have formally brought the bank into existence.[278] The directors' "misconduct [could not] … shield the bank from liability to bill-holders, who were ignorant of such misfeasance."[279] The court contrasted banks with a railroad company which might improperly issue bonds, say in violation of its charter. The court argued that in this example, "the public would take them at their peril" and "no liability would attach to the company, because no such power was designated by the charter."[280]

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273. *Id.* at 324.
274. *Id.*
275. *Id.* at 324–25.
275. McDougald v. Bellamy, 18 Ga. 411 (1855).
277. *Id.* at 433.
278. *Id.* at 411.
279. *Id.* 433–37.
280. *Id.* at 433.
281. *Id.*

7. Shareholder Liability is Related to Courts' Disapproval of Bills of Credit

The *McDougald* court also distinguished between those innocent customers holding the bank's banknotes and those who had relied on unconstitutionally issued Missouri state banknotes, which were bills of credit.[281] Bills of credit, we note, are instruments whereby states issue debt and then circulate the government debt as currency. States are prohibited from issuing such bills.[282] As such, the United States Supreme Court in *Craig v. Missouri* had invalidated banknotes issued by the state of Missouri holding that even those who were holding the notes could not be paid anything.[283] The question of what constituted bills of credit was contentious prior to the Civil War with the U.S. Supreme court ruling against Missouri on its notes, but finding that Kentucky's state owned bank unbacked paper notes not to be unconstitutionally issued bills of credit.[284]

As an aside, we note that the prohibition against states issuing unbacked paper money did not extend to private individuals, at least constitutionally speaking:

> The Constitution does not prohibit the emission of all bills of credit, but only the emission of bills of credit by a state, and when I say by a state, I mean by or in behalf of a state, in whatever form issued. It does not prohibit private persons or private partnerships or private corporations … from issuing bills of credit. No evils, or at least no permanent evils, have ever flowed from such a source. The history of the country had furnished no examples of that sort -- of a durable or widely extended public mischief. And if any should exist, it would be within the competency of the state legislatures to furnish an adequate remedy against such issues by private persons.[285]

The *McDougald* court held that the public was charged with knowledge of the Constitution, and as such could not rely on the fact that the state was issuing these notes to make a claim against those who had issued the note.[286] Additionally, the entire community and not just the specific parties on that case are affected by the Supreme Court's ruling. In the current case, the court noted, there was no way for the members of

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281. *Id.*

282. U.S. Const. Article I, Sec. 10, Cl. 1. *See* THOMAS COOLEY, THE GENERAL PRINCIPLES OF CONSTITUTIONAL LAW IN THE UNITED STATES OF AMERICA 81–82 (1880) (explaining the origin and meaning of the clause).

284. Craig v Missouri, 29 U.S. 410 (1830).

284. Briscoe v. Bank of Kentucky, 36 U.S. 257 (1837).

285. *Id.* at 348 (Story, J., dissenting).

287. McDougald, 18 Ga. at 433–37.

the public holding the banknotes to ascertain whether the specie had been paid by the shareholders, and whether there was a possibility of the bank being able to redeem their notes. The court emphasized the need to hold the shareholders liable for the unpaid balances for the outstanding notes by appealing to policy. If the court did not hold the shareholders liable,

> there would be . . . few rational persons dealing with banks." Additionally, this "would destroy public confidence and shake the foundation of paper currency, by sweeping away, at once, every substantial liability of monied corporations, and leave all persons, unwise enough to deal with them, at the mercy of every faithless officer in their employment.[287]

As such, the liability was imposed to "quiet the community, and to maintain and uphold the best interests of society."[288]

Similarly, a court in *King v Elliott*,[289] held that a shareholder in a bank chartered in Mississippi was required to pay in specie for his shares in the bank, especially when the shareholder was in default of his original shareholder obligations. The shareholder in that case tried to pay for his outstanding debt with bank notes, even though the legislation authorizing the bank, i.e. the bank's charter, was silent on the question. Notwithstanding that there was state legislation that provided for the payment of debts due to state banks in state banknotes, the court held that when it came to the capital of banks, they must be backed by specie.[290] The counsel for the plaintiff suing the shareholder argued that if the shareholder were allowed to pay off his initial stock subscription, which was supposed to be in specie, with paper banknotes then this would be in violation of the constitutional limitation on states making anything but gold or silver as legal tender.[291] Although the court did not address the constitutional point, they held that only specie could be used to back the initial set of banknotes that were issued against the shares of the bank.[292] Chief Justice Sharkey observed that since banks put notes into circulation, the over-issuing of notes which brought about the depreciation of the value of the notes meant that justice required that the original shares of the bank must be backed by specie. The shares or reserves against which the notes are issued, once put into circulation, become a "trust fund for the benefit of the note-holders."[293]

In another case, discussing why banks suspend redemption of notes, the Court of Errors of South Carolina made the point that legislatively

288. *Id.* at 436.
289. *Id.*
289. 13 Miss. 428 (1845).
291. *Id.* at 449–50.
291. *Id. See* U.S. Const. Article I, Section 10, Clause 1.
293. Elliott, 13 Miss. at 49–50.
293. *Id.* at 446.

allowing the suspension of redemption of paper banknotes would essentially convert banknotes from specie-backed notes into unbacked notes that would resemble the constitutionally prohibited bills of credit.[294] After all, Article I, Section 10 of the United States Constitution prohibits states from making anything but gold or silver legal tender for the payment of debts. States are also prohibited from making laws that impair the obligation of contracts. Allowing the suspension of payment in specie would do these two prohibited things, the court argued.[295] Indeed, the court noted that "[p]aper money may be as good as gold and silver coin, and is much more convenient in daily business. But without a metalic [*sic*] basis ever ready to take its place, such money is deceptive, becomes the root of frauds and spreads out its scions far and deep in society."[296] It pointed to the experience in England when the Bank of England suspended payment in specie, with the authority of the British Parliament, and noted that the value of its circulating bills had fallen twenty percent in value.[297] Allowing suspension in a haphazard way, it reasoned, would visit such devaluation on the current banknotes and impair the pre-existing obligations that the banks owed its customers.[298] The court also argued that suspension of payment in specie changes the nature of the paper money, which everyone has come to treat the same as gold and silver. "Suspension produces a change as instantaneously as the coldness of the atmosphere causes a depression in the thermometer," he mused.[299] The court did acknowledge that "exigencies may arise, in which a bank . . . may be excused for conduct," but such excuses, the court argued, were "not for judicial tribunals" but for "the discretion of that authority which has entire control over the subject."[300]

8. Note Issuers and Holders could Agree on the Mode of Redemption

In *Anderson v. Ewing*,[301] the court confronted the question of how much a defendant who issued a promissory note owed. The note had promised to pay $800 in bank notes, but due to some ambiguity in the law or facts, the court had to decide whether the promise meant that the "defendant was to pay the amount in specie, . . . or did it bind the party to pay only so many paper dollars?"[302] The court opined on the meaning of the instrument as a question of what parties to the note intended. They

295. State v. Bank of S.C., 28 S.C.L. 433 (S.C. Err. 1843).
296. *Id.* at 480–82.
297. *Id.* at 482.
298. *Id.* at 492.
299. *Id.* at 520–21.
300. *Id.* at 519.
300. *Id.* at 521.
301. Anderson v. Ewing, 13 Ky. 245 (1823).
303. *Id.* at 246.

posed the hypothetical of an instrument that promised payment "of a certain number of dollars in cattle, wheat, or other commodities."[303] The case also cited to an earlier case where the promisor had promised to pay "thirty pounds in militia certificates."[304]

Similarly, in another case when discussing regular debts not owed by bank shareholders, banknotes were usually acceptable as forms of payment. In upholding contracting between parties who specified the mode of payment as being banknotes, a discussion ensured regarding what value would the banknotes be assessed for the purposes of settling a debt.[305] In dissent, one judge noted that parties were free to agree upon whatever commodity or medium of exchange for settling debts.[306] He observed that if the parties agreed that their debts were "receivable in wheat," then they "could only be discharged by the delivery of wheat, according to its value in money."[307] All in all, the court saw nothing wrong with promises to pay in units of commodities or in units of banknotes, regardless of what backed them.

9. Suspension of Redemption Could be a Legitimate way of Dealing with Bank Runs

In *State v The Bank of South Carolina*, the question before the court was whether a bank that suspended redemption of its notes in specie had forfeited its charter, absent an authorization from the legislature.[308] The court answered in a narrowly divided opinion answered in the affirmative, overruling the chancellor (the trial judge for the court of equity) who answered in the negative.[309] It is interesting to note that South Carolina was not one of the free-banking states. Also interestingly, it was a state characterized by excessive state banking regulation, as the case evidences. There had been a panic, started in New York in 1837 when payment in specie was suspended, and the panic had spread to the rest of the country. At some point, the Bank of South Carolina, as did others in South Carolina,[310] made the decision to suspend payment in specie in order to protect itself from bank runs and ultimate ruin. This, the court held, was fatal to its charter. Absent explicit permission from

304. *Id.*

304. *Id.* at 248 (citing Clay v. Huston's Adm'rs, 14 Ky. 461 (1809)).

305. Bush v. Shipman, 5 Ill. 186 (1843).

307. *Id.* at 192 (Shields, J., dissenting).

308. *Id.*

309. Bank of S.C., 28 S.C.L. at 444.

310. *Id.* at 440–59.

310. See the companion case of State v. The Bank of Charleston, 27 S.C.L. 439 (Court of Errors of South Carolina, 1842) (reaching the opposite conclusion that the bank had not forfeited its charter due to suspension of payment in specie, because it had received legislative permission).

the legislature, the court held that the bank was not allowed to suspend redemption.[311]

The decision of the court below as well as the discussion by the judges on appeal is illuminating for several reasons. The chancellor noted that the bank had been chartered with various privileges, including the right to issue

> promissory notes and bills of credit in the nature of a circulating medium, not being of a lower denomination than five dollars, and payable on demand, when due, in gold and silver legal current coin of the said State; to receive and hold moneys on deposit; to make loans of money, and discount promissory notes, at a rate of interest not exceeding six *per centum per annum*; to deal and trade in bills of exchange, and in gold and silver bullion; and to carry on and transact such other moneyed operations and banking business, as are usually carried on, transacted and performed by incorporated banks.[312]

The bank, the chancellor noted, had suspended payment in specie but then resumed after a year or so. The chancellor suggested that the run on the banks all over the country was a result of panic and perhaps market manipulation and not a reflection on the quality of the bank's holdings.[313] The chancellor observed that the bank panics had become the "subject of excited popular discussion, and to some extent have been prejudged by legislative enactment."[314] Nonetheless, the chancellor observed that the bank was a corporation that deserved to be treated fairly. While the "temper of the times may influence political bodies, and change popular sentiment," he went on to argue that "it cannot change the rules of construction governing private rights, under charter or contract."[315]

The argument against the bank by the state was, as summarized by the chancellor: the bank

> had issued and put into circulation, as a part of the currency of the country, more of its notes than it was able or willing to redeem in gold and silver, when demanded; . . . that it had continued to issue its depreciated bills, after suspension, thereby making profit without adequate responsibility on its part.[316]

312. Bank of S.C., 28 S.C.L. at 440–59.
313. *Id.* at 434.
313. *Id*. at 438.
315. *Id*. at 443.
315. *Id.* at 444.
317. *Id.* at 452.

In other words, the chancellor noted that the state was imputing "mischievous effects" of the suspension to the bank, and this was the source of the bank's offence.

The chancellor also noted that while the bank was not obligated to issue notes, it was free to do so. Indeed, he noted it had the "right to perform the functions of a bank, namely, to receive money on deposit, to discount mercantile paper, to lend money, and to issue its own or other paper, *in lieu* of notes discounted."[317] Furthermore, he observed, "notes of the bank are no more to be regarded as money, than the notes of private individuals, put into circulation as the representatives of gold and silver."[318] He went on to note that both sets of notes "may circulate and serve the purposes of money, upon the assurance that they can be converted into gold and silver, at the pleasure of the holders."[319]

As such, the price of paper currency "will be estimated as approaching the value of money, more or less, according to the credit of the source whence it emanates. This, in general, will be settled by mercantile sagacity, public security, and the competition of free trade."[320] And as "long as notes and bills are received and used as currency, the courts, for many purposes, will treat them as money."[321] He remarked that the checks drawn on another well-known bank "were regarded as better than gold and silver, as they increased in value according to the number of hands through which they passed, and of course the number of indorsements on them."[322] Nonetheless, he pointed out that these circulating checks from "a legal point of view, . . . were securities for the payment of money," even if the functioned as "conventional money."[323]

The chancellor seemed to question the motivation of the state in bringing this action against the bank. After all, he noted, its suspension of redemption in specie had not really harmed anyone. Depositors who had deposits in the bank and who did not demand redemption were no worse off than before the suspension. Indeed, suspending redemption was the best thing the bank could have done to protect all the depositors. The chancellor found the suspension motivated by desire to serve rather than mischief, something he thought the state was imputing against the bank. The chancellor did not find any fraud or over-circulation of notes. Rather, he noted that the notes in circulation were three times its reserves in specie.[324] Such a bank, known as a bank of circulation, would by its very

318. *Id.* at 453.
319. *Id.* at 452.
320. *Id.* at 453.
321. *Id.*
322. *Id.*
323. *Id.* at 454.
324. *Id.*
325. *Id.* at 456.

nature of operating with less than 100% reserves would always have the potential to be exposed to a bank-run, and as such would need to suspend payments every now and then. The chancellor than opined that:

> A redundancy of depreciated paper has been the great cause of suspension. The legislation of the country, not of this State alone, but of all the States, should bear a share of the blame in producing the disastrous state of affairs, which gave rise to the late suspension of the banks. The number of banks created by acts of legislation, more than the excessive issues of any one bank in this State, has inflated and deranged the currency.[325]

We note again that South Carolina was not a free-banking state, and indeed, the chancellor pointed the blame at the state rather than the banks themselves. In the end, the chancellor found in favor of the bank and against the bank. On appeal, the Court of Errors reversed in a narrowly split opinion. The majority held that the bank had violated the letter of the law that stated that banks suspending payment would lose their charter.[326]

In other states, when banks suspended specie payments for their notes, their courts also did not seem to attribute this to malice or inherent flaw in the banking design. Just as they seemed blasé about the idea of contracts that were denominated in multiple notes from specified banks, which could be circulating at lower than their face value, the courts were also generally unmoved by the prospect of banks suspending payment in specie for their notes. For example, in *State v. New Orleans Gas Light and Banking Co.*,[327] the Louisiana Supreme Court dealt with an action by the state of Louisiana against one of its chartered banks, New Orleans Gas Light and Banking Company for failing to satisfy certain conditions of its charter, namely that the bank had suspended payment in specie for

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326. *Id.* at 458.

326. In other words, it was up to legislature to sanction what the bank did and not the courts. Justice Richardson traced the history of corporations and their rights and responsibilities back to English law. He also observed that "banks and paper money are interwoven with [American] history, to fullness and repletion." He remarked that just a few years prior to the case, South Carolina had almost eight hundred banks, some of whom had failed and some that had suspended payment in specie. Nevertheless, he remarked that the banking situation was one of "comparative peace and safety." He remarked that "[c]oin hoarded is not money; for the purposes of commerce, or a practical currency, its character as money is suspended. It is only gold or silver." As such, notes that were not convertible were also worthless. And while the state, he remarked, had no interest in worthless railroad, hotel, or even municipal bonds, worthless banknotes posed a threat to the circulating media of currency. The state's interest in seeing that banknotes are redeemed related to the state's role in assuring the public of the "uniformity, value and permanence, in bank bills that represent money, by the only possible means—the payment of them, as well as of deposits, in lawful coin."

327. State v. New Orleans Gas Light & Banking Co., 2 Rob. (LA) 529 (1842).

its notes. The legislature, the court noted, had enacted various regulations in 1837 due to the "general derangement in the monetary system of the country," that had led to the suspension of payment in specie for notes as had many banks throughout the United States.[328]

The court found in favor of the bank, but in the process recited some of the requirements that the bank's state charter required. These included that the bank "should at all times pay all its notes and liabilities in lawful money of the United States," that all banks "should pay or settle every Monday morning in gold or silver, the balances that each might owe to the other Banks," that the banks "should publish, at least once a month, a statement of its condition, in some newspaper in the city of New Orleans, showing the amount of its circulation, deposits, specie in the vaults, and other assets and liabilities."[329] The bank had indeed done all of these, but had also run into a general economic meltdown that necessitated the suspension. The court observed that suspending payment was also authorized by the legislature for a period not exceeding 90 days, suggesting that the idea of a cooling off period to avoid bank runs was quite common back then. The court was quick to emphasize that a bank, "whose stock is owned by private individuals is essentially a private corporation," which means that a "right of property is . . . vested . . . which . . . should not be divested for light causes."[330] The court emphasized this notwithstanding that a bank's goals, "uses and operations partake of a public nature," something that could also be said of "insurance, canal, bridge and turnpike companies."[331] In other words, the court viewed the banking operations as a legitimate private business subject to some regulatory oversight. Even though the bank had suspended specie payment, the court did not perceive the banking crises with the level of alarm today's commentators raise about stablecoins.

10. Bank Notes were Forms of Negotiable Instruments, Which also Circulated as Currency

In *Bonnell v. Covington*,[332] there was an action where the defendant had issued a "promissory note for five hundred and seventy-three dollars in the current notes of either of the banks of Natchez or of the [the Mississippi] Union Bank, for value received."[333] The court also held that since the method of payment was banknotes, it would not hold that the plaintiff "was entitled to claim the amount in specie."[334] Similarly, in

329. *Id.* at 531.
330. *Id.* at 530.
331. *Id.* at 532.
332. *Id.*
332. Bonnell v. Covington, 8 Miss. 322 (Miss. Err. & App. 1843).
334. *Id.* at 326.
335. *Id.* at 327.

Kennedy v. Vanwinkle,[335] the court dealt with a promissory note where the promisor issued a sealed note stating that

> For value received of William Scott, we, or either of us, promise to pay him, against the first day of January, 1824, the just and full sum of four hundred dollars in notes on the Bank of Tennessee, Alabama, North Carolina or Virginia; that is, if neither of the banks should fail. Given under our hands the 19th December, 1822.[336]

The *Bonnell* case also leads to another well-known observation, namely that promissory notes, regardless of whether they were bank notes or not, also circulated as cash or currency substitutes. Indeed, the whole reason the law of negotiable instruments codified in the modern-day Article 3 of the Uniform Commercial Code (UCC), was developed because of the high volume of commercial paper circulating as currency substitutes. Most readers may recall the case *Swift v Tyson* from their first-year law school Civil Procedure class.[337] Most readers will also probably remember the case for the proposition that federal courts can create federal common law that could differ from the states' common law even when hearing a lawsuit arising out of diversity jurisdiction, but most readers probably do not remember the details of the case. Fascinatingly, at least for the purpose of this Article, the case involved the question of what law applied to negotiable instruments.[338] Justice Story opted to apply a federal common law, as opposed to New York's common law of negotiable instruments, partly to ensure that negotiable instruments

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335. Kennedy v. Vanwinkle, 22 Ky. 398 (1828).

337. *Id.* at 398.

337. 41 U.S. 1 (1842); Swift v. Tyson, 41 U.S. 1 (1842), *overruled by* Erie R. Co. v. Tompkins, 304 U.S. 64 (1938).

338. Uniform Commercial Code (UCC) § 3-104 defines negotiable instruments as

> an unconditional promise or order to pay a fixed amount of money, with or without interest or other charges described in the promise or order, if it:
>
> (1) is payable to bearer or to order at the time it is issued or first comes into possession of a holder;
>
> (2) is payable on demand or at a definite time; and
>
> (3) does not state any other undertaking or instruction by the person promising or ordering payment to do any act in addition to the payment of money, but the promise or order may contain (i) an undertaking or power to give, maintain, or protect collateral to secure payment, (ii) an authorization or power to the holder to confess judgment or realize on or dispose of collateral, or (iii) a waiver of the benefit of any law intended for the advantage or protection of an obligor.

Black's Law Dictionary notes that "the various types of negotiable instruments are bills of exchange, promissory notes, bank checks, certificates of deposit, and other negotiable securities"

crossing state lines received uniform treatment across the nation.[339] Indeed, Justice Story seemed to think that the law of negotiable instruments were "not the law of a single country only, but of the commercial world."[340] A comprehensive survey of the caselaw is beyond the scope of this Article, and there are hundreds of reported cases where negotiable instruments were treated as currency or substitutes for currency. A few examples will suffice. In *McArthur v. McLeod*,[341] a North Carolina court discussed how the law

> made promissory notes negotiable, like the bills of exchange, it intended to impart to them a mercantile character, so as to make them answer many of the purposes of money in trade; and, therefore, the courts were obliged early to lay down rules to prevent frauds on the public, and to sustain that character.[342]

These instruments are still, at the end of the day, contracts that require consideration. But the consideration passes from user to user, as long as the notes pass along for value. Indeed, unless it is apparent on the face of the instrument that the note is only negotiable at a bank, then it free to be "thrown into the market" as a cash substitute.[343]

11. Legislative Views on Free-Banking

Finally, before ending this section, we note that in addition to the lack of disapproval, and sometime the existence of outright approval, of the free-banking regime, there did not seem to be much opposition to free-

339. Swift v. Tyson, 41 U.S. at 14–22; Craig Green, *Turning the Kaleidoscope: Toward a Theory of Interpreting Precedents*, 94 N.C. L. REV. 379 (2016); Arthur John Keeffe, *In Praise of Joseph Story, Swift v. Tyson and the True National Common Law*, 18 AM. U. L. REV. 316 (1969).

341. Swift v. Tyson, 41 U.S. at 14–22.

341. 51 N.C. 475 (1859).

342. *Id.* at 477. *See also* Miller v. Riley, 2 Root 522 (Superior Court of Connecticut, 1797) (explaining that the statutes regulating banks and the common law "makes notes payable to the bank, and notes payable to order, etc. and indorsed to the bank, negotiable as bills of exchange … as applied to commercial transactions among merchants.").

343. *Id.* at 478. *See also* Raymond v. Middleton, 29 Pa. 529 (1858) (holding that because the note did not contain the words "or order" "or bearer," and "payable and negotiable without defalcation at the Kensington Bank," the note was not negotiable to be circulated as cash). *See also* discussions by Rollin M. Perkins, *May a Promissory Note Be Payable in Foreign Money*, 5 IOWA L. REV. 209 (1919–1920) (canvassing the law at the time including a discussion about whether money substitutes can be used to redeem negotiable instruments, and "[i]f so, then in any community in which tobacco or cotton or gold dust commonly passed as substitutes for money a note could be payable in such commodities."); Herman Oliphant, *The Theory of Money in the Law of Commercial Instruments*, 29 YALE L. J. 606 (1920) (discussing the history of money and its legal status including the question of what can be used to pay off negotiable instruments); Charles A. Conant, *Securities as a Means of Payment*, 14 ANNALS AM. ACAD. OF POLITICAL & SOC. SCI., 25 (1899) ("Among the most important instruments of modern commerce, coming next to banking credits in their usefulness as a medium of exchange, are negotiable securities.").

banking at the political level. The end of the free-banking era seems to have been brought about by the federal government's need for funds during the Civil War. This led to the federal government printing paper money and declaring it legal tender. Indeed, prior to that, several reports to Congress discussed the free-banking situation in the states. There was a recognition that there were problems here and there with the system that required some regulatory oversight, but there was never a wholesale condemnation of the system. While a historical canvassing of the political atmosphere is beyond the scope of this Article, we will provide two small pieces of evidence supporting this claim.

The first is the various Congressional discussions and reports at the time. In 1856, Secretary of the Treasury James Guthrie wrote to the House of Representatives a report regarding the state of banking in the United States.[344] The report included individualized reports from each state's banking supervisor outlining the state of affairs of banks in their state. The Superintendent of The Banking Department of New York, for example, in his report noted that previous banking systems in New York, which relied on the legislature granting banking charters, had resulted in many financial disasters for the banks and the public.[345] As such, the superintendent noted, New York adopted a banking system with the feature of "free and unlimited exercise of banking privileges by individuals and associations without the necessity of any special act of incorporation."[346] Banks who wished to circulate currency needed to deposit certain assets with the superintendent. Any bills issued by the bank would be countersigned by the superintendent. The result was that banking in New York was now on a sound footing. Indeed, the superintendent cautioned against "any radical change in the banking laws, or any general revision of them," which "would be unwise and inexpedient."[347] The system now, he cautioned, "operates admirably well, furnishes a paper currency equal to any in the world, and has answered the most sanguine expectations of its friends."[348]

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344. SEC'Y OF THE TREAS., LETTER FROM THE SECRETARY OF THE TREASURY TRANSMITTING A REPORT ON BANKS, ETC., IN CONFORMITY TO THE HOUSE RESOLUTION OF THE HOUSE OF JULY 10, 1832., H.R. DOC. NO. 34-102 (1st Sess. 1856), https://www.govinfo.gov/content/pkg/SERIALSET-00858_00_00-011-0102-0000/pdf/SERIALSET-00858_00_00-011-0102-0000.pdf [https://perma.cc/V9WZ-R28K]. Secretaries of the Treasury were asked to make these reports on annual basis pursuant to the House Resolution passed on July 10, 1832. The resolution the report refers to was passed when President Andrew Jackson vetoed the Second Bank of the United States, something many have blamed for the lead up to the panic of 1837.

345. *Id.* at 123.

346. *Id.*

347. *Id.* at 124.

348. *Id.* We note that writers at the time were also very supportive of free-banking, as can be seen in the 1840 history of banking where the author Richard Hildreth dedicates an entire chapter to making the case for free-banking as a cure for the abuses that had accompanied state grants of

The Indiana banking auditor in his report discussed the situation with its free-banking banks. Some were insolvent, while others were doing well. He noted that the "experiment of free banking in Indiana, disastrous as it has been in some particulars, has demonstrated most conclusively the safety and wisdom of the system."[349] Even though the system, as originally designed by the Indian legislature, was "crude and imperfect" and encouraged "irresponsible men" to enter the banking business who lacked the means to sustain their banks in the times of economic downturns.[350] The downturn in Indiana had come "at a time of universal commercial depression" when the free banks' circulation had vastly expanded, and many notes were not redeemable.[351] Yet, the auditor noted, that when all was said and done, losses to those who were holding the bank notes, in most cases "did not exceed five per cent., and in no case exceeded twenty per cent. of the amount in his hands." The auditor went on to note that "[w]hatever defects there were, it was evident, could not be attributed to the free banking system, but resulted from the ambiguity of the law itself."[352]

The second piece of evidence is the Congressional debates when the Legal Tender Act was passed in 1862. In addition to our reading of the debates, former Federal Communications Commission (FCC) Chairman Ajit Pai authored an article examining those debates.[353] We did not see nor did former Chairman Pai encounter any discussion of the Legal Tender Act being necessary to counter the ills of free-banking. Rather, the main goal was to allow the federal government to live beyond its

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banking monopolies. R. HILDRETH, BANKS, BANKING, AND PAPER CURRENCIES (1840). The book provides a history of banking and the role the government played in its regulation and instability over time in England and the United States. His arguments and analysis can easily be translated into today's regular and crypto-currency world.

349. H.R. DOC. NO. 34-102.

350. *Id.* at 183.

351. *Id.* at 183–84.

352. *Id.* The only complaint about free-banking came from the New Jersey state banking superintendent who claimed that:

> The tendency of the free-bank system in this State has been to encourage the issue of notes of the smaller denominations, which you properly condemn in your recent report to Congress, and in which opinion you have the support of all intelligent bankers who look to the preservation of a sound currency throughout the whole of the United States.

The root of the evil is in the State of New York, with her detestable system, which should be struck at by an excise, or some such. stringent measure, under the authority of the Union. *Id.* at 135.

353. Ajit V. Pai, *Congress and the Constitution: The Legal Tender Act of 1862*, 77 OR. L. REV. 535 (1998).

means during the time of war without having to borrow money from abroad.[354]

All in all, neither the judicial record nor the Congressional record discloses a real apprehension of the free-banking era. Rather, the era was seen as part of the evolution of banking that facilitated the orderly creation and circulation of money in the commercial system alongside other currency-substitutes such as negotiable instruments.

12. Free-Banking: Lessons from the Caselaw

Free-banking was never seen at the time as some sort of obstreperous regime. Rather, the era was seen at the time as one of many possible banking regimes that were introduced to counter the corruption that had accompanied the granting of banking charters by the various legislatures. But the absence of free-banking in some states did not mean that those banks did not issue bank-notes. Rather, it meant that the state legislature determined which institution was licensed to issue bank-notes. As such, regardless of the state, banks were all issuing their own notes backed by various assets, whether it be specie or other assets that the state regulations specified. Some banks failed, and some bank note-holders were left with unredeemed notes. But this was also seen as a normal operation of the banking business where the circulation of currency was crucial for the ever-expanding economy. Bank note circulated sometimes at face value and sometimes discounted. The discounts were a function of the public's perception of which banks were solvent and which were not.

But the evolution of banking in this regard was also part of a general expansion of what passed as currency and close-substitutes for currency, such as negotiable instruments. This is where the banks of the free-banking era start to resemble today's crypto-currency platforms and what passed as currency then starts to resemble the expansion of what passes as currency today. Indeed, bank-notes were simply one type of negotiable instruments used as a medium of exchange among merchants and the

354. The academic writings at the time debated the wisdom of the Legal Tender Act, but there was no mention of the ills of free-banking as the reason for the passage of the act. Rather, it was a question of the federal government securing revenues for the civil war. Henry Brooks Adams, *Book Review of History of the Legal-Tender Paper Money Issued during the Great Rebellion, being a Loan without Interest, and a National Currency by E. G. Spaulding: Opinion Delivered in the Supreme Court of the United States by Chief Justice Chase, on the 7th of February, 1870, in Regard to the Construction of the Legal-Tender Act by Chief Justice Chase*, 110 N. AM. REV. 299 (Apr. 1870). Little discussion regarding free-banking and its abolition for reasons other than the state's need for revenue can be found in this academic writing fifty years after the Legal Tender Act, other than to note that the demand for currency in the West led to the over-issuance of unbacked notes to satisfy the lack of legitimate free-banking notes that used to circulate prior to the civil war. G.D. Hancock, *The National Gold Banks*, 22 Q. J. ECON. 602, 603–04 (1908).

public alike. So are stablecoins. The courts honored the terms of exchange specified between the makers and acceptors of the notes. While notes were usually backed by specie or other financial assets, the courts saw nothing wrong with notes backed by any other assets, such as wheat or commodities. The two main concerns of the courts at the time were the states issuing unbacked paper-money, known as bills of credit. Sometimes the same concerns were applied to the federal government. The other concern was outright fraud by the makers of the notes or by whomever was dealing with them.

The one aspect of the era that would be applicable today was shareholder liability, sometimes double and sometimes more for the outstanding notes. To not hold shareholders liable for their outstanding notes was seen as a license to print money, something that the courts held was akin to issuing bills of credit. That being said, many courts were fine with banks suspending redemption every now and then as a way to deal with bank-runs, and 100% reserves was never something any court or legislature ever imposed.

IV. SO WHAT ABOUT STABLECOINS AND RIPPLE?

The discussion above shows the panic that central banks and some legislators seem to be displaying towards stablecoins is entirely unwarranted.[355] The critics of stablecoins invoke the phrase "free-banking" as a shibboleth for the Federal Reserves and regulators to do their magic.[356] But free-banking was quite the orderly banking system in

355. *See also* Chamber of Digital Commerce's Open Letter to the PWGFM, available at https://digitalchamber.org/open-letter-presidents-working-group-stablecoin/ [https://perma.cc/JB46-B3NU].

356. We note that when paper money, even backed by specie, was being circulated at the start of the 1800s, forgery was a key concern, and many of the objections to the paper money came in the form of concerns over fraud. Robert E. Mensel, *Nothings into Something: Intrinsic Value and Counterfeit Money in Antebellum Law and Culture*, 37 OHIO N.U. L. REV. 111, 143 (2011) ("Counterfeiting of currency, as the type of counterfeiting easiest to understand and the most obviously fraudulent, became the rhetorical center of traditionalist objection to the new dispensation. Despite the likelihood that it caused little real loss, it became the epitome in the public mind of the larger problem of the counterfeiting of value.").

Today, it also seems that invoking Tether seems to be the "boogeyman" that everyone invokes to stir up the fears of stablecoins. Kollen Post, *As Congress weighs stablecoins, Tether emerges as a regulatory boogeyman* (Feb. 10, 2022, 4:27 PM EST), https://www.theblockcrypto.com/post/133812/as-congress-weighs-stablecoins-tether-emerges-as-a-regulatory-boogeyman [https://perma.cc/3XED-A76Z]. In many ways, the worries of the stablecoin critics are a form of reverse "underpants gnomes" get rich scheme. In other words, "collect dollar" followed by "?", followed by "collapse of the system." And yet, no coherent explanation has been put forward of how coins operating in a crypto-sphere will somehow affect the real or non-crypto financial economic system. This seems to be where the invocation of "free-banking" becomes the missing "?" in the underpants plot.

an interconnected world where bank-notes and negotiable instruments operated to facilitate commerce all over the world.

The volleys of regulatory rhetoric aimed at stablecoins as well as the regulatory actions being taken against Ripple and other crypto-currencies displays a level of insecurity amongst the regulatory community including the established banking sector.[357] For one, it is puzzling that, at least in the United States, the two main crypto-currencies—Bitcoin and Ethereum—have escaped regulatory scrutiny the way Ripple and others have not.[358] This may be a case of the horses having escaped the stables or a genuine belief that these two systems present no threat (at present) to the financial system. Regardless, it seems odd that neither of these two platforms are being scrutinized in the same manner, while the much less valuable (in terms of market capitalization) systems of Ripple and the stablecoins seem to be attracting so much exacting scrutiny.

After all, the stablecoins were created ostensibly to facilitate transactions on the Bitcoin and Ethereum (and other) platforms. If anything, the stablecoins are a threat to the Bitcoin system, as the private class action lawsuit against Tether argues.[359] Nonetheless, there is a concern that somehow stablecoins, because their values are linked to major currencies such as the U.S. dollar, will pose a threat beyond the crypto-sphere. In other words, the concerns are that individuals will now convert their dollars to stablecoins and then engage in all sorts of speculative endeavors, such as inflating Bitcoin's value, which will ultimately come crashing down. This, in turn, will somehow cascade into stablecoin holders wanting to cash their coins back to dollars, and if there are insufficient dollars in reserve, then the system will collapse.[360]

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357. Eva Marie Uzcategui, *Crypto Firms Want Federal Reserve Payment Systems Access—and Banks Are Resisting*, WALL ST. J. (Aug. 28, 2021), https://www.wsj.com/articles/crypto-firms-want-fed-payment-systems-accessand-banks-are-resisting-11630143002 [https://perma.cc/97Q9-G2VM].

358. That may be changing soon. President Biden's administration may be conducting a wholesale look into whether all crypto-currencies should be regulated. Billy Bambrough, Crypto Crash: Market Now Braced For A Game-Changing White House Executive Order As Price Of Bitcoin And Ethereum Collapse (Jan. 25, 2022, 5:30 AM EST), https://www.forbes.com/sites/billybambrough/2022/01/25/crypto-crash-market-now-braced-for-a-game-changing-white-house-executive-order-as-price-of-bitcoin-and-ethereum-collapse/ [https://perma.cc/T7FM-N9L2].

359. See Appendix A.

360. Some have argued that the attacks are more political deflection instead of genuine concern for the public. Andrea O'Sullivan, As U.S. Establishment Fails Financially, Leaders Try to Make Cryptocurrencies the Scapegoat: Politicians attack dollar-backed cryptocurrencies called "stablecoins" and the decentralized finance it enables (Dec. 21, 2021, 8:30 AM), https://reason.com/2021/12/21/as-u-s-establishment-fails-financially-leaders-try-to-make-crypto currencies-the-scapegoat/printer/ [https://perma.cc/9DAV-C436]. This level of rhetoric typically ensures when the government in the past has tried to wrestle control over the financial institutions. During the Civil War, when the *Legal Tender Act* was being debated, similar rhetoric was used against the bankers who were resisting the imposition of paper money. Terms like "sharks and

The evidence discussed above on free-banking hardly warrants the alarm the term conjures up in the minds of stablecoins' critics. If anything, the free-banking era presents several lessons for regulators in the current era and in the future, which we canvass in the three sections that follow.

A. *Stablecoins are not Traditional Financial Investments*

The evolution of payments systems has been taking place for centuries. The free-banking era discloses that, in addition to specie, many other financial instruments circulated as currency. The most common of these were the bank-notes, a specific type of negotiable instrument, but non-bank note negotiable instruments also circulated. The reason is that as the economy expands, economic actors seek media of exchange to facilitate commercial transactions. These media must have certain characteristics, and the courts would frequently look to the terms of the instruments to decide what payments were needed to satisfy the circulating notes. Some courts opined that specie was not the only acceptable medium of redemption and would have allowed redemption in whatever was quoted on the face of the instrument. What did bother the courts, however, was when states engaged in the issuance of bills of credit, unbacked state-issued paper money.

As such, the current stablecoin situation, if it is indeed analogous to the free-banking era, suggests that what matters is that stablecoin issuers be allowed to issue their coins backed by whatever media their customers are willing to accept. It could be U.S. dollars, foreign currencies, a basket of goods, or just plain simple fiat crypto-coins, i.e. algorithmic stablecoins. As long as the issuers are able to redeem them, regardless of how much or what kind of reserves they have, the regulatory authorities should not be concerned. In the event of redemption issues, the courts can easily enforce redemption orders against the coin issuers as they did against the directors and shareholders of the free-banking era banks.

Lessons from past and present banking experiences teach us that stablecoin issuers need not keep their coins 100% backed by whatever asset is backing the coins.[361] The experience with Tether is instructive.

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brokers," "harpies," "out of the blood of their sinking country they may be enabled to coin the gains of their infamy," or that the struggle was between "brokers and jobbers and money-changers on the one side, and the people of the United States on the other" were used quite routinely. To this one commentator observed, "[i]nvective like this properly belongs only to a debating-club of boys." Henry Brooks Adams, *Book Review of History of the Legal-Tender Paper Money Issued during the Great Rebellion, being a Loan without Interest, and a National Currency by E. G. Spaulding: Opinion Delivered in the Supreme Court of the United States by Chief Justice Chase, on the 7th of February, 1870, in Regard to the Construction of the Legal-Tender Act by Chief Justice Chase*, 110 N. AM. REV. 299, 320 (Apr. 1870).

361. *See also* Steven Kelly, Why Forcing Stablecoin Issuers to Hold All-Cash Reserves Is a Bad Idea: Recent calls for stablecoin issuers to keep all of their reserves only in cash are

Notwithstanding the NYAG's allegations against Tether that it did not maintain 100% reserves, Tether's price in the marketplace seems to have stayed at the $1 range. Tether is one of the few consistently stable stablecoins, i.e. its value on the market measured in U.S. dollars not having an "average deviation of … more than 0.5 cent, and a maximum deviation of no more than 1.5 cents, during" the past year.

Figure 1: Tether's price in $US (source: Coinmarketcap.com)

In other words, the price of Tether's coins seems very stable. Even when the Office of the Comptroller of the Currency (OCC) announced that banks were allowed to use stablecoins as payment instruments, its price did not jump that much, indicating its true stability.[362] The availability of these metrics on a daily basis is more information that one has about their local bank or, for that matter, any national financial institution. All of this is to say that the requirement that stablecoins be 100% collateralized seems out of place both in terms of the analogy to traditional banks and the market reaction to the news regarding their financial backing.

In the free-banking era, notes from various banks circulated. Note brokers collected and aggregated the notes of various banks, much like the various crypto websites today reporting on the price and stability of crypto-currencies generally.[363] The courts saw nothing wrong with different notes circulating at different prices, and obviously the public did

misguided. Here's why (Nov. 18, 2021), https://decrypt.co/86122/stablecoin-cash-reserves [https://perma.cc/ZXR2-8WVL].

362. Mark Schaub, *On the OCC Announcement Allowing US Banks to Use Stablecoins and the Immediate Impact on Cryptocurrency Valuations*, 8 THE ECON. & FIN. LETTERS 154 (2021).

363. *See, e.g.*, COINMARKETCAP, https://coinmarketcap.com/ [https://perma.cc/3WZW-HGBC].

not either.[364] The Civil War brought about the end of the free-banking era, but it was the government's desire for revenue that brought that and not flaws in the system. It is clear, for example from *Swift v Tyson*, that ordinary folks would accept, what we might think of today as random pieces of paper known as, negotiable instruments issued by non-bank third parties not even connected to the original transaction. So common was this, that an entire law of negotiable instruments emerged over the centuries all over the world.[365] But it is not just the various instruments that emerged over the centuries but all sorts of means of payments. Some functioned as media of exchange and units of account, while others served as one or another.[366]

What matters, albeit to some economists, is whether the instruments become an accepted unit of exchange, which is why Bitcoin may be a currency, albeit accepted in a small landscape for now.[367] Stablecoins and

364. Matthew Jaremski, *Bank-Specific Default Risk in the Pricing of Bank Note Discounts*, 71 J. ECON. HIST. 950 (2011) (discussing how bank notes circulated discounted according to various economic indicators).

365. Ralph W. Aigler, *Commercial Instruments the Law Merchant and Negotiability*, 8 MINN. L. REV. 361 (1924) (explaining how the law of negotiable instruments tracked the practices of merchants over the centuries as the common law developed); Fredrick Read, *The Origin, Early History, and Later Development of Bills of Exchange and Certain Other Negotiable Instruments*, 7 CDN. BAR REV. 440 (1926) (tracing the history of bills of exchanges and their roles in the economy from ancient times); A. H. Pruessner, *The Earliest Traces of Negotiable Instruments*, 44 AM. J. SEMITIC LANG. & LIT. 88 (1928) (finding evidence of negotiable instruments as far back as the Babylonian era); J. S. Waterman, *The Promissory Note as a Substitute for Money*, 14 MINN. L. REV. 313 (1930) (discussing the characteristics of what passes as money generally and negotiable instruments specifically); Frederick K. Beutel, *The Development of Negotiable Instruments in Early English Law*, 51 HARV. L. REV. 813 (1938) (tracing the law of negotiable instruments in England back to William the Conqueror). The classic text that explains both the law and economics remains JUSTICE JOSEPH STORY, COMMENTARIES ON THE LAW OF BILLS OF EXCHANGE, FOREIGN AND INLAND, AS ADMINISTERED IN ENGLAND AND AMERICA; WITH OCCASIONAL ILLUSTRATIONS FROM THE COMMERCIAL LAW OF THE NATIONS OF CONTINENTAL EUROPE (4th ed. 1860).

366. Economists have noted that as a theoretic matter something perishable like ice-cream could be a currency under certain conditions, as history has shown that "perishable goods" have been used as a "medium of exchange" such as "[e]ggs in Guatemala, cocoa beans in Mexico and Central America, butter in Norway, tobacco, rice, grain, beef, peas, pork, dairy products, etc. in the United States". Xavier Cuadras-Morato, *Can ice cream be money? Perishable Medium of Exchange*, 66 J. ECON. 103, 104 (1997).

367. Peter K. Hazlett & William J. Luther, Is Bitcoin Money? And what that Means, 77 Q. REV. ECON. & FIN. 144 (2020); Jens Mattke, Christian Maier & Lea Reis, *Is Cryptocurrency Money? Three Empirical Studies Analyzing Medium of Exchange, Store of Value and Unit of Account*, PROCEEDINGS OF THE 2020 ON COMPUTERS AND PEOPLE RSCH. CONF. (SIGMIS-CPR'20) 26 (2020), https://doi.org/10.1145/3378539.3393859 [https://perma.cc/YSB6-JZDM] (finding that when it comes to the three functions of money (medium of exchange, store of value, and unit of account). "Bitcoin is perceived significantly better in fulfilling all three functions than Ethereum or Ripple" and concluding that "cryptocurrency research needs to include or at least control for the basic perceptions of core functions when examining individuals' adoption or use

other crypto-currencies may be emerging as currencies, securities, investments tools, or all of the above. That is something that only time will tell, and something that no one individual let alone government agency can prognosticate about.

The idea of money, the reader should understand, poses an intriguing question to economists. Why does money, regardless of form, exist? After all, the ultimate goal is not the money itself, but rather the goods and services that money commands. Economists, usually, argue that money is an instrument that has evolved over time to serve three purposes: a medium of exchange, a store of value, and a unit of account.[368] This allows money to overcome the problem of the absence of double coincidence of wants that obstructs trade in a barter economy.

Various commodities, in addition to gold and silver, have served as money throughout history.[369] Today fiat money, i.e. unbacked by any commodity such as gold or silver, is the norm around the world. The question of why an intrinsically worthless piece of paper can have positive value in exchange for goods and services is a puzzle.[370] Generally speaking, one of the main argument for what fiat money provides, and hence gives it value, is that it, just like commodity-backed currency, lowers the transaction costs arising from exchange in an

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of cryptocurrency as money" as well as that "existing knowledge from Bitcoin use or adoption research cannot be easily transferred to the context of another cryptocurrency").

368. Karl Brunner & Allan H. Meltzer, *The Uses of Money: Money in the Theory of an Exchange Economy*, 61 AM. ECON. REV. 784 (1971) (identifying the functions of money as the "medium of exchange, store of value and unit of account"); Paul Davidson, *Money and the Real World*, 82 ECON. J. 101 (1972) ("Money . . . is a difficult concept to define, partly because it fulfils not one but three functions, each of them providing a criterion of moneyness . . . those of a unit of account, a medium of exchange, and a store of value."). For two classic texts examining the origins and evolution of money, see W. STANLEY JEVONS, MONEY AND THE MECHANISM OF EXCHANGE (1875); Chapter 8 of CARL MENGER, PRINCIPLES OF ECONOMICS (1871).

369. See examples in W. STANLEY JEVONS, MONEY AND THE MECHANISM OF EXCHANGE (1875); Chapter 8 of CARL MENGER, PRINCIPLES OF ECONOMICS (1871). In the early days of colonial America, beaver furs and wampums were used for exchanges with indigenous Americans. In South Carolina, rice was used as money, and in Virginia tobacco was the main currency. MURRAY N. ROTBARD, HISTORY OF MONEY AND BANKING IN THE UNITED STATES, 48 (2002). Interestingly, warehouse receipts for tobacco circulated as money with the tobacco in the warehouse backing the receipts.

370. This challenge or puzzle is known as the *Hahn Problem*, named after the British economist Frank Hahn. A good overview of the problem as well as the possible solutions can be found in Martin F. Hellwig, *The Challenge of Monetary Theory*, 37 EUR. ECON. REV. 215 (1993) (outlining the various models that economists had come up with at the time to explain the *Hahn problem*); Thomas W.L. Norman, *The Evolution of Monetary Equilibrium*, 122 GAMES & ECON. BEHAVIOR 233 (2020) (providing the latest research on the question); Lukas Altermatt, Kohei Iwasaki & Randall Wright, *Asset Pricing in Monetary Economies*, 115 J. INT. MONEY & FIN. 102352 (2021) (arguing that the ability of fiat money to provide liquidity is the key driver for why fiat money and other financial assets are valued).

economy.[371] Whether the transaction costs arise from buyers and sellers of goods and services being in different locations or at different stages of their production, money, fiat or commodity, allows the exchange of these goods and services without worrying about keeping track of everybody's products.

But of course, if there were an asset that could track a commodity or have the same characteristics as a commodity-backed money, economic theory could suggest that this currency would dominate fiat unbacked money.[372] That was the thinking behind the launch of Bitcoin, namely the idea that a currency that would have limited supply and that did not need a central agency to verify transactions could ultimately displace or provide a substitute to fiat money.[373]

The idea of Bitcoin was not novel, except perhaps in its ability to create a credible mechanism for non-centralized verification of transactions. Forty years ago, there were many payments systems emerging that we could characterize today as digital currencies.[374] Indeed, as far back as the 1980s, one could write a check drawing on one's mutual fund or money market fund account,[375] and the idea that someday electronic barter systems would emerge with no need for fiat money as a medium of exchange was not that far fetched.[376]

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371. *See, e.g.*, Robert W. Clower, *A Reconsideration of the Microfoundations of Money*, 6 WEST. ECON. J. 1 (1967).

372. Joshua R. Hendrickson, *Commodity Money, Free Banking, and Nominal Income Targeting: Lessons for Monetary Policy Reform*, Q. REV. ECON. & FIN. (forthcoming) https://doi.org/10.1016/j.qref.2020.10.001 [https://perma.cc/KAL6-9DJ3]) (arguing that a commodity based monetary system with bank notes backed by the commodity have characteristics that are superior to a fiat unbacked monetary system).

373. SAIFEDEAN AMMOUS, THE BITCOIN STANDARD 167–90 (2018) (explaining the advantage of decentralized money); Lawrence H. White, *The Market for Cryptocurrencies*, *in* MONETARY ALTERNATIVES: RETHINKING GOVERNMENT FIAT MONEY (ed. James A. Dorn, 2017) (explaining why quantity commitments, i.e. the limited supply of bitcoins can be a credible mechanism for creating a decentralized currency).

374. *See, e.g.*, JOHN MARTI & ANTHONY ZEILINGER, MICROS AND MONEY: NEW TECHNOLOGY IN BANKING AND SHOPPING (1982); PATRICK FRAZER, PLASTIC AND ELECTRONIC MONEY (1985).

375. Hearings before the Subcommittee on Financial Institutions of the Committee on Banking, Housing, and Urban Affairs, United States Senate Ninety -Sixth Congress Second Session on Oversight on the Supervision and Regulation of Money Market Mutual Funds and the Effects of the Funds on Financial Markets, at page 4, January 24 and 30, 1980.

376. C. Dianne Martin & Fred Weingarten, *The Less-Cash/Less-Check Society: Banking in the Information Age*, *in* ELECTRONIC MONEY FLOWS: THE MOLDING OF A NEW FINANCIAL ORDER 187 (Ellinor H. Solomon ed., 1991). The chapter is very prophetic in outlining the opportunities and challenges that electronic payment systems would provide for consumers and regulators alike. Another collection of essays also edited by Solomon contain numerous chapters outlining similar challenges and opportunities. ELECTRONIC FUND TRANSFERS AND PAYMENTS: THE PUBLIC POLICY ISSUES (Ellinor H. Solomon ed., 1987). Professor Larry White also foresaw this as well as what could be characterized as stablecoins today in Lawrence H. White, *Thoughts on the Economics of "Digital Currency*," 7 EXTROPY: THE J. OF TRANSHUMANIST THOUGHT 16 (1995).

Even thirty years ago when cash was still a dominant form of currency,[377] electronic based systems were growing rapidly. While transactions using the electronic funds transfers system (EFTS) were low in terms of percentage of transactions, they represented large value transactions.[378] These EFTs included electronic transfers within banks, among different banks, retail transactions, as well as corporate transfers.[379] But even back in the late 1980s, pure electronic money was emerging. One was simply bank-linked money flows, where final balances were settled using money or bank deposits. The other form of electronic money that was emerging then was corporate barter flows. These were transfers between corporate entities that had no settlement using cash.[380] These transfers used what was called electronic data interchange (EDI).[381] EDI is computer-to-computer communication using standardized messages called transaction sets. These sets specify purchase orders, invoices, and other firm related transactions. Interfirm or intrafirm transactions may take place under this scheme. Corporate barter was seen a way for companies to transact with one another without having to even utilize actual cash or bank deposits.

In the intervening years, other forms of decentralized electronic payments systems were developed and experimented with. DigiCash in the early 1990s, Mondex in the late 1990s, Liberty Dollars in the late 1990s represented several efforts at launching a completely decentralized system prior to the emergence of Bitcoin.[382] The current emergence of crypto-currencies, as seen in the discussion in Section II, ultimately started with Satoshi Nakamoto's white paper launched in the aftermath of the 2008 financial collapse.[383]

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377. Paul B. Henderson, *Modern Money*, *in* ELECTRONIC FUND TRANSFERS AND PAYMENTS: THE PUBLIC POLICY ISSUES (Ellinor H. Solomon ed., 1987).

378. Ellinor H. Solomon, *Electronic Funds Transfer: Challenge for the Computer Age*, 176–81 BANKERS MAG. 69 (1993). *See also* Robert C. Effros, *A Banker's Primer on the Law of Electronic Funds Transfers*, 105 BANKING L.J. 510 (1988) (explaining the mechanics and laws applicable to such transactions).

379. Effros, *supra* note 378. Electronic point of sale transfer machines were already being installed at retail shops, which allowed customers to transfer their funds directly from their bank accounts to the retailer's account. Today, this is a very standard debit card machine transaction that almost all retailers have along with credit card machines, usually both in the same machine.

380. Ellinor H. Solomon, *Today's Money: Image and Reality*, *in* ELECTRONIC MONEY FLOWS: THE MOLDING OF A NEW FINANCIAL ORDER 27 (Ellinor H. Solomon ed., 1991).

381. Mir F. Ali, *EDI and EFT: The Height of Efficiency*, 99 CANADIAN BANKER 44 (1992) (describing EDI and its benefits including the reduction in information processing costs, increased speed of information flows, and streamlined business processes).

382. Paul Vigna & Michael J. Casey, THE AGE OF CRYPTO CURRENCY 53–68 (2015).

383. *Id.*; Kevin Dowd, *Contemporary Private Monetary Systems*, *in* RENEWING THE SEARCH FOR A MONETARY CONSTITUTION REFORMING GOVERNMENT'S ROLE IN THE MONETARY SYSTEM (Lawrence H. White, Viktor J. Vanberg, & Ekkehard A. Köhler eds., 2015).

As such, stablecoins are not only nothing new conceptually analogous to free-banking era banknotes, but they are also nothing new in terms of technologically in the systems of electronic money have been around for more than fifty years now. Indeed, even thirty years ago, one of us noted that the idea of free-banking in a cashless society was even more realistic where notes could be issued backed by any commodity or basket of commodities.[384] What may have changed is the speed and ease of transactions, and the power of computing, that has allowed decentralized verifiable payment systems to take hold. There have been many developments over the millennia that saw the development of cash, currencies, and substitutes for currencies including systems of credit and money transfers. Negotiable instruments were one such instruments that developed in Europe,[385] while in Islamic countries over the centuries and still popular today, the Hawala system developed allowing the transfer of cash from one location to another.[386]

What is important to understand is that these means of payments evolved in order to respond to needs of those who were engaged in commercial transactions. For some, specie was sufficient. For others, banknotes were sufficient. For merchants, sophisticated commercial

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384. Moin A. Yahya, Free Banking in an Economy without Cash (unpublished MA project in economics, University of Alberta 1994) (on file with author).

385. Uniform Commercial Code (UCC) § 3-104 defines negotiable instruments as

> an unconditional promise or order to pay a fixed amount of money, with or without interest or other charges described in the promise or order, if it:
>
> (1) is payable to bearer or to order at the time it is issued or first comes into possession of a holder;
>
> (2) is payable on demand or at a definite time; and
>
> (3) does not state any other undertaking or instruction by the person promising or ordering payment to do any act in addition to the payment of money, but the promise or order may contain (i) an undertaking or power to give, maintain, or protect collateral to secure payment, (ii) an authorization or power to the holder to confess judgment or realize on or dispose of collateral, or (iii) a waiver of the benefit of any law intended for the advantage or protection of an obligor.

Black's Law Dictionary notes that "the various types of negotiable instruments are bills of exchange, promissory notes, bank checks, certificates of deposit, and other negotiable securities."

386. U.S. v. Banki, 685 F.3d 99, 103 (2d Cir. 2011) (describing the Hawala system as it currently is practiced in many countries). The question of whether Bitcoin is acceptable in Islamic Law has also occupied the minds of many Islamic legal scholars. Some have declared it impressible, while others have allowed it under certain conditions. In many of their discussions, the question becomes whether Bitcoin is becoming a universally accepted method of payment. *See, e.g.*, Mohammad Al-Uqail, The Islamic Jurisprudence (Fiqh) Rules Associated with Electronic Transactions in Bitcoin (in Arabic), original can be downloaded at https://www.kutubypdf.com/link/?21651/ [https://perma.cc/Y3Z8-WKBG]. For more on this point see Hazlett & Luther, *supra* note 367.

paper could be sufficient.[387] Today, it is clear that the growth of stablecoins, crypto-currencies, and decentralized finance (DeFi) are part of a movement to take advantage of technological efficiencies that the traditional banking and payments systems cannot satisfy.[388]

A study conducted of what keeps stablecoins stable suggests that today's customers are more like the nineteenth century bank-note customers.[389] The study examines whether supply issuance by the stablecoin issuers or demand pressures by customers are what keeps the price of stablecoins stable. The study found that, unlike central banks and the price of fiat currency, the demand-side is what drives the stability. The study found that "stablecoin issuance, the closest analogue to central-bank intervention, plays only a limited role in stabilization, pointing instead to the demand side as providing the fundamental stabilizing forces."[390] If anything, "stablecoin premiums are due to coins' uniqueness as a safe-haven asset within the digital-asset economy, citing evidence of significant premiums during the crash in non-stable crypto-currencies in early 2018 and during the COVID-19 crisis, whereas stablecoin discounts derive from both liquidity effects and collateral concerns."[391] In other words, crypto-investors are figuring out how the system works.

But today's regulatory laws presume a much more risk-averse investor. Know Your Client (KYC) rules, for example, require financial institutions to ascertain, among other things, their customers' risk

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387. When it comes to other traditional payments instruments, such as the letter of credit, there is still no systematic data explaining the persistence of this method. Professor Ronald Mann, over twenty years, attempted to investigate the question empirically and still emerged with inconclusive answers. Ronald J. Mann, *The Role of Letters of Credit in Payment Transactions*, 98 MICH. L. REV. 2494 (2000). Notwithstanding their persistent usage might not be easily explainable, there is evidence that they are useful in providing financial institutions with some diversification of risk. M. Kabir Hassan, *An Empirical Analysis of Bank Standby Letters of Credit Risk*, 2 REV. FIN. ECON. 31 (1992).

388. CAMPBELL R. HARVEY, ASHWIN RAMACHANDRAN & JOEY SANTORO, DEFI AND THE FUTURE OF FINANCE 58–78 (2021) (describing some of the advantages of decentralized finance over traditional finance such as efficiency, speed, lack of need for centralized control, interoperability across platforms); Fabian Schär, *Decentralized Finance: On Blockchain- and Smart Contract-Based Financial Markets*, FED. RSRV. BANK OF ST. LOUIS REV., Second Quarter 153 (2021), https://doi.org/10.20955/r.103.153-74 [https://perma.cc/794F-Q52A] (explaining the basics of DeFi and concluding that "DeFi still is a niche market with certain risks but that it also has interesting properties in terms of efficiency, transparency, accessibility, and composability. As such, DeFi may potentially contribute to a more robust and transparent financial infrastructure."). For a more cautious note on what DeFi has to offer, see HILARY J. ALLEN, DRIVERLESS FINANCE (2022); Hilary J. Allen, $=€=Bitcoin?, 76 MD. L. REV. 877 (2017).

389. Richard K. Lyons and Ganesh Viswanath-Natraj, *What Keeps Stablecoins Stable?* NBER Working Paper No. 27136 May 2020, https://www.nber.org/papers/w27136 [https://perma.cc/A3J3-CK3D].

390. *Id.*

391. *Id.*

profiles. This is done ostensibly to protect customers and the financial institutions. But these rules do not apply, yet, to crypto-currency investors. Studies show that the profile of crypto-investors, generally speaking, is different from the usual customer investing in traditional financial assets. For example, one study found that most investors who invest in initial coin offerings (ICOs), the crypto equivalent of initial public offering for stocks, are motivated by ideology and technology.[392] Those investors motivated by financial gains, and hence more risk-averse, invested smaller amounts in these ICOs.[393] Another study found that "crypto-currency investors are active traders, prone to investment biases, and hold risky portfolios."[394] As well, the study found that "average crypto-currency investor substantially increases log-in and trading activity after his or her first crypto-currency purchase."[395] The study points to a "a certain type of retail investor who participates in crypto-currency investments, namely, one that is an early adopter of financial and technological innovation and who has experience with high investment risk. From the perspective of policymakers, this type of investor can be considered less vulnerable than the average retail investor."[396]

Another study found that stablecoins pegged to U.S. dollars "have better risk-dispersion abilities for traditional crypto-currencies than gold-pegged ones," with "Tether show[ing] the best properties of risk diversification."[397] The study examined other hedging aspects of various stablecoins and concluded that more research was needed. They suggested that future work focus on studying "the hedging ability of stablecoins against traditional assets in different countries," investigating "the safe haven property of stablecoins during political and economic turmoil," and comparing "the potential roles of stablecoins with traditional safe haven assets such as gold and USD, in order to explore whether they compete with or complement each other."[398] As such, the issuers of stablecoins may be providing an investment product meant to

392. Christian Fisch, Christian Masiak, Silvio Vismara, & Joern Block, *Motives and profiles of ICO Investors*, 125 J. BUS. RSCH. 564 (2021).

393. *Id*.

394. Dominique Marcel Lammer, Tobin Hanspal & Andreas Hackethal, *Who are the Bitcoin investors? Evidence from indirect cryptocurrency investments*, REV. FIN. (2021), https://doi.org/10.1093/rof/rfab034 [https://perma.cc/SXH7-QJVC].

395. *Id*.

396. *Id*.

397. Gang-Jin Wang, Xin-yu Ma, & Hao-yu Wu, *Are stablecoins truly diversifiers, hedges, or safe havens against traditional cryptocurrencies as their name suggests?*, 54 RSCH. IN INT. BUS. FIN. 101225 (2020).

398. *Id*.

hedge against volatility as opposed to a banking-like currency.[399] Having various designs of stablecoins emerge and be tested by various events, like the COVID-19 pandemic, has allowed the market and researchers discern which designs are optimal in withstanding financial volatility with the need for regulatory oversight, and in some sense because of and in response to the absence of the oversight.[400]

These motivations of ICO investors, and general crypto-customers, shows that when it comes to securities enforcement, labelling a crypto-currency like Ripple a security may not be in the public's interest.[401] We

399. Michael P. Malloy, *There Are No Bitcoins, Only Bit Payers: Law, Policy and Socio-Economics of Virtual Currencies*, 1 ATHENS J.L. 21 (2015) (arguing that "the appropriate legal analogue for classifying Bitcoins should be investment and commercial notes, since this characterisation would lead to the application of an appropriate and effective body of transactional and regulatory law to Bitcoins."); Helene Braun, Asset Manager Van Eck Says Stablecoins Should Be Treated as Investment Funds, Not Banks: Jan van Eck, the firm's CEO, argues against the position of government officials (updated Feb. 11, 2022, at 9:39 AM MST), https://www.coindesk.com/markets/2022/02/11/asset-manager-van-eck-says-stablecoins-should-be-treated-as-investment-funds-not-banks/ [https://perma.cc/LNP4-NARK].

400. Clemens Jeger, Bruno Rodrigues, Eder Scheid & Burkhard Stiller, Analysis of Stablecoins during the Global COVID-19 Pandemic, 2020 Second International Conference on Blockchain Computing and Applications (BCCA), 30, 39 available at doi: 10.1109/BCCA50787.2020.9274450 (finding that "USD pegged off-chain collateralized stablecoins in our sample performed best in terms of stability and popularity. These two stablecoins enjoyed the most trust by investors as their market capitalization each grew by over 50% in the first weeks during and after the financial market crash," "the two largest capitalized and fiat collateralized stablecoins provided liquidity and stability during the crash of the cryptocurrency market in 2020," as well as that the "on-chain stablecoins displayed many flaws during the crisis, providing insight that the on-chain collateral design will not win a larger market share.").

401. J. Scott Colesanti, *Sorry, They Were On Mute: The Sec's "Token Proposal 2.0" As Blueprint For Regulatory Response To Cryptocurrency*, 3 CORP. & BUS. L.J. 1 (2022) (explaining how the concepts of securities laws and tokens apply under current laws and SEC proposals); Yuliya Guseva, *A Conceptual Framework for Digital-Asset Securities: Tokens and Coins as Debt and Equity*, 80 MD. L. REV. 166 (2021) (outlining how securities laws can apply to crypto assets and currencies); Nate Crosser, *Initial Coin Offerings as Investment Contracts: Are Blockchain Utility Tokens Securities*, 67 U. KAN. L. REV. 379, 422 (2018) (cautioning against blanket labelling of ICOs as securities, especially "ICOs of certain … assets … [,which] … sometimes should be viewed as the sale of a commodity or asset rather than an investment contract" and arguing that "courts should recognize the economic realities surrounding this bleeding edge technology and far-reaching policy implications of such determinations."). *See also* Shlomit Azgad-Tromer, *Crypto Securities: On the Risks of Investments in Blockchain-Based Assets and the Dilemmas of Securities Regulation*, 68 AM. U. L. REV. 69 (2018) (arguing that regulators should proceed cautiously when approaching new technologies and should weigh the costs and benefits of regulation); Philipp Maume & Mathias Fromberger, *Regulations of Initial Coin Offerings: Reconciling U.S. and E.U. Securities Laws*, 19 CHI. J. INT'L L. 548 (2019) (surveying the various approaches different countries have taken with respect to ICOs with some, such as the U.S.A. viewing them as securities offerings and others are quite vague on the question); Michael Mendelson, *From Initial Coin Offerings to Security Tokens: A U.S. Federal Securities Law Analysis*, 22 STAN. TECH. L. REV. 52 (2019) (arguing that the status of ICOs is still quite

take no view on whether Ripple, as such, is a security or whether the motivation of its ICO would make it fall under the ambit of the Securities Act (1933). Rather, we build on our observations of the free-banking era to make the following points. The idea that a crypto-currency, which was created for the purpose of facilitating currency transfers, is a security suggests that traditional regulatory boxes are misplaced here. Negotiable instruments have long circulated as currency substitutes, but they were not necessarily seen as currencies. They were also not seen as securities in the traditional sense.[402] The Securities Act has explicit exemptions for negotiable instruments, under certain conditions, and will issue no-action letters when there is doubt about whether those conditions apply.[403] Indeed, the SEC can choose in its discretion not to pursue a claim against someone violating the laws, even when it doesn't fall under any exemption.[404]

Professor Brian Frye famously wrote an article which he also intended to be a collector's item, whose value could increase by those who held a certificate of authenticity.[405] In his article, he argued that his article would be a security under the *Howey* test.[406] He sought a non-action letter from the SEC, something that he has not received to date. Indeed, in his article, he argues that conceptual art such as a banana on a wall coupled with a certificate of authenticity (with only a limited number of these certificates issued) would also fall under the definition of a security.[407]

Consider, as an analogous example, if one were to purchase a young calf and write on the calf "I promise to pay to the holder of this calf/cow the sum of $10,000 upon presentment plus 0.5% interest every year for

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ambiguous under federal securities legislation.); G. A. Walker, *Regulatory Technology (Regtech) - Construction of a New Regulatory Policy and Model*, 54 INT'L LAW. 1 (2021) (surveying the international regulatory approach to new financial technologies).

402. Cuadras-Morato, *supra* note 366.

403. Section 3(a)(3) exempts "[a]ny note, draft, bill of exchange, or banker's acceptance which arises out of a current transaction … which has a maturity at the time of issuance of not exceeding nine months …". The SEC will issue no-action letters if an issuer of a financial instrument is unsure whether this instrument is covered by the law. No Action Letters, SEC, https://www.investor.gov/introduction-investing/investing-basics/glossary/no-action-letters [https://perma.cc/Z5F5-H9JM].

404. Section 21(a)(1) of the Securities Exchange Act of 1934 ("The Commission may, in its discretion, make such investigations as it deems necessary to determine whether any person has violated, is violating, or is about to violate … [any laws].").

405. Brian L. Frye, *SEC No-Action Letter Request*, 54 CREIGHTON L. REV. 537 (2021).

406. Securities and Exchange Commission v. W. J. Howey Co., 328 U.S. 293, 301 (1946).

407. Frye, *supra* note 405, at 537. Professor Frye also famously sold portions of his articles including the one mentioned as Non Fungible Tokens (NFTs) and made thousands of dollars. *A Law Professor Made $65,000 Selling NFTs. Here's How* (Oct. 2, 2021), https://www.nftradius.com/a-law-professor-made-65000-selling-nfts-heres-how-business-insider-nftradius/ [https://perma.cc/FWT4-UJU8].

every year the holder of this calf/cow in their possession."[408] This calf, and eventually cow, would be a negotiable instrument. Whoever owned or had the calf, and ultimately the cow, would also have a claim to $10,000 plus interest. It would be no different, in that regards, if the holder of the calf held a piece of paper that had the exact same words written on it. But the difference is that the calf can grow up to become a cow. It can ultimately provide the holder with milk, which could be sold over the years. As such, the value the calf would not only be the price of the negotiable instrument but also the price of the calf if it were sold without the writing. The calf provides utility beyond its negotiable nature, which also adds value beyond what the narrow negotiability provides. And yet, no one would suggest that the SEC (or the CFTC) should be regulating cows.

In many ways, the coins on the Ripple platform (or any other platform that could be the target of an SEC improper securities offering lawsuit) are akin to the negotiable cows. They are novel assets that seem to have been created for the purpose of facilitating the transfer of funds, which also have value beyond the narrow fund transfer property.[409] In that way, Ripple is similar to the Ethereum and Bitcoin platforms, both of which have not been pursued by the SEC. The *Howey* test, invoked by the SEC is its lawsuit against Ripple, we note is just one test used to analyze whether a transaction qualifies as an investment contract. We note (as did Professor Wilmarth) that there are other tests,[410] something that has led some to conclude that Bitcoin and Ethereum are not securities.[411] It would seem that the same principles would also apply to stablecoins and Ripple's XRP.

Stablecoins, while also providing a claim against the issuer of the coin, also provide some utility beyond other crypto-currencies, namely the stability of the value and ease of usage. This suggests that, if anything, the laws of negotiable instruments should be what applies to crypto-

408. This example is based on the famous negotiable cow that appeared in the fictitious case of *Board of Inland Revenue v. Haddock* from A.P. Herbert, Uncommon Law (2001). The case has been cited approvingly by Judge Easterbrook in Transparent Prod. Corp. v. Paysaver Credit Union, 864 F.2d 60 (7th Cir. 1988) and Messing v. Bank of Am., N.A., 373 Md. 672, 821 A.2d 22 (2003).

409. Thomas Silkjær, 14 Common Misunderstandings About Ripple And XRP (Mar. 7, 2019, 4:41 PM EST), https://www.forbes.com/sites/thomassilkjaer/2019/03/07/14-common-misunderstandings-about-ripple-and-xrp/?sh=7c1d79c171d0 [https://perma.cc/9M49-SM92].

410. Kenneth L. MacRitchie, *Is a Note a Security - Current Tests under State Law*, 46 S.D. L. REV. 369 (2001); Cori R. Haper, *Sometimes Promising Is Not So Promising: The Breakdown of the Family Resemblance Test*, 29 U. DAYTON L. REV. 71 (2003–2004); Lawrence Page, *Even after Reves, Securities Do Not Have Families: Returning to Economic and Legal Realities through a Connotative Definition of a Security*, 1992 U. ILL. L. REV. 249 (1992).

411. Justin Henning, *The Howey Test: Are Crypto-Assets Investment Contracts?*, 27 U. MIAMI BUS. L. REV. 51 (2018–2019).

currencies generally and stablecoins specifically. Such laws do exist, in the form of the various articles of the UCC, especially Article 3. State courts not only had the expertise to enforce these laws against stablecoin issuers, but as we argued earlier, they had no problem enforcing their state laws on banking (which still exist today) against state banks.

As such, absorbing stablecoins into the federal regulatory fold at this stage has the potential to upset an equilibrium that has been developing among investors. Those who wish for safer havens stick to the traditional regulated world of financial assets. Those who wish to experiment and see what else the world has to offer are venturing into the crypto-sphere, some unhedged and some hedged with stablecoins. At this stage, more work is needed, which leads us to two basic recommendations: (1) now is not the time for wholesale regulation of stablecoins and (2) if regulations are needed, they should be at the state level.

1. A Wait and See Approach Is the Best for Stablecoins & Crypto-currencies

The legislative and judicial history shows that many states moved to a free-banking system, but not all did at once, if at all. Some states moved to free-banking when they had their constitutional conventions and some moved by an act of their legislatures. By moving in a measured manner, courts were able to develop the details on how to address the redemption rules and liability of banks that may have been unable to redeem their notes at a particular moment.

Until there is real evidence of some threat from the stablecoins, moving in to subsume stablecoins under the regulatory aegis of the Federal Reserve, SEC, or any other agency would be counterproductive. The *raison d'être* of crypto-currencies was to escape the unwieldly fiat money system that had created the financial instability in 2008. In other words, for the Federal Reserve to point at stablecoins as the threat to the financial system is somewhat ironic,[412] given the Federal Reserve's role in almost every financial upheaval this past century.[413] For example, while the Great Recession of 2008 has been debated by economists and

412. A recent working paper from the Federal Reserve also argues that "suggesting that fears of a so-called global stablecoin replacing domestic sovereign currencies may be overstated." Garth Baughman & Jean Flemming, *Global Demand for Basket-Backed Stablecoins*, Finance and Economics Discussion Series 2020-048. Washington: Board of Governors of the Federal Reserve System, https://doi.org/10.17016/FEDS.2020.048 [https://perma.cc/F4NL-KB7B].

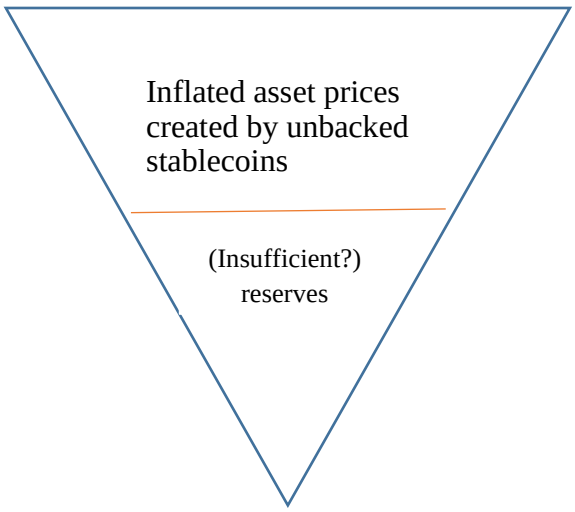
413. George Selgin, William D. Lastrapes & Lawrence H. White, *Has the Federal Reserve been a Failure?*, 34 J. MACROECON. 569 (2012) (arguing that during the 100 years that the Federal Reserve has existed, the Federal Reserve's history has displayed "more rather than fewer symptoms of monetary and macroeconomic instability than the decades leading to the Federal Reserve's establishment," and that its performance, albeit improved somewhat even since WWII, "has not … surpassed that of its undoubtedly flawed predecessor, the National Banking system, before World War I").

policy experts alike with disagreements on the exact causes, the common denominator in all their narrative is the Federal Reserve's maintaining of low interest rates that induced much of the risky behavior that led to the meltdown.

In the *Report of the Financial Crisis Inquiry Commission*, a commission established by the Fraud Enforcement and Recovery Act (2009), several factors that led to the Great Recession are analyzed. The report is notable for having both two views, a majority and dissenting view, that disagree on the various causes of the recession. Yet, both sides all point to, among other causes, the fueling of the housing market by low interest rates and the Federal Reserve's failure to regulate the resulting risk-related issues resulting from the low interest rates as key factors in the leadup to the recession. The resulting aftermath of the Great Recession was a barrage of regulations and apparent change in monetary policy, which has now resulted in a different set of challenges for the Federal Reserve and central bankers everywhere.[414]

What the critics of stablecoins seem to be worried about is that by having insufficient reserves, the stablecoins can latch onto a crypto-system and inflate the assets fueling a bubble that may ultimately collapse—a sort of pyramid scheme. The pyramid can be seen in the following graph:

Figure 2: Stablecoins not 100% backed

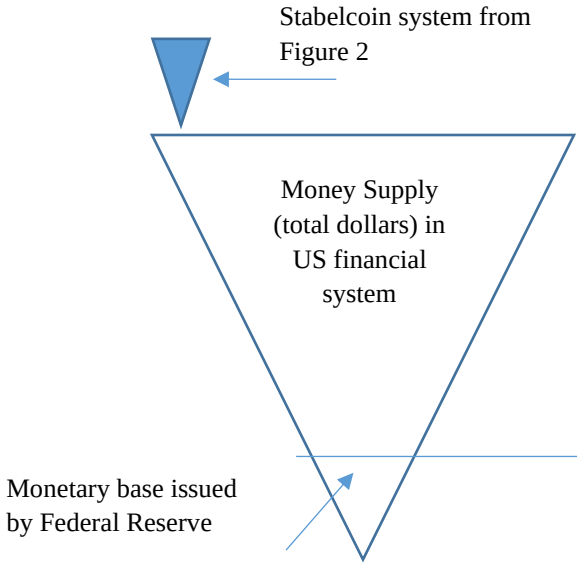


But of course, what is missing is that these reserves, namely the U.S. dollars that supposedly are backing the issued stablecoins, are themselves coming from an upside down pyramid, namely the US financial system.

414. *See also* JOHN A. ALLISON, THE FINANCIAL CRISIS AND THE FREE MARKET CURE (2013).

The Federal Reserve prints money that is then transmitted to the various banks, all of whom keep very little in terms of liquid assets on hand as a percentage of total assets. The official reserve requirement for banks was recently dropped from 10% to 0%, which means that banks have no officially required ratio of assets that they must maintain to back the currency in circulation. As such, one dollar issued by the federal reserve could generate up to 100 times that many dollars circulating in the financial system. The graph when superimposed on the financial system would look like the following graph:

Figure 3: Financial System plus Stablecoins



In other words, as the Federal Reserve expands the supply of money, some of these dollars make their way into the stablecoin and crypto-currency systems. Even if these dollars somehow come back into the real or traditional financial system, the cause of these stablecoins chasing assets is the underlying supply of U.S. dollars floating in the economy. The recent crash of crypto-currencies has been attributed by some to the threat of rising interest rates by the Federal Reserve as a response to the growing threat of inflation,[415] something the Federal Reserve may have caused in the first place. For the government to now bring stablecoins

415. Chris Morris, *Higher-than-expected inflation numbers torpedo Bitcoin, other cryptocurrencies*, FORTUNE (Feb. 10, 2022, 9:29 AM), https://fortune.com/2022/02/10/inflation-bitcoin-cryptocurrency-crash/ [https://perma.cc/T25W-NSRX].

under its ambit would be defeating the very purpose of these crypto-currencies in the first place. While we may see many of the stablecoins accede to regulation, their regulation will not prevent the development of other crypto-currencies that will be unconnected in valuation or regulation to the U.S. dollar.

The creation of algorithmic stablecoins, for example, represents this trend. Algorithmic stablecoins, as discussed above, at present might be inherently unstable. This is because there is no underlying asset backing the coins other than the supply and demand for these coins.[416] Yet, governments around the world engage in this algorithmic approach to their own currencies, especially when these regimes pursue fixed exchange-rates for their currencies. If anything, the record of many governments has been abysmal.[417] In comparison to the existing algorithmic stablecoins, the record seems to be on the coins' side.[418] Various countries in the past, such as Canada, the United Kingdom, Malaysia, Thailand, and others tried to maintain a fixed-exchange rate with respect to the U.S. dollar. To do so requires that they maintain various economic fundamentals in check, such as their money supply, inflation rate, or balances of foreign reserves. When these fundamentals were out of sync with what the market expected, the result was market pressure by investors, sometimes speculators, on the currency. Almost always when the fundamentals were off, the result was large losses to the central banks trying to prop up their currencies and ultimate devaluation.

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416. *See* Clements, *supra* note 59. An economist might observe that algorithmic stablecoins are the equivalent of fiat stablecoins. George Selgin had argued that it is very difficult to introduce a new fiat (unbacked by a commodity) money, and as such "[t]oday, only a commodity-based money can be both new and independent. A new fiat money, in contrast, must be linked to some established money to have a plausible prospect of getting off the ground." In this regards, stablecoins that are either pegged to the U.S. dollar or to a basket of commodities, including other established cryptocurrencies such as Bitcoin, seem to be the ones most stable. George Selgin, *On Ensuring the Acceptability of a New Fiat Money*, 26 J. MONEY, CREDIT & BANKING 808 (1994). In that sense, however, stablecoins can also circulate as a medium of exchange, but the unbacked US dollar can continue to be a unit of account, something that can also emerge in a competitive currency equilibrium. Lawrence H. White, *Competitive Payments Systems and the Unit of Account*, 74 AM. ECON. REV. 699 (1984).

417. Andrew Filardo & Stephen Grenville, *Central bank balance sheets and foreign exchange rate regimes: understanding the nexus in Asia* (Bank for Int'l Settlements Papers, Working Paper No. 66, 2013), https://www.bis.org/publ/bppdf/bispap66e_rh.pdf [https://perma.cc/C9WU-QDD2]; PETER M. GARBER, THE COLLAPSE OF THE BRETTON WOODS FIXED EXCHANGE RATE SYSTEM 461–94 (Michael D. Bordo et al. eds., 1993), https://www.nber.org/system/files/chapters/c6876/c6876.pdf [https://perma.cc/4Z28-QETR].

418. Timothy Craig, *Can Terra's UST Stablecoin Hold Its Peg?*, CRYPTO BRIEFING (Feb. 8, 2022), https://cryptobriefing.com/can-terras-ust-hold-its-peg-cryptos-top-algorithmic-stablecoin-unpacked/ [https://perma.cc/4DFM-VVEB] (discussing the ups and downs of the algorithmic stablecoin Terra, and how for now it has been resilient in the face of market pressures).

Yet, no one would attack these central banks as running a ponzi scheme or chastise them the way stablecoins have been.[419]

Not only are central banks inept at sometimes managing their currencies, their overall record at managing the economy is also mixed. Despite clear signals in the leadup to the 2008 subprime mortgage meltdown, the Federal Reserve was asleep at the switch when the episode unraveled. Even in this pandemic-induced recession, while the Federal Reserve (and central banks globally) may have done a commendable job putting a dampening on the economic impact of the pandemic, their record on inflation is beginning to tarnish their credibility. It remains, at this moment, to see what their next steps will be, but the (perhaps once consensus) view that the banks had acted admirably in the face of the pandemic is beginning to wear off.

All of this is to say that Central banks and other regulators, including the Federal Reserve, have not yet mastered the tools needed to deal with the traditional financial systems.[420] It would seem hasty for them to jump in now to regulate a nascent emerging financial payment system. When the Federal Reserve first jumped in to take over the supply of money, after the gold standard or specie-backed money had been the norm in

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419. Apart from the philosophical question of whether central banks around the world printing paper currencies are the ones truly operating a Ponzi scheme, some central banks were actually operating a Ponzi scheme, which has led to disastrous results. Saree Makdisi, *Behind the Crisis in Lebanon, a Vast Bank-Run Ponzi Scheme: From gas lines to medicine shortages, Lebanon is suffering the fallout of years of political and financial corruption*, THE NATION (Aug. 12, 2021), https://www.thenation.com/article/world/lebanon-financial-collapse/ [https://perma.cc/RE65-AC8A]. The Turkish Lira has also been under devaluation attack mostly due to its central bank's loose monetary policy, which has also led to flight of some investments toward crypto-currencies. Jamie Redman, *Turkey's Inflation Jumps to 36%, Lira's Value Plummets, Citizens Flock to Stablecoins*, BITCOIN.COM (Jan. 3, 2022), https://news.bitcoin.com/turkeys-inflation-jumps-to-36-liras-value-plummets-citizens-flock-to-stablecoins/ [https://perma.cc/QF8V-LUMF]; Natasha Turak, *Turkish lira crashes to 'insane' historic low after President Erdogan sparks sell-off*, CNBC (Nov. 23, 2021, 5:12 AM EST), https://www.cnbc.com/2021/11/23/ turkish-lira-plummets-to-historic-low-after-erdogan-sparks-selloff-.html [https://perma.cc/3DMN-CZ8L].

420. During the 2007–2008 financial meltdown, even what was considered the safest of non-government assets, commercial paper, which meant the Federal Reserve had to intervene there too. Marcin Kacperczyk & Philipp Schnabl, *When Safe Proved Risky: Commercial Paper during the Financial Crisis of 2007–2009*, 24 J. ECON. PERSP. 29 (2010) (finding that "[b]efore the crisis, market participants regarded commercial paper as a safe asset due to its short maturity and high credit rating" and yet during the crisis because "many investors became reluctant to purchase asset-backed commercial paper", the "total value of asset-backed commercial paper outstanding fell by 37 percent," which necessitated the Federal Reserve for the first time to "purchase commercial paper directly").

Despite all of the legislation aimed at reducing risk in the financial system, the Federal Reserve continues to act in a contradictory manner. A while back, for example, it rejected an application to start a new bank, because its business model was too safe! Matt Levine, *Federal Reserve Rejects Bank for Being Too Safe*, BLOOMBERG (Sept. 6, 2018, 9:04 AM MDT), https://www.bloomberg.com/opinion/articles/2018-09-06/fed-rejects-bank-for-being-too-safe [https://perma.cc/MMH7-MU9Y].

most of the world, the result was, as some have argued, disastrous.[421] It would seem prudent to allow the crypto-system to evolve, warts and all, to a point where economic actors around the world agree on whether such financial systems are indeed viable or a threat to the system.[422]

For regulators to swoop in now and regulate stablecoins, specifically, or even the whole crypto-system, generally, has many risks. First, to jump in with regulations at this stage would halt much of the progress and evolution the crypto-sphere that has taken place at a rapid pace the past decade. From one currency, i.e. Bitcoin, to hundreds of currencies that are traded daily, some legitimate and some probably scams, we have seen an explosion in financial innovation that the traditional financial sector has not been able to generate. Indeed, the Ripple system's key advantage was the speed of transferring money across clients and in a cost-effective manner. The fact it could also generate some profits for its holders, and as such be the target of the SEC's lawsuit, shows that traditional regulatory boxes cannot fit all newcomers. Crypto-currencies are emerging all over the world in response to different needs. Some of the needs are the need for speedy, innovative, and technically efficient ways for carrying out financial transactions. This is the case for Bitcoin and Ethereum, as used in the West and economically developed countries. In other countries, the need is simply to be able to have access to currency in the first place.[423]

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421. Allison, *supra* note 414. Just a few months ago, there was even a discussion of the federal government issuing $1 trillion platinum coins in order to side-step the debt ceiling. If that had happened, with all the money floating around the system, one wonders what the rate of inflation would be at present. Andy Kiersz and Joseph Zeballos-Roig, *The Biden administration could sidestep McConnell's refusal to pay America's bills by minting a $1 trillion platinum coin*, BUS. INSIDER (Sept. 28, 2021, 1:46 PM), https://www.businessinsider.com/mint-1-trillion-platinum-coin-debt-ceiling-2021-9 [https://perma.cc/UE2J-PB5Y].

422. We note that the Federal Reserve has taken this approach in the past with respect to new emerging financial technologies at that time. Malte Krueger, *E-money regulation in the EU* in ROBERT PRINGLE AND MATTHEW ROBINSON (EDS.), E-MONEY AND PAYMENT SYSTEMS REVIEW, LONDON: CENTRAL BANKING 239 (2002) ("When e-money appeared on the scene central banks in [the early 90s,] North America and Europe took a noticeably different regulatory stance. Whereas the Federal Reserve advocated a 'wait and see' attitude, most European central banks demanded far-reaching steps to regulate the issue of e-money."). *See also* Marlene Amstad, Regulating Fintech: Objectives, Principles, and Practices, Asian Development Bank Institute Working Paper Series 1016 (2020), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3541003 [https://perma.cc/T5VH-2NHU].

423. Vincent Ventures, *Bitcoin And Digital Asset Regulation: What To Expect*, SEEKING ALPHA (Feb. 1, 2022, 5:38 PM EST), https://seekingalpha.com/article/4483327-bitcoin-regulation-what-expect [https://perma.cc/KBC8-FFT5] (explaining that the Bitcoin and cryptocurrencies are not a threat to the U.S. dollar, but that "Bitcoin and other cryptocurrencies are a far greater threat to disfavored and unstable regional currencies."); MacKenzie Sigalos, *Inside Afghanistan's cryptocurrency underground as the country plunges into turmoil*, CNBC (Aug. 21, 2021, 8:31 AM EDT), https://www.cnbc.com/2021/08/21/bitcoin-afghanistan-cryptocurrency-taliban-capital-flight.html [https://perma.cc/B44A-7YX6] (quoting one local

Second, the stunting of evolutionary growth by any regulations will also have the consequence of driving the innovation underground and outside the newly regulated system. When Facebook a few years back thought of entering the crypto-space with its stablecoin Libra, Congressional barking scared it off, and despite its attempt at coming back again with Diem, it seems to have been gotten cold feet.[424] Yet, other

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crypto trader who "still sees crypto as the safest place to park his cash," and who "feels virtual tokens are his safest hedge against political uncertainty"). As far back as 2013, Bitcoin was used to efficiently transfer money to countries such as Afghanistan. PAUL VIGNA & MICHAEL J. CASEY, THE AGE OF CRYPTO CURRENCY: HOW BITCOIN AND DIGITAL MONEY ARE CHALLENGING THE GLOBAL ECONOMIC ORDER 1–3 (2015). Other countries like Lebanon have experienced a complete meltdown in their banking system due to their central bank's actions, which has led some to suggest that Bitcoin could fill the financial void there too. Marty Bent, *Two Developments, On Opposite Ends of The Earth Highlight Bitcoin's Range of Utility*, BITCOIN MAG. (Feb. 3, 2022), https://bitcoinmagazine.com/culture/global-developments-highlight-bitcoin-utility [https://perma.cc/VK7W-4KVL]. In some ways, crypto-currencies can also emerge in order to fill in the voids that traditional banking does not provide leaving millions in the U.S. unbanked and spurring calls for government provision of banking services. Some have called for the state to enter this unserved market via postal banking. Mehrsa Baradaran, *It's Time for Postal Banking*, 127 HARV. L. REV. F. 165 (2013–2014). Recent moves by money transfer services such as MoneyGram International partnering up with stablecoin issuers demonstrates some of the many possible synergies that exist between traditional financial services and the crypto-sphere. Nina Bambysheva, *MoneyGram Partners With Ripple Competitor Stellar, Will Settle Transactions With USDC Stablecoin*, FORBES (Oct. 6, 2021, 4:15 PM EDT), https://www.forbes.com/sites/ninabambysheva/2021/10/06/moneygram-partners-with-ripple-competitor-stellar-will-settle-transactions-with-usdc-stablecoin/?sh=5d1afcd34db4 [https://perma.cc/BG38-Q4P7]; Timothy G. Massad, *Regulating stablecoins isn't just about avoiding systemic risk*, BROOKINGS (Oct. 5, 2021), https://www.brookings.edu/research/regulating-stablecoins-isnt-just-about-avoiding-systemic-risk/ [https://perma.cc/Z64B-BFL2].

As an aside, we also note that a test program launched by the U.S. Post Office to test the idea of postal banking does not seem to be getting much traction from the public. David Dayen, Postal Banking Test in the Bronx Yields No Customers: From September 13 to October 31, not a single customer put a paycheck on a gift card in one of the four test locations (Nov. 9, 2021), https://prospect.org/economy/postal-banking-test-in-the-bronx-yields-no-customers/ [https://perma.cc/X7E7-R3GL]. Professor Saule Omarova has advocated a more radical approach to postal banking with her advocating a more direct role for the Federal Reserve as having much broader banking activities. Saule T. Omarova, *The People's Ledger: How to Democratize Money and Finance the Economy*, 74 VAND. L. REV. 1231 (2021).

424. Daniel Roberts, On Its Way to the Grave, Diem Claims a Senior US Regulator Praised Its Stablecoin: In its sale announcement, Diem made a "Trumpian" comment about a U.S. regulator praising its design. Here's why that's significant, even as Diem shuts down (Feb. 4, 2022), https://decrypt.co/91692/facebook-meta-diem-libra-regulator-praised-stablecoin-design [https://perma.cc/K2EC-WL6E]; Dimitar Dzhondzhorov, *Diem's Downfall: From an Ambitious Single Global DigitalCurrency Idea to a Painful End*, CRYPTOPOTATO.COM (updated Feb. 6, 2022), https://cryptopotato.com/diems-downfall-from-an-ambitious-single-global-digital-currency-idea-to-a-painful-end/ [https://perma.cc/ZG6F-756C]; Kevin Stankiewicz, *Here's what the bank that bought assets from Zuckerberg's crypto project plans to do with them*, CNBC (Jan. 31, 2022, 7:42 PM EST), https://www.cnbc.com/2022/01/31/bank-that-bought-assets-from-zuckerbergs-diem-plans-to-launch-stablecoin.html [https://perma.cc/WAQ6-YM9E]; Richard Partington, *How the wheels came off Facebook's Libra project*, THE GUARDIAN (Oct. 18, 2019, 14.42 BST),

stablecoins, such as Tether, were not deterred by these regulatory attacks. They simply evolved outside U.S. regulations. Even with the New York prohibition on Tether, other stablecoins are emerging and slowly supplanting Tether's dominance.[425] This means that bringing stablecoins

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https://www.theguardian.com/technology/2019/oct/18/how-the-wheels-came-off-facebook-libra-project [https://perma.cc/N5NY-G5Y7]. *See also* Amanda Simmons, *Regulating Libra: Will Legal and Regulatory Uncertainty Prevent the Launch of Facebook's Cryptocurrency Project?*, 16 J. BUS. & TECH. L. 83 (2021); G. A. Walker, *Bigtech, Stabletech, and Libra Coin - New Dawn, New Challenges, New Solutions*, 53 INT'L LAW. 303 (2020).

Many years ago, Walmart thought of entering the banking system due to the high volume of daily small transactions it deals with, but they too were scared off by the Federal Reserve. That may change today with Walmart's foray into FinTech with an eye to serving the millions of unbanked. Robert Armstrong, *Goldman bankers join Walmart effort to take on Wall Street*, FIN. TIMES (Feb. 28, 2021), https://www.ft.com/content/118b29ba-f118-46ff-b639-675ceb3c1cf6 [https://perma.cc/587Y-NH74].

425. For example, see Martin Young, Circle's USDC stablecoin gobbles Tether's market share with 50B milestone: The 50 billion USDC circulating milestone has increased Circle's share of the stablecoin market to almost 30%. (Feb. 1, 2022), https://cointelegraph.com/news/circle-s-usdc-stablecoin-gobbles-tether-s-market-share-with-50b-milestone [https://perma.cc/LJH3-2MKS]; Cointelegraph Consulting: Stablecoin activity drops after May peak: Despite the tumble in stablecoin activity, average transactions of stablecoins DAI and UST still exceed those of USDT and USDC (July 16, 2021), https://cointelegraph.com/news/cointelegraph-consulting-stablecoin-activity-drops-after-may-peak [https://perma.cc/M4PN-4GYF] ("there are some signs of institutional avoidance of Tether. Rather, institutional users seem to prefer using MakerDAO's DAI, even though USDT has exceeded DAI's total number of transactions and total trading volume by a long shot."). The negative press from the NYAG lawsuit and ensuing bad press may be putting pressure on Tether's dominance. Yequi Yang, *Tether Fails to Dispel Mystery on Stablecoin's Crucial Reserves*, BLOOMBERG (Dec. 3, 2021, 7:38 AM MST), https://www.bloomberg.com/news/articles/2021-12-03/tether-gives-more-details-on-assets-backing-crypto-stablecoin [https://perma.cc/J8XT-UYS4]. It can also spur other stablecoin actors into creating more transparency and best practices. *See, e.g.*, Ryan Browne, *The world's second-largest stablecoin is undergoing a massive change*, CNBC (updated Aug. 23, 2021, 8:21 PM EDT), https://www.cnbc.com/2021/08/23/crypto-usdc-stablecoin-to-change-reserves-composition.html [https://perma.cc/3SZF-SZCB].

Other competition comes not only from the stablecoins but the platforms upon which they operate. While most stablecoins operate on Ethereum, Solana is emerging as a strong alternative. Danny Nelson, 'Pay' Product Looks to Boost Stablecoin Payments on Solana: Can Solana Labs' open-source payment plug-in pick up where the Bitcoin white paper left off? (Feb. 1, 2022, 7:00 AM MST), https://www.coindesk.com/business/2022/02/01/pay-product-looks-to-boost-stablecoin-payments-on-solana/ [https://perma.cc/9WML-YTMM]. Similalry, the Flow blockchain has seen USDC being launched on its platform. Sergio Goschenko, *Circle Launches USDC on Flow Blockchain*, BITCOIN.COM (Feb. 1, 2022), https://news.bitcoin.com/circle-launches-usdc-on-top-of-flow-blockchain/ [https://perma.cc/PHY8-7TEK]. Of course, stablecoins and other crypto-currencies are themselves competitors, in some sense, to the Bitcoin system in the first place. Olga Kharif, *When it comes to buying things with crypto, Ether, stablecoins and Dogecoin are starting to encroach on Bitcoin's turf*, FORTUNE (Jan. 16, 2022, 9:55 PM MST), https://fortune.com/2022/01/16/ether-bitcoin-stablecoin-dogecoin-bitpay-crypto-payments-share/ [https://perma.cc/39FS-DPQS]. In many ways, reputational constraints are very similar to the reputational constraints on private mints that minted gold coins during the first half of the nineteenth century.

under the regulatory fold so soon will simply put us back to square one, namely new and more evasive coins will emerge and operate even further away from regulatory reach.[426]

As an aside, we note that notwithstanding the rapid development of crypto-currencies in the past 13 years, other alternatives to using government issued money have been around for a long time. While corporate barter was one such mechanism,[427] actual individual to individual barter systems have been flourishing for quite some time now.[428] Modern ledger technology will only make it grow even further.[429] The motivations may vary, but the impact is the same, i.e., the lack of financial regulatory oversight or the adverse impacts regulations have on the provision of financial services.

The imprimatur of official approval also carries the risk of upsetting a delicate balance that has been struck between the courts and commercial practices on the one hand and the customers and users of financial products on the other. The late Professor Lynn Stout had observed that the roots of the 2008 recession can be traced back to the legislative removal on the prohibition against speculation in over-the-counter derivatives.[430] So while derivatives and speculating on them were legal

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Lawrence H. White, *The private mint in economics: Evidence from the American gold rushes*, 75 ECON. HIST. REV. 3 (2022).

426. The growth of FinTech lending even though their rates are higher than traditional banks has been explained by regulatory impediments to serving certain customers and the creativity of getting around regulations imposed on traditional banks. Greg Buchak, Gregor Matvos, Tomasz Piskorski & Amit Seru, *Fintech, regulatory arbitrage, and the rise of shadow banks*, 130 J. FIN. ECON. 453 (2018).

427. Ali, *supra* note 81.

428. Suzanne Bearne, *A barter way of life: Covid crisis fuels swapping of goods and skills*, THE GUARDIAN (Oct. 31, 2020, 9:00 GMT), https://www.theguardian.com/money/2020/oct/31/barter-covid-swapping-goods-skills [https://perma.cc/BB3N-6CDX]; John Baldessari, *There's a Thriving Underground Barter Network Among Artists. Doug Aitken, Dread Scott, and 12 Others Tell Us About Their Most Memorable Trades*, ARTNET NEWS (Apr. 10, 2019), https://news.artnet.com/art-world/artist-trades-1512625 [https://perma.cc/D2QL-BG35]; David Amsden, Inside Portland's Cash-Free Bartering Economy: Discovering the farm collectives, coffee shops and more that make this Oregon city's cashless bartering society work (Sept. 21, 2017), https://www.rollingstone.com/culture/culture-news/inside-portlands-cash-free-bartering-economy-198566/ [https://perma.cc/YD7W-K32G]; Valerie Vande Panne, Detroit's Underground Economy: Where Capitalism Fails, Alternatives Take Root: Over decades of poverty, Detroiters have fostered a resilient informal economy based on trust (June 29, 2017), https://inthesetimes.com/article/detroits-underground-economy-gift-barter [https://perma.cc/26XB-UU8M]; Lauren McKeon, No money? No problem. How more and more Torontonians are capitalizing on the barter economy (Oct. 24, 2013), https://torontolife.com/city/toronto-barter-economy/ [https://perma.cc/287M-VKVW].

429. Akbar Marvasti & David Smyth, *Barter in the US Economy: A Macroeconomic Analysis*, 30 APPLIED ECON. 1077 (1998).

430. Lynn A. Stout, *Derivatives and the Legal Origin of the 2008 Credit Crisis*, 1 HARV. BUS. L. REV. 1 (2011).

and had existed since time immemorial, the courts did not enforce the speculative aspect of derivatives.[431] This meant that the market could innovate, but not expect to get too much help from the law. Rather, those who wished to engage in speculation needed to figure out how to fend for themselves, which meant that only those who had the wherewithal or smarts could survive. Opening up the system by removing the prohibition seems to have accelerated the speculative ventures that led to the great meltdown of 2008.

We note that even basic auditing of investment service providers meant to protect the public seems to escape the SEC's watch every now and then. Who can forget the Madoff Ponzi scheme that operated for years despite official clearances from the SEC.[432] Whether this was because of his cozy relationship with the SEC or because he knew how to work the system has been debated, but the result was the same: investors were defrauded. It is in this vein, we suggest that while the technical and financial innovations are attracting those with the stomach to engage in stablecoin and crypto-transactions, legalizing it by regulating it will attract a lot more who may not be ready for this market.

Third, by bringing stablecoins (and possibly other crypto-currencies) under regulatory control at a time when the technology is evolving and the regulatory agencies lack the technical ability to keep up, risks making things worse in terms of outcomes for the public. There is always the risk of the regulated capturing the regulator, as the Nobel Laureate George Stigler observed. Hence, once certain entities receive governmental blessing to operate as official sanctioned stablecoins, because they are now regulated by the Federal Reserve, SEC, or FDIC, the risk of the public taking these entities as being blessed by the agencies will encourage them to go ahead and deal with them without taking any cautions they may take at present. Furthermore, it is not clear what capacity these agencies have at present to even engage in crypto-

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431. *Id.* at 11.

432. Liz Moyer, *Why The SEC Missed Madoff*, FORBES (Dec. 17, 2008, 6:00 PM EST), https://www.forbes.com/2008/12/17/madoff-sec-cox-business-wallst-cx_em_bw_1217ponzi.html [https://perma.cc/N9YH-YHR6].

Traditional frauds have also been proven elusive to nip in the bud, with resulting lawsuits and criminal prosecutions exposing the ineptitude of all regulators alike. *See, e.g.*, *Note, Congress, The Supreme Court, and the Rise of Securities-Fraud Class Actions*, 132 HARV. L. REV. 1067 (2019)(calling for more Congressional action on securities fraud); Miles Kruppa & Richard Waters, *Conviction of Theranos founder Elizabeth Holmes splits Silicon Valley*, FIN. TIMES (Jan. 4, 2022), https://www.ft.com/content/e04cb9f0-3726-490b-bbcd-2a6f522a42a2 [https://perma.cc/7SGV-47MU]; Chris Flood and Harriet Agnew, Hedge funds oppose SEC's reform plans after GameStop debacle: Regulator's 'misguided' securities lending proposals risk fuelling volatility, say managers, FIN. TIMES (Jan. 16, 2022), https://www.ft.com/content/4464e205-3708-49ec-83b9-eb4934ce3a51 [https://perma.cc/FB56-5PSQ] (discussing proposed rules the SEC is putting forth to avoid the meme stock saga).

regulation. Ensuring that there are adequate reserves is one thing. But how to measure the volume of crypto or how to understand what contracts are being executed on the crypto-sphere is another. We note that for example, none of the official papers issued by the PWGM or the Federal Reserve provide any technical details on how they propose to carry out their regulations.[433] That may be because these papers are simply high-level papers unconcerned with the minutiae. However, it does raise the question of who will carry out the regulations. Indeed, if these agencies will start employing coders who formerly worked at a specific crypto-currency or platform, will the technical standards at those platforms become the norm for all actors in the crypto-sphere?[434]

In another realm long maligned in the popular press,[435] namely high-frequency-trading (HFT), for example, one author notes that much of the regulatory action seemed to be driven by political factors.[436] Politicians and regulators, under pressure from incumbents, seem to drive much of the regulatory agenda. The political influence comes in two manners. One is the "when political figures are lobbied by specific financial interest groups and in turn seek to exert pressure on regulators."[437] The second, which he notes is "much rarer but occasionally highly consequential, occurs when there has been a crisis or scandal whose effects are sufficiently widespread that members of Congress can envisage broader political rewards (and not simply campaign contributions) from being seen as reformers of the financial system."[438] In many ways, we seem to be seeing these two forms in action today.

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433. The computing science and engineering literature is filled with technical analysis of the crypto-sphere with somewhat different ideas of stability and security. *See, e.g.*, Ariah Klages-Mundt and Andreea Minca, *(In)Stability for the Blockchain: Deleveraging Spirals and Stablecoin Attacks*, CORNELL U. LIBR., Mar. 2, 2021, https://arxiv.org/pdf/1906.02152.pdf [https://perma.cc/DUM2-DZGE].

434. Already with talk of central bank digital currencies, there are hints that the existing blockchain platforms are not good enough and that new platforms will have to be created. Jason Brett, *Former Boston Federal Reserve President Claims Blockchain Not Fit For Central Bank Digital Currency*, FORBES (Oct. 16, 2021), https://www.forbes.com/sites/jasonbrett/2021/10/16/former-boston-fed-president-predicts-bitcoin-stablecoins-and-digital-dollar-will-coexist/?sh=308691a82680 [https://perma.cc/T4TD-B9HR].

435. Michael Lewis popularized the case against HFTs in his book MICHAEL LEWIS, FLASH BOYS: A WALL STREET REVOLT (2014). But see for a contrasting view, Michelle Fox, HFT critic Michael Lewis 'dead wrong:' Author (Nov. 24, 2014, 5:25 PM EST), https://www.cnbc.com/2014/11/24/hft-critic-michael-lewis-dead-wrong-author.html [https://perma.cc/CDK2-K4KW].

436. DONALD MACKENZIE, TRADING AT THE SPEED OF LIGHT: HOW ULTRAFAST ALGORITHMS ARE TRANSFORMING FINANCIAL MARKETS (2021) (documenting the history and technology behind the emergence of HFT, but also the behind-the-scenes political machinations that create the regulatory environments in which these trades take place).

437. *Id.* at 220.

438. *Id.*

This leads to the question of who are the favored parties trying to clamp down on stablecoins, and is there a crisis that Congress and the SEC seem to be trying to capitalize on? At one level, it could be argued that traditional incumbent financial institutions may be behind the regulatory clampdown on stablecoins.[439] The lawsuit against Ripple by the SEC raises the question, which Ripple also raised, of why Bitcoin and Ethereum have been left alone. Perhaps it is a case of the horses having left the stable. Perhaps it is a case of the SEC genuinely believing there is nothing wrong with these two platforms. Regardless, it creates the impression that certain players are officially favored, while others are not.[440] This last point also points to another reason the regulatory pace should proceed in a cautious manner. In addition to the risk of putting all stablecoins under one regulatory regime, both technical and economic, the risk of favoritism is high.[441]

On another level, it seems, especially in light of the almost simultaneous attacks on crypto-currencies generally and stablecoins specifically around the world, that it is the central banks and their associated treasury departments that are the most threatened.[442] Bitcoin and Ethereum are still clunky and have not been able to become fast moving media of exchange, which is why the stablecoins were created. But stablecoins look just like regular currencies. This poses an existential threat to central banking, and hence government revenue itself. As such, ideas such creating central bank digital currencies are now being explored, in addition to regulation of stablecoins. Already there is talk that the existing blockchain platforms will be insufficient to ensure a

439. Eva Marie Uzcategui, *Crypto Firms Want Federal Reserve Payment Systems Access—and Banks Are Resisting*, WALL ST. J. (Aug. 28, 2021), https://www.wsj.com/articles/crypto-firms-want-fed-payment-systems-accessand-banks-are-resisting-11630143002 [https://perma.cc/MGU7-YWQP].

440. Tolu Ajiboye, *SEC Accused of Deliberately Trying to 'Kill' XRP by Favoring Ethereum (ETH)*, COINSPEAKER (Dec. 28, 2021, 11:19 UTC), https://www.coinspeaker.com/sec-accused-kill-xrp-favoring-eth/ [https://perma.cc/85NH-4FEY].

441. In the current campaign against stablecoins, it is worth noting that one of the sharpest critics of cypto-currencies, in general, receives a large amount of his campaign donations from large banks, which could lead one to cynically conclude that the opposition is not necessarily driven by the public interest. Brad Polumbo, *Exposed: Congressman Trying to 'Shut Down' Cryptocurrency Gets Biggest Donations from Big Banks and Financial Institutions*, FEE (July 1, 2021), available at https://fee.org/articles/exposed-congressman-trying-to-shut-down-crypto currency-gets-biggest-donations-from-big-banks-and-financial-institutions/ [https://perma.cc/DR9C-RU48].

442. In addition to the various reports discussed above, we note that the Treasury Department's Financial Stability Oversight Council also addressed stablecoins in their 2021 annual report. https://home.treasury.gov/system/files/261/FSOC2021AnnualReport.pdf [https://perma.cc/Z8GY-3YFU].

proper digital cash system,[443] something that may lead to the end of stablecoins.[444] Crypto-currencies were once only the playground of "everyone from hardcore libertarians and bank-hating leftwingers to dedicated "cypherpunks," a group of privacy-obsessed cryptographers and coders that had coalesced in the 1980s."[445] But now the Super Bowl is featuring advertisements for crypto,[446] and ordinary Americans are now getting rich from crypto-investing.[447]

Perhaps, sensing this flight from traditional central bank issued currencies, governments are stepping in with a two-prong strategy. The first is to co-opt the movement by introducing their digital currencies, as we have seen China do recently. The second is to rein the threat in by regulating or banning them, also as we have seen China do recently.[448] But digital currencies, while they may solve the central banker's lament, they do not necessarily solve the original concerns that of those who flocked to crypto-currencies in the first place. Digital currencies have already attracted criticisms related to privacy and the ineptitude of central

443. Jason Brett, *Former Boston Federal Reserve President Claims Blockchain Not Fit For Central Bank Digital Currency*, FORBES (Oct. 16, 2021, 1:24 AM EDT), https://www.forbes.com/sites/jasonbrett/2021/10/16/former-boston-FederalReserve-president-predicts-bitcoin-stablecoins-and-digital-dollar-will-coexist/?sh=308691a82680 [https://perma.cc/7NP4-S34F].

444. Andrew Singer, Does a Federal Reserve digital dollar leave any room for crypto stablecoins? Could stablecoins be undone by a Federal Reserve that takes consumer deposits? Would retail banks be hobbled? (Jan. 21, 2022), https://cointelegraph.com/news/does-a-fed-digital-dollar-leave-any-room-for-crypto-stablecoins [https://perma.cc/7KCF-2Z6N] ("A widely and easily accessible digital dollar would undercut the case for privately issued stablecoins," Eswar Prasad, professor of economics at Cornell University and author of the book, The Future of Money, told Cointelegraph, though "stablecoins issued by major corporations could still have traction, particularly within those corporations' own commercial or financial ecosystems.").

445. Siddharth Venkataramakrishnan & Robin Wigglesworth, Inside the cult of crypto: Debate? No thanks. Doubts? Not welcome. How the world of cryptocurrency diehards really works (Sept. 9, 2021), https://www.ft.com/content/9e787670-6aa7-4479-934f-f4a9fedf4829 [https://perma.cc/V48N-B82Z].

446. Ezra Marcus, *Super Bowl crypto ads are as predatory as celebs hawking cigarettes*, THE GUARDIAN (Feb. 14, 2022, 18.57 GMT), https://www.theguardian.com/culture/2022/feb/14/super-bowl-crypto-ads-are-as-predatory-as-celebs-hawking-cigarettes [https://perma.cc/5YF2-TY2P].

447. Rikki Schlott, *Four ordinary people share how they got rich from crypto*, N.Y. POST (Feb. 5, 2022, 8:33 AM), https://nypost.com/2022/02/05/how-cryptocurrency-made-these-four-ordinary-people-rich/ [https://perma.cc/UU4G-F3AS].

448. In many ways, this is reminiscent of the time private entrepreneurs, including the lawyer Lysander Spooner, challenged the federal government's monopoly over the postal office. Offering lower priced services, the Post Office initially prosecuted Spooner and shut his services down, although some other low-profiles competitors escaped regulatory scrutiny. In the end, Congress lowered the postage rate in order to prevent more competitors from entering. Kelly B. Olds, *The Challenge to the U.S. Postal Monopoly, 1839-1851*, 15 CATO J. 1 (1995–1996).

bank's monetary policies.[449] The ability to print money, and more importantly having a monopoly over the printing of money, gives great fiscal advantages to governments that possess this power.[450] As such, at the very time deficits are ballooning and money is being liberally printed, it should be no surprise that the noise regarding stablecoins keeps getting louder and louder. This observation also lines up with the past history of the U.S. government in the face of the Civil War and the Great Depression, when it ended the gold standard (once temporarily and the second time permanently).

All in all, we suggest that it is better at this stage to let the crypto-world develop its own protocols for figuring out who is trustworthy and who is not. The field is so dynamic that for rules to be imposed at this time will be counterproductive.[451] It also risks drawing in all the special interests that may wish to affect the pace of developments in the crypto-world, including the Treasury and the Federal Reserve. If regulation,

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449. Scott Chipolina, Erik Voorhees: Central Bank Digital Currencies Are 'Orwellian Spy Surveillance Nightmare': Erik Voorhees, outspoken libertarian and Bitcoin OG, slammed central bank digital currencies during an appearance on Decrypt's gm podcast (Feb. 7, 2022), https://decrypt.co/92129/shapeshift-erik-voorhees-cbdc-orwellian-spy-surveillance-nightmare [https://perma.cc/C3WR-VB5B]; James Mackintosh, Digital Currencies Pave Way for Deeply Negative Interest Rates: If people can't hoard physical money, it becomes much easier to cut rates far below zero (updated Sept. 8, 2021, 6:11 AM EST), https://www.wsj.com/articles/digital-currencies-pave-way-for-deeply-negative-interest-rates-11631091581 [https://perma.cc/88XR-2SDG]; George Selgin, *Central Bank Digital Currency as a Potential Source of Financial Instability*, 41 CATO J. 333 (2021). For a measured view from the Federal Reserve's research department on the potential impact of stablecoins on the banking system, as well as a good overview of the possible interactions between the two systems, see Gordon Y. Liao & John Caramichael, Stablecoins: Growth Potential and Impact on Banking,International Finance Discussion Papers 1334. Washington: Board of Governors of the Federal Reserve System (2022), https://doi.org/10.17016/IFDP.2022.1334 [https://perma.cc/KTP2-3CWX]; Cheng, Jess, Angela N Lawson, and Paul Wong (2021). "Preconditions for a general-purpose central bank digitalcurrency," FEDS Notes. Washington: Board of Governors of the Federal Reserve System, February 24, 2021, https://doi.org/10.17016/2380-7172.2839 [https://perma.cc/K9JL-7QQA].

450. *See, e.g.*, Brian D. Galle & Yair Listokin, *Monetary Finance*, TAX L. REV. (forthcoming), available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3885966 [https://perma.cc/QL94-WGK8] (outlining the fiscal power that comes with the ability to print money); George Selgin & Lawrence H. White, *A Fiscal Theory of Government's Role In Money*, 37 ECON. INQUIRY 154 (1999) (arguing that "public monopoly production of coins and banknotes, substitution of fiat for commodity standards, and restrictions on substitutes for government money all generate revenue and especially provide means for meeting fiscal emergencies," but not because of a "conscious design," but rather a result of the "evolutionary survival of the fiscally advantageous").

451. This point has also been made by current SEC Commissioner Hester Pierce. Jamie Crawley, Hester Peirce Warns Proposed SEC Reform of Securities Trading Platforms Could Threaten DeFi: "Crypto Mom" believes a new 654-page plan designed to add oversight to trading government securities could also allow new powers to scrutinize DeFi platforms (Feb. 1, 2022, 9:15 AM MST), https://www.coindesk.com/policy/2022/02/01/hester-peirce-warns-proposed-sec-reform-of-securities-trading-platforms-could-threaten-defi/ [https://perma.cc/235R-4AXD].

must take place, however, we suggest that the better place for it to take place is at the state level.

2. Regulation Should Come at the State Level

As discussed above, states were where much of the regulatory and deregulatory action took place in the first part of the nineteenth century. The state level of regulation allowed citizens who felt that their banking system was subject to corruption to demand reforms that allowed free-banking, so that banks were established without fear or favor of those in power. Today, states are also the perfect laboratories for crypto-currencies as well as stablecoins to be housed, regulatorily speaking.

On the one hand, we have already seen that the NYAG acted against Tether, long before any federal officials even thought of jumping in. When federal officials initially reacted to stablecoins, it was when Congress scared Facebook off its initial currency Libra. On the other hand, some states, such as Wyoming and Arizona, are already looking into integrating crypto-currencies into their banking landscape.[452] Wyoming's legislative action has "encouraged several high-profile companies in the industry to move operations from traditional high-tech hubs like San Francisco to Wyoming's capital city of Cheyenne, including crypto exchange Kraken, blockchain platform Cardano and payment protocol firm Ripple Labs."[453] This of course, has "put the state on a potential collision course with federal regulators who appear far more skeptical of the costs and benefits of blockchain technology than libertarian-leaning Wyomingites."[454] The mayor of New York City, Eric

452. Ben Schreckinger, A crypto breakthrough? Western states consider taking digital currency: Proposals in Wyoming and Arizona to accept tax payments in Bitcoin and other cryptocurrencies would undermine the dollar's unique status (Feb. 1, 2022, 4:30 AM EST), https://www.politico.com/news/2022/01/31/crypto-wyoming-arizona-tax-payments-00003910 [https://perma.cc/AA23-B9AR].

453. Chris Matthews, *How Wyoming became the promised land for bitcoin investors*, MARKETWATCH (last updated Apr. 24, 2021, at 8:21 AM ET), https://www.marketwatch.com/story/how-wyoming-became-the-promised-land-for-bitcoin-investors-11619201182 [https://perma.cc/NHG8-STUH]. See also Turner Wright, Tennessee lawmaker introduces bill which would allow state to invest in crypto: The two bills introduced on Feb. 2 propose allowing the state of Tennessee as well as its counties and municipalities to invest in crypto, as well as forming a committee aimed at studying crypto and blockchain (Feb. 9, 2022), https://cointelegraph.com/news/tennessee-lawmaker-introduces-bill-which-would-allow-state-to-invest-in-crypto [https://perma.cc/CR84-8MLS].

454. Chris Matthews, *How Wyoming became the promised land for bitcoin investors*, MarketWatch (last updated Apr. 24, 2021, at 8:21 AM ET), https://www.marketwatch.com/story/how-wyoming-became-the-promised-land-for-bitcoin-investors-11619201182 [https://perma.cc/FY4K-HE2S].

Adams, wishes to be paid in Bitcoin, and Miami's mayor is already there.[455]

State laws already have their own jurisprudence developed over the past two centuries with respect to negotiable instruments and banking, as well as securities.[456] It would be much easier to allow the states to test the waters with crypto-regulation than having the federal agencies do it all at once.[457] If anything, given the enthusiasm of many state and local actors, they would be much more motivated to find proper solutions than their overly bureaucratic counterparts in Washington, D.C.[458]

Interstate competition, or competitive federalism, has long been touted as the laboratory of the states where policies can be developed in an organic evolutionary manner.[459] This is in contrast with a one size fits all approach any federal oversight would bring. It is worth noting that in Canada, securities regulation including that of crypto-currencies has been handled primarily by provincial regulators.[460] It would make sense based on the legislative and judicial history of the nineteenth century to allow the states to start the process. If the states are incapable or there are widespread systemic issues affecting the regulation of crypto-currencies, the federal government can step in as it has in the past. Indeed, the possible looming threat from the federal government is the constant that keep state laws competing to the top instead of racing to the bottom.[461]

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455. David Gura, *Miami wants to become crypto's financial capital. New York's response? Bring it on*, NPR (Dec. 25, 2021), https://www.npr.org/2021/12/25/1063578188/miami-wants-to-become-cryptos-financial-capital-new-yorks-response-bring-it-on [https://perma.cc/HMX4-VKVG].

456. Andrew K. Jennings, *State Securities Enforcement*, 47 BYU L. REV. 67 (2021).

457. Turner Wright, US lawmaker pushes for state-level regulations on stablecoins at hearing on digital assets: Patrick McHenry implied that the U.S.' regulation of stablecoins with a "single regulator at the federal level" would likely fail (Feb. 8, 2022), available at https://cointelegraph.com/news/us-lawmaker-pushes-for-state-level-regulations-on-stablecoins-at-hearing-on-digital-assets [https://perma.cc/ZBK7-5MND].

458. *See also* Matthew Homer, The Infuriating Patchwork of Crypto Regulations Is Good for Crypto: Calls for a centralized crypto regulator in the U.S. feed the false narrative that the industry is unchecked (Dec. 13, 2021, 1:12 PM MST), available at https://www.coindesk.com/layer2/2021/12/13/the-infuriating-patchwork-of-crypto-regulations-is-good-for-crypto/ [https://perma.cc/MPK8-776E].

459. Larry E. Ribstein & Erin Ann O'Hara, *Corporations and the Market for Law*, 2008 U. ILL. L. REV. 661 (2008).

460. Clements, *Emerging Canadian Crypto-Asset Jurisdictional Uncertainties and Regulatory Gaps*, 37 BANKING & FIN. L. REV. (2021) (outlining the regulation of cryptocurrencies in Canada); Catherine Rousseau, *Cryptocurrency Offerings in Canada: Why and How We Should Modernize the Securities Law Framework*, 35 BANKING & FIN. L. REV. 63 (2021).

461. Renee M. Jones, *Rethinking Corporate Federalism in the Era of Corporate Reform*, 29 J. CORP. L. 625 (2004); Mark J. Roe, *Delaware's Competition*, 117 HARV. L. REV. 588 (2003).

CONCLUSION

Stablecoins, and other crypto-currencies that operate in a similar functionality, like Ripple's XRP, are increasingly attracting regulatory scrutiny. The linchpin underlying the scrutiny of stablecoins seems to be a harkening back to what many believe was a dark era in American banking history, namely the free-banking era. But the record discloses that the era was no worse, in many ways, than our modern central banking era today. If anything, that era allowed states to experiment with the provision of banking services as long as they did not outright print money. That all changed with the advent of the Civil War when the federal government, starved for cash, mandated the use of its paper money as legal tender. Since the 1930s, that remains the case. Over a century ago when the Canadian government outlawed the private issuance of the dollar bill, the astute observer Professor Goldwin Smith wrote the following:

> . . . it appears that the treasury having been depleted . . . the government proposes to replenish it by appropriating the circulation of the banks. Dealing with currency is a time-honoured expedition of governments in financial difficulties . . . . The circulation, while it is in the hands of the banks, is under the control of the legislature, which can impose all needful restrictions in the way of reserves or inspection . . . A government commanding a majority can vote itself all the license that it pleases; it is its own inspector. So long as the paper circulation is issued by the banks, its volume, like the volume of any other instrument of credit, will be regulated by the requirements of commerce. But what is to regulate the volume of the paper circulation when it is issued by the government?[462]

Professor Smith may as well have been speaking of today's campaign against crypto-currencies and stablecoins.

In this Article, we argue that the evidence does not support the fears of those who invoke the free-banking era as a reason to regulate stablecoins and other currencies such as XRP. Rather, these coins are part of an ongoing evolution of payments systems responding to technological innovations and also regulatory ineptitude. To bring these coins under federal oversight may tame these wild coins for now, but other instruments will continue to evolve and escape regulatory oversight. Therefore, we argue that a "wait and see" approach is the better approach while the crypto-sphere adapts over time to develop mature institutions that can demonstrate their true potential. If any regulation should be had,

462. Goldwin Smith, *The Government and the Bank Circulation*, THE WEEK 70 (Jan. 4, 1889).

we suggest that it be done at the state level given the rich history of the states regulating banking and commercial transactions. We also suggest that some of this attack on stablecoins may be motivated by a fiscal and monetary possessiveness by the federal government's various agencies.

Appendix A: The Complaint in the Class Action Lawsuit Against Tether

This lawsuit was filed by a group of plaintiffs against various parties including Bitfinex and Tether.[463] The plaintiffs alleged that the defendants manipulated the price of BTC by issuing USDT that was unbacked by the U.S. dollar, and that the defendants used the unbacked USDT to purchase and artificially inflate the price of bitcoins.[464] Furthermore, the plaintiffs alleged that the defendants used inside information about the USDT issuances to be able to sell off their Bitcoin holdings once Bitcoin prices were artificially inflated.[465] The plaintiffs also alleged manipulation of the market for derivatives related to Bitcoin, including Bitcoin futures.[466] As such, the plaintiffs allege that they were deprived of trading in a competitive market for bitcoins and their futures. As such, they have been injured in their business and property.[467]

Another claim the plaintiffs made is based on commodities laws and regulations. Because they argued that Tether had manipulated the futures markets for bitcoins, the plaintiffs invoked the Commodity Exchange Act (CEA).[468] Because the Chicago Mercantile Exchange (CME) and Chicago Board Options Exchange (CBOE) are designated by the Commodity Futures Trading Commission (CFTC) as a contract market,[469] this means that anyone trading futures and options is subject to various rules and regulations that these exchanges have. This is because, their rules have official sanction from the CFTC. The claim is that since the defendants intended to and did manipulate the price of Bitcoin, the very commodity underlying the various futures and options being traded on the CME and CBOE, this also caused harm to the plaintiffs who traded options and futures.[470]

The plaintiffs further argued that the defendants had committed various species of common law and statutory fraud. Specifically, they claimed that the manipulation of Bitcoin's prices should be considered a manipulative or deceptive device,[471] a charge somewhat akin to the classic securities fraud claims under SEC Rule 10b-5.[472]The

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463. Complaint, Young v. iFinex, No. 1:20-cv-00169 (S.D.N.Y filed Jan. 8, 2020), https://storage.courtlistener.com/recap/gov.uscourts.nysd.529661/gov.uscourts.nysd.529661.1.0.pdf [https://perma.cc/W9A3-PQAY]. There are three other similar lawsuits, which have now been consolidated into one.

464. Complaint, *supra* note 463, at para. 1–3.

465. Complaint, *supra* note 463, at para. 3.

466. Complaint, *supra* note 463, at para. 4–7.

467. Complaint, *supra* note 463, at para. 7.

468. 7 U.S.C. § 1-27f.

469. The authority to do so comes from Section 5 of the CEA, 7 U.S.C. § 7.

470. Complaint, *supra* note 463, at para. 156.

471. CEA 7 U.S.C. § 1, ET SEQ. AND CFTC REGULATION 180.1(A), 17 C.F.R. § 180.1(A).

392. 17 CFR § 240.10b-5.

manipulation and deceit alleged on Tether's part includes the making of untrue statements regarding Tether's issuances of USDTs; the untrue statements regarding Tether's reserves in U.S. dollars; the failure to disclose of the various trades in Bitcoin using the inflated USDTs; the failure to disclose of the coordinated manipulation of Bitcoin's and Bitcoin future's prices by Tether and various other defendants named in the complaint.[473]

The plaintiffs allege that between January 2016 and December 2017, the price of Bitcoin jumped from $400 to a peak of $19,497.[474] The defendants were prior to November 2017 issuing around 50,000,000 USDT per issuance.[475] After November 2017, and around the height of the Bitcoin bubble, the defendants were issuing on average no less than 100,000,000 USDT per issuance.[476] The plaintiffs claim that their economic analyses show that the excess issuances were used to purchase Bitcoin in large quantities once the prices declined, which then stopped the decline and stabilized the price.[477] Indeed, during the mentioned time period, the plaintiffs allege that USDT was the major source of liquidity for Bitcoin transactions, representing more than 98.7% of the total Bitcoin trading in stablecoins.[478]

The plaintiffs further allege that the various defendants had already owned bitcoins prior to the alleged manipulation.[479] Thus, the claim is that the inflation of Bitcoin's price was meant to allow the defendants to liquidate their holdings, presumably purchased at lower prices, at the higher inflated price.[480] Their analysis purported to show that the Bitcoin's returns generally declined just before the USDT issuance dates and improved afterwards, which, the plaintiffs suggest, demonstrates that the printing of USDT was timed to inflate the price of Bitcoin.[481]

As an aside, we note that if Tether had issued 1 USDT, which means that it had taken in 1 U.S. dollar, then simply buying Bitcoin to inflate its price would probably require a lot of dollars. This would mean that the idea that it could simply inflate the price, and then sell its Bitcoin holdings at a higher price might not make economic sense.[482] Hence, the plaintiffs

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473. The plaintiffs made other claims that are related to the same underlying facts, including unjust enrichment at the expense of the plaintiffs.

474. Complaint, *supra* note 463, at para. 71.

475. Complaint, *supra* note 463, at para. 72.

476. *Id.*

477. Complaint, *supra* note 463, at para. 74.

478. Complaint, *supra* note 463, at para. 76.

479. Complaint, *supra* note 463, at para. 81.

480. Complaint, *supra* note 463, at para. 91.

481. Complaint, *supra* note 463, at para. 90.

482. In some ways, the allegations are reminiscent of the claims of predatory pricing in Antitrust law. The idea there, is that a company will price its product so low, indeed below its cost of production, to bankrupt the competition. Then after the competitors have exited, the company

use the findings of the NYAG namely that Tether was maintaining insufficient reserves, to make their case of profitable manipulation. In other words, their claim is that what Tether was really running was a fractional reserve system akin to the banking system. As such, Tether only held only a fraction of the U.S. dollar deposits backing the circulating USDT. This means, we note, that if they took in 1 U.S. dollar, they may have issued 100 USDT for example. This means that they could exchange what people thought was 100 U.S. dollars worth of USDT for bitcoins, when in reality it was only 1 U.S. dollar that was being exchanged.

The plaintiffs pointed to an anonymous statistical analysis, titled "Quantifying the Effect of Tether," which analyzed the relationship between Bitcoin's prices and USDT.[483] It found that Tether was responsible for approximately 48.8% of Bitcoin's price increases in 2017 during the Bitcoin bubble.[484] The analysis also concluded that it was unlikely that Tether was growing from organic demand for its USDT, but instead it was simply printing more USDT to take advantage of market circumstances.[485] The Plaintiffs' economic analysis identified 236 large flow events on 115 days.[486] These events displayed U-shaped Bitcoin price patterns. Negative Bitcoin returns would precede a USDT issuance by 24 hours with Bitcoin returns turning positive immediately after that.[487]

Finally, we should note that what drives much of the allegations are what the plaintiffs claimed in their first claim for relief, namely that the defendants possessed and exercised monopoly power in violation of the Sherman Act. This, the plaintiffs, claim was done by conspiracy among the defendants in order to "fix, lower, maintain, stabilize and/or otherwise manipulate Bitcoin." This claim, of course, requires several elements to prove, which is beyond the scope of this Article.

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can raise its price above the competitive level. The Supreme Court has held that this theory can only make sense if the losses incurred are also factored into the post-exit of competitors pricing. In other words, a plaintiff alleging predatory pricing by a defendant company must show that the company was or will be able to recoup the losses from the above-competitive prices, which is not an easy task. *See* Louis Kaplow, *Recoupment, Market Power, and Predatory Pricing*, 82 ANTITRUST L.J. 167 (2018).

483. Quantifying the Effect of Tether, TETHER REPORT, http://www.tetherreport.com/ (last visited Oct. 20, 2022) [https://perma.cc/7CVV-CKZG].

484. *Id.*

485. *Id.*

486. Complaint, *supra* note 463, at para. 143.

487. Complaint, *supra* note 463, at para. 144. CFTC published their findings on this issue. Generally, Tether was fined for not maintaining reserves. *See*, *In re* Tether Holdings Ltd., CFTC No. 22-04, 2021 WL 8322874 (Oct. 15, 2021), https://www.cftc.gov/media/6646/enftetherholdingsorder101521/download [https://perma.cc/4EUP-4RJH]; Press Release, CFTC, Release No. 7380-16 (June 2, 2016), https://www.cftc.gov/PressRoom/PressReleases/8450-21 [https://perma.cc/WLJ2-3YFD].

Appendix B: The Complaint by the SEC Against Ripple

The SEC claims that Ripple's offering of its XRP for sale violated Sections 5(a) and 5(c) of the Securities Act of 1993.[488] The SEC claims that Ripple sought the advice of an international law firm regarding certain state and federal legal risks associated with the distribution and monetization of XRP. The law firm prepared two memos that warned Ripple that XRP was unlikely to be considered "currency" under the Exchange Act because, unlike "traditional currencies," XRP was not backed by a central government and was not legal tender. Nonetheless, Ripple sold XRP to the public without registering.

In arguing that XRP is a security, the SEC points to the Supreme Court's *Howey* test for determining whether a security is an "investment contract."[489] The test is whether "the scheme involves an investment of money in a common enterprise with profits to come solely from the efforts of others."[490] If a transaction or scheme satisfies the test, then "it is immaterial whether the enterprise is speculative or nonspeculative, or whether there is a sale of property with or without intrinsic value."[491] The test can be broken into four parts: (1) whether there is an investment of money; (2) the investment is in a common enterprise; (3) there is a reasonable expectation of profit; and (4) whether the profit is to be derived from the efforts of others. The SEC argues that XRP satisfies all four of these conditions.

The SEC argues that Ripple's stated business plan made Ripple's conduct alleged here a foregone conclusion, i.e. Ripple made it part of its "strategy" to sell XRP to as many speculative investors as possible.[492] The SEC concedes that Ripple touted the potential future use of XRP by certain specialized institutions such as banks.[493] The SEC argues, however, that Ripple sold XRP widely into the market, specifically to individuals who had no "use" for XRP as Ripple has described such potential "use" and for the most part when no such use even existed.[494] The SEC deduces that Ripple raised the money from speculative investors based on the observation that Ripple was short on funds both for developing its platform for financial institutions and for its general

488. Section 5 of the Securities Act is all embracing; it prohibits any unregistered securities offering. Through exemption provisions like Section 4 of the Securities Act [15 U.S.C. § 77d], however, Congress distinguished between (1) sales by issuers of their securities into public markets, which require registration, and (2) ordinary trading transactions in the market by investors, once the securities have come to rest with them, which typically are exempted from registration.

489. S.E.C. v. W. J. Howey Co., 328 U.S. 293, 301 (1946).

490. *Id.*

491. *Id.*

492. Complaint, *supra* note 140, at para. 69.

493. Complaint, *supra* note 140, at para. 67.

494. Complaint, *supra* note 140, at para. 69.

corporate business expenses, which in 2013 and 2014 already exceeded $25 million. Hence, the need for funds led to Ripple selling XRP.[495] One of its senior executives, the SEC argues, orchestrated the initial stage of Ripple's offering of XRP. It did so by controlling the timing and amount of offers and sales to three groups: (1) purchasers in the open market; (2) investment funds, wealthy individuals, or other sophisticated investors; and (3) others enlisted to assist Ripple's efforts to develop an XRP market.[496] The effect was that Ripple controlled the price and liquidity in the XRP market. The control over the price and liquidity meant that Ripple could sell "XRP as an investment into a common enterprise that included Ripple's promises to undertake significant entrepreneurial and managerial efforts, including to create a liquid market for XRP, which would in turn increase demand for XRP and therefore its price."[497] In other words, because Ripple had not yet developed its platform for usage by financial institutions, or for that matter did not have any institutional customers at the time, the only thing it was selling when it sold XRP was the promise to work hard to generate profits for those who purchased the units of XRP.

As such, the SEC alleges, the purchasers of XRP were investing into a common enterprise. The commonality stems from the fact that XRP is fungible, and hence, the XRP purchasers' fortunes were intertwined and dependent on the success of Ripple's XRP Strategy.[498] Ripple's success or failure in stimulating trading of XRP is what created the demand for XRP, and this determines the profits, if any, that the investors would see from their initial purchases. Indeed, the SEC further alleges, Ripple pooled the funds it raised from the sales of XRP and used them to fund its operations, including the development of its platform as well as paying its executives.[499] This pooling suggests that the XRP was sold as a common enterprise. By generating an expectation that Ripple would use the funds to develop markets for XRP and platforms that financial institutions could use, the SEC argues, the investors in XRP expected their profits to come from the efforts of the Ripple's management, i.e. the efforts of others.[500]

The SEC anticipatorily rejects any claims that XRP is a currency.[501] It argues that there were no non-investment usages at the time of the sale of XRP.[502] Furthermore, XRP is not a currency under federal securities

495. Complaint, *supra* note 140, at para. 70.
496. Complaint, *supra* note 140, at para. 73.
497. Complaint, *supra* note 140, at para. 213.
498. Complaint, *supra* note 140, at para. 269.
499. Complaint, *supra* note 140, at para. 268.
500. Complaint, *supra* note 140, at para. 289.
501. Complaint, *supra* note 140, at para. 353.
502. Complaint, *supra* note 140, at para. 375.

laws, as XRP has not been designated as legal tender in any jurisdiction. XRP is not issued by, nor is backed by the full faith and credit of any country, national government, central bank, or other central monetary authority.[503] A "native currency" that operates, for example, on Ripple's decentralized network of blockchain technology is a specialized instrument for a particular computer network, not legal tender.[504] Similarly, using XRP as a "bridge" between two real fiat currencies does not bestow legal tender status on XRP, according to the SEC.[505]

In response to the SEC's complaint, Ripple has made the following submissions.[506] Its main argument is that XRP transactions take place on the XRP Ledger (XRPL), a decentralized, cryptographic ledger powered by a network that is not controlled nor owned by any one party.[507] The XRPL has successfully recorded hundreds of millions of transactions for over eight years without error or dispute.[508] Far from being a security, XRP is a currency and as such, exempt from the statutory definition of a security. Indeed, XRP operates as a currency in that it is a "medium of exchange, unit of account, and/or a store of value."[509] It functions as a currency and is traded on crypto-currency exchanges in massive volumes with a large number of traders, the vast majority of whom have never transacted with Ripple.[510] Ripple also disputes whether the sale of XRP constitutes an investment contract, precisely because there is no contract. Ripple argues that an investment contract requires privity between the buyer and seller, and since the vast majority of XRP trading is on the secondary market, i.e. on crypto-exchanges independent of Ripple, there is no contract with Ripple.[511]

As such, Ripple argues there is no common enterprise with the XRP purchasers.[512] Indeed, Ripple denies that there was any pooling of the proceeds of the XRP sales to support returns on the initial investments in XRP.[513] Ripple claims that the sales of XRP were on secondary markets, where purchasers do not know the identity of the sellers and vice versa.[514] Ripple also denied that there was a reasonable expectation of profits by

503. Complaint, *supra* note 140, at para. 356.

504. Complaint, *supra* note 140, at para. 356.

505. Complaint, *supra* note 140, at para. 356.

506. Defendant's Answer at 1–2, S.E.C. v. Ripple Labs, Inc., No. 20 Civ. 10832 (S.D.N.Y. 2021), https://storage.courtlistener.com/recap/gov.uscourts.nysd.551082/gov.uscourts.nysd.551082.43.0_2.pdf [https://perma.cc/E37G-J65S].

507. Complaint, *supra* note 140, at para. 12.

508. Complaint, *supra* note 140, at para. 16.

509. Complaint, *supra* note 140, at para. 3.

510. Complaint, *supra* note 140, at para. 8.

511. Complaint, *supra* note 140, at para. 13.

512. Complaint, *supra* note 140, at para. 9.

513. *Id.*

514. Complaint, *supra* note 140, at para. 35.

the XRP purchasers based on the efforts of Ripple.[515] Ripple argues that it never promised to increase XRP's prices, and that if anything, Ripple has always represented XRP as a currency and Ripple as providing a payment solution.[516] The promise to increase liquidity, Ripple argues, was to facilitate the transfer of currencies across international borders, something that had been inefficient under traditional money transfer systems.[517] As such, the subjective expectations of the purchasers are irrelevant to what the XRP represents in the *Howey* test. Indeed, because of Ripple's decentralized payment system that relies on various algorithmic validations, rather than a centralized ledger system, the SEC cannot argue that the XRP purchasers were relying on the efforts of Ripple to increase the value of the XRP units they purchased.

Ripple also argues the fact that Ripple owns units of XRP, which could increase in value and therefore benefit Ripple, by itself does not make the sale of XRP a sale of securities.[518] Ripple analogizes its position to that of companies that produce commodities and that also own the commodities. Oil companies, for example, may produce oil and also own the oil it produces.[519] Similarly, diamond producers may produce diamonds and own them as well.[520] Ripple even analogizes its position to that of Bitcoin, where many bitcoin miners own large amounts of bitcoin.[521] Ripple concludes by making policy arguments against finding XRP to be an investment contract.[522] Ripple argues that classifying XRP as a security and granting the SEC its sought remedies will stifle innovation in the crypto-currency industry and lead to the leadership in the field being dominated by China.[523] Ripple points out that because Chinese miners numerically dominate the Bitcoin and Ethereum platforms, they can control developments on those systems, whereas the Ripple system does not allow centralization to take place.[524] Furthermore,

515. Complaint, *supra* note 140, at para. 8.

516. Complaint, *supra* note 140, at para. 12.

517. Complaint, *supra* note 140, at para. 334.

518. Complaint, *supra* note 140, at para. 10.

519. *Id.*

520. *Id.*

521. *Id.*

522. Complaint, *supra* note 140, at para. 15.

523. China, the state, has now changed its tune from welcoming Bitcoin miners to trying to close them down. *See* Vijitra Duangdee, *China's crackdown on cryptocurrencies is fueling a crypto-mining cottage industry in Thailand* (Dec. 29, 2021), available at https://www.aljazeera.com/economy/2021/12/29/chinas-crypto-crackdown-sparks-thai-crypto-mining-boom [https://perma.cc/X7JK-4LH3].

524. *See Measuring the Environmental Impact of Cryptocurrency*, RIPPLE https://xrpl.org/assets/pdf/xrpl-sustainability-methodology-2020.pdf [https://perma.cc/8UYT-GQL8] (last visited Oct. 20, 2022). According to the XRP white paper, their mission is to reduce the carbon footprint of using digital currency. Presently, about 17% of XRP Ledger is powered by Ripple's recommended Unique Nodes List (UNL). Ripple works with a company called WaterShed to help

a broad reading of the *Howey* test will have a huge chilling effect on the blockchain industry in general. It will be very hard to promote any digital asset without running into securities regulations.

each node cut energy consumption and carbon emissions of the XRP Ledger. We conjecture that this focus on sustainability gives Chinese miners less of a comparative advantage to mine XRP, which means they have less of an incentive to mine XRP, distributing the nodes to regions with more efficient machines and infrastructure to validate XRP.

FAKE NEWS AND INTENT TO DISTRIBUTE: HOW THE FTC CAN STOP THE SPREAD

Pete Love[*]

Abstract

The proliferation of fake news through targeted social media disinformation campaigns originating in the United States and abroad threatens the hallmark of a well-functioning democracy—"a well-informed electorate." This Note will describe the most damaging type of fake news—knowingly false stories made with the intent to distribute in return for advertising income. First, this Note will provide an overview of fake news and explain why current legal frameworks are insufficient to effectively deter the spread of fake news. Then, this Note will argue that the Federal Trade Commission (FTC) has the authority to address this issue and will recommend the FTC adopt a rule based on a theory of intent to distribute. Finally, this Note will discuss how the proposed rule will better equip the FTC to combat the proliferation of fake news and deter its dissemination from the source—the author.

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INTRODUCTION

The rapid rise of user technology and social media has ushered in an era of unprecedented access to information, revolutionized the process of information distribution, and dramatically changed the landscape of news media.[1] By 2019, 93% of American adults received at least some news from online sources.[2] Additionally, recent survey data has shown that 52% of Americans prefer to obtain their news from digital sources while only 35% preferred television and 5% preferred print publications.[3] The transition to digital media dominance has been so rapid that the truth cannot keep up. The 2016 U.S. presidential election illustrated the prominence of misinformation and falsehoods being presented as fact ("fake news") and the deleterious effects of such fake news on voters. The impact of this phenomenon was so profound that Oxford University Press selected "post-truths" as its 2016 word of the year.[4] The prominence of fake news has not abated since the 2016 election. To wit, a 2019 poll conducted by the Pew Research Center found that Americans believe fake

1. Darrell M. West, *How to Combat Fake News and Disinformation*, BROOKINGS (Dec. 18, 2017), https://www.brookings.edu/research/how-to-combat-fake-news-and-disinformation/ [https://perma.cc/WE3D-499L].

2. *Digital News Fact Sheet*, PEW RSCH. CTR. (July 23, 2019), https://www.pewresearch.org/topics/state-of-the-news-media/ [https://perma.cc/BC7Q-38RG].

3. Elisa Shearer, *More Than Eight-In-Ten Americans Get News from Digital Devices*, PEW RSCH. CTR. (Jan. 12, 2021), https://www.pewresearch.org/fact-tank/2021/01/12/more-than-eight-in-ten-americans-get-news-from-digital-devices/ [https://perma.cc/6TMB-D5CM].

4. *Word of the Year 2016*, OXFORDLANGUAGES, https://languages.oup.com/word-of-the-year/2016/ [https://perma.cc/B7UX-6BUM] (The term is defined as "denoting circumstances in which objective facts are less influential in shaping public opinion than appeals to emotion and personal belief.").

news is a bigger problem than terrorism, climate change, and illegal immigration.[5]

Fake news threatens the existence of a well-functioning democratic discourse built upon shared facts and truths supported by empirical evidence.[6] In *Buckley v. Valeo*, the Supreme Court of the United States noted that "democracy depends on a well-informed electorate. . . ." Judge Wright of the D.C. Circuit further opined that "secrecy . . . dampens well-informed public debate."[7] This Note will argue, however, that it is not secrecy which poses the direst threat to modern public discourse. It is, instead, fake news, designed to reach as vast an audience as possible to generate maximum advertising revenue for the author. Fake news obliterates productive public discussion of meaningful issues and jeopardizes the lifeblood of a democratic society: a well-informed electorate.

Fake news is not a new phenomenon. Numerous examples of the dissemination of falsified information can be seen throughout history,[8] including during the founding of the United States,[9] which impacted both politics as well as issues and industries beyond the political realm.[10] However, while fake news is certainly not a new phenomenon, the advent of the Internet and Internet-based services has drastically exacerbated the detrimental effects of fake news to unprecedented levels. In contrast to its historical modes of dissemination, fake news can now be circulated around the world instantaneously by any individual with one retweet, like, or share making it a much more ominous threat than before.[11]

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5. Amy Mitchell et al., *Many Americans Say Made-Up News Is a Critical Problem That Needs To Be Fixed*, PEW RSCH. CTR.: JOURNALISM & MEDIA (June 5, 2019), https://www.journalism.org/2019/06/05/many-americans-say-made-up-news-is-a-critical-problem-that-needs-to-be-fixed/ [https://perma.cc/JPA3-VL4V].

6. Bobby Chesney & Danielle Citron, *Deep Fakes: A Looming Challenge for Privacy, Democracy, and National Security*, 107 CALIF. L. REV. 1753, 1777 (2019).

7. Buckley v. Valeo, 424 U.S. 1, 49 n.55 (1976); Clark-Cowlitz Joint Operating Agency v. F.E.R.C., 798 F.2d 499, 505 (D.C. Cir. 1986) (Wright, J., dissenting).

8. "Fabricated, sensationalistic, and exaggerated stories have been pervasive throughout Western societies for centuries." Alan K. Chen, *Free Speech, Rational Deliberation, and Some Truths About Lies*, 62 WM. & MARY L. REV. 357, 369 (2020). *See also* Jacob Soll, *The Long and Brutal History of Fake News*, POLITICO (Dec. 18, 2016), https://www.politico.com/magazine/story/2016/12/fake-news-history-long-violent-214535 [https://perma.cc/2ME7-NLU4] (describing the importance of the printing press in the prominence of fake news in history).

9. Chen, *supra* note 8, at 370 ("From the Founding Era until the twentieth century, fake news stories were prevalent in the United States."). Following the Revolutionary War, false articles were published claiming George Washington was miserable during the war believing it was a mistake, effectively convincing some members of the public that Washington was a British loyalist. *Id*.

10. *Id*. at 374.

11. *Id.* at 375.

Due to the polarizing and problematic influence of fake news campaigns,[12] many scholars have explored the phenomenon and proposed a variety of solutions. Some propose that the immunity granted by Section 230 of the Communications Decency Act should not extend to online service providers that do not take steps to combat the issue of fake news.[13] Others assert that Section 230 should be amended to include notice and takedown procedures and provide an adequate tort remedy for harmed parties.[14] Other scholars contend that courts offer the best avenue for rectifying the problem, arguing the judicial standard used to determine the constitutionality of proposed legislation targeting fake news should be reduced from strict scrutiny to a more deferential version of intermediate scrutiny.[15] While some have already explored the FTC's role in controlling fake news through its enforcement powers,[16] this Note will draw lessons from an established body of law to propose a specific, novel approach to stopping the spread of fake news.

This Note will focus on authors who knowingly create political fake news stories with the intent to use the Internet as a forum for widely distributing misinformation for personal financial gain.[17] While fake news can mean many things, this Note defines fake news as unequivocal, verifiable falsehoods that are intentionally passed off as accurate, legitimate news.[18] Those who, via the Internet or social media, post opinions or mistaken falsehoods, republish the fake news of another

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12. West, *supra* note 1. A false tweet during the Obama presidency wiped out $130 billion of equity value in a single day. Molly Wood, *One Problem with Fake News? It Really, Really Works*, MARKETPLACE (Aug. 27, 2018), https://www.marketplace.org/2018/08/27/one-problem-fake-news-it-really-really-works/ [https://perma.cc/WV8C-LJWH].

13. Danielle K. Citron & Benjamin Wittes, *The Internet Will Not Break: Denying Bad Samaritans § 230 Immunity*, 86 FORDHAM L. REV. 401, 420 (2017) (CDA's immunity provision would be unavailable to operators only when they cannot make a cogent argument that they are behaving reasonably to stop illegal activity).

14. Lee K. Royster, *Fake News: Potential Solutions to the Online Epidemic*, 96 N.C. L. REV. 270 (2017); Benjamin Volpe, *From Innovation to Abuse: Does the Internet Still Need Section 230 Immunity?*, 68 CATH. U. L. REV. 597 (2019); Vanessa S. Browne-Barbour, *Losing Their License to Libel: Revisiting § 230 Immunity*, 30 BERKELEY TECH. L.J. 1505 (2015); Emma M. Savino, *Fake News: No One is Liable, and That is a Problem*, 65 BUFF. L. REV. 1101 (2017).

15. Dallas Flick, *Combatting Fake News: Alternatives to Limiting Social Media Misinformation and Rehabilitating Quality Journalism*, 20 SMU SCI. & TECH. L. REV. 375, 405 (2017).

16. John Roberts, *From Diet Pills to Truth Serum: How the FTC Could be a Real Solution to Fake News*, 71 FED. COMM. L.J. 105, 123 (2018); John Allen Riggins, *Law Student Unleashes Bombshell Allegation You Won't Believe!: "Fake News" as Commercial Speech*, 52 WAKE FOREST L. REV. 1313, 1336 (2017).

17. Wood, *supra* note 12 ("a lot of the false news that spreads is not spread for political reasons. It's spread for economic reasons.").

18. Jessica Stone-Erdman, *Just the (Alternative) Facts, Ma'am: The Status of Fake News Under the First Amendment*, 16 FIRST AMENDMENT L. REV. 410, 418 (2017). *See also* West, *supra* note 1.

author, or who otherwise do not intend to widely distribute false writings online are not the focus of this Note. Additionally, parodies, such as those published by *The Onion*, are not included in this Note's definition of fake news, as they are protected under the First Amendment[19] and are thus legally distinguishable from the scope of fake news examined here. Additionally, parodies are reasonably understood as not describing actual facts or events,[20] whereas for-profit fake news is written and disseminated to be reasonably believed.

This Note will argue that the FTC possesses authority under the FTC Act to combat commercialized fake news as an unfair, deceptive practice affecting commerce. The FTC should use its rulemaking authority to develop a regulation imposing civil fines against authors of commercialized fake news. Such a regulation should be modeled after the construction of federal criminal possession with intent to distribute statutes and analogized to the methods of proving intent to distribute found within a well-developed body of existing case law.

Part I will narrow the focus of this Note and explain why knowingly falsified fake news stories–intentionally designed to be widely distributed online for the personal financial gain of the author–constitutes the most damaging form of fake news. Part II will provide a snapshot of the current legal framework available to combat fake news and demonstrate why it ultimately fails to sufficiently discourage the brand of fake news that is the focus of this Note. Finally, Part III will examine a well-established body of law to draw comparisons to the issue at hand and suggest developments that can improve our collective ability to discourage fake news while more effectively empowering the legal system to seek redress for the harms fake news causes.

I. THE FINANCIAL INCENTIVES AND PERILS OF FAKE NEWS

Before analyzing the problems posed by fake news in more depth, one must understand the origin of fake news and why it is so prevalent in modern society. Though there are many reasons why individuals may fabricate stories about political or public figures, writers of widely disseminated fake news stories are most often primarily motivated by personal economic gain.[21] Websites which display, publish, or promote fake news commonly make money through pay-per-click advertising networks such as Google Adsense.[22] An advertiser will agree to a fee that is paid to the network (Google) for every click their advertisement

19. Hustler Mag., Inc. v. Falwell, 485 U.S. 46, 57 (1988).

20. New Times, Inc. v. Isaacks, 146 S.W.3d 144, 158 (Tex. 2004).

21. Royster, *supra* note 14, at 274.

22. Joshua Gillen, *Punditfact: How Clickbait Ads Make Money for Fake News Sites*, TAMPA BAY TIMES (Oct. 5, 2017), https://www.tampabay.com/news/perspective/punditfact-how-clickbait-ads-make-money-for-fake-news-sites/2339879/ [https://perma.cc/N7K5-M64L].

receives. The network will then share a portion of that fee with the publisher of the fake news website.[23] Anyone can make a website, display ads on it through an advertising network, and create fake content to lure internet traffic to their website.[24] The more a fake news story is shared, the more Internet traffic will be driven to the advertiser's site and, in turn, the more money the fake news author can net from advertising clicks.[25] In short, fake news authors are incentivized to write their stories to be widely believed and shared, such that the fake news is spread to as many people as possible—maximizing the author's advertising revenue by sowing confusion and discord.

Because fake news authors design their stories to be believable, a vast majority of the public are unable to differentiate real news from fake news.[26] A poll conducted by Buzzfeed revealed that 75% of American adults who read a fake news headline believed it,[27] in addition, a survey conducted by YouGov showed 96% of Britons could not differentiate fake news from factual reports.[28]

Consider Jestin Coler, the owner of Disinfomedia.[29] He oversees twenty to twenty-five fake news authors who write for his various websites, earning a profit through advertising.[30] Coler admitted to receiving between $10,000 and $30,000 a month from knowingly publishing fake news,[31] yet he insists fake news did not sway the 2016

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23. *Id.*

24. Abby Ohlheiser, *This is How Facebook's Fake-News Writers Make Money*, WASH. POST (Nov. 18, 2016), https://www.washingtonpost.com/news/the-intersect/wp/2016/11/18/this-is-how-the-internets-fake-news-writers-make-money/ [https://perma.cc/9YCL-Q95M].

25. *Id.*; *See* Wood, *supra* note 12 ("if false news spreads farther, faster, deeper and more broadly than the truth, then it incentivizes producers of false news to produce more false news in order to earn more advertising revenue.").

26. Elisabeth Perlman, *Fool's Gold: Remove the Financial Incentive of Fake News*, VERDICT (Feb. 15, 2017), https://www.verdict.co.uk/fools-gold-remove-financial-incentive-fake-news/ [https://perma.cc/6ZLE-3JNJ].

27. Craig Silverman & Jeremy Singer-Vine, *Most Americans Who See Fake News Believe It, New Survey Shows*, BUZZFEED NEWS (Dec. 6, 2016), https://www.buzzfeednews.com/article/craigsilverman/fake-news-survey#.vhYMPe78W [https://perma.cc/PD2Q-AMKL].

28. Jessica Goodfellow, *Only 4% of people can distinguish fake news from truth, Channel 4 study finds*, THE DRUM (Feb. 6, 2017), https://www.thedrum.com/news/2017/02/06/only-4-people-can-distinguish-fake-news-truth-channel-4-study-finds [https://perma.cc/WF58-AGGB].

29. Laura Sydell, *We Tracked Down a Fake-News Creator in the Suburbs. Here's What We Learned*, NPR (Nov. 23, 2016, 3:31 PM), https://www.npr.org/sections/alltechconsidered/2016/11/23/503146770/npr-finds-the-head-of-a-covert-fake-news-operation-in-the-suburbs [https://perma.cc/U9DB-PTQJ].

30. *Id*.

31. *Id*. Paul Horner, a fake news writer, makes $10,000 per month and Macedonian teenagers can make up to $5,000 per month. Ohlheiser, *supra* note 24. A fake news share from a person within the Trump campaign earns a fake news author as much as $10,000 in extra revenue. *Id.*

election.[32] Research, however, suggests otherwise. In fact, in the three months leading up to the 2016 election, fake news received more attention (shares, comments, likes) than real news on Facebook.[33] Consequently, one study linked this rise in fake news attention to a defection of voters who formerly supported Barack Obama away from Hillary Clinton.[34] Publication of fake news significantly impacts voter opinion, with a well-informed electorate becoming misguided.

Fake news is able to disseminate rapidly and receive widespread attention and acceptance in large part due to social media. As just one example, a fake news story published by Disinfomedia, claiming that a FBI agent involved in leaking Hillary Clinton's emails was killed, received 1.6 million views in just ten days.[35] Some fake news stories are even shared by political figures, which serves to validate the fake news's source in the public's eyes, thereby helping fake news garner further acceptance.[36]

Not only does the proliferation of fake news seriously affect voter opinion, it also affects society in other dangerous ways. For example, one of Coler's falsified stories that claimed Colorado food stamp recipients were using benefits to buy marijuana resulted in proposed legislation in the Colorado House banning such activity.[37] More famously, on December 4, 2016, Edgar Maddison Welch fired three shots inside Comet Ping Pong, a Washington, D.C. pizzeria, after he traveled 350 miles from Salisbury, North Carolina, to investigate a fake news story which claimed

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32. Sydell, *supra* note 29.

33. Savino, *supra* note 14, at 1102. Craig Silverman, *This Analysis Shows How Fake News Stories Outperformed Real News Stories on Facebook*, BUZZFEED NEWS (Nov. 16, 2016, 4:15 PM), https://www.buzzfeednews.com/article/craigsilverman/viral-fake-election-news-outperformed-real-news-on-facebook [https://perma.cc/4Q2P-46H3] (In the three months leading up to the 2016 election, the top 20 fake news stories received 8.7 million comments, likes, shares; the top 20 news articles from the mainstream media (19 major news outlets combined) received only 7.3 million, a decline from 12 million earlier that year).

34. Richard Gunther, Paul A. Beck & Erik C. Nisbet, *Fake News May Have Contributed to Trump's 2016 Victory* (Mar. 8, 2018), https://www.documentcloud.org/documents/4429952-Fake-News-May-Have-Contributed-to-Trump-s-2016.html [https://perma.cc/F5AW-HLQ2].

35. Sydell, *supra* note 29.

36. Ohlheiser, *supra* note 24. Eric Trump and Corey Lewandowski, Trump's then-campaign manager, shared one of Paul Horner's fake news stories that the Amish were committing their vote to Donald Trump. Sally French, *This Person Makes $10,000 a Month Writing Fake News*, MARKETWATCH (Nov. 18, 2016, 3:27 AM), https://www.marketwatch.com/story/this-person-makes-10000-a-month-writing-fake-news-2016-11-17 [https://perma.cc/4BBE-VUKU]. Lewandowski shared another one of Horner's fake news stories which falsely described a person was paid $3,500 to be a Trump protester. Caitlin Dewey, *Facebook Fake-News Writer: 'I Think Donald Trump is in the White House Because of Me*,' WASH. POST (Nov. 17, 2016, 6:00 AM), https://www.washingtonpost.com/news/the-intersect/wp/2016/11/17/facebook-fake-news-writer-i-think-donald-trump-is-in-the-white-house-because-of-me/ [https://perma.cc/TYB7-Z5AK].

37. Sydell, *supra* note 29.

that Hillary Clinton was involved in a child sex-slave ring run in Comet Ping Pong's basement.[38] Despite the intense media coverage and ubiquitous consensus that the story was fake, a poll conducted by YouGov between Dec. 17-20, 2016 found that 46% of Trump supporters believed that leaked Hillary Clinton campaign emails discussed pedophilia and human trafficking.[39] Even Edgar Maddison Welch, following the incident and his subsequent arrest, refused to dismiss the claims he set out to investigate as false.[40] The criminal and potentially deadly actions of Welch were inspired by the publication of a fake news story, illustrating the dangerous ramifications fake news poses to our democracy and to anyone enjoying a slice of pizza.

Following the 2016 election, advertisement networks expressed their intent to combat the issue of fake news. Google told Reuters that it would restrict ads on sites that "misrepresent, misstate, or conceal information about . . . the publisher's content . . . ."[41] Yet, a 2019 study by the Global Disinformation Index, which examined 20,000 websites that published misinformation, found that Google provided AdSense services to 70% of these websites and accounted for 37% of their revenue, $86 million annually, more than any other advertisement company.[42] Networks such as Google and Facebook profit greatly from fake news,[43] thus they are likely to be resistant to adopting policies that effectively combat the issue.[44] The impact of fake news authorship and the "existential threat" it poses to democracy requires a reexamining of current legal frameworks

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38. Adam Goldman, *The Comet Ping Pong Gunman Answers Our Reporter's Questions*, N.Y. TIMES (Dec. 7, 2016), https://www.nytimes.com/2016/12/07/us/edgar-welch-comet-pizza-fake-news.html [https://perma.cc/98LW-SQAG].

39. Kathy Frankovich, *Belief in Conspiracies Largely Depends on Political Identity*, YOUGOV (Dec. 27, 2016), https://today.yougov.com/topics/politics/articles-reports/2016/12/27/belief-conspiracies-largely-depends-political-iden [https://perma.cc/ZZZ4-8C73].

40. Goldman, *supra* note 38.

41. Daniel Funke, Susan Benkelman & Cristina Tardáguila, *Factually: How Misinformation Makes Money*, AM. PRESS INST. (Sept. 26, 2019), https://www.americanpressinstitute.org/fact-checking-project/factually-newsletter/factually-how-misinformation-makes-money/ [https://perma.cc/B5KW-7HXA].

42. *Id.*

43. David Kirkpatrick, Questions Linger Over How Much Ad Revenue Fake News Generates for Facebook, MARKETING DIVE (Nov. 28, 2016), https://www.marketingdive.com/news/questions-linger-over-how-much-ad-revenue-fake-news-generates-for-facebook/431149/ [https://perma.cc/K7GH-VUQD] (suggesting that fake news could have accounted for up to half of Facebook's ad revenue in the months leading up to the 2016 election). Both Google and Facebook could lose revenue if they shut down fake news sites – Facebook benefits whenever something goes viral, regardless if it's true or not. Ohlheiser, *supra* note 24. *See also* Perlman, *supra* note 26 (noting Facebook financially benefits from hosting fake news platforms).

44. Peter Cohen, *Does Facebook Generate Over Half of Its Ad Revenue From Fake News?*, FORBES (Nov. 25, 2016), https://www.forbes.com/sites/petercohan/2016/11/25/does-facebook-generate-over-half-its-revenue-from-fake-news/?sh=4cdef9e8375f [https://perma.cc/MGJ6-XH29].

in order to provide meaningful policies to remove fake news from our democratic society.[45]

II. EXISTING LEGAL AVENUES DO NOT PROVIDE MEANINGFUL SOLUTIONS

Despite the risks associated with fake news, current legal frameworks do not provide viable pathways to effectively prevent the widespread dissemination of fake news by authors seeking commercial gain. This section will explore three obstacles that currently prevent the legal system from effectively combating fake news. To begin, Part A will discuss the First Amendment protections given to speech and how they stymie efforts to control fake news through legislation. Next, Part B will show why expanding defamation law is not a viable solution and how the current state of defamation law fails to provide adequate incentives for those harmed to bring suit. Finally, Part C will discuss how Section 230 of the Communications Decency Act protects social media from liability and accountability by not requiring Internet service providers to implement any measures to combat fake news.

A. *First Amendment Limitations*

The First Amendment to the U.S. Constitution promotes the free exchange of ideas, no matter how unpopular or offensive.[46] The robust Free speech protections in the United States, as discussed below, block efforts to control fake news through the legislative process and complicate efforts to seek remedies through defamation law. These protections are especially robust in cases concerning political speech, which enjoys the strongest protection under the First Amendment.[47] Political speech enjoys heightened protections because it is essential to public discourse.[48] Accordingly, the First Amendment seeks to prevent a majority government from suppressing the views of the minority.[49]

Unlike some other countries, the United States has failed to adopt legislative measures to control fake news, largely because the First Amendment bars Congress from passing any law "abridging the freedom

45. Eric Clemons, *Why Fake News Campaigns are so Effective*, KNOWLEDGE@WHARTON (Oct. 3, 2018), https://knowledge.wharton.upenn.edu/article/build-fake-news-campaign/ [https://perma.cc/N24M-YDRC].

46. JP Perry, *Defamation and the First Amendment: Protecting Free Speech While Promoting Accountability Under Trump*, 21 CUNY L. REV. 259, 259 (2018).

47. R.A.V. v. City of St. Paul, 505 U.S. 377, 422 (1992) (Stevens, J., concurring) ("Our First Amendment decisions have created a rough hierarchy in the constitutional protection of speech. Core political speech occupies the highest, most protected position . . . .").

48. Riggins, *supra* note 16, at 1316.

49. *Id.*

of speech, or of the press."[50] Under Supreme Court jurisprudence, any law that restricts speech based on its content is subject to judicial strict scrutiny.[51] Strict scrutiny review of a content-based law requires the government to demonstrate that the law is necessary to serve a compelling state interest and is narrowly drawn to achieve that interest.[52] Additionally, the Supreme Court in *Brown v. Entertainment Merchants Ass'n* established that the government must show a direct causal link between the regulated speech and the problem to be solved.[53]

Consider a bill proposed in 2017 by California assembly member Ed Chau as an example of the difficulties in combatting fake news through legislation.[54] Chau attempted to amend The California Political Cyberfraud Abatement Act to combat the spread of fake news by adding Section 18320.5, which read:

> It is unlawful for a person to knowingly and willingly make, publish or circulate on an Internet Web site, or cause to be made, published, or circulated in any writing posted on an Internet Web site, a false or deceptive statement designed to influence the vote on either of the following:
>
> (a) Any issue submitted to voters at an election.
>
> (b) Any candidate for election to public office.[55]

The proposed amendment was met with immediate backlash, with opponents calling it "obviously unconstitutional" under the Supreme Court's case law.[56] Concerns about the amendment regarded its potential to allow public officials to rampantly hurl criminal accusations at each other and how the amendment would affect satire and parody, as well as who would have the power to determine what was is and is not "fake

50. U.S. CONST. amend. I.

51. Roberts, *supra* note 16, at 113. "Content-based laws are defined as those targeting speech based on its communicative content." *See supra* note 50. Any legislative measure adopted by a state or the federal government that attempts to limit fake news would be considered a content-based law.

52. *Id.* at 113-14. *See* Annie C. Hundley, *Fake News and the First Amendment: How False Political Speech Kills the Marketplace of Ideas*, 92 TUL. L. REV. 497, 504 (2017) (explaining that content-based laws rarely survive strict scrutiny).

53. Brown v. Ent. Merchs. Ass'n, 564 U.S. 786, 799 (2011).

54. Dave Mass, *California Bill to Ban "Fake News" Would be Disastrous for Political Speech*, EFF (Mar. 27, 2017), https://www.eff.org/deeplinks/2017/03/california-bill-ban-fake-news-would-be-disastrous-political-speech [https://perma.cc/6V7C-M5FJ].

55. Cal. Political Cyberfraud Abatement Act, sec. 18320, AB 1104 § 18320.5, http://leginfo.legislature.ca.gov/faces/billNavClient.xhtml?bill_id=201720180AB1104 [https://perma.cc/T5E7-CJXL].

56. Mass, *supra* note 54.

news"?[57] Ultimately, the bill was removed from its scheduled committee hearing at the last minute and was never adopted.[58] Although this proposed, content-based amendment seemingly offers a compelling state interest—protecting against attacks designed to sway an election—it would almost certainly fail a court's strict scrutiny analysis.

First, California would need to prove a direct causal link between "false and deceptive statements" and actual influence upon the outcomes of elections.[59] Second, the state would need to demonstrate that the influence on elections is not simply "small and indistinguishable from effects produced by other media."[60] This would be difficult to prove beyond anecdotal and ambiguous evidence[61] because there are many factors that influence voters, and research points in both directions.[62] Even if the government could demonstrate a direct causal link between fake news and harm to election results, it would then also need to prove the law was narrowly drawn to achieve the interest.

In addition to proving this causal link, the "narrowly tailored" prong of strict scrutiny requires that the government use the least restrictive method possible for achieving its asserted compelling interest of regulating fake news.[63] This would require the government to prove the ineffectiveness of three alternative, less-restrictive means of preventing voters from being misled by fake news: counter speech,[64] education, and self-regulation. These approaches are viable alternatives to legislation criminalizing fake news and would likely be found by a court to be effective means for achieving the state's interest. The foregoing analysis

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57. *Id.*; Becket Adams, *California Takes Another Swing at First Amendment*, WASH. EXAMINER (Mar. 31, 2017, 6:08 PM), https://www.washingtonexaminer.com/california-takes-another-swing-at-the-first-amendment [https://perma.cc/783F-AJMF].

58. David Kravets, *Alternative Facts Alert: Proposed Legislation Bans Fake News*, ARSTECHNICA (Mar. 28, 2017), https://arstechnica.com/tech-policy/2017/03/alternative-facts-alert-proposed-legislation-bans-fake-news/ [https://perma.cc/9NYW-VYA4].

59. *Brown*, 564 U.S. at 786.

60. *Id.*

61. Clay Calvert et. al., *Fake News and the First Amendment: Reconciling A Disconnect Between Theory and Doctrine*, 86 U. CIN. L. REV. 99, 110 (2018).

62. *Compare* Krysten Crawford, *Stanford Study Examines Fake News and the 2016 Presidential Election*, STAN. NEWS (Jan. 18, 2017), https://news.stanford.edu/2017/01/18/stanford-study-examines-fake-news-2016-presidential-election/ [https://perma.cc/XPY6-F55Q] (finding that the impact of fake news may not have had an impact on the outcome of the election), *with supra* note 34 (finding that, due to the very narrow margin of victory in 2016, may have had an impact on the outcome of the election.).

63. U.S. v. Playboy Ent. Grp., 529 U.S. 803, 813 (2000) ("If a less restrictive alternative would serve the Government's purpose, the legislature must use that alternative."). When a less restrictive means is offered to a content-based restriction, the burden shifts to the government to show the ineffectiveness of the proposed less restrictive means. Calvert et al., *supra* note 61.

64. *Infra* note 165.

of Section 18320.5 illustrates why legislation designed to restrict fake news faces a steep uphill battle in court.[65]

False reporting statutes are the closest that a legislative body in the United States has come to taking action against misinformation. Such statutes limit the circulation of false reports of criminal activity or natural catastrophes to the public.[66] False reporting statutes are constitutionally permissible because certain categories of "low-value"[67] speech fall outside of First Amendment protection.[68] Although these statutes have been codified in state legislatures for many years, they are seldom used in the context of online speech.[69] This is because the Supreme Court in *Reno v. ACLU* held that the Internet is a modern-day forum for Justice Holmes' marketplace of ideas theory of free expression[70] and determined that there is "no basis for qualifying the level of First Amendment scrutiny . . . to this medium."[71]

B. *Tort Law Limitations*

Expanding the types of remedies available under tort law to include those arising out of harms caused by fake news publication is not a feasible option. Defamation is an existing cause of action that allows an individual to recover for reputational harm caused by another's false speech.[72] Defamation laws, however, exist in tension with the First Amendment, especially in the context of fake news.[73] Strengthening defamation laws may place increased restrictions on publications, thereby "chilling" free speech, something courts are likely to oppose.[74] An individual's reputational rights harmed by the spread of fake news are far outweighed by the interests of Free Speech in the modern public forum of the Internet.[75]

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65. *Playboy*, 529 U.S. at 818 ("It is rare that a regulation restricting speech because of its content will ever be permissible.").

66. Louis W. Tompros, Richard A. Crudo, Alexis Pfeiffer & Rahel Boghossian, *The Constitutionality of Criminalizing False Speech Made on Social Networking Sites in a Post-Alvarez, Social Media-Obsessed World*, 31 HARV. J.L. & TECH. 65, 82 (2017).

67. Those categories include: "incitement, libel, obscenity, defamation, speech integral to criminal conduct, fighting words, child pornography, fraud, true threats, and speech presenting some grave and imminent threat the government has the power to prevent." *Id.* at 89.

68. Speech that falls within these categories is typically subject to rational basis review, a highly deferential standard under which a law is almost always upheld. *Id.*

69. *Id.* at 82.

70. False or otherwise misleading speech must be allowed to compete unrestrained with other speech, which false speech can be tested and refuted. *Id.* at 87.

71. Reno v. Am. C.L. Union, 521 U.S. 844, 870 (1996).

72. Perry, *supra* note 46, at 259.

73. *Id.*

74. Royster, *supra* note 14, at 274.

75. *Id.* at 287.

In the case of *New York Times Co. v. Sullivan*, where an Alabama public official, L.B. Sullivan, sued the New York Times, the Supreme Court considered for the first time the constitutionality of common law defamation. The Court concluded that state defamation laws are limited by the First Amendment's protection of political speech, holding that, to succeed on a claim of defamation, a public official plaintiff must prove actual malice—that the defamatory statement at issue was known by the defendant to be false or was published by the defendant with reckless disregard for its truth or falsity.[76] A public official suffering reputational or political harm from fake news may well be able to prove knowing falsity or reckless disregard. So, why has the nation not seen public figures such as Hillary Clinton, as per the fake news stories mentioned in Part I,[77] sue in response to such particularly damaging fake news stories?[78]

Defamation fails to provide sufficient incentives and policy options to adequately engage the problem of fake news. The significant time and costs required to bring a defamation lawsuit serve to make defamation litigation a non-option for many parties who may have faced injury due to fake news. First, due to anonymity on the Internet and the difficulty and cost of identifying the source of an online story, it can be onerous to locate defendants against whom to bring a claim.[79] Second, litigating a libel suit is both time consuming and expensive for plaintiffs. While perhaps most public officials could handle the costs, the defendant is unlikely to possess the deep pockets necessary to pay damages if a verdict is returned for the public official. Those parties that do have the fiscal resources to justify the costs of litigation—Facebook, Google, and YouTube, for instance—are already protected from liability with the immunity provided by Section 230 of the Communications Decency Act (discussed below). Third, and most important, it would be detrimental to the public official to keep the false allegations within the public's attention for months or years during the lawsuit.[80] Proving actual malice, though possible, is arduous and would involve depositions and perhaps testimony in court from the public official, exposing them to unwanted publicity and perhaps damaging their reputation more than the lawsuit can repair the original injury.[81]

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76. Jennifer Benedict, *Deafening Silence: The Quest for a Remedy in Internet Defamation*, 39 CUMB. L. REV. 475, 480 (2009).

77. Goldman, *supra* note 38.

78. Steven Seidenberg, *Lies and Libel: Fake News Lacks Straightforward Cure*, A.B.A. (July 1, 2017), https://www.abajournal.com/magazine/article/fake_news_libel_law [https://perma.cc/6NMG-47D8].

79. Royster, *supra* note 14, at 274.

80. Seidenberg, *supra* note 78.

81. *Id.*

C. *Section 230*

The Communications Decency Act (CDA) was originally adopted to prevent minors from accessing sexually explicit material on the Internet by making it illegal to expose them to obscene or indecent content.[82] Following the signing of the Act into law by President Bill Clinton, it was immediately challenged by the ACLU for violating the First Amendment.[83] In 1997, the Supreme Court struck down the majority of the law as an unconstitutional restriction of free speech in the case of *Reno v. ACLU*.[84] Only one provision survived—Section 230.[85] Congress included Section 230 in the CDA in response to the paradox created by the lower court decisions in *Stratton Oakmont, Inc. v. Prodigy Services, Co.* and *Cubby, Inc. v. CompuServe, Inc.*[86] Under these rulings, Internet-based companies that filtered the content available on their platforms would be held liable under common law publisher liability, while those companies that ignored problematic posts escaped liability altogether.[87] However, the broad interpretation of Section 230 creates freedom from liability for Internet service providers for any defamatory material published on the providers' websites, regardless of whether or not they exercise editorial control of their website's content.[88] The provisions in Section 230 grant Internet service providers broader protection from defamation liability than what is granted to television and print broadcasters.[89] Some proposed solutions to the fake news problem call for amending the protections of Section 230 to require more responsibility from online service providers in combatting fake news.

One such proposed solution is to impose a modified version of common law distributor liability, which would hold Internet service providers, including social media websites, responsible for the fake news which they know is posted to their platforms.[90] Another proposition

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82. Sara Ziegler, *Communications Decency Act of 1996 (1996)*, FIRST AMENDMENT ENCYCLOPEDIA (last visited Nov. 30, 2020), https://www.mtsu.edu/first-amendment/article/1070/communications-decency-act-of-1996 [https://perma.cc/CZ92-HFA9]; Ambika Doran & Tom Wyrwich, *Section 230 of the Communication Decency Act Turns 20*, LAW360 (Sept. 7, 2016, 12:27 PM), https://www.law360.com/articles/836281/section-230-of-the-communications-decency-act-turns-20 [https://perma.cc/Q8P4-2CHM].

83. Ziegler, *supra* note 82.

84. Reno, 521 U.S. at 844.

85. Benedict, *supra* note 76, at 484.

86. Andrea Butler, *Protecting the Democratic Role of the Press: A Legal Solution to Fake News*, 96 WASH. L. REV. 419, 431–32 (2018); Doran & Wyrwich, *supra* note 82.

87. Butler, *supra* note 86, at 432

88. *Id.* at 434. In *Zeran v. American*, the court reasoned that Congress intended the CDA to shield both publishers and distributors. *Id.* at 433. This, in effect, continues to shield websites that curate or promote certain postings to users. *Id.*

89. *Id.* at 433.

90. *Id.* at 435.

would suggest adding a reasonableness standard to Section 230 by requiring that reasonable steps be taken by Internet service providers to combat certain types of content in return for immunity from liability.[91] However, imposing increased responsibility on content forums, considering the immense amount of activity on the most popular websites, simply shifts the burden to those who are not responsible for the original content. Furthermore, social media giants now are taking steps to better police their forums[92] and are likely to comply with the reasonableness standard suggested. But there is speculation that fake news authors will simply adapt to the new community standards to retain their revenue streams.[93]

III. MODELING INTENT TO DISTRIBUTE

Rather than create new laws that would have to survive strict scrutiny or grapple with Internet service providers and their immunity from liability under Section 230, the issues surrounding fake news should instead be handled by an agency that currently possesses the means and authority to do so—the FTC.[94] Regulation by the FTC has drawn recent attention as a possible solution to curb the dissemination of fake news. However, the FTC's current approach to the fake news issue does not serve the same interest that is necessary to provide a comprehensive solution to the focus of this Note. The FTC directs the majority of its resources towards the exchange of commodities. FTC regulation combats "posting misinformation about a product, and then selling the product . . .," whereas the "consumers" of a fake story have not purchased such a "product" in the traditional sense.[95] The dissemination of fake news is thus currently outside of the scope of the FTC's concern. But, because fake news generates revenue for the author, the FTC should consider the dissemination of fake news to be a type of fraudulent commercial activity, which would be under the purview of the FTC's authority. With this approach, FTC regulation, modeled after a theory of an intent to distribute, can provide a solution for fake news most detrimental to society.

Part A will explain the current approach being taken by the FTC, Part B will explain the authority of the FTC and why fake news falls within the scope of their authority, and Part C will discuss why the FTC should

91. Citron & Wittes, *supra* note 13, at 419.

92. *Instagram and Facebook introduce features to combat fake news and bullying*, MARKETING TECH (Dec. 17, 2019), https://www.marketingtechnews.net/news/2019/dec/17/instagram-facebook-features-combat-fake-news-and-bullying/ [https://perma.cc/8STN-HPB5].

93. Ohlheiser, *supra* note 24.

94. Roberts, *supra* note 16, at 112.

95. Stone-Erdman, *supra* note 18, at 429.

adopt a rule modeled after statutory intent to distribute and impose civil fines in order to provide a meaningful solution to fake news.

A. *The Current Approach by the FTC*

In *FTC v. Leadclick Media, LLC*, the Second Circuit held that "a defendant may be liable for deceptive practices that cause a consumer harm if, with knowledge of the deceptive nature of the scheme, he either participates directly in the practices or acts or has authority to control them."[96] Leadclick Media, LLC participated in and controlled "fake news websites" that drove Internet traffic to an online retailer.[97] This assertion of the FTC's authority, in bringing this action against Leadclick Media, demonstrates the Commission's potential to effectively discourage the dissemination of fake news, which similarly involves moving Internet traffic for commercial gain.

B. *FTC Regulation*

Generally, the FTC may prosecute any inquiry necessary to carry out its duties and is authorized to investigate the business, conduct, and practices of any person engaged in, or whose business affects, commerce.[98] The FTC accordingly has two meaningful ways to combat fake news: Section 5(a) enforcement and rulemaking under Section 18.

1. Enforcement

FTC enforcement must be preceded by an investigation.[99] The FTC may conduct any investigation necessary to carry out its duties and gather information concerning the business or practice of any person, partnership, or corporation engaged in or whose business affects commerce, except certain financial institutions.[100] Under Section 9 of the FTC Act, the FTC may use subpoenas to compel testimony by the witnesses of all documentary evidence relating to any matter under investigation.[101] Additionally, under Section 6, the Commission can force business entities to answer specific questions about themselves.[102] Following an investigation, the Commission has the authority to initiate

96. Fed. Trade Comm'n v. Leadclick Media, LLC, 838 F.3d 158, 169 (2nd Cir. 2016).

97. *Id.*

98. *A Brief Overview of the Federal Trade Commission's Investigative, Law Enforcement, and Rulemaking Authority*, FTC (Oct. 2019), https://www.ftc.gov/about-ftc/what-we-do/enforcement-authority [https://perma.cc/X5L6-CMSP] [hereinafter *A Brief Overview*].

99. *Id.*

100. *Id.*

101. *Id.*

102. *Id.*

an enforcement action using either administrative or judicial processes if it has "reason to believe" the law is being violated.[103]

Section 5(a) states that "unfair or deceptive acts or practices in or affecting commerce . . . are . . . declared unlawful."[104] Deceptive practices involve a material misrepresentation, omission, or other practice that is likely to mislead a consumer acting reasonably under the relevant circumstances.[105] Unfair practices are those which cause, or are likely to cause, a substantial injury to consumers that is not reasonably avoidable by consumers themselves and is not outweighed by countervailing benefits to consumers or competition.[106]

The fake news at issue in this Note falls well within the authority of the FTC, given that such fake news is classifiable as a deceptive practice and might, in fact, be considered an unfair practice as well for the following reasons. First, the advertising revenue generated by these fake news stories should unquestionably be considered commerce. Section 44 of the FTC Act defines commerce as including "commerce among the several states."[107] The dissemination of fake news reaches all corners of the United States, and the authors collect revenue based on clicks (engagement with fake news) that transverse state lines.[108] Next, the nature of the scheme employed by fake news authors is deceptive because the authors materially misrepresent fabricated content as legitimate news stories, target vulnerable consumers,[109] and generate click revenue through the consumer's false and misled belief that the content of the author's website and stories are accurate.[110] Additionally, the for-profit

103. *Id.*

104. *Id.*

105. *Id.*

106. *Id.*

107. Fed. Trade Comm'n v. Pointbreak Media, LLC, 376 F. Supp. 3d 1257, 1282 (2019).

108. Callum Borchers, *How the Federal Trade Commission could (maybe) crack down on fake news*, WASH. POST (Jan. 30, 2017, 12:22 PM), https://www.washingtonpost.com/news/the-fix/wp/2017/01/30/how-the-federal-trade-commission-could-maybe-crack-down-on-fake-news/ [https://perma.cc/KV36-J6US] (Acknowledging that fake news websites are engaged in commerce in that they sell advertisements).

109. Certain demographics of Internet users are more vulnerable to believe and share fake news. Older users of social media (above 65 years and older) may be more vulnerable to believing fake news because they have less experience using the Internet and, generally, are more trusting. Paula Span, *Getting Wise to Fake News*, N.Y. Times (Sept. 11, 2020), https://www.nytimes.com/2020/09/11/health/misinformation-social-media-elderly.html [https://perma.cc/7GUR-FE7C]. In addition, older users are targets because they tend to be more likely to vote in elections. *Id*. Fake news authors can also use targeted advertising based on user's ideologies. A University of Colorado Boulder study found that users on the most extreme ends of both sides of the political spectrum were responsible for more than half of the fake news stories circulated in their study. *Who Shares the Most Fake News? New Study Sheds Light*, CU BOULDER TODAY (June 17, 2020), https://www.colorado.edu/today/2020/06/17/who-shares-most-fake-news-new-study-sheds-light [https://perma.cc/HG23-5XNK].

110. Roberts, *supra* note 16, at 112.

dissemination of fake news should additionally be considered unfair under Section 5(a), as legitimate news organizations rely on, and compete for, the same advertising revenue that fake news websites garner through fraud. Legitimate news organizations are thus injured by fake news stories, and there is no countervailing benefit from the confusion and injury that fake news causes.[111] Thus, because of the nature and ubiquity of fake news, and the lack of any countervailing benefit to its existence, the FTC should undertake a rulemaking procedure in lieu of individually adjudicating claims against purveyors of fake news.

2. Rulemaking

Under Section 18 of the FTC Act, the FTC is authorized to develop rules which "define with specificity acts or practices which are unfair or deceptive acts or practices in or affecting commerce" within the meaning of Section 5(a)(1) of the Act.[112] Section 57a(b)(3) requires the FTC to believe that any unfair or deceptive practices which the FTC seeks to address through rulemaking occur commonly and are "prevalent."[113] Finally, once a rule is promulgated, anyone who violates said rule while possessing actual or fairly implied knowledge that their practice is unfair or deceptive is liable for civil penalties.[114] However, any person that violates a rule, regardless of intent, is liable for any injury which the violation caused to consumers, a lesser penalty than the civil penalty noted above.[115]

The FTC has the requisite rulemaking authority to develop a rule regarding the authoring and distribution of for-profit fake news because, as argued in the prior section, such a practice (1) is deceptive due to the inherent falsity of the stories that are disseminated to generate advertising revenue and (2) affects commerce, given that these revenue-driven fake news stories unfairly compete for advertising dollars with truthful content produced by authentic news organizations. The FTC currently regulates deceptive advertising under 15 U.S.C. § 52 (a).[116] The FTC's authority under this section should be interpreted to also provide it with the ability

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111. Claire Atkinson, *Fake News Causes 'Irreversible Damage' to Companies – and Sink Their Stock Price*, NBC NEWS (Apr. 25, 2019), https://www.nbcnews.com/business/business-news/fake-news-can-cause-irreversible-damage-companies-sink-their-stock-n995436 [https://perma.cc/VA3L-QSGU].

112. *A Brief Overview*, *supra* note 98.

113. 15 U.S.C. § 57a(b)(3). "The Commission may use rulemaking to address unfair or deceptive practices or unfair methods of competition that occur commonly, in lieu of relying solely on actions against individual respondents." *A Brief Overview*, *supra* note 98.

114. *A Brief Overview*, *supra* note 98.

115. *Id.*

116. "[P]erson, partnership or corporation to disseminate, or cause to be disseminated, any false advertisement . . . having an effect upon commerce of food, drugs, devices, services or cosmetics." 15 U.S.C. § 52(a).

to regulate fake news. Congress has given the FTC expansive authority to regulate false advertising as commercial speech because of its tendency to mislead the public.[117] Fake news distributed to generate advertising revenue, just as with false advertising, is knowingly false, is disseminated for economic gain, and has a tendency to mislead the public. Furthermore, fake news should fall within the FTC Act's broad delegation of regulating authority to address "practices that the Commission determines are against public policy for other reasons."[118] Rulemaking is an appropriate step by the FTC because fake news is a prevalent problem, recently becoming more impactful than real news on social media.[119] By issuing a rule, the FTC will establish an industry-wide, bright-line standard regarding what constitutes improper practices, such as the act of profiting from the dissemination of fake news.[120] An FTC rule will provide clarity about the narrow scope of the rule thereby assuaging concerns about a chilling effect on free speech.[121]

Additionally, a regulation adopted by the FTC would provide the most effective method of combatting fake news because it is likely to survive a constitutional challenge. This is due to the fact that the regulated content (fake news) would constitute commercial speech, and the regulation would therefore be subject to a lower standard of judicial scrutiny than are regulations targeting core political speech. Additionally, because fake news is, by definition, false and misleading speech it would fail the first facet of the *Central Hudson* test and would thus be stripped of any First Amendment protection.[122] Further, by attaching civil fines to the clearly defined unlawful practice of knowingly writing fake news with the intent

117. Amanda Z. Naprawa, *Don't Give Your Kid That Shot!: The Public Health Threat Posed by Anti-Vaccine Speech and Why Such Speech Is Not Guaranteed Full Protection Under the First Amendment*, 11 CARDOZO PUB. L. POL'Y & ETHICS J. 473, 507 (2013).

118. Fed. Trade Comm'n v. Ind. Fed'n of Dentists, 476 U.S. 447, 454 (1986).

119. Silverman, *supra* note 27; Peter Dizikes, *Study: On Twitter, False News Travels Faster Than True Stories*, MIT NEWS (Mar. 8, 2018), http://news.mit.edu/2018/study-twitter-false-news-travels-faster-true-stories-0308 [https://perma.cc/Q24Q-PGRG] (finding that fake news stories are 70% more likely to be retweeted than true stories and spread faster, deeper, and more broadly than true stories). An Oxford University study of 22 million tweets in the final weeks before the election found that on average for every story produced by a professional news organization, one polarizing story was produced from a nonprofessional news organization. Denise Clifton, *Fake News on Twitter Flooded Swing States That Helped Trump Win*, MOTHER JONES (Sept. 28, 2017, 1:00 AM), http://www.motherjones.com/politics/2017/09/fake-news-including-from-russian-sources-saturated-battleground-states-trump-barely-won/ [https://perma.cc/2J8S-NNY3].

120. Riggins, *supra* note 16, at 1326.

121. Richard Schmidt, Jr. & Robert Clifton Burns, *Proof or Consequences: False Advertising and the Doctrine of Commercial Speech*, U. CIN. L. REV. 1237, 1290 (1988).

122. Roberts, *supra* note 16, at 121. *See also* Naprawa, *supra* note 117, at 507 ("[W]here the commercial speech is false or inherently misleading, the First Amendment does not provide even a residual level of protection and the Central Hudson test does not even apply.").

to distribute for monetary gain through pay-per-click advertising, the FTC would discourage fake news by stopping the spread before it starts.

3. Permissible Enforcement as Commercial Speech

Commercial speech is poorly defined by the courts.[123] The Supreme Court in *Central Hudson Gas & Electric Co. v. Public Service Commission of New York*, in recognizing the commonsense distinction between commercial speech and other varieties of expression, defined commercial speech simply as "expression related solely to the economic interests of the speaker and its audience."[124] The Court also defines commercial speech as that which "does no more than propose a commercial transaction."[125]

Although truthful commercial speech concerning lawful goods and services is protected by the First Amendment,[126] such speech still receives less protection within the hierarchy of speech values than political expression, partly because truthful commercial speech is economically motivated instead of politically driven.[127] Economically motivated commercial speech is more easily verifiable by its disseminator and is less likely than noncommercial speech to be chilled by proper regulation.[128] Furthermore, the government's legitimate interest in protecting consumers from commercial harms allows for commercial speech to be subject to greater government regulation than noncommercial speech.[129] In *Central Hudson*,[130] the Supreme Court held that the government may ban commercial speech that is more likely to deceive than inform, and that First Amendment protection for commercial speech exists only if the speech is neither false or

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123. Kerri A. Thompson, *Commercial Clicks: Advertising algorithms as Commercial Speech*, VAND. J. OF ENT. & TECH. L. 1019, 1034 (2019); J. Thomas McCarthy, McCarthy on Trademarks and Unfair Competition § 31:139.25 (5th ed. 2021).

124. Cent. Hudson Gas & Elec. Corp. v. Pub. Serv. Comm'n of New York, 447 U.S. 557, 561 (1980).

125. U.S. v. United Foods, 533 U.S. 405, 409 (2001).

126. The First Amendment applies to commercial speech because it not only serves the economic interests of the speaker, but also because advertising disseminates information and assists consumers. *Central Hudson*, 447 U.S. at 561–62.

127. Riggins, *supra* note 16, at 1313; *R.A.V.*, 505 U.S. at 422 (Stevens, J., concurring) ("commercial speech . . . [is] regarded as sort of second-class expression . . . "). Second-class in comparison to core political speech.

128. *Kasky*, 27 Cal. 4th at 962.

129. Sorrell v. IMS Health Inc., 564 U.S. 552, 579 (2011).

130. *Cent. Hudson Gas*, 447 U.S. at 566. In *Central Hudson*, the Supreme Court established a four-part test to determine the constitutionality of a regulation of commercial speech: (1) Does the speech concern illegal activity or constitute false or deceptive advertising that is not protected by the First Amendment? (2) Is the government's restriction justified by a substantial government interest? (3) Does the restriction advance the government's interest? (4) Is the regulation no more expansive than necessary to achieve the interest? *Id.*

misleading.[131] By failing to define commercial speech narrowly, however, courts have afforded themselves flexibility in future commercial speech cases to adapt to changing technological advancements.[132] Inherent in the commercial speech doctrine are two threshold determinations: (1) deciding if the speech is, in fact, commercial, and (2) if the speech is commercial, then determining if it is either false or misleading.[133]

Fake news falls well within these threshold determinations inherent in the doctrine of commercial speech.

a. Whether the Speech is Commercial

Because the degree of protection afforded by the First Amendment depends on whether speech is commercial or non-commercial, the aforementioned initial determination requires classifying the expression at issue as either commercial or non-commercial. The Supreme Court in *Bolger v. Young Drugs Products Corp.* identified three relevant considerations when deciding whether speech is commercial: advertising format (the extent the speech at issue is an advertisement), reference to a particular product, and economic motivation.[134] These factors are not necessarily dispositive, but the existence of all these characteristics within a given publication strongly supports the conclusion that the publication at issue constitutes commercial speech.[135]

i. Advertising Format

"Advertising" does not need to take the format of a person directly offering a good or service to a target audience.[136] Moreover, the fact that a certain expression discusses matters of public concern does not prevent that expression's categorization as commercial speech.[137] The ultimate purpose of the type of fake news discussed in this Note simply serves as a vessel for misleadingly connecting consumers with advertisements, motivated by the author's self-serving economic interest.[138] The

131. Riggins, *supra* note 16, at 1320; Va. State Bd. of Pharm. v. Va. Citizens, 425 U.S. 748, 771 (1976) (holding the State may regulate commercial speech which is false, deceptive, misleading, or which proposes illegal transactions).

132. Riggins, *supra* note 16, at 1321. Kerri A. Thompson, *Commercial Clicks: Advertising Algorithms as Commercial Speech*, VAND. J. ENT. & TECH. L. 1019, 1034 (1980) (stating that commercial speech is not limited to traditional advertisements); Zauderer v. Off. of Disciplinary Couns. of Supreme Ct. of Ohio, 471 U.S. 626, 637 (1985) (casting doubt upon the precise bounds of the category of commercial speech).

133. Riggins, *supra* note 16, at 1321.

134. Ariix, LLC v. NutriSearch Corp., 985 F.3d 1107, 1116 (9th Cir. 2021).

135. Dex Media W., Inc. v. City of Seattle, 696 F.3d 952, 958 (9th Cir. 2012).

136. *Kasky*, 27 Cal. 4th at 960.

137. Bolger v. Youngs Drug Prod. Corp., 463 U.S. 60, 68 (1983).

138. *Id*. at 65.

advertising format of both traditional commercial speech advertisements and fake news successfully markets goods and services to consumers and generates a profit through consumer engagement.[139] The sole and insignificant distinction between these two formats is their commercial subject. The commercial subject of a traditional advertisement is a good or service, whereas the commercial subject of a fake news article is the advertisement itself, veiled by a fabricated news story which is intended solely to disseminate the advertisement to more consumers. Hence, just like a traditional advertisement, the essential function of fake news is to propose a commercial transaction. This, in turn, should favor a finding that such fake news is commercial speech. The idea that fake news would be able to escape the reach of the commercial speech doctrine because of an insignificant difference in the advertising format of its commercial expression, as compared to more traditional advertisements, is impracticable.

ii. Product Reference

The failure to reference a specific product is a relevant consideration in the commercial speech determination, but it is far from dispositive where expression other than product advertising is concerned.[140] In *Jordan v. Jewel Food Stores, Inc.*, the Seventh Circuit held that an advertisement by Jewel-Osco that did not contain a single word about a specific product was nonetheless properly characterized as commercial speech because the dominant, implicit commercial function of the message was to promote the Jewel-Osco brand in the mind of consumers.[141] Similarly, fake news will likely not contain any specific reference to a particular product or service. However, as in *Jewel Food Stores*, the implicit commercial purpose of the expression of fake news is to serve the overall economic purpose of the author. Just because the expression within fake news publications fails to include a specific reference to a particular good or service does not necessarily mean that it is properly characterized as non-commercial speech.

iii. Economic Motivation

"Economic motivation" implies that a given expression is intended to lead to commercial transactions and that the target audience is composed

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139. Matthew LoBello, *The Journalism Licensing Program: A Solution to Combat the Selective Exposure Theory in Our Contemporary Media Landscape*, 36 CARDOZO ARTS & ENT. L.J. 509, 535 (2018).

140. Jordan v. Jewel Food Stores, Inc., 743 F.3d 509, 519 (7th Cir. 2014).

141. *Id*. at 518 (In this case, a former basketball player brought suit against Jewel Food Stores when the defendant ran an advertisement congratulating the plaintiff on his induction into the basketball hall of fame.).

of individuals who will engage in such transactions.[142] Not all types of economic motivation will support a finding of commercial speech. For example, a mere incidental economic benefit, without more, will not support a finding of commercial speech.[143] The focus of the inquiry is instead on whether the speaker had an adequate economic motivation, such that an economic benefit was their primary purpose for speaking.[144] The main incentive for fake news is economic profit for the author; if the fabricated fake news story spreads farther and faster than the truth, more advertising revenue will be generated for the producer.[145] The false statements of fact within fake news only serve the speaker's economic interest, providing no benefit to the public. This primary economic motivation for the publication of fake news favors a finding that fake news is commercial speech.

Considering the foregoing factors, fake news, which ultimately amounts to false statements of fact imitating real news stories with the purpose of deceptively disseminating the fake news to as many consumers as possible for the sole purpose of maximizing the speaker's economic gain, should unquestionably be found to constitute commercial speech. "Such speech becomes more like 'the offspring of economic self-interest' and 'is a hardy breed of expression that is not particularly susceptible to being crushed by overbroad regulation.'"[146] In *Ariix, LLC v. NutriSearch Corp.*, the Ninth Circuit found that when a speaker profited from actively misleading the public about their purported objectivity, they "drowned the public trust for economic gain" and, therefore, their speech was commercial in nature.[147] Similarly, fake news actively misleads the public in order to promote the economic interest of the speaker and is the type of speech that "society has little interest in protecting . . . under the mantle of the First Amendment."[148] Hence, after making the determination that the type of fake news at issue does constitute commercial speech, the inquiry then moves on to the aforementioned second determination: whether such commercial speech is false or misleading.

142. *Kasky*, 27 Cal. 4th at 961.
143. *Ariix*, 985 F.3d at 1117.
144. *Id*.
145. Wood, *supra* note 12.
146. *Ariix*, 985 F.3d at 1119 (quoting *Cent. Hudson Gas*, 447 U.S. at 564 n.6).
147. *Id.*
148. *Id.*

b. Is the Speech False or Misleading?

False and misleading commercial speech is not entitled to any First Amendment protection.[149] Fake news publications are intentionally false and misleading, often imitating reputable news organizations to make the fake news story look credible to the consumer, driving up Internet distribution and revenue for the author.[150] This clearly fits into the *Central Hudson* definition of expression which is based solely upon misleading, false, deceptive commercial speech, which is within the reach of State regulation.[151] The fact that fake news is often linked to important issues of public debate[152] does not rescue the expression from a determination that it constitutes commercial speech within the reach of State regulation.[153] Because fake news is intentionally false and misleading commercial speech, any effort by the government to regulate and prevent its dissemination would be permissible.[154]

In addition, the regulation of fake news would also comport with the policy considerations that have shaped the doctrine of commercial speech. In *Virginia State Board of Pharmacy v. Virginia Citizens*, the Supreme Court stated that when an expression is made, freedom of speech protects both the speaker and the right of the recipient to receive the expression.[155] The Court elaborated that in the context of commercial speech, both individual consumers and society as a whole have a keen interest in the free and clean flow of commercial information so consumers may make intelligent and well-informed decisions.[156] The Court, in *Zauderer v. Office of Disciplinary Counsel of Supreme Court of Ohio*, reflected on the *Virginia* decision and opined that the extension of First Amendment protection to commercial speech is justified principally by the "value to consumers of the information such speech provides."[157]

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149. Jordan v. Jewel Food Stores, Inc., 743 F.3d 509, 518 (7th Cir. 2014). Commercial speech that is not misleading or does not concern unlawful activity may be regulated if the government can satisfy the three prongs of "intermediate" scrutiny review: (1) the government must assert a substantial interest in support of its regulation, (2) the government must demonstrate that the restriction on commercial speech directly and materially advances that interest, and (3) the regulation must be "narrowly drawn." *Accord* Fla. Bar v. Went For It, Inc., 515 U.S. 618, 624 (1995).

150. LoBello, *supra* note 139, at 534.

151. Friedman v. Rogers, 440 U.S. 1, 9 (1979).

152. *Bolger*, 463 U.S. at 68.

153. *Id.* (holding that the informational pamphlets at issue describing family planning and venereal disease can, and in this case do, constitute commercial speech despite expression concerning current public debate).

154. *Zauderer*, 471 U.S. at 638 ("States and the Federal Government are free to prevent the dissemination of commercial speech that is false, deceptive, or misleading . . . .").

155. *Id.* at 756.

156. Va. State Bd. Pharmacy v. Va. Citizens Consumer Council, Inc., 425 U.S. 748, 763–65 (1976).

157. *Zauderer*, 471 U.S. at 651.

The position taken by the Supreme Court in *Virginia State Board of Pharmacy v. Virginia Citizens*, is supported by Alexander Meiklejohn's theory of democratic self-governance. Meiklejohnian theory holds that speech should be protected to facilitate the "voting of wise decisions."[158] More particularly, Meiklejohn argued that the "minds of the hearers" take precedent over the speaker's rights and that speech which mutilates the thinking process of the hearers is rightfully suppressed—it is not essential that everyone shall speak.[159]

Fake news, as defined in this Note, does not facilitate the voting of wise decisions and mars the thinking process of the recipients of the speech in the community. By writing verifiably false stories and imitating genuine news publishers, fake news authors target communities or demographics with the intent to distribute falsehoods in order to reap significant monetary returns on the back of misinformation and confused minds of the victims. This is the type of expression which the theory of democratic self-governance posits would rightfully be suppressed. According to Meiklejohn, there should be no obstacle to suppressing the unfair and irresponsible transmission of information that mutilates the thinking process of the community and leads to the voting of unwise decisions.

In conclusion, under *Central Hudson* a court should find that for-profit fake news falls outside of the scope of protection which the First Amendment affords to commercial speech. Fake news should be considered commercial in nature because it is expression which does no more than propose the commercial transaction of clickbait advertising,[160] motivated solely by the economic benefit of the speaker. After defining the expression as commercial, a court would consider whether the speech is afforded any protection by the First Amendment.[161] For commercial speech to receive such protection, it must be neither false nor misleading and it must pertain to a lawful good or service.[162] Thus, there is no constitutional objection to the suppression of commercial speech that does not accurately inform the public, because the government "may ban forms of communication more likely to deceive the public than inform it."[163] Fake news clearly falls into the category of deceptive and false commercial speech because fake news stories and articles are composed of intentionally false statements that generate economic benefit to the

158. ALEXANDER MEIKLEJOHN, FREE SPEECH AND ITS RELATION TO SELF-GOVERNMENT 25 (1948).

159. *Id*. at 25–26.

160. Perlman, *supra* note 26 (Aptly described by Ben Edelman, associate professor at Harvard Business School, "You want to read it. It sounds so good you can't help but click on it, hence the term clickbait.").

161. *Bolger*, 463 U.S. at 69.

162. *Id*. at 68–69.

163. *Cent. Hudson Gas*, 447 U.S. at 563 (1980).

speaker by deceiving the public. In addition, fake news contravenes the policy notion underlying the commercial speech doctrine—the audience's right to receive truthful information in order to make better consumer-based, economic choices.[164] Fake news consists of no-value, false statements that do nothing to inform the public or promote the facilitation of information. Therefore, fake news is properly categorized and regulated under the commercial speech doctrine.

It is important to remember that the definition and scope of fake news in this Note narrowly focuses on fake news that is created and disseminated to generate significant commercial activity through clickbait advertising. The argument made here does not infringe upon the notions of a marketplace of ideas[165] and counterspeech[166] that the First Amendment is built upon. Individuals are free to express their views on matters of public concern on the vast public forum of the Internet without inhibition, but when their expression constitutes no more than commercial activity that is deceptive and misleading and serves no other purpose than to serve the economic interests of the speaker, then the commercial speech doctrine rightfully intervenes and allows such speech to be suppressed due to its harmful impact.

C. *Modeling an FTC Rule on a Theory of Intent to Distribute*

Modeling a rule on a theory of intent to distribute will: (1) focus the regulation on fake news that is properly under the purview of FTC authority; (2) create a bright-line rule disincentivizing a prevalent practice; and (3) inform the Commission of specific theories of proof that have already been developed in an analogous body of law. An analogy

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164. *Zauderer*, 471 U.S. at 651 (1985) ("Because the extension of First Amendment protection to commercial speech is justified principally by the value to consumers of the information such speech provides . . . .").

165. Calvert et al., *supra* note 61, at 131 (John Stuart Mill's marketplace of ideas is arguably the most prominent theory to shape the United States' tradition of free speech. The theory promotes an uninhibited, open free exchange of ideas. Mill's opposed the suppression of opinion. Such a process of uninhibited debate will ultimately promote the discovery of truth). Here, the marketplace of ideas theory would protect non-commercial expression of opinion, any suppressive measures taken in response to the fake news as defined by this Note would not infringe upon such non-commercial opinion expression.

166. In *Whitney v. California*, Justice Brandeis articulated the premise of counterspeech: "If there be time to expose through discussion the falsehood and fallacies, to avert the evil by process of education, the remedy to be applied is more speech, not enforced silence." Lynne Tirrell, *Toxic Misogyny and the Limits of Counterspeech*, 87 FORDHAM L. REV. 2433, 2445 (2019). The doctrine of counterspeech is an outgrowth of the marketplace of ideas theory. Philip M. Napoli, *What If More Speech Is No Longer the Solution? First Amendment Theory Meets Fake News and the Filter Bubble*, 70 FED. COMM. L.J. 55, 61 (2018). The doctrine of counterspeech implores the preferred remedy to a feared injury is to add more speech, rather than censor speech, to the metaphorical marketplace of ideas. Robert D. Richards & Clay Calvert, *Counterspeech 2000: A New Look at the Old Remedy for "Bad" Speech*, 2000 B.Y.U. L. REV. 553, 553–54 (2000).

will be drawn to the federal drug enforcement statute, 21 U.S.C. § 841(a)(1), which states:

"Except as authorized by this subchapter, it shall be unlawful for any person knowingly or intentionally-- (1) to manufacture, distribute, or dispense, or possess with intent to manufacture, distribute, or dispense, a controlled substance . . . ."[167]

Under existing legal doctrine, to establish a defendant's possession with an intent to distribute the government must prove the defendant (1) knowingly (2) possessed the drug in question, and (3) intended to distribute.[168] Knowingly possessing a controlled substance can be established by actual possession or constructive possession.[169] A person who, although not in actual possession of a substance, has both knowledge of its presence and control over it either directly or through another person, is in constructive possession of it.[170]

1. Knowledge of Falsified Story

It is important that the suggested regulation over fake news governs only intentionally written falsehoods, thereby distinguishing fake news made with the intent to distribute from sloppy journalism and misinformed opinions.[171] Similarly, to sustain a conviction for possession with intent to distribute, the government must, as the first required element of their claim, demonstrate that the defendant had knowledge of the existence of the contraband at issue.[172] However, suspicious behavior by itself, without proof of the defendant's knowledge of the contraband at issue, is not enough to support a conviction of possession with intent to distribute.[173]

Similarly, the FTC should be required to show that a distributor of fake news knew that the story at issue was false. This requirement should be easy to meet when considering fake news as a type of "controlled substance" in question. Authors of fake news knowingly write falsehoods to target specific audiences to generate an emotional response and thus increase the likelihood the reader will share the story, generating more website traffic and revenue for the author. One can imagine, however,

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167. U.S.C.A. § 841(a)(1).

168. U.S. v. Ramirez-Maldonaldo, 928 F.3d 702, 707 (8th Cir. 2019).

169. U.S. v. Mangual-Garcia, 505 F.3d 1, 11 (1st Cir. 2007).

170. U.S. v. Peebles, 883 F.3d 1062, 1068 (8th Cir. 2018).

171. Riggins, *supra* note 16, at 1316.

172. U.S. v. Gasper, 524 F. App'x 514, 516 (11th Cir. 2013) (the government must prove: (1) knowledge; (2) possession; and (3) intent to distribute).

173. U.S. v. Torres, 604 F.3d 58, 66 (2d Cir. 2010) (holding defendant did not have knowledge of narcotics where defendant had been paid to pick-up packages, which contained narcotics hidden inside cabinets within the packages, and government proffered no evidence showing that the defendant took part in any conversation informing him of the presence of narcotics).

that purveyors of fake news would claim that they were unaware that a story was false and that they did not intentionally write a false story.

However, this is an issue that the courts are equipped to address. Such a state-of-mind requirement already exists in the context of defamation law, where a fact finder must determine whether a message was published with actual malice. Here, the FTC should be required to show that such fake news was made with "knowledge that it was false or with reckless disregard of whether it was false or not."[174] Knowledge can be proven by circumstantial evidence, records, or a cooperating witness.[175] In its enforcement action of the rule, the court can make a determination of whether the FTC met the standard, similar to a finding under an actual malice standard.

2. Knowingly "Authored"

The second element in proving possession with intent to distribute is possession itself. In the context of fake news, possession is analogous to authorship of the fake news story. Just like possession, authorship could be proven through "actual authorship" or "constructive authorship."[176] A showing of actual authorship would require proof that the fake news story was written by the author against whom the claim was brought. This could be proven by records, such as emails, showing that the defendant was the one who wrote a story, or by a witness who has first-hand knowledge the defendant actually wrote the story. Alternatively, the FTC could show constructive authorship by demonstrating that the person against whom the claim is brought had (1) knowledge that the fake news story was being written and (2) control over the story, either directly or through another person.[177] Constructive authorship is an important theory of possession, especially considering the business-like structure of for-profit fake news and the difficulty technology poses to proving a direct link between the author and an article.[178]

Consider, once again, Jestin Coler. As the owner of Disinfomedia, Coler managed "employees" who wrote fake news stories for the company. Coler may not have written any fake news stories himself and thus would not have been found to have the "immediate, hands-on

174. N.Y. Times Co. v. Sullivan, 376 U.S. 254, 280 (1964).

175. *Torres*, 604 F.3d at 66, 70 (holding that without records, a cooperating witness, or other evidence, the government could not prove he had the knowledge necessary to sustain a conviction of intent to distribute).

176. *Mangual-Garcia*, 505 F.3d at 11.

177. *Peebles*, 883 F.3d at 1068.

178. Modern trends in remote work technology would allow authors to work independently, removing the possibility of an eyewitness to corroborate. Additionally, the FTC would have to prove an article was associated with an IP address that the person against whom the claim was brought owned.

physical possession"[179] of the fake news story required to prove actual authorship. However, under a theory of constructive authorship, Coler would be shown to have both (1) knowledge and (2) control over the fake news stories. Coler could be shown to exercise control over the fake news stories by evidence (emails, texts, recordings) showing that Coler made decisions regarding the content or publications of certain stories, or that Coler paid a person to write fake stories for Disinfomedia.[180]

3. Intent to Distribute

The third element necessary to prove possession with intent to distribute is a finding that the defendant acted with the specific intent to distribute the controlled substance at issue.[181] Because of the subjective nature of a person's intent to distribute, "circumstantial evidence[182] alone can establish the possession with the intent to distribute offense."[183] Specific intent may be proven by circumstances surrounding the defendant's possession that give rise to a reasonable inference of their intent to distribute or at least increase the probability that intent was present. This theory of intent to distribute controlled substances is analogous to a fake news author's intent to distribute a story to as many readers as possible to increase traffic and advertising clicks on their websites. The following sections will explore in more detail how circumstantial evidence and reasonable inferences can establish a fake news author's intent to distribute.

i. Quantity

Courts have held that "the intent to distribute can be solely established by the quantity of drugs."[184] "Intent to distribute may be inferred from possession of . . . a quantity of drugs larger then needed for personal use."[185] Similarly, it may be possible to infer that an author possessed the intent to distribute fake news if the author published a certain quantity of fake stories within a given time frame.

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179. U.S. v. Padilla-Galarza, 886 F.3d 1, 5 (1st Cir. 2018) (quoting U.S. v. Guzman-Montanez, 756 F.3d 1, 8 (1st Cir. 2014) (defining "actual possession")).

180. *Id.* (holding that the defendant exercised constructive possession "over an area" by making mortgage payments on the house where a controlled substance was found).

181. U.S. v. Heras, 609 F.3d 101, 106 (2d Cir. 2010).

182. U.S. v. Patel, 370 F.3d 108, 113 (1st Cir. 2004) ("Circumstantial evidence asserts something else from which the trier of fact may either (i) reasonably infer the truth of the proposition or (ii) at least reasonably infer an increase in the probability that the proposition is in fact true.").

183. U.S. v. Clark, 331 Fed. Appx. 670, 671 (11th Cir. 2009); U.S. v. Rodriguez, 993 F.2d 1170, 1175 (5th Cir. 1993).

184. *Peebles*, 883 F.3d at 1068 (8th Cir. 2018); U.S. v. Savinovich, 845 F.2d 834, 838 (9th Cir. 1988).

185. U.S. v. Yancey, 228 F. Appx. 267, 269 (4th Cir. 2007).

Conversely, under current caselaw, a lesser quantity of controlled substances, consistent with personal use, does not raise an inference of intent to distribute, at least in the absence of additional evidence showing intent.[186] The Fifth Circuit held that a man possessing 2.89 grams of cocaine could not be found to possess with an intent to distribute as a matter of law.[187] Similarly, a person who rarely distributed any fake stories could not be found to have intended to distribute fake news. This theory of proof would protect individuals who do not cause the sort of widespread public harm that the FTC should prosecute.

ii. Cash or Value

Further, an "[i]ntent to distribute may be inferred from the . . . price . . . of the drug possessed."[188] In *U.S. v. Peebles*, the Eighth Circuit affirmed the jury's finding of possession with the intent to distribute when police discovered one-quarter of a kilogram of a controlled substance, worth $15,000 to $18,000.[189] Additionally, courts have considered cash discovered with a controlled substance to be sufficient circumstantial evidence to support a finding of intent to distribute.[190]

Courts often examine the value of the substance at issue or the presence, or exchanging, of money to support a finding of intent to distribute. After all, the impetus behind distributing controlled substances is to make money—and the same is true of for-profit fake news. The FTC can prove intent to distribute fake news for profit with evidence of the amount of money that is being generated from advertising or the presence of "cash" associated with those businesses. For example, consider the revenue stream of Disinfomedia. Coler admitted that he received between $10,000 and $30,000 per month by circulating knowingly fake stories which he exerted actual or constructive possession over through his ownership and managing of Disinfomedia and through his making of

186. U.S. v. Skipper, 74 F.3d 608, 611 (5th Cir. 1996).

187. *Id.*

188. *Savinovich*, 845 F.2d at 838 (holding that evidence of the resale value is probative of intent to distribute).

189. *Peebles*, 883 F.3d at 1068.

190. *Yancey*, 228 F. Appx. at 269 (*quoting* U.S. v. Collins, 412 F.3d 515, 519 (4th Cir. 2005) ("Intent to distribute can be inferred from, *inter alia*, the 'amount of cash seized with the drugs.'"); U.S. v. Stephens, 23 F.3d 553, 556 (D.C. Cir. 1994) (recognizing that possession of relatively large amounts of cash may support a finding of intent to distribute); U.S. v. Maldonado, 108 F.3d 331 (5th Cir. 1997) ("Possession of drugs coupled with additional evidence such as large quantities of cash may support an inference of intent to distribute."); *Skipper*, 74 F.3d at 611 (stating a quantity of drugs consistent with personal use does not support a finding of intent to distribute but can if augmented with additional evidence such as large quantities of cash); U.S. v. Khondaker, 263 Fed. Appx. 693, 701 (10th Cir. 2008) (holding $2,300 in cash found near the seized drugs gives rise to an inference of intent to distribute).

editorial decisions, effectively exercising control over the stories. Disinfomedia's monthly income is incredibly similar to the value of the substance possessed in *Peebles*, which the court held was sufficient to support a finding of intent to distribute. This level of income should thus serve as sufficient evidence for the FTC to establish that Coler intended to distribute fake news for profit.

As an alternative to showing the monthly "value" of fake news, the FTC could use evidence of cash associated with either Jestin Coler or Disinfomedia to prove intent to distribute. Courts often have held that the presence of cash has been sufficient to show intent to distribute.[191] In *United States v. Stephens*,[192] the court found that additional evidence of $15,000 in cash seized along with a quantity of marijuana exceeding a quantity for personal use was ample evidence to support a finding of intent to distribute.[193] For-profit fake news generates a significant amount of money for the disseminators; the presence and exchange of cash sufficient to prove intent to distribute under 21 U.S.C. § 841 (a)(1) should similarly be sufficient to prove intent to distribute in the context of fake news. For example, the FTC could show evidence in the form of bank accounts held in the name of Disinfomedia, financial statements showing the origin of deposits from AdSense, or payments made directly to Coler or his writers from accounts associated with Disinfomedia.

iii. Behavior

Intent to distribute can also be proven by the defendant's behavior.[194] In *United States v. Foster*,[195] an expert testified that traveling by train (in an effort to keep luggage close by), purchasing a one-way ticket with cash shortly before departure, carrying a beeper, using hard suitcases and masking agents such as talcum powder (to contain drug odor), and avoiding using their real name are all behaviors typical of drug couriers.[196] The court held that expert testimony regarding the defendant's behavior was admissible as relevant circumstantial evidence to prove the defendant knew and intended to carry under 21 U.S.C. § 841 (a)(1) because these behaviors made it more probable that the fact of consequence was true.[197]

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191. *Id.*

192. *Stephens*, 749 Fed. Appx. at 179.

193. "The intent to distribute can be inferred from a number of factors, including but not limited to . . . the amount of cash seized with the drugs." *Id.* (quoting *Collins*, 412 F.3d at 519).

194. U.S. v. Foster, 939 F.2d 445, 451 (7th Cir. 1991); U.S. v. Lopez, 403 Fed. Appx. 362, 374 (11th Cir. 2010); U.S. v. Williams, 541 F.3d 1087, 1089 (11th Cir. 2008) (holding that behavior, such as evidence of flight, is admissible to demonstrate consciousness of guilt and thereby guilt itself).

195. *Foster*, 939 F.2d at 451.

196. *Id.*

197. *Id.*

Under a similar theory, the FTC can support a finding of intent to distribute through evidence that a fake news author: wrote fake news stories under a pseudonym or published anonymously, established a social media presence specifically targeting certain groups of people who are likely to disseminate fake news, or took certain cyber security measures to ensure anonymity in the conduct of their publication. Such factors, even potentially developed through adjudication of many cases, would establish the common behaviors and practices of individuals who operate for-profit fake news publications. The FTC could use these behaviors as circumstantial evidence to counter an argument by a defendant who claims that they were unaware or lacked the intent to disseminate fake news—just as the defendant in *Foster* attempted to argue.[198]

iv. Network Engagement

Participation in, and involvement with, distribution activity is not alone sufficient to convict under current legal frameworks, but such evidence is permissible in evaluating the totality of circumstances of the charged offense.[199] In *U.S. v. Lopez*, the court ruled that evidence showing the defendant arranged the sale of 211 kilograms of cocaine to distributors was sufficient to demonstrate knowledge of the general scope and nature of the conspiracy.[200] Next, the court in *Lopez* determined that attending meetings and traveling frequently with coconspirators on flights along with the evidence of arranging deals, was sufficient to satisfy the totality of the circumstances test. *Lopez* shows that serving as the entity that delivered the drugs into the network of distribution could be used as circumstantial evidence to show the defendant was guilty of intent to distribute. Similarly, a regulation could assign a heightened degree of culpability, under a similar theory of intent to distribute, by a showing that an author engaged with distribution networks to spread their fake news story for financial gain.

Fake news authors are able to widely distribute their stories by engaging with social media—the modern news distribution network—and by targeting users through harvested data that reveals individuals who are more likely to believe and share fake news stories.[201] A fake news author who targets their audience—through data harvesting, political ideology, or other means—and engages the specific distribution network by placing their fake news story into those channels, should be said to have intended to distribute. Additionally, the volume of activity of a fake news author could be a factor supporting a finding of intent to distribute.

198. *Stevens*, 749 Fed. Appx. at 179.
199. *Lopez*, 403 Fed. Appx. at 374.
200. *Id*. at 374–75.
201. Clemons, *supra* note 45.

If the author posts infrequently, then it is unlikely that they would have acted with the requisite intent to widely distribute their falsehoods. However, an author who posts with frequency would demonstrate their intent to distribute by regularly attempting to attract the attention of vulnerable consumers and make money from their promotion of the post.

v. "Tools of the Trade"

Equipment or materials that are "tools of the trade" are admissible as evidence to allow for a reasonable inference that the defendant intended to distribute.[202] Tools of the trade, items which are commonly used in drug transactions, may be used to support an inference that a defendant in possession of drugs intended to engage in such a drug transaction, rather than to simply engage in personal use.[203] In *U.S. v. Winder*,[204] the defendant did not dispute that he possessed and had knowledge of the drugs found in the car he was driving at the time of his arrest, but he nonetheless challenged the sufficiency of the evidence to prove intent to distribute. The Tenth Circuit turned to the circumstantial evidence of other key items located in the car: two firearms, ammunition, baggies, and a digital scale. The Court held that the caselaw recognized these items as "tools of the trade" and that they suggested the defendant was engaged in distributing illegal drugs. Thus, the court ultimately affirmed the conviction.

Similarly, the circumstances surrounding the operation of a purveyor of fake news could be used to prove an intent to distribute. In furtherance of the public policy concerns addressed by the proposed FTC regulation,[205] the FTC can use, as evidence of intent to distribute, the "tools of the fake news trade"—namely, Google AdSense accounts or agreements, payments received from advertising networks, or websites used to publish fake new stories and drive Internet traffic—to show circumstances and "equipment" which demonstrates the defendant had

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202. *Savinovich*, 845 F.2d at 837 (holding that because scales are tools of the drug trade, they are probative of intent to distribute); U.S. v. Billingsley, 160 F.3d 502, 506 (8th Cir. 1988) (holding that cutting agent, scales, and wrapping supplies found in defendant's apartment are "tools of the drug trade" and are inconsistent with a finding of personal use, but rather are indicative of intent to distribute); U.S. v. Brown, 7 F.3d 648, 656 (7th Cir. 1993) (holding weapons found in conjunction with narcotics may be considered "tools of the trade" and support a finding of intent to distribute); U.S. v. Espinoza, 684 F.3d 766, 779 (8th Cir. 2012) (holding evidence of multiple guns and ammunition admissible as "tools of the trade" to prove intent to distribute even when no drugs were found in the home).

203. *Savinovich*, 845 F.2d at 837 (holding that because guns are used in many drug transactions, it may reasonably be inferred that an armed possessor of drugs has more in mind than personal use . . . Thus, guns seized from a defendant's residence are admissible in trial for intent to distribute).

204. U.S. v. Winder, 557 F.3d 1129, 1138 (10th Cir. 2009).

205. Ind. Fed'n of Dentists, 476 U.S. at 454.

more in mind than personal use and intended to distribute fake news to profit from a deceptive, unfair practice.

vi. Multiple Types of Evidence

Combinations of two, three, or more of the aforementioned types of evidence have been held sufficient to establish intent to distribute in cases where one of these types of evidence may not have been sufficient alone.[206] The court may, for example, consider a certain quantity as sufficient to prove intent to distribute when augmented by evidence of distribution paraphernalia or "tools of the trade," large quantities of cash, or the value and quality of the substance.[207]

In *United States v. Shaw*, the court found that possessing 0.89 grams of cocaine, or approximately nine doses according to expert testimony, was insufficient alone to establish intent to distribute.[208] However, the defendant also possessed $1,776 in cash and a loaded pistol when the cocaine was discovered.[209] The court ultimately held that the additional evidence of a significant amount of cash and a loaded weapon—a "tool of the trade"—was sufficient to infer an intent to distribute despite the quantity of cocaine in possession being small.[210] In *Shaw*, the court thus considered a combination of the types of evidence to make a finding of intent to distribute.

Similarly, a court can examine a combination of the aforementioned types of evidence (i.e., quantity, cash or value, behavior, and network engagement) when making a determination as to whether a fake news author intended to distribute knowingly false news stories in order to profit from their targeted dissemination. Each inquiry should be fact-specific, with the FTC bearing the burden of proof, just as the burden is on the government under 21 U.S.C. § 841 (a)(1) to make a showing of intent to distribute.

CONCLUSION

Gone are the days of reliance upon printing presses, distribution centers, and delivery channels to place the news at your front door. There now is greater freedom to distribute information because the Internet and social media have empowered individual actors to inexpensively publish statements within seconds.[211] Unlike traditional press distribution and

206. Martin J. McMahon, Annotation, *Sufficiency of Evidence that Possessor of Cocaine Had Intent to Distribute It, so as to Violate 21 U.S. C.A. § 841(A)(1)*, 80 A.L.R. FED. 397 § II.3 (2004).

207. *Id.*

208. U.S. v. Shaw, 751 F.3d 918, 922 (8th Cir. 2014).

209. *Id.*

210. *Id.*

211. Benedict, *supra* note 76, at 484.

television broadcasting, the barriers to distribution on the Internet are low—there is no publisher, editor, broadcaster, or cable operator to act as a gatekeeper to the dissemination of information.[212] Anyone can establish a legitimate-looking website, create a Google AdSense account, write share-worthy falsehoods, and make money from the distribution of fake news. Now that most people obtain their news online, social media has become the main source of news for many.[213] Through these modern channels of media consumption, the harms of fake news can be spread instantaneously around the globe.[214] This recent, rapidly developing phenomenon poses serious public policy concerns for a democratic society.

The rulemaking authority of the FTC, this Note argued, provides the best option for stopping the spread of for-profit fake news. By focusing on for-profit fake news, action taken by the FTC is likely to survive a Constitutional challenge because commercial speech receives no First Amendment protection when it is inherently false or misleading. An industry-wide rule promulgated by the FTC should clearly define what constitutes improper conduct, so as to precisely and effectively disincentivize the actions and consequences associated with disseminating fake news.

The FTC should model its rule on a theory of criminal possession with intent to distribute, while penalizing offenders with civil fines instead of criminal prosecution. Possession with intent to distribute provides a useful analogy to the for-profit fake news industry. By focusing on an author's knowledge of the falsity of the story, actual or constructive authorship, and intent to distribute the falsehoods to as many people as possible to maximize profit, the FTC's focus will fall solely upon those individuals who pose serious public policy concerns while also not exceeding the scope of the FTC's authority under the FTC Act. Additionally, criminal possession with intent to distribute jurisprudence is built upon decades of varying theories for proving the elements of intent to distribute, many of which can be analogized to the issue of fake news. Such possession with intent to distribute frameworks thus serves as a strong foundation for the development of an FTC rule addressing the fake news epidemic.

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212. Ed Cook, *Everyone Now is a Publisher*, MEDIUM (May 10, 2019), https://medium.com/@edcook_1690/everyone-is-now-a-publisher-c7b4b1b0c1b7 [https://perma.cc/J9TV-C4LK].

213. Nicole Martin, *How Social Media Has Changed How We Consume News*, FORBES (Nov. 30, 2018, 4:26 PM), https://www.forbes.com/sites/nicolemartin1/2018/11/30/how-social-media-has-changed-how-we-consume-news/?sh=22a1d68c3c3c [https://perma.cc/2BK8-YVAN].

214. Chen, *supra* note 8, at 376.