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BUYER POWER IN THE DIGITAL ECONOMY: THE CASE OF UBER AND AMAZON

THOMAS K. CHENG*

Abuses of market power by the Big Tech companies have been an enforcement priority for antitrust authorities across the globe in recent years. The focus of enforcement has been abuses of market power on the seller's side. Buyer power abuses have hitherto received much less attention. This is largely because antitrust has always held a somewhat ambivalent attitude toward buyer power abuses. Analysis of such abuses has been mostly informed by the monopsony model, which only account for a small fraction of buyer power abuses by the digital behemoths. The remainder of buyer power abuses that arise in the bargaining context have often been dismissed on the grounds that antitrust has no business interfering with arms-length commercial transactions between two well-informed parties. This Article examines buyer power abuses in the digital context with the examples of Uber and Amazon. It argues that the digital setting has rendered the welfare effects of potential abuses by Uber more benign. It further argues that while some of Amazon's conduct may call for regulatory responses, antitrust may not be the appropriate tool to address it. New legislation may be needed.

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INTRODUCTION

Digital economy issues have taken the field of antitrust by storm. Each of the GAFA or GAMA companies, Google, Apple, Facebook (since renamed Meta), and Amazon, has been the subject of an investigation or lawsuit on either side of the Atlantic. The theories of harm in these cases run the gamut. With Google, at least within the European Union ("EU"), the

focus has been on what has been termed self-preferencing conduct in its online services.[1] This refers to preferential treatment of Google's own services on Google Search that allegedly helps Google to leverage its market position from search, where it is highly dominant, to adjacent or related markets, such as shopping comparison.[2] Apple has been sued by Epic Games in connection with its refusal to allow apps to conduct transactions with users outside of the App Store.[3] In a decision that is viewed as a partial victory for both parties, Judge Yvonne Gonzalez Rogers found that Epic Games failed to prove that Apple possesses monopoly power in the app store market, but prohibited Apple from continuing its prior practice of requiring all payments to be processed on its App Store under California state law.[4]

Meta has faced serious privacy issues. A German court held that Meta's collection of user data was an abuse of dominance[5] and the European Commission has recently launched an investigation into whether an agreement between Google and Meta regarding online display advertising infringes EU competition law.[6] Lastly, Amazon's policies on the Amazon Marketplace and its treatment of its sellers have attracted attention from regulators in both the United States and Europe. Both the U.S. Federal Trade Commission ("FTC") and the European Commission have launched investigations into Amazon's use of data from third-party sellers to give its own products an unfair advantage.[7] The Italian Competition Authority

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1. Case T-612/17, Google LLC v. Comm'n, ECLI:EU:T:2021:763 (Nov. 10, 2021).

2. *Id.* at ¶¶ 143–49.

3. Epic Games, Inc. v. Apple Inc., 559 F.Supp. 3d 898, 923 (N.D. Cal. Sept. 10, 2021).

4. *Id.* at 922.

5. Adam Satariano, *Facebook Loses Antitrust Decision in Germany Over Data Collection*, N.Y. Times, June 23, 2020, https://www.nytimes.com/2020/06/23/technology/facebook-antitrust-germany.html.

6. European Commission Press Release IP/22/1703, Antitrust: Commission Opens Investigation into Possible Anticompetitive Conduct by Google and Meta, in Online Display Advertising (Mar. 11, 2022), https://ec.europa.eu/commission/presscorner/detail/en/ip_22_1703.

7. European Commission Press Release IP/20/2077, Antitrust: Commission sends Statement of Objections to Amazon for the use of Non-public Independent Seller Data and Opens Second Investigation into its E-commerce Business Practices (Nov. 10, 2020), https://ec.europa.eu/commission/presscorner/detail/en/ip_20_2077 [hereinafter Eur. Comm'n]; Tyler

has imposed hefty fines on Amazon for coercing its third-party sellers to use Amazon's logistical services.[8]

What has thus far escaped the enforcers' attention is monopsony power or buyer power abuses. In one sense, this is hardly surprising. The law on seller-side monopolization is considerably more developed than that on buyer power abuses. The last prominent monopsonization case in the United States was *Weyerhaeuser v. Ross-Simmons*.[9] The case, which concerned predatory bidding, spawned a fierce debate about whether predatory bidding should be treated as the mirror image of predatory pricing and whether the analytical framework from *Brooke Group* should be applied to predatory bidding.[10] This debate, however, has relatively little salience to the digital economy; there have been few allegations of predatory bidding in the online world thus far. Predatory bidding is probably more likely to take place in the commodities markets.[11]

This does not mean that the digital economy is devoid of buyer power issues. Amazon has been accused of imposing unduly harsh contractual terms on its suppliers and third-party sellers. Some of these terms may have helped Amazon leverage its market position while some others are purely exploitative. Amazon has reportedly even forced its suppliers to sell it an equity stake.[12] Despite Epic Games' valiant effort to character-

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Sonnemaker, *Amazon is Reportedly Facing a New Antitrust Investigation into its Online Marketplace Led by the FTC and Attorneys General in New York and California*, INSIDER (Aug. 4, 2020, 7:36 PM), https://www.businessinsider.com/amazon-antitrust-probe-ftc-new-york-california-online-marketplace-2020-8.

8. Adam Satariano, *Amazon is Fined $1.3 Billion in Italy over Antitrust Violations*, N.Y. TIMES (Dec. 9, 2021), https://www.nytimes.com/2021/12/09/business/amazon-italy-fine.html; Elvira Pollina & Maria Pia Quaglia, *Italy Fines Amazon Record $1.3 Bln for Abuse of Market Dominance*, REUTERS (Dec. 10, 2021, 5:28 PM), https://www.reuters.com/technology/italys-antitrust-fines-amazon-113-bln-euros-alleged-abuse-market-dominance-2021-12-09/.

9. Weyerhaeuser Co. v. Ross-Simmons Hardwood Lumber Co., 549 U.S. 312 (2007).

10. *Id.* at 313.

11. Michael E. Haglund, *Weyerhaeuser's Aftermath: Increased Vulnerability of Resource-based Input Markets to Monopsony*, 53 ANTITRUST BULL. 411, 440–41 (2008).

12. Dana Mattioli, *Amazon Demands One More Thing from Some Vendors: A Piece of Their Company*, WALL ST. J. (June 29, 2021, 8:01 AM), https://www.wsj.com/articles/amazon-demands-one-more-thing-from-some-vendors-a-piece-of-their-company-11624968099.

ize Apple's conduct as exclusionary, Epic Games' ultimate gripe was that Apple imposes excessive charges for use of its App Store.[13] Given that Epic Games and other app developers are suppliers of apps, the dispute essentially amounts to a case about excessive low wholesale prices offered by Apple. Further back in time, Uber's treatment of its drivers captured much media attention. The question of whether Uber drivers constitute employees or subcontractors, and, if they count as employees, whether they should be allowed to unionize, generated significant controversy.[14] Uber has also been criticized for mistreating its drivers.[15] The wave of criticisms and lawsuits eventually forced Uber to grant its drivers better remuneration and to recognize its drivers as workers in some jurisdictions.[16]

These three instances of exercise of buyer power all raise interesting issues. The starting point of an economic analysis of buyer power issues has long been the classic monopsony model, under which the monopsonist must reduce demand in order to artificially suppress prices.[17] This will lead to a reduction in market output and a deadweight loss.[18] With the notable exceptions of commodities and labor markets, however, very few real-world markets fit into this model.[19] Uber's interaction with its drivers is possibly one of them. Application of

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13. Complaint at 1, Epic Games, Inc. v. Apple Inc., 559 F.Supp. 3d 898 (N.D. Cal. 2021) (No. 20-5640) (noting "Apple exacts an oppressive 30% tax on the sale of every app.")

14. People v. Uber Techs., Inc., 270 Cal. Rptr. 3d 290 (Ct. App. 2020); Adv. Mem. Off. Gen. Counsel, 367 N.L.R.B. (2019), https://www.nlrb.gov/case/13-CA-163062.

15. Michael Sainato, *"They Treat us like Crap": Uber Drivers Feel Poor and Powerless on Eve of IPO*, The Guardian (May 7, 2019, 2:00 PM), https://www.theguardian.com/technology/2019/may/07/uber-drivers-feel-poor-powerless-ipo-looms; Kathianne Boniello, *Like Uber, Lyft, Ride-sharing App Via Accused of Mistreating Drivers*, N.Y. Post (Mar. 13, 2021, 7:54 PM), https://nypost.com/2021/03/13/like-uber-ride-sharing-app-via-accused-of-mistreating-drivers/.

16. Adam Satariano, *In a First, Uber Agrees to Classify British Drivers as "Workers,"* N.Y. Times (Mar. 16, 2021), https://www.nytimes.com/2021/03/16/technology/uber-uk-drivers-worker-status.html.

17. Roger D. Blair & Jeffrey L. Harrison, Monopsony in Law and Economics 41–45 (2010).

18. *Id.* at 45–48.

19. *Id.* at 172–204; Chris Doyle & Roman Inderst, *Some Economics on the Treatment of Buyer Power in Antitrust*, 28(3) Eur. Competition L. Rev. 210, 211 (2007).

the classic monopsony model to Uber will show whether and how the model needs to be adapted to the digital setting and whether such adaptations will alter the policy prescriptions for monopsonistic conduct in the online world.

Apple and Amazon's relationships with their suppliers, respectively, require a different theoretical model. Unlike the classic monopsony model, which is populated by atomistic sellers selling their supply at the prevailing market price, Apple and Amazon enjoy a more individual relationship with their suppliers where the wholesale price is set by bargaining conducted through all-or-nothing offers. The individual bargaining relationships mean that Apple and Amazon can push for lower prices without necessarily curtailing their demands. The all-or-nothing bargaining model is thus the relevant paradigm.

It will be didactic to examine how exercise of such bargaining power is affected by and adapted to the digital setting. Many of the accusations leveled at Amazon are not new. They have been previously leveled at powerful brick-and-mortar retailers such as Walmart in the United States and the big four supermarkets of Tesco, Sainsbury, Asda, and Morrisons in the United Kingdom. Walmart's buyer power abuses have generally not been subject to scrutiny in the United States, while the United Kingdom has resorted to industry codes of conduct to address the issue. These codes have not put an end to such abuses.[20] Does Amazon's digital setting render its bargaining power more problematic and warrant a different regulatory response? Or is it a case of old wine in new bottles?

This Article is divided into five Parts. After the Introduction, Part I provides an overview of buyer power and describes the three models of buyer power, monopsony power, bargaining power, and retailer gatekeeper power, which is a specific type of bargaining power. Part II explains the competitive harm of buyer power, namely the waterbed effect, quality erosion, increased concentration in the supply chain, creation of downstream market power, reduced investment incentives for upstream suppliers, and wealth transfer from sellers to powerful buyers.

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20. Sarah Butler, *Tesco Suppliers Say Retailer Worst at Following Grocery Code of Practice*, THE GUARDIAN (June 22, 2015, 8:02 AM), https://www.theguardian.com/business/2015/jun/22/tesco-suppliers-say-retailer-worst-at-following-grocery-code-of-practice.

After introducing the models of buyer power and the possible competitive harm of such power, Uber and Amazon will be discussed as illustrations of digital buyer power. Uber and Amazon are chosen because they exemplify the two essential models of buyer power of monopsony and the all-or-nothing bargaining model in the digital context. Part III discusses Uber as a digital monopsonist. It delves into Uber's technological capacity to monopsonize and the welfare effects of Uber's digital monopsony and concludes that the opportunity afforded to Uber to practice more precise price discrimination by virtue of its digital operation may in fact reduce the detrimental welfare effects of classic monopsony.

Part IV focuses on Amazon as a digital gatekeeper and examines Amazon's bargaining power vis-à-vis its suppliers and third-party sellers. It catalogs allegations of buyer power abuses perpetrated by Amazon, which include excessively low wholesale prices, Most Favored Nation ("MFN") clauses, unduly harsh contractual terms, tying, unfair competition with third-party sellers, and coerced investment. It asserts that apart from MFN clauses and tying, which readily fall within the ambit of existing antitrust law, the remaining abuses do not lend themselves to easy solution. The only practice the regulation of which rests on a solid theoretical basis and does not face insurmountable implementation obstacles is retroactive amendment of contractual terms. The remainder of Amazon's practices may require new legislation. Part V offers proposals for possible policy responses to these abuses.

I.
BUYER POWER—AN OVERVIEW

A. *Defining Buyer Power*

Whether unilateral buyer power abuses deserve special attention, or perhaps any attention, from antitrust has been the subject of a long-running debate. This is to be distinguished from buyer cartels, which raise different issues.[21] This Article is concerned with unilateral buyer power abuses.[22] Atomistic sell-

21. BLAIR & HARRISON, *supra* note 17, at 107–12.

22. The term "monopsony power" will be used to refer to a particular kind of unilateral buyer power where the powerful buyer faces atomistic sellers, in contradistinction with all-or-nothing bargaining power, or bargaining power for short.

ers are arguably even more vulnerable than consumers. These sellers are more dependent on their buyers than consumers are on their sellers due to a variety of reasons such as sunk costs and relation-specific investments.[23] They are hence worthier of protection. Other scholars insist that "there is nothing special about market power on the buyer side of markets,"[24] and that there is no basis for different treatment of unilateral buyer power abuses beyond the traditional doctrines on vertical restraints and monopolization.[25] This Article does not aim to settle this debate, even though this Author is more sympathetic to the pro-interventionist views of the first group of scholars. Instead, this Article seeks to answer whether the terms of this debate need to shift as the economy continues to digitize.

Without attempting to decide whether atomistic sellers or final consumers are more deserving of protection, one implication that emerges in a comparison between seller-side market power and buyer power is that a much smaller market share is necessary to give a powerful buyer control over its suppliers.[26] To understand this, one must probe the notion of market power. Market power conveys the state of competition in the market, or, more precisely, the availability of alternatives. When it is said that a seller has limited market power, it means that there are ample reasonable substitutes available in the market which will prevent the seller from raising prices.[27] Likewise, when a buyer is said to have meagre buyer power, it indicates that there are alternative buyers available to absorb the seller's supply.[28]

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23. Warren S. Grimes, *Buyer Power and Retail Gatekeeper Power: Protecting Competition and the Atomistic Seller*, 72 ANTITRUST L.J. 563, 563 (2005).

24. Richard Scheelings & Joshua D. Wright, *'Sui Generis'?: An Antitrust Analysis of Buyer Power in the United States and European Union*, 39 AKRON L. REV. 207, 210 (2006).

25. *Id.* at 211–12.

26. *See* Peter C. Carstensen, *Buyer Power, Competition Policy, and Antitrust: the Competitive Effects of Discrimination Among Suppliers*, 53 ANTITRUST BULL. 271, 314 (2008). Seller-side market power of course can be exercised vis-à-vis downstream firms that buy a product either as an input of production or for resale.

27. *See* LAWRENCE A. SULLIVAN, WARREN S. GRIMES & CHRISTOPHER L. SAGERS, THE LAW OF ANTITRUST: AN INTEGRATED HANDBOOK 32 (3d ed. 2016).

28. *Id.*

A seller and a final consumer seek different alternatives or substitutes when trying to circumvent market or buyer power. A final consumer purchases a product for personal consumption. At the final consumer level, it is rare for any buyer to account for a significant portion of the market demand. All that it takes for an individual consumer to defeat a seller's market power is an alternative supply of what she purchases for personal use. She also has the option of doing without the product. In contrast, a powerful buyer purchases supply for resale or as an input in its production. It is not uncommon for a buyer to absorb a substantial proportion of a seller's output. Walmart accounted for eleven to seventeen percent of the output of suppliers as prominent as Procter & Gamble, Kellogg, and Kraft.[29] When a seller seeks an alternative buyer, it needs to find one that can take over the previous buyer's purchases. If a buyer absorbs twenty percent of a seller's output, the seller will need to find other buyers to purchase that amount of output to defeat that buyer's exercise of buyer power. It goes without saying that it is much more difficult to find a buyer for twenty percent of one's output than another brand of smartphone. The seller does not have the option of abstention either. For a supplier that operates on slim margins, losing twenty percent or even ten percent of its sales could be a matter of the business' life or death. Therefore, in the *Toys 'R' Us* case, the court found that Toys 'R' Us had substantial buyer power over its suppliers even though it only bought twenty percent of all toys sold in the United States.[30]

To make matters worse, switching buyers can entail substantial costs. This is especially true if relation-specific investments are involved. If a particular buyer requires special packaging or logistical arrangement, it could be very difficult to switch buyers in the short term.[31] It is small surprise that the UK Competition Commission found that a market share of eight percent could be sufficient to give a retailer significant

29. Christian Rojas, Nathalie Lavoie, & Shinn-Shyr Wang, *Buyer Power and Vertically Differentiated Retailers*, 10 J. AGRIC. & FOOD INDUS. ORG. 1, 1 (2012).

30. Carstensen, *supra* note 26, at 295.

31. *See* Ariel Ezrachi, *Unchallenged Market Power? The Tale of Supermarkets, Private Labels, and Competition Law*, 33 WORLD COMPETITION: L. & ECON. REV. 257, 266 (2010).

unilateral buyer power.[32] Even though this discussion does not settle the question of whether antitrust should scrutinize unilateral buyer power abuses in the digital economy, it does suggest that a much lower market share would suffice to confer meaningful unilateral buyer power. Market share is not the only relevant factor in determining unilateral buyer power. The elasticity of market supply and the elasticity of demand of the fringe buyers are also important considerations.[33]

A number of definitions have been offered by scholars and international organizations such as the Organization of Economic Co-operation and Development ("OECD") for unilateral buyer power (heretofore "buyer power" for short). The exact language varies but all previously offered definitions encapsulate the idea that buyer power exists when a powerful buyer, by virtue of its position in the market, is able to command favorable or preferential supply terms that are not available to other buyers in a competitive market.[34] Warren Grimes defines buyer power as "the ability of a buyer to significantly influence the terms of a purchase for reasons other than efficiency."[35] Roger Noll suggests that a powerful buyer can depress prices below the competitive level.[36] A powerful buyer may not only be interested in lower prices, or in lower prices alone. It may demand other favorable contractual terms as well.[37] Thus the OECD defines buyer power as "the situation which exists when a firm or a group of firms, either because it has a dominant position as a purchaser of a product or a service or because it has strategic or leverage advantages as a result of its size or other characteristics, is able to obtain from a

32. Paul W. Dobson, *Exploiting Buyer Power: Lessons from the British Grocery Trade*, 72 ANTITRUST L.J. 529, 535 (2005).

33. *See* Roger D. Blair & Jeffrey L. Harrison, *The Measurement of Monopsony Power*, 37 ANTITRUST BULL. 133, 146–47 (1992).

34. Zhiqi Chen, *Buyer Power: Economic Theory and Antitrust Policy*, 22 RSCH. IN L. & ECON. 17, 19 (2007); Maurice E. Stucke, *Looking at Monopsony in the Mirror*, 62 EMORY L.J. 1509, 1516–17 (2013); Paul W. Dobson et al., *Buyer Power and its Impact on Competition in the Food Retail Distribution Sector of the European Union*, 1 J. INDUS., COMPETITION & TRADE 247, 248–49 (2001).

35. Grimes, *supra* note 23, at 565.

36. *See* Roger G. Noll, *"Buyer Power" and Economic Policy*, 72 ANTITRUST L.J. 589, 589 (2005).

37. Dobson et al., *supra* note 34, at 248–49; Stucke, *supra* note 34, at 1516.

supplier more favorable terms than those available to other buyers."[38]

The distinction between an exercise of buyer power and normal negotiations is that, in the presence of buyer power, the buyer is able to extract contractual terms that would not be available under normal competitive conditions.[39] The aforementioned definitions suggest that the focus is on the outcome of market interaction or negotiation and, in particular, whether the outcome deviates from some notional competitive outcome.[40] In the case of monopsonistic suppression of purchase price, a comparison is made against a competitive benchmark. In the case of other terms of supply, where it is difficult to postulate some hypothetical competitive terms of supply, the comparator would be "those [terms] available to other buyers or those that would otherwise be expected to be available under normal competitive conditions."[41] The only basis upon which one can postulate such benchmark supply terms would be some notion of fairness, for example, under the unfair trade regulation of some jurisdictions.[42] The objectivity of conceptions of "fairness" when applied in this context is open to dispute. This debate is closely tied to the question of the feasibility of regulating contractual terms that are purely exploitative and not exclusionary in nature, which will have bearing on how some buyer power abuses by digital platforms should be regulated, if at all.

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38. Chen, *supra* note 34, at 19 (citing OECD, COMMITTEE OF EXPERTS ON RESTRICTIVE PRACTICES, BUYING POWER: THE EXERCISE OF MARKET POWER BY DOMINANT BUYERS 10 (1981)).

39. *See* PAUL W. DOBSON, MICHAEL WATERSON & ALEX CHU, *The Welfare Consequences of the Exercise of Buyer Power*, OFFICE OF FAIR TRADING 5–6 (Sep. 1998), https://wrap.warwick.ac.uk/21/1/WRAP_Waterson_oft239.pdf.

40. Gordon Mills, *Buyer Power of Supermarkets*, 10 AGENDA: J. OF POL'Y ANALYSIS & REFORM 145, 145 (2003) (defining buyer power to refer to situations "when, for like transactions, it can obtain from a supplier terms that are more favourable (for the buyer) than those available to other buyers.")

41. Zhiqi Chen, *Defining Buyer Power*, 53 ANTITRUST BULL. 241, 245 (2008) (quoting ROGER CLARKE, STEPHEN DAVIES, PAUL W. DOBSON & MICHAEL WATERSON, BUYER POWER AND COMPETITION IN EUROPEAN FOOD RETAILING 2 (2002)).

42. Examples include Japan and Korea. The antitrust law of these jurisdictions, the Anti-Monopoly Act in Japan and the Monopoly Regulation and Fair Trade Act, both contain provisions that regulate unfair trade practices. Monopoly Regulation and Fair Trade Act ("MRFTA"), Law 3320/1980; Dokusenkinshi ho [Anti-Monopoly Law], Law No. 54 of 1947.

B. *Taxonomy of Buyer Power*

1. *Monopsony Power*

There are two contexts in which buyer power is exercised. The first context is the classic monopsony model where a powerful buyer wields what is known as monopsony power.[43] In this model, the relevant parameter is price. The powerful buyer faces numerous atomistic sellers who are price-takers.[44] The powerful buyer alone faces the market supply curve, which means its demand will have a direct impact on the market price.[45] If the buyer wants a lower price, it can only do so by reducing its own demand. This results from the fact that the buyer must offer the same price for every unit of output it purchases.[46] When the powerful buyer reduces its demand, market output is lowered, resulting in a deadweight loss. Ultimately, a monopsonist exercises its market power by withholding demand, just like a monopolist exercises market power by withholding supply.[47]

Exercise of monopsony power is premised on a few conditions, which include situations in which "(i) the buyers contribute to a substantial portion of purchases in the market; (ii) there are barriers to entry into the buyer's market; and (iii) the supply curves are upward sloping."[48] Furthermore, when a monopsonist attempts to depress the market price by reducing its demand, the same price must apply to all of the units purchased.[49] In other words, the monopsonist is unable to resort to non-linear pricing.[50] The final two prerequisites are particularly important for monopsony power. It is only when the supply curve is upward sloping that the buyer faces a tradeoff be-

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43. *See* BLAIR & HARRISON, *supra* note 17, at 41–45.

44. *Id.* at 48.

45. *See* Ariel Ezrachi, *Buying Alliances and Input Price Fixing: In Search of a European Enforcement Standard*, 8 J. COMPETITION L. & ECON. 47, 48 (2012).

46. *See* BLAIR & HARRISON, *supra* note 17, at 42.

47. Chris Doyle & Roman Inderst, *Some Economics on the Treatment of Buyer Power in Antitrust*, 3, https://www.wiwi.uni-frankfurt.de/profs/inderst/Competition_Policy/Articles%20and%20Book%20Chapters%20on%20applied%20Competition%20Economics/Some_Economics_06.pdf (last visited Apr. 5, 2022).

48. ROGER CLARKE ET AL., BUYER POWER AND COMPETITION IN EUROPEAN FOOD RETAILING 12 (2002).

49. Chen, *supra* note 34, at 22.

50. *Id.*

tween quantity and price.[51] This tradeoff would not exist if the buyer faced a perfectly elastic supply curve. The hallmark of monopsony power is "the depression of quantity purchased by a buyer."[52] The harmful welfare effects and deadweight loss only materialize because a monopsonist must offer the same price for all units purchased under linear pricing.[53] The welfare analysis would be different if price discrimination or other forms of non-linear pricing such as two-part tariffs were possible.[54] The requirement of linear pricing is not a prerequisite for monopsony power itself, but the condition for the harmful welfare effects of such power.

The welfare effects of monopsony power are not affected by the competitiveness of the downstream market. Deadweight loss results regardless of the degree of competitiveness of the downstream market.[55] The only determinant is whether linear pricing applies. The effect on consumers, however, *would* depend on the degree of competitiveness of the downstream market. If the downstream market is competitive and the monopsonist is a price taker in that market, other sellers should be able to fill any supply gap left by the monopsonist due to its curtailed purchase of the upstream input.[56] There should be no immediate impact on the price and output in the downstream market.[57] Alternatively, if the monopsonist has market power in the downstream market, the monopsonist would be able to raise prices by reducing downstream output.[58] This would create deadweight loss in the downstream market as well, which would be doubly harmful to consumers.[59] There is, hence, no reason to believe that the lower input prices will be passed on to consumers in the form of lower prices for the final product, which is often invoked to defend the exercise of buyer power.[60] The best-case scenario for final

51. *Id.*
52. Chen, *supra* note 41, at 243.
53. Chen, *supra* note 34, at 34.
54. *Id.* at 22, 34.
55. *Id.*
56. James Mellsop & Kevin Counsell, *Assessing the Implications of Upstream Buyer Power on Downstream Consumers*, ANTITRUST INSIGHTS, 4 (2009).
57. Carstensen, *supra* note 26, at 282.
58. Roger D. Blair & Jeffrey L. Harrison, *Antitrust Policy and Monopsony*, 76 CORNELL L. REV. 297, 305–06 (1991).
59. Carstensen, *supra* note 26, at 282–83.
60. Noll, *supra* note 36, at 606.

consumers would seem to be no change in price and output in the final product market. Zhiqi Chen argues that even if the upstream buyer and seller are able to use efficient contracts to minimize deadweight loss, monopsony power would still yield no benefit to final consumers.[61]

In addition to the deadweight loss resulting from a reduction in the output of the monopsonized input, welfare loss also results from inefficient substitution of imperfect substitutes.[62] Assuming that there are imperfect substitutes for the monopsonized input, the monopsonist may make the substitution after cutting back on the monopsonized input. Production of the downstream output will become less efficient.[63] Meanwhile, the lower price of the monopsonized input may cause other downstream competitors to make inefficient substitution for that input, again rendering their production of the downstream output less efficient. Such inefficient substitutions may cause the downstream product to be under-supplied, resulting in higher prices for the final consumers.[64] In light of all these distortions in both the upstream and downstream markets, Roger Blair and John Lopatka advocate for the condemnation of anticompetitive practices that lead to monopsony pricing.[65]

2. *Bargaining Power (in All-or-Nothing Negotiations)*

Monopsony power is rare in practice. Unilateral buyer power in most real-world cases involves a superior bargaining position in bilateral negotiations. Exercising superior bargaining power allows the powerful buyer to reduce prices without suppressing its demand.[66] The powerful buyer does so by issuing an all-or-nothing offer, which pushes the seller onto an all-or-nothing supply curve[67] where quantity and price are no longer necessarily negatively correlated.[68] A powerful buyer

61. Chen, *supra* note 34, at 28.
62. Noll, *supra* note 36, at 595.
63. *Id.*
64. *Id.* at 596.
65. Roger D. Blair & John E. Lopatka, *Predatory Buying and the Antitrust Laws*, 2008 UTAH L. REV. 415, 444 (2008).
66. Stefan Thomas, *Ex Ante and Ex Post Control of Buyer Power*, *in* ABUSIVE PRACTICES IN COMPETITION LAW 283, 288 (Fabiana Di Porto & Rupprecht Podszun eds., 2018).
67. Blair & Harrison, *supra* note 58, at 317–18.
68. Thomas, *supra* note 66, at 289.

can pursue four strategies to inflict its bargaining power: "take it or leave it" offers, threats of selective withholding of demand for less critical products, buyer-demanded exclusivity, and buyer-demanded tying practices.[69]

Sellers are susceptible to all-or-nothing offers in several scenarios. The first scenario is where supply is so inelastic that a powerful buyer can reduce its purchase price by demanding non-cost justified discounts without reducing its quantity of purchase.[70] The second scenario is where the seller has expended significant sunk costs in the supply relationship.[71] If the seller has made specific investments to create tailored packaging or special logistical arrangements for a particular buyer, the seller will likely tolerate a substantial price reduction before abandoning the supply relationship. The third scenario is where significant economies of scale in production or a high minimum efficient scale persist.[72] A seller may be loath to lose scale and push up its costs of production across the board by losing sales to a powerful buyer. And where significant fixed costs exist which can only be recouped when production operates at a sufficient scale, a seller may also try to avoid losing sales to avoid dipping below the minimum efficient scale. The final and a likely scenario is where the demand side of an input is concentrated while the supply side exhibits product differentiation.[73] In a market with low entry barriers where each supplier charges a price equal to their long-run average cost,[74] a powerful buyer can extend all-or-nothing offers at a price above the marginal cost but below the long-run average cost.[75] Most suppliers would have the incentive to accept the offer so long as marginal cost is covered.[76] These four scenarios are not mutually exclusive. It is possible for a market to combine economies of scale and inelastic demand, or significant sunk costs on the part of the seller with a high minimum efficient scale.

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69. Ioannis Kokkoris, *Buyer Power Assessment in Competition Law: A Boon or a Menace?*, 29 World Competition 139, 142 (2006).
70. Thomas, *supra* note 66, at 288.
71. Grimes, *supra* note 23, at 567.
72. Carstensen, *supra* note 26, at 300.
73. Noll, *supra* note 36, at 610.
74. *Id.*
75. *Id.* at 611.
76. *Id.*

Negotiations may not be confined to price. A powerful buyer can exercise its bargaining power to obtain favorable contractual terms on other parameters. The OECD thus describes the exercise of buyer power as a situation where a buyer "can credibly threaten to impose a long term opportunity cost (i.e. harm or withheld benefit) which, were the threat carried out, would be significantly disproportionate to any resulting long term opportunity cost to itself."[77] This captures the notion that buyer power in a bilateral bargaining context is ultimately about a comparison of what economists have called "outside-option payoff" or "disagreement payoff."[78] This payoff refers to what the party would stand to lose if the negotiation fails. As Ariel Ezrachi suggests, in the bargaining context, "lower prices are obtained by the threat of shifting demand, rather than the actual withholding of demand."[79] The party that stands to lose less or has more readily available alternatives would wield greater bargaining power.

The existence of greater competition on one side of the market will give the counterparty greater bargaining power, all else being equal, as it means that the counterparty will have more alternatives to turn to.[80] Size can cut both ways as far as bargaining power is concerned.[81] A large share on the buyer's side of the market gives the buyer greater leverage, as the withdrawal of a large portion of demand from a seller is more likely to jeopardize the seller's economic viability.[82] But such share also makes the threat of withdrawal less credible when the seller knows that the buyer has no meaningful alternative source of supply to replace itself. A large buyer, however, may be better positioned to sponsor new market entry given the size of its order, which would allow the entrant to cover more

77. Org. for Econ. Coop. & Dev. [OECD], *Buying Power of Multiproduct Retailers*, at 281 (1998), https://www.oecd.org/competition/abuse/2379299.pdf.

78. Paul W. Dobson & Roman Inderst, *The Waterbed Effect: Where Buying and Selling Power Come Together*, 2008 WIS. L. REV. 331, 338 (2008).

79. Ezrachi, *supra* note 45, at 50.

80. Scheelings & Wright, *supra* note 24, at 220.

81. Walter Beckert, *Empirical Analysis of Buyer Power*, 3–4 (Ctr. for Microdata Methods & Prac., Working Paper No. CWP17/09, 2009), https://www.econbiz.de/Record/empirical-analysis-of-buyer-power-beckert-walter/10003854239.

82. Dobson & Inderst, *supra* note 78, at 339–40.

of its fixed costs.[83] When a powerful buyer holds an edge in bargaining power over a seller, it is said to possess "all-or-nothing bargaining power" or "bargaining power" for short. John Kirkwood defines bargaining power as "the power to obtain a concession from another party by threatening to impose a cost, or withdraw a benefit, if the party does not grant the concession."[84]

The welfare consequences and consumer impact of bargaining power are less obvious, at least in the short term. If output level remains the same following the price reduction, and the seller does not adjust the prices it charges other buyers, exercise of bargaining power will usually only result in a wealth transfer from the seller to the powerful buyer.[85] The welfare effect is purely redistributive.[86] This will be especially true if the seller can resort to non-linear pricing or two-part tariffs, which would allow the buyer to extract surplus from the seller without affecting the per-unit wholesale price.[87] This led Richard Scheelings and Joshua Wright to assert that antitrust has no role to play in regulating bargaining between sellers and buyers, arguing that these are merely routine commercial transactions where the negotiating parties strive for the best bargain for themselves.[88] Similarly, Chris Doyle and Roman Inderst contend that in a bilateral negotiation setting, "the exercise of buyer power should be seen as leading primarily to the realisation of individual discounts."[89]

In fact, some have gone so far as to suggest that exercise of bargaining power can be welfare-enhancing.[90] They argue that the only reason the seller can reduce prices in response to the powerful buyer's demand is that the seller commands at

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83. *Id.* at 339.

84. Chen, *supra* note 41, at 244.

85. Ezrachi, *supra* note 45, at 50–51.

86. *See* Roger D. Blair & Jessica S. Haynes, *Monopsony, monopsony power, and antitrust policy*, *in* RESEARCH HANDBOOK ON THE ECONOMICS OF ANTITRUST LAW, 249 (Einer Elhauge ed., 2012); *see also* Blair & Harrison, *supra* note 58, at 318.

87. *See* Chen, *supra* note 34, at 22.

88. *See* Scheelings & Wright, *supra* note 24, at 242–43.

89. Chris Doyle & Roman Inderst, *Some economics on the treatment of buyer power in antitrust*, 2007 EUR. COMPETITION L. REV. 210, 212 (2007).

90. *See, e.g.*, Ariel Ezrachi & Koen De Jong, *Buyer power, private labels and the welfare consequences of quality erosion*, 2012 EUR. COMPETITION L. REV. 257, 258 (2012).

least some market power and the current price is supra-competitive.[91] Therefore, a powerful buyer flexing its muscles merely pushes the wholesale price back or closer to the competitive level. While that would no doubt ameliorate allocative efficiency loss, whether consumers will benefit would depend on whether the powerful buyer passes its savings on to consumers, an unlikely outcome absent competitive pressure in the downstream market.[92]

3. *Retailer Gatekeeper Power*

One species of bargaining power in all-or-nothing negotiations which has attracted considerable attention across jurisdictions is retailer gatekeeper power. This form of buyer power is also of greatest interest at present as digital platforms such as Amazon have often been described as gatekeepers as well. In the pre-digital world, retailer gatekeeper power most often arose in the context of the grocery market: Walmart in the case of the United States,[93] the big four grocery stores in the United Kingdom,[94] and Woolworths and Coles in Australia.[95]

An FTC report distinguishes between three types of buyer power: monopsony power, buyer power without monopsony [bargaining power], and gatekeeper power.[96] The report notes that bargaining power can also be subsumed under the rubric of the gatekeeper power of multi-brand retailers.[97] One

91. *Id.* at 258.

92. *See* Chen, *supra* note 34, at 35–36.

93. *See generally* Albert A. Foer, *Mr. Magoo Visits Wamart: Finding the Right Lens for Antitrust*, 39 CONN. L. REV. 1307 (2007).

94. *See generally* UK COMPETITION COMM., THE SUPPLY OF GROCERIES IN THE UK MARKET INVESTIGATION (2008), https://webarchive.nationalarchives.gov.uk/ukgwa/20140402235418mp_/http://www.competition-commission.org.uk/assets/competitioncommission/docs/pdf/non-inquiry/rep_pub/reports/2008/fulltext/538.pdf.

95. *See* Barbara Jedlickova, *Vertical Issues Arising from Conduct Between Large Supermarkets and Small Suppliers in the Grocery Market: Law and Industry Codes of Conduct*, 36(1) EUR. COMPETITION L. REV. 19, 20 (2015).

96. *See* FED. TRADE COMM., REPORT ON THE FEDERAL TRADE COMMISSION WORKSHOP ON SLOTTING ALLOWANCES AND OTHER MARKETING PRACTICES IN THE GROCERY INDUSTRY, 8 (2001), https://www.ftc.gov/sites/default/files/documents/reports/report-federal-trade-commission-workshop-slotting-allowances-and-other-marketing-practices-grocery/slottingallowancesreportfinal_0.pdf.

97. *See id.* at 58.

way to understand the relationship between the latter two is that the role of a gatekeeper as a critical retail outlet gives the retailer particularly strong bargaining power in bilateral negotiations with its suppliers.[98] The nature of the bargaining power is the same but exercised in the specific context of retail, and, very often, grocery retail.

Retailers, especially grocery retailers, occupy a gatekeeper role for several reasons. First, these retailers play three important and often overlapping roles vis-à-vis their suppliers. The retailer is a customer, a competitor, and a supplier or seller to its suppliers all at once.[99] A retailer is obviously a customer when it purchases goods from the suppliers. A retailer is a competitor when it offers its own private label products in competition with its suppliers' products.[100] Lastly, a retailer serves as a supplier when it sells shelf space to suppliers in exchange for listing fees or slotting allowances.[101] They also sell in-store promotional opportunities to suppliers.

The role of retailer as a competitor is particularly critical to its gatekeeper power because it significantly increases its outside-option payoff in its negotiation with suppliers. With the exception of "must stock" brands that consumers follow across retailers, private label products render a brand much more fungible to the retailer.[102] If the negotiation breaks down, the retailer can quickly replace that supplier's products with in-house products instead of scrambling to find another supplier.[103] Private label products hence give a retailer considerable leverage over its suppliers. An empirical study in Germany confirms this, although the study suggests that the positioning of the private label products vis-à-vis the national brands makes a critical difference in their contribution to the retailer's bargaining power.[104]

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98. *See id.*

99. Dobson, *supra* note 32, at 531.

100. *Id.* at 536.

101. *See generally* Benjamin Klein & Joshua D. Wright, *The Economics of Slotting Contracts*, 50 J.L. & ECON. 421 (2007).

102. *See* Dobson, *supra* note 32, at 535.

103. *See* Grimes, *supra* note 23, at 581.

104. *See* Michaela Draganska, Daniel Klapper & Sofia B. Villas-Boas, *A Larger Slice or a Larger Pie? An Empirical Investigation of Bargaining Power in the Distribution Channel*, 29 MKTG. SCI. 57, 59, 68 (2010).

Retailers' multitude of roles gives them considerable leverage over their suppliers. Paul Dobson explains that "the combination of suppliers' dependency on and insecurity about retaining contracts [ ] allows retailers to exploit the interaction of these three roles, leaving suppliers little or no room for maneuver in negotiations."[105] Grimes describes this power in more concrete terms when he states that "control of what items will be carried, how much shelf space they will be given, how prominently they will be displayed, and whether they will be priced or marketed aggressively gives the large multi-brand retailer substantial leverage in dealing with even the largest producers of strong brands of consumer products."[106]

Another reason that retailers serve as gatekeepers is that many consumers are more loyal to the retailers than to product brands.[107] This is especially true in the grocery context.[108] While much of antitrust tends to subscribe to an inter-brand primacy model of consumer behavior under which consumers are supposed to attach primary importance to brands, in many contexts consumers are more wedded to their retailers, especially multi-brand retailers.[109] Considerable evidence supports the fact that, with the exception of "must stock" brands, consumers would rather switch brands within store than switch stores within brand.[110] A retailer would thus suffer relatively little consequence if it chooses to delist a recalcitrant supplier.[111] Meanwhile, large retailers control a supplier's access to final consumers.[112]

Perhaps more related to the point of relative bargaining power, rather than the retailer's gatekeeper status, even though the two are inextricably related, is the fact that a retailer is much more important to a supplier than vice versa. Sheer math supports this view. A multi-brand retailer such as a

105. Dobson, *supra* note 32, at 531.

106. Grimes, *supra* note 23, at 579.

107. *See* Thomas K. Cheng, *A Consumer Behavioral Approach to Resale Price Maintenance*, 12 VA. L. & BUS. REV. 1, 20–21 (2017).

108. *See* Dobson, *supra* note 32, at 535.

109. *See generally* Cheng, *supra* note 107, at 20–31 (discussing the Inter-Retailer Primacy Model, where consumers choose the retailer first, then browse for brands).

110. *See* Robert L. Steiner, *The Nature of Vertical Restraints*, 30 ANTITRUST BULL. 143, 157–58 (1985).

111. Dobson, *supra* note 32, at 533.

112. *See* Carstensen, *supra* note 26, at 277.

supermarket carries thousands, if not tens of thousands of brands, none of which will account for more than a few percent of the retailer's sales at most. A supplier sells to a much smaller number of retailers, some of which are likely to account for a significant proportion of overall sales. The relationship between Procter & Gamble and Walmart vividly illustrates this. As of mid-2000s, Procter & Gamble, which is Walmart's largest supplier, accounts for two percent of Walmart's sales, while Walmart is responsible for eighteen percent of Procter & Gamble's revenue.[113] A retailer hence does not need any particular supplier to survive, not even one as large as Procter & Gamble. The reverse, however, is not true. Even a supplier as large as Procter & Gamble probably could not remain profitable without Walmart.

The same situation is observed in the United Kingdom, where even the very largest suppliers only account for less than roughly three percent of a major grocery retailer's sales, while forfeiting sales to one of the top four supermarkets will cut a supplier's revenue by at least ten to thirty percent.[114] Because a supplier cannot remain profitable after losing ten or twenty percent of revenue, retailers hold significant bargaining power over their suppliers notwithstanding the fact that such bargaining power is achieved at a much lower market share than is typically necessary for a seller to be found dominant.[115] The European Commission found that a twenty-two percent share of overall revenue is sufficient to render a retailer indispensable to a supplier[116] and some have suggested as low as ten percent or even eight percent of revenue would be sufficient for indispensability.[117]

Moreover, it is possible for multiple retailers to possess bargaining power over the same set of suppliers at the same time because a supplier needs access to multiple retailers to

113. Foer, *supra* note 93, at 1312.

114. Dobson, *supra* note 32, at 534.

115. Myriam Vander Stichele & Bob Young, The Abuse of Supermarket Buyer Power in the EU Food Retail Sector Preliminary Survey of Evidence, 15 (2009), https://www.somo.nl/wp-content/uploads/2009/03/The-Abuse-of-Supermarket-Buyers-Power-in-the-EU-Food-Sector.pdf.

116. Thomas, *supra* note 66, at 289.

117. *See* Vander Stichele & Young, *supra* note 115, at 15; Grimes, *supra* note 23, at 563–64.

stay profitable.[118] Retailers are likely to hold even greater bargaining power when production exhibits significant economies of scale, which means that losing output forces the supplier to operate inefficiently by raising per-unit cost of production.[119] Overall, the magnitude of retailer gatekeeper power depends on a number of factors including "the size of the retailer relative to the size of the supplier, the absolute size of the retailer and supplier, and the supply of competing products (including own-label and branded items) that compete with the supplier's product."[120]

Retailers' gatekeeper power allows them to extract favorable price and supply terms from their suppliers. These terms include listing fees and slotting allowances, retroactive discounts on goods sold, unreasonably high contributions to retailer promotion, delayed payment, and others.[121] In addition to extracting financial benefits from the suppliers, some of these contractual terms also shift the financial risks in the supply relationship to the suppliers, perhaps unfairly and excessively so in the eyes of some commentators. Retailers may force suppliers to accept return of unsold goods.[122] They may demand compensation for products that fail to meet sales expectations.[123] They may extort retrospective discounts from the suppliers on a variety of grounds not provided for in the supply contract.[124] They may also make delinquent payments, often significantly past the contractually stipulated payment date, knowing that the supplier would not sue or terminate the supply relationship.[125]

II.
Competitive Harm of Buyer Power

Exercise of buyer power can lead to a range of competitive harm. Apart from the price and welfare effects noted previously, further competitive harm includes the waterbed effect,

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118. Carstensen, *supra* note 26, at 291.
119. *Id.* at 290.
120. Paul W. Dobson & Ratula Chakraborty, *Buyer Power in the U.K. Groceries Market*, 53 Antitrust Bull. 333, 337–38 (2008).
121. Dobson, *supra* note 34, at 249.
122. *Id.* at 269.
123. *Id.*
124. *Id.*
125. *See id.*

quality erosion, increased concentration in the supply chain, creation of downstream market power, reduced incentives to invest for upstream suppliers, and wealth transfer from the seller to the buyer. These will be explained in this Part.

A. *Waterbed Effect*

The welfare effect of bargaining power would be significantly more harmful if the seller raises the prices that it charges other smaller buyers after offering discounts to the powerful buyer. Such price discrimination would favor the powerful buyer in the downstream market.[126] Discrimination may not be confined to the wholesale price. Smaller buyers can be discriminated against by being denied favorable product allocation, delivery terms, or certain attractive package sizes or promotional packaging.[127] This phenomenon is labeled as the "waterbed effect."[128]

The nature and the mechanism of the waterbed effect is controversial. Some have questioned why the seller would wait until the powerful buyer has demanded a price cut to raise prices on the smaller buyers.[129] In other words, if the seller had the ability to do so, it should have done so long ago. Others have questioned whether the seller is positioned to price discriminate.[130] If the seller is barely breaking even due to a lack of market power, it would be unable to implement price discrimination. David Mills provides an explanation for this conundrum. He argues that the root cause of the waterbed effect, in many cases, is increasing marginal cost.[131] Mills postulates that the emergence of a powerful buyer demanding discounts from the seller will have no effect on other buyers if the seller's marginal costs are constant. If, however, the seller exhibits increasing marginal costs, the powerful buyer's demand for a discount "triggers a price increase for

126. Dobson & Inderst, *supra* note 78, at 346.

127. NAT'L GROCERS ASS'N, *Buyer Power and Economic Discrimination in the Grocery Aisle: Kitchen Table Issues for American Consumers* 10 (2021), https://www.nationalgrocers.org/wp-content/uploads/2021/03/NGA-Antitrust-White-Paper25618.pdf.

128. Carstensen, *supra* note 26, at 298.

129. Thomas, *supra* note 66, at 293.

130. Dobson & Inderst, *supra* note 78, at 342.

131. David S. Mills, *Buyer Power and Industry Structure*, 36 REV. INDUS. ORG. 213, 219 (2010).

remaining small buyers because supplying more output to the dominant buyer increases the incremental cost of supplying the rest."[132] Rising marginal cost means that some units are cheaper for the seller to produce than others. If the cheaper units must be sold to the powerful buyer, the remaining buyers are left purchasing the more expensive ones, which necessitates a price increase. The powerful buyer essentially pushes the other buyers up on an upward-sloping marginal cost curve. Alternatively, Peter Carstensen argues that if a seller needs to recoup substantial fixed costs, lower prices for one buyer would require the seller to raises prices on other buyers so that fixed costs are recouped overall.[133] The waterbed effect requires all the buyers to compete in both the upstream and the downstream markets.[134] It "relies on the interaction of buyer and seller power."[135] It would not arise if some of the downstream competitors obtain their input from another market or use another input for production.

Furthermore, price discrimination by the seller could set off a vicious cycle where the powerful buyer reduces prices in the downstream market, thereby expanding its sales, while the smaller buyers lose sales after being forced to raise their retail prices due to the wholesale price increase.[136] A reduced demand from the smaller buyers for the upstream input may further increase their wholesale prices, making it harder for them to compete in the downstream market.[137] Consequently, their market share shrinks over time and they could eventually be forced out of the market.[138] Stefan Thomas calls this the spiral effect.[139] Whether this vicious cycle will materialize depends on the relative strengths of the buyers in the downstream market.[140] Market exit is likely only if a significant disparity exists between the various buyers' bargaining power such that the

132. *Id.*
133. Carstensen, *supra* note 26, at 284.
134. *See* Roman Inderst & Tommaso M. Valletti, *Buyer Power and the 'Waterbed Effect'*, 59 J. INDUS. ECON. 1, 2 (2011).
135. Dobson & Inderst, *supra* note 78, at 348.
136. *Id.* at 347–48.
137. Noll, *supra* note 36, at 611.
138. Dobson & Inderst, *supra* note 78, at 345.
139. Thomas, *supra* note 66, at 293.
140. Chen, *supra* note 34, at 36.

powerful buyer can obtain a sufficient cost advantage to squeeze out downstream rivals.[141]

In the short term, the waterbed effect may benefit consumers if the powerful buyer reduces its retail prices to take market share away from rivals.[142] Meanwhile, the smaller buyers may face conflicting incentives with respect to their own retail prices. On the one hand, higher input prices may push them to raise downstream prices.[143] On the other hand, these firms may be prevented from raising prices by the powerful buyer's downstream price reductions.[144] The relative strength of these two competing effects is difficult to predict.[145] In fact, the waterbed effect could be so strong that the powerful buyer need not reduce its prices to steal customers from its rivals. It can instead accomplish the same by maintaining its pre-existing prices as rivals are forced to raise their retail downstream prices.[146] In such case, consumers are harmed because the waterbed effect raises the prevailing price in the downstream market.[147] Moreover, the long-term effect of the waterbed effect is not confined to price and could also lead to loss in product variety and distortion of investment decisions.[148]

The waterbed effect has empirical support. Doyle and Inderst point to evidence that suppliers do seek better terms from smaller buyers to make up for lost profit resulting from concessions made to a more powerful buyer.[149] Further evidence reveals that a significant portion of sellers reduce the quality of their services to smaller buyers once a large buyer demands better or additional services.[150] Several theoretical models bolster the case for the waterbed effect[151] and the subsequent spiraling effect that further strengthens the powerful

141. *Id.* at 35.
142. Dobson & Inderst, *supra* note 78, at 335.
143. *Id.* at 352.
144. *Id.*
145. *See id.*
146. *See id.* at 351–52.
147. Inderst & Valletti, *supra* note 134, at 2.
148. Dobson & Inderst, *supra* note 78, at 352.
149. *Id.* at 343.
150. *Id.*
151. *See generally* Inderst & Valletti, *supra* note 134. *But see* Zhiqi Chen, *Dominant Retailers and the Countervailing-Power Hypothesis*, 34 RAND J. ECON. 612 (2003).

buyer.[152] Nonetheless, the UK Competition Commission has failed to find evidence of the waterbed effect in the highly concentrated grocery market in the United Kingdom.[153]

B. *Quality Erosion*

Ariel Ezrachi and Koen de Jong contend that buyer power can lead to quality erosion in supply. They argue that when the supplier's margin is squeezed too hard by the powerful buyer, the supplier may have incentives to cut costs by lowering product quality,[154] especially when such quality erosion cannot be readily discerned.[155] Substantial quality erosion could even cancel out any price reduction that may have occurred.[156] The supplier will only resort to quality reduction if it believes that the powerful buyer will not detect such reduction.[157] Otherwise, the supplier may instead victimize other buyers to the extent that these buyers are unable to detect quality deterioration.[158] This amounts to a quality waterbed effect. Instead of increasing price, buyer power reduces quality. Whether this will trigger the spiral effect discussed in Section A depends on whether consumers can readily detect the quality deterioration. If so, the quality deterioration of competing buyers' products will drive consumers to the powerful buyer, lifting its market share.

An economic model by Pierpaolo Battagalli, Chiara Fumangalli, and Michele Polo lends support to this quality erosion hypothesis. They note that exercise of buyer power may influence the supplier's quality choice and reduce the supplier's incentive to engage in quality improvement.[159] The situation presents a classic hold-up scenario where suppliers are reluctant to engage in quality improvement for fear that its investment would be appropriated by the powerful buyer.[160]

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152. *See generally* Roman Inderst, *Leveraging Buyer Power*, 25 INT'L. J. INDUS. ORG. 908 (2007).

153. *See* UK COMPETITION COMM'N, *supra* note 94, at 87–92.

154. Ezrachi & De Jong, *supra* note 90, at 258.

155. *Id.*

156. *Id.* at 259.

157. *Id.*

158. *Id.*

159. Pierpaolo Battigalli, Chiara Fumagalli & Michele Polo, *Buyer Power and Quality Improvements*, 61 RSCH. ECON. 45, 47 (2007).

160. *Id.*

The buyer lacks the mechanism to credibly commit itself to refrain from appropriation. In fact, they argue that this may ultimately harm the powerful buyer as a deterioration in quality may drive consumers away from the market generally, leaving the powerful buyer with a larger slice of a smaller cake.[161] Thus, exercise of buyer power harms consumers and total welfare and may undermine the powerful buyer as well.

C. *Increased Concentration in the Supply Chain*

Exercise of buyer power may also increase concentration in the supply chain. As a powerful buyer continues to squeeze supplier margin, some suppliers would rather exit the market than reinvest.[162] The National Grocers Association reports that exercise of buyer power has led to consolidation in the supply chain.[163] In particular, it notes that the private label sector has rapidly consolidated.[164] For instance, there is only one private label manufacturer of canned soup.[165] Consolidation has also occurred in other sectors such as canned fruit, pasta, snacks, and paper products.[166]

This consolidation has reduced the manufacturing capacity in the private label sector and inadvertently created a waterbed effect in the supply of private label products. The remaining private label manufacturers tend to prioritize the orders of the large retailers, forcing small retailers to pay higher prices or leaving their orders unfulfilled altogether.[167] Even if private label manufacturers continue to supply the small retailers, per-unit costs increase and the competitiveness of their products is reduced.[168] This results in a particular private-label waterbed effect, or the "direct waterbed effect."

If suppliers deny small retailers of their private label products, small retailers will lose bargaining power.[169] These retailers no longer have a readily available alternative if negotiations with a brand supplier fail, allowing the advantaged supplier to

161. *Id.*
162. Thomas, *supra* note 66, at 314.
163. NAT'L GROCERS ASS'N, *supra* note 127, at 13.
164. *Id.* at 14.
165. *Id.*
166. *Id.*
167. *Id.*
168. *See id.*
169. *Id.*

raise wholesale prices against the small retailers.[170] This can be referred to as the "indirect waterbed effect," as the increase in wholesale prices is the indirect consequence of the cessation of supply by the private label manufacturers. Either type of waterbed effect, direct or indirect, could set off the spiral effect previously described.

An obvious challenge to this line of argument is that the powerful buyer has no incentive to condone greater supplier concentration.[171] More powerful suppliers may demand higher prices or drive harder bargains against the buyer.[172] From the powerful buyer's perspective, it would prefer to squeeze the suppliers to the maximum extent without causing any exit. The powerful buyer may be able to accomplish this balancing act in a world of perfect information.[173] The reality, however, is more complicated. The suppliers may have the incentive to bluff and claim that the proffered margin is too low for survival. The powerful buyer will be suspicious in anticipation of such claims. If the buyer miscalculates and mistakes a genuine claim of supplier hardship for a bluff, the buyer may accidentally drive a supplier out of business. This kind of miscalculation is more than theoretical, and one cannot assume that buyer rationality or self-interest will necessarily forestall buyer-induced increases in supplier concentration.

Alternatively, a large retailer may be unperturbed by increased concentration in the supply chain either because alternative suppliers exist or because the retailer is so powerful that it does not fear supplier concentration. For example, Walmart's suppliers have reportedly been forced out of business due to unprofitability of supplying Walmart.[174] Walmart seems unconcerned, perhaps because of its overwhelming buyer power. Similarly, the abundance of third-party sellers eager to sell on Amazon gives Amazon license to churn through them.[175] Ultimately, the huge number of potential sellers avail-

170. *Id.*
171. Blair & Harrison, *supra* note 58, at 319.
172. *Id* at 324.
173. *Id.*
174. Thomas A. Piraino Jr., *A Proposed Antitrust Approach to Buyers' Competitive Conduct*, 56 HASTINGS L.J. 1121, 1123 (2005).
175. STACY MITCHELL, RON KNOX & ZACH FREED, REPORT: AMAZON'S MONOPOLY TOLLBOOTH (2020), https://ilsr.org/amazons_tollbooth/.

able to Amazon ameliorates any fears of increased supplier concentration.

D. *Creation of Downstream Market Power*

Exercise of buyer power may also exacerbate downstream market power to the extent that the same upstream buyers compete in the downstream market.[176] This follows from the direct and the indirect waterbed effects discussed in Part II. The direct waterbed effect, either in the private label or the general context, will raise wholesale prices for the smaller retailers.[177] Given that multi-brand retailers sell numerous brands, and tens of thousands of brands in the case of supermarkets, direct waterbed effect in a limited number of brands is unlikely to affect a retailer's viability. If the effect is widespread, however, the death spiral may ensue. A powerful buyer can be expected to exert its bargaining power against every susceptible supplier and has no incentive to spare any particular supplier.[178] Therefore, it is reasonable to assume that the waterbed effect will be widespread and the spiral effect more plausible than it may initially seem.

The indirect waterbed effect, found only in the private label context, is unlikely to force a retailer to exit the market on its own. It is, however, likely to exacerbate the pressure exerted on the smaller retailers by the direct waterbed effect. Direct and indirect waterbed effects may, together, create such a hostile operating environment for smaller retailers that they will be forced to leave the market. While highly advantageous to the large retailer, consumer harm will result when the large retailer takes advantage of its newly found market power to raise prices.

E. *Reduced Investment Incentives for Upstream Suppliers*

Short of driving suppliers out of the market, exercise of buyer power can still harm competition by reducing these suppliers' incentive to invest in product improvement, product development, brand building, and other value-enhancing activities. These can occur for one of two reasons. The first rea-

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176. Stucke, *supra* note 34, at 1524.

177. *Id.* at 1552.

178. Lina M. Khan, *Amazon's Antitrust Paradox*, 126 YALE L.J. 710, 775 (2017).

son is that lower margin may leave suppliers with less funds to invest in such activities. The second reason is due to opportunistic behavior by the powerful buyer.[179] A supplier may plan to make an investment that is profitable *ex ante* and enter into a contract with a retailer accordingly. After investment is made and the costs are sunk, the powerful buyer will have strong incentives to engage in *ex post* opportunistic behavior to change the contractual terms retrospectively.[180] Mindful of the possibility of such buyer hold-up, the supplier will be hesitant to invest in the first place.[181] Such a scenario is far from purely academic. Experience tells us that powerful retailers regularly impose retrospective amendment of contractual terms to the detriment of the suppliers.[182]

Supplier investment may be deterred not only by *ex post* financial exploitation, but also by direct copying or imitation by the retailer. If a supplier perceives a high risk that the retailer will copy its product design and replicate the product to compete with the supplier, the supplier will be reluctant to invest in product improvement or development.[183] The buyer need not get its hands dirty. It can out-source product development to private label manufacturers. Investment in product development can be subject to *ex post* hold-up because the supplier is susceptible to opportunistic behavior once the initial R&D costs are sunk.[184] Amazon has reportedly engaged in precisely this kind of opportunistic behavior in India, appointing a private label manufacturer to copy the designs of some of the most popular products on its Marketplace.[185]

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179. Peter Davis & Alan Reilly, *The UK Competition Commission's Groceries Market Investigation: Market Power, Market Outcomes and Remedies* 1, 16–17 (July 16, 2009), https://ageconsearch.umn.edu/record/53210/files/Peter%20Davis%20Beijing%20Paper%20-final.pdf.

180. *Id.*

181. Thomas, *supra* note 66, at 310.

182. Dobson, *supra* note 32, at 532.

183. Feng Zhu & Qihong Liu, *Competing with Complementors: An Empirical Look at Amazon.com*, 39 STRATEGIC MGMT. J. 2618, 2623 (2018); *see* Davis & Reilly, *supra* note 179, at 17.

184. *See* Thomas, *supra* note 66, at 311.

185. Aditya Kalra & Steve Stecklow, *Amazon Copied Products and Rigged Search Results to Promote Its Own Brands, Documents Show*, REUTERS (Oct. 13, 2021, 11:00 AM), https://www.reuters.com/investigates/special-report/amazon-india-rigging/.

Commentators have argued that two factors may help to minimize hold-up or at least mitigate its effect.[186] The first factor is that supplier investment in product development also benefits the retailer to the extent that it increases product sales or raises the product price.[187] The retailer will get a share of the increased sales. There is hence a tradeoff between short-term profit and long-term detriment.[188] In a world of perfect information, a powerful buyer would exercise its power up to the point where investment incentives become impaired. Beyond that point, the buyer must balance the extra profit that it makes by depressing supplier margin and the lost profit from reduced product innovation. A powerful buyer would only push beyond that threshold when the former outweighs the latter. The second factor concerns reputational effects, particularly the retailer's reluctance to be labeled as a serial opportunist.[189] Reputational effects, however, would only be effective if suppliers have a meaningful choice of retailers. An essential retailer which every supplier must sell to will not be constrained by reputational effects. Such is reportedly the case for Amazon.[190] Meaningful choice may also be absent if opportunistic behavior is prevalent among retailers. Some conduct, such as *ex post* financial exploitation in the form of delayed payments, may be so common that suppliers cannot realistically avoid it.[191]

F. *Wealth Transfer from Sellers to Buyers*

Finally, wealth transfer from sellers to buyers is one of the more controversial effects that may result from the exercise of buyer power. Wealth transfer is arguably not a competitive harm as it does not entail distortion or restriction of competi-

186. Davis & Reilly, *supra* note 179, at 17.

187. *Id* (noting that "[i]t is in retailers' long-term interests that suppliers invest and innovate").

188. *Id.*

189. Davis & Reilly, *supra* note 179, at 17.

190. MITCHELL, KNOX & FREED, *supra* note 175.

191. Eugene Kim, *Some Amazon Sellers Are Outraged Over a New Payment Policy Designed to Attract More Corporate Buyers*, CNBC (Aug. 21, 2018, 8:14 PM), https://www.cnbc.com/2018/08/21/amazon-corporate-buyers-longer-terms-some-sellers-upset.html.

tion, but rather just results in less surplus for the seller.[192] This is especially true in the case of bargaining power in all-or-nothing negotiations, where reduction in output level is not required. By making an all-or-nothing offer, a powerful buyer can extract a lower price from sellers without reducing its demand and extract surplus from its sellers without causing any allocative inefficiency.[193] Commentators have argued that such wealth transfer is of no concern to antitrust law.[194] Moreover, in the case of all-or-nothing negotiations, the wholesale price splits the surplus between the seller and the buyer. To say that there is a wealth transfer from the seller to the buyer suggests that there is an objectively optimal split of surplus, which necessitates the ascertainment of a fair wholesale price. Such concepts simply do not exist in antitrust law.[195]

Grimes argues that the debate about whether antitrust should be concerned with this wealth transfer is, in a sense, less important because most exercises of buyer power create other competitive harm or loss in aggregate welfare.[196] While this may be true, the argument sidesteps the issue of whether antitrust should pay heed to wealth transfer independent of other competitive harm. Grimes asserts that "[i]f monopsony abuses are truly the mirror image of monopoly abuses, the focus for buyer power ought not to be on consumers as atomistic buyers, but on the atomistic sellers forced to accept less than a competitive price,"[197] and that "[r]ecognizing the legitimate interests of atomistic sellers in free and fair competition is not a policy for Luddites, but a progress-friendly and forward-looking vision that players of all sizes have an opportunity to enter and compete in a market."[198]

Unfortunately, Grimes' assertions do not fully address the detractors' objections. First, while it may be possible to justify

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192. Robert H. Lande, *Wealth Transfers as the Original and Primary Concern of Antitrust: The Efficiency Interpretation Challenged*, 34 HASTINGS L.J. 65, 74–77 (1982).

193. Thomas, *supra* note 66, at 299.

194. *Id.* at 306; Scheelings & Wright, *supra* note 24, at 223.

195. Thomas, *supra* note 66, at 299 (noting that "the antitrust laws lack any standard for the definition of 'supplier harm'. It is unclear how the price of a certain good can be determined to be appropriate, just, fair, or sufficiently high in order not to 'harm' the supplier.").

196. Grimes, *supra* note 23, at 569.

197. *Id.* at 573.

198. *Id.* at 575.

the need for special protection of atomistic sellers such as small-time farmers or labor,[199] the sellers in many all-or-nothing negotiations are not atomistic. These sellers may be dwarfed by retail giants such as of Walmart and Amazon, but their business may still be sizable.[200] If atomistic is understood in an absolute rather than a relative or comparative sense, no persuasive argument exists for extending special protection to these suppliers simply because they are smaller than the giant retailers. Second, no workable standard guides the inquiry into when an unfair or unjustified wealth transfer has taken place, which, as suggested earlier, requires a determination of the fairness of the wholesale price.[201] A fairness assessment need not be confined to the wholesale price, it can be applied to other non-price contractual terms as well. There are no clear standards of fairness for these terms either. While retroactive amendment of contractual terms may be objectionable as an instance of opportunistic behavior, no reasonable basis exists upon which to delineate the boundary of acceptability for contractual terms agreed upon by the parties *ex ante* in open negotiations. Accordingly, prohibiting exercises of buyer power on the grounds of pure wealth transfer seems untenable.

This discussion is salient in examining Amazon's treatment of third-party sellers. Many sellers on Amazon Marketplace are not manufacturers or product developers.[202] Rather, they are merely resellers of products sourced elsewhere.[203] In the case of resellers, an exercise of buyer power against them should not lead to the waterbed effect, quality erosion, or reduced investment incentives. Resellers do not engage in production. Nor do they make investment in production facilities or product development. And to the extent that these resellers are numerous and largely fungible, no danger of increased supplier concentration exists. In any case, Amazon's buyer

199. *See* BLAIR & HARRISON, *supra* note 17, at 172.

200. Foer, *supra* note 93, at 1312–13.

201. *See generally* Pinar Akman & Luke Garrod, *When Are Excessive Prices Unfair?*, 7 J. OF COMPETITION L. & ECON. 403, 418 (2011).

202. *See* discussion *infra* Part IV.A.

203. Jennifer Rankin, *Third-Party Sellers and Amazon - a Double-Edged Sword in E-Commerce*, THE GUARDIAN (June 23, 2015, 9:31 AM), https://www.theguardian.com/technology/2015/jun/23/amazon-marketplace-third-party-seller-faustian-pact.

power should allow Amazon to withstand a significant degree of supplier concentration, casting doubt upon any basis for intervening in Amazon's exploitation of these sellers.

III.
Uber as a Digital Monopsonist

A. *An Overview of Two-sided Platforms*

It is superfluous at this day and age to note that digital platforms such as Amazon and Apple App Store are two-sided platforms. The undisputed nature of their designations as two-sided platforms notwithstanding, the definition of two-sided platforms remains controversial.[204] Benjamin Hermalin and Michael Katz note that "[a]n unusual feature of two-sided markets is that there is no consensus regarding what they are."[205] In *Ohio v. American Express Co.*, the Supreme Court defined two-sided platforms as firms that "offer[ ] different products or services to two different groups who both depend on the platform to intermediate between them."[206] The Court proceeded to observe that one of the distinguishing features of these platforms is indirect network effects.[207] Other commentators generally agree on the central importance of these effects to two-sided platforms.[208] According to Alexei Alexandrov, George Deltas, and Daniel F. Spulber, this means that "[t]heir pricing policies and strategic interaction on one side of the market are necessarily connected to pricing and strategic interaction on the other side of the market."[209] Jean-Charles Rochet and Jean Tirole define two-sided platforms by their ability to resolve ex-

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204. Ben Bloodstein, *Amazon and Platform Antitrust*, 88 Fordham L. Rev. 187, 192 (2019).

205. Benjamin E. Hermalin & Michael L. Katz, *What's So Special About Two-Sided Markets?*, *in* Toward a Just Society: Joseph Stiglitz and Twenty-First Century Economics, 111 (Martin Guzman ed., 2018).

206. Ohio v. Am. Express Co., 138 S. Ct. 2274, 2280 (2018).

207. *Id.*

208. Marc Rysman, *The Economics of Two-Sided Markets*, 23 J. Econ. Persps. 125 (2009); David S. Evans, *The Antitrust Economics of Two-Sided Markets*, 19 Yale J. on Regul. 335 (2002); Jay Pil Choi, *Tying in Two-Sided Markets with Multi-Homing*, 58 J. Indus. Econ. 607, 608 (2010); Lapo Filistrucchi, Damien Geradin & Eric van Damme, *Identifying Two-Sided Markets*, 36 World Competition 33, 37–38 (2013).

209. Alexei Alexandrov, George Deltas & Daniel F. Spulber, *Antitrust and Competition in Two-Sided Markets*, 7 J. Competition L. & Econ. 775, 779 (2011).

ternalities that prevent efficient contracting by users on both sides.[210] The first externality that platforms must resolve is the need initially to attain a critical mass of users on both sides of the platform.[211] The second externality concerns pricing, more particularly, how platforms should allocate the overall price of the platform between the two sides.[212] Overcharging one side of the platform can have grave consequences as the loss of customers on one side will, in turn, lead to customer defection on the other side of the platform.[213]

Ben Bloodstein classifies two-sided platforms into three types: transaction platforms, ad-sponsored or media platforms, and software platforms. Some complex, vertically integrated platforms, including Amazon, Google, and Facebook, combine all three types.[214] Transaction platforms are platforms that allow buyers and sellers of goods or services to meet and transact.[215] Uber is a prime example of a digital transaction platform. In the pre-digital age, supermarkets and classified ads would serve as paradigmatic transaction platforms. Ad-sponsored or media platforms are platforms where one side consists of advertisers. Indirect network effects on these platforms are uni-directional: while the advertisers are concerned with the number of users on the other side of the platform, the users are indifferent to the amount of advertising.[216] In fact, users probably prefer less or no advertising. It is information that is primarily exchanged on these platforms. The platforms offer a service that attracts users, such as entertainment or social media, and present to those users advertising information from the advertisers. Transactions between the advertisers and the users are consummated off the platform. Lastly, well-known software platforms, including Windows, Mac OS, iOS, and Android, probably need no introduction. Computer

210. Jean-Charles Rochet & Jean Tirole, *Two-Sided Markets: A Progress Report*, 37 RAND J. Econ. 645, 649 (2006).

211. Jonas Wanner, Carsten Bauer & Christian Janiesch, *Two-Sided Digital Markets: Disruptive Chance Meets Chicken or Egg Causality Dilemma*, 2019 IEEE 21st Conference on Business Informatics 335, 336 (2019), https://ieeexplore.ieee.org/document/8808087; Erik Hovenkamp, *Platform Antitrust*, 44 J. Corp. L. 713, 715–16 (2019).

212. Bloodstein, *supra* note 204, at 189.

213. *Id.* at 194.

214. *Id.* at 200.

215. *Id.* at 198.

216. *Id.* at 199.

or smartphone users populate one side of the platform while app or software developers sit on the other side.[217]

B. *Digital Monopsony*

As previously suggested, monopsony power is rare in fact and is most likely to be present in an agricultural or labor market. For example, monopsony power may exist in the case of a large food processor or buyer of a perishable agricultural product[218], a professional sports league[219] or a single large employer in a small town.

As it turns out, monopsony power can also be observed in the case of several digital platforms, including ride sharing apps such as Uber and Lyft and food delivery apps such as DoorDash and Grubhub. While not the only employer of drivers or delivery workers in their respective geographic markets and thus not textbook monopsonists, these companies are very large and powerful buyers dealing with numerous atomistic sellers of labor services.[220] Recall the prerequisites for monopsony power: (i) the buyer contributes to a substantial portion of purchases in the market; (ii) barriers to entry into the buyer's market; and (iii) an upward-sloping supply curve. In the case of Uber and DoorDash, each contributes to a substantial portion of purchases in the relevant labor market[221], prospective entrants into the respective markets of ride sharing apps and food delivery apps face significant barriers to en-

217. *Id.* at 199–200.

218. BLAIR & HARRISON, *supra* note 17, at 11–12.

219. *Id.* at 10–11.

220. Ignacio Herrera Anchustegui & Julian Nowag, *Buyer Power in the Big Data and Algorithm Driven World: The Uber & Lyft Example*, CPI ANTITRUST CHRON., Sept. 2017, at 4, https://www.competitionpolicyinternational.com/wp-content/uploads/2017/09/CPI-Anchustegui-Nowag.pdf.

221. *How many rideshare drivers are there in the US?*, ZIPPIA (June 29, 2022), https://www.zippia.com/answers/how-many-rideshare-drivers-are-there-in-the-us/; Dee-Ann Durbin, *Despite GrubHub and Uber Eats, restaurants still hiring for deliveries — and may offer drivers a better gig*, CHICAGO TRIBUNE (Sept. 5, 2019), https://www.chicagotribune.com/business/ct-biz-grubhub-restaurant-delivery-jobs-20190904-xjfi26tpqbe4lgpkeo5z5srndy-story.html.

try,[222] especially in view of recent market consolidation,[223] and the labor supply curve in each market is upward-sloping (the offer of a higher wage attracts greater supply).[224]

The welfare effects of a classic monopsony are a lower output level and resultant deadweight loss.[225] Price increases for the final product are contingent on the degree of competition in the downstream market. In the case of a competitive downstream market, price and output may remain the same. Conversely, if the powerful buyer has market power in the downstream market, prices will likely go up.

Whether these conclusions hold where the monopsonist is a digital platform, such as Uber, remains an interesting question. One key distinction between these digital platforms and the classic offline monopsonist is the former's ability to engage in price discrimination. While price discrimination in the case of digital platforms is not perfect, evidence suggests that Uber, for example, is capable of offering highly personalized pricing under its so-called "Hell" program.[226] The welfare calculus of monopsony changes fundamentally where the buyer is able to offer different prices to individual drivers and it is no longer necessary to reduce overall demand to depress the purchase price.

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222. *Rideshare Insurance: Key Barrier To Entry And Eventual Profit Driver For Uber And Lyft*, SEEKING ALPHA (Oct. 6, 2020), https://seekingalpha.com/article/4377832-rideshare-insurance-key-barrier-to-entry-and-eventual-profit-driver-for-uber-and-lyft (noting rideshare insurance as a key barrier to entry for Uber's competitors); Viktor Hendelmann, *Uber's 4 Biggest Competitive Advantages*, PRODUCT MINT (last accessed Nov. 3, 2022), https://productmint.com/uber-competitive-advantage/ (noting network economies and branding as some of Uber's key competitive advantages).

223. The market share of competitors of Uber and Lyft is essentially negligible. *See Market share of the leading ride-hailing companies in the United States from September 2017 to July 2021*, STATISTA (Sept. 2022), https://www.statista.com/statistics/910704/market-share-of-rideshare-companies-united-states/. The food delivery app market is also highly concentrated, with DoorDash at forty-five percent, Uber Eats at thirty percent, and Grubhub at roughly twenty percent. David Curry, *Grubhub Revenue and Usage Statistics (2022)*, BUS. OF APPS (Sept. 6, 2022), https://www.businessofapps.com/data/grubhub-statistics.

224. This is evident from the rationale behind surge pricing employed by Uber.

225. BLAIR & HARRISON, *supra* note 17, at 43–48.

226. Anchustegui & Nowag, *supra* note 220, at 2.

C. *Uber's Technological Capacity to Monopsonize*

Uber's Hell program uses algorithms to personalize the incentives offered to its drivers.[227] The main purpose of the program is not to exercise monopsony power. Instead, the Hell program targets Uber drivers who also drive for a competitor. The program has three components: (1) the collection and combination of data, (2) the identification of drivers who are also driving for competitors, and (3) targeted incentives for these drivers.[228] Initially, information is collected on the availability of drivers in a geographic area who offer their services via a competitor. The data are then combined with the data of drivers who offer their services via Uber in the same geographic area and time frame. By combining these two data sets collected over a long period, Uber can algorithmically identify multi-homing drivers. In the final step, Uber treats these drivers more favorably compared to other drivers. To entice multi-homing drivers to drive exclusively for Uber, these drivers would receive more offers to pick up passengers and special bonuses if the target number of rides per week is met.[229] These drivers may also be offered better prices.[230] All this occurs with no knowledge on the part of the drivers.[231]

The technical feasibility of personalized pricing, or first-degree price discrimination, has been widely debated. The debate has mostly centered on the consumer side.[232] Undoubtedly, some platforms already engage in third-degree price discrimination based on address, type of smartphone used, and other personal attributes.[233] Platforms have also used cookies to track browsing history and price discriminate on such ba-

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227. *Id.* at 3.

228. Anchustegui & Nowag, *supra* note 220, at 2.

229. Mariella Moon, *Uber's "Hell" Program Tracked and Targeted Lyft Drivers*, ENGADGET.COM (Apr. 13, 2017, 3:32 AM), https://www.engadget.com/2017/04/13/uber-hell-program-lyft-drivers.

230. In the case of Uber this is done by lowering the fee that Uber charges drivers.

231. Anchustegui & Nowag, *supra* note 220, at 3.

232. *See generally* Salil Mehra, *Price Discrimination-Driven Algorithmic Collusion: Platforms for Durable Cartels*, 26 STAN. J.L. BUS. & FIN. 171 (2021); Michal S. Gal, *Algorithms as Illegal Agreements*, 34 BERKELEY TECH. L.J. 67 (2019); Axel Gaultier, Ashwin Ittoo & Pieter Van Cleynenbreugel, *AI Algorithms, Price Discrimination and Collusion: A Technological, Economic and Legal Perspective*, 50 EUR. J.L. & ECON. 405 (2020).

233. Gaultier, Ittoo & Van Cleynenbreugel, *supra* note 232, at 409.

sis.[234] In fact, some consumers report being offered lower prices by Amazon after deleting their cookies or browsing history.[235] Customer identification and segmentation is made easier by clustering algorithms, which group customers with a similar willingness to pay.[236]

Still, some distance remains between price discrimination based on clusters or rough demographic groups and truly personalized pricing, with opinions differing on the feasibility of the latter. Salil Mehra believes that platforms already possess the capability to gauge a consumer's willingness to pay and implement first-degree price discrimination.[237] Michal Gal asserts that "as more data are gathered about each consumer's preferences, a personalized 'digital profile' can be created through the use of algorithms that calculate and update consumers' elasticity of demand in real time."[238] Axel Gaultier, Ashwin Ittoo, and Pieter Van Cleyenbreugel are less sanguine about the technical capability of algorithms and argue that, at the moment, there is no strong evidence that finer-grained price discrimination is implemented against consumers.[239]

Whatever the current technical limits of pricing algorithms, some industry experts believe that personalized pricing is the future. Jonathan Cave observes that machine learning is, in principle, capable of achieving something close to first-degree price discrimination.[240] The CEO of Safeway notes that it is only a matter of time before shelf prices become obsolete and personalized pricing turns into a reality.[241] Yet not all hope is lost for the consumers. Despite her faith in the capability of pricing algorithms, Gal downplays the impending threat of personalized pricing, arguing that reputational risks will deter the platforms.[242] Price discrimination has faced public

234. *Id.* at 409.
235. *Id.* at 408.
236. *Id.* at 412.
237. Mehra, *supra* note 232, at 175.
238. Gal, *supra* note 232, at 91.
239. Gaultier, Ittoo, & Van Cleynenbreugel, *supra* note 232, at 415.
240. Jonathan Cave, *Can Machines Learn Whether Machines Are Learning to Collude?*, *in* INTERNET SCI.: 6TH INT'L CONF., INSCI 2019 133, 134 (Samira El Yacoubi, Franco Bagnoli & Giovanna Pacini eds., 2019).
241. Terrell McSweeny & Brian O'Dea, *The Implications of Algorithmic Pricing for Coordinated Effects Analysis and Price Discrimination Markets in Antitrust Enforcement*, 32 ANTITRUST 75, 77 (2017).
242. Gal, *supra* note 232, at 92.

backlash in the past.[243] Gal further suggests that consumers can protect themselves with anonymous browsing.[244]

Uber appears more capable, relative to other digital platforms, of offering personalized pricing. Mehra notes that "given enough data, Uber could estimate an individual consumer's demand curve, and thereby gauge its willingness to pay."[245] While Mehra may have slightly overstated the case, there are reasons to believe that Uber can target its drivers more accurately than can other digital platforms. Uber can track a driver's willingness to drive at different times of the day and determine how that willingness changes in reaction to the availability of surge pricing, weather conditions, road conditions, and other factors.[246] Further, Uber can track how long a driver is willing to stay idle before picking up a ride.[247] The Hell program indicates that Uber can identify with considerable accuracy multi-homing drivers and predict their willingness to drive for Uber.[248] Uber could presumably obtain even more information about a driver's willingness to drive in response to different fare levels if it was willing to release an estimated fare in advance of driver acceptance of a ride. At the moment, drivers only find out about the destination in advance in some jurisdictions such as California.[249] In many instances, the drivers only find out about the destination after they have accepted the ride.[250] Fares are calculated after the

243. *Id.*

244. *Id.*

245. Mehra, *supra* note 232, at 184.

246. Sarah Holder, *For Ride-Hailing Drivers, Data is Power*, BLOOMBERG (Aug. 22, 2019, 12:03 PM), https://www.bloomberg.com/news/articles/2019-08-22/why-uber-drivers-are-fighting-for-their-data.

247. *See id.*

248. Anchustegui & Nowag, *supra* note 220, at 2.

249. Carolyn Said, *Uber May Stop Letting Drivers See Destinations and Name Prices*, S.F. CHRON. (Apr. 6, 2021, 6:13 PM), https://www.sfchronicle.com/business/article/Uber-may-stop-letting-drivers-see-destinations-16078491.php; Sasha Lekach, *Uber's New Driver Features Could Mean More Destination Discrimination*, MASHABLE (Dec. 4, 2019), https://mashable.com/article/uber-driver-california-changes-destination-discrimination.

250. Adam Tuss, *Uber Drivers Stiff Passengers After Finding Out Final Destination*, NBC4 WASH. (Dec. 28, 2016, 10:03 AM), https://www.nbcwashington.com/news/local/uber-drivers-stiff-passengers-after-finding-out-final-destination-2/127513/; Tina Bellon, *Uber Revamps Driver Pay Algorithm in Large U.S. Pilot to Attract Drivers*, REUTERS (Feb. 25, 2022, 8:20 PM), https://

trip based on the distance traveled and time taken,[251] although Uber has reportedly launched pilot programs which allow drivers to see the destination and pay before accepting a ride.[252] Nonetheless, it is fair to assume that Uber possesses sufficient information about its drivers to engage in reasonably refined price discrimination. Moreover, the fact that Uber drivers are compensated on a per trip basis, as opposed to an hourly basis or even a monthly basis, gives Uber significant room to individualize compensation. In a way, compensation of Uber drivers is, by definition, personalized according to factors such as how much she drives, how many trips she accepts, and the time of the day she drives. Even if Uber falls short of first-degree price discrimination, its pricing model is a far cry from the single equilibrium price offered by a classic monopsonist.

The defense mechanisms identified by Gal are not available to Uber drivers. Personalized pricing against Uber drivers is unlikely to cause a public outcry nor do Uber drivers have the option to interact with Uber anonymously. Further, Uber can seek additional assistance from increasingly powerful pricing algorithms. The OECD notes that these algorithms "allow for constant adjustment and optimization of individual prices based on many factors, including available stock and anticipated demand."[253] Using a huge volume of data, pricing algorithms learn through trial and error to discern patterns and formulate optimal pricing.[254] These algorithms are automated and require no human intervention, which means they can constantly adjust prices based on changing conditions.[255]

Uber is also likely to face fewer technical challenges compared to a digital platform attempting to price discriminate against its consumers. First, determining a consumer's willingness to pay requires a high dimensionality of data, much of

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www.reuters.com/business/autos-transportation/exclusive-uber-revamps-driver-pay-algorithm-large-us-pilot-attract-drivers-2022-02-26/.

251. *How Much Can Drivers Make With Uber?*, UBER, https://www.uber.com/hk/en/drive/how-much-drivers-make/ (last visited Apr. 7, 2022).

252. Bellon, *supra* note 250.

253. OECD, ALGORITHMS AND COLLUSION: COMPETITION POLICY IN THE DIGITAL AGE 16 (2017), www.oecd.org/competition/algorithms-collusion-competition-policy-in-the-digital-age.htm.

254. *Id.*

255. *Id.*

which is often incomplete.[256] Determining a driver's willingness to drive should require a relatively smaller set of information about the drivers. Because Uber would collect the information itself, an incomplete data set should not be a problem. Second, much of the consumer data from third-party online sources is unlabeled, which greatly impedes supervised learning by pricing algorithms.[257] Supervised learning requires annotated data, yet manual annotation is costly and error prone.[258] Again, because Uber will be collecting most of the driver data itself, the problem of unlabeled data is unlikely to arise. Third, it is well noted that most retailers lack the appropriate technical infrastructure, such as electronic price tags, that is needed to gauge consumers' willingness to pay.[259] Given that Uber conducts all its interaction with its drivers through smartphones, the lack of technical infrastructure should be irrelevant.

D. *Welfare Effects of Digital Monopsony*

Even if Uber is not able to engage in fully personalized pricing, it can closely tailor driver compensation, with an increasing degree of individualization over time. As previously noted, the possibility of individualization fundamentally changes the welfare calculus of digital monopsony. Recall that classic monopsony leads to a lower level of output and deadweight loss, and the degree to which consumer prices remain stable or increase depends on the state of downstream competition. Textbook economics suggests that the efficiency loss of price discrimination decreases as it approximates first-degree price discrimination.[260] Market outcome with first-degree price discrimination mirrors that under perfect competition.[261] The only difference is that producer surplus is fully

256. Gaultier, Ittoo, and & Van Cleynenbreugel, *supra* note 232, at 421.

257. *Id.* at 422.

258. *Id.*

259. WERNER REINARTZ ET AL., PRICE DIFFERENTIATION AND DISPERSION IN RETAILING 17 (2018), https://marketing.uni-koeln.de/sites/marketingarea/user_upload/Price_Differentiation_and_Dispersion_in_Retailing_Whitepaper_Einzelseiten_Version_1_ohne_letzte_Seite.pdf.

260. *See* JOHN BLACK, NIGAR HASHIMZADE & GARETH MYLES, A DICTIONARY OF ECONOMICS 483, 692 (5th ed. 2017).

261. Daniel L. White & Michael C. Walker, *First Degree Price Discrimination and Profit Maximization*, 40 S. ECON. J. 313, 313–14 (1973).

extracted by the price-discriminating monopsonist.[262] The deadweight loss disappears as there is no restriction of output. A price-discriminating monopsonist need not resort to demand depression to obtain lower prices. In fact, the closer the monopsonist approaches perfect price discrimination, the more benign are the welfare effects.[263] While personalized pricing against customers is controversial, price discrimination by a digital monopsonist is much less objectionable. If monopsony is unavoidable in any event, it may as well be implemented with perfect price discrimination.

The benign welfare effects upstream do not mean that consumers are necessarily indifferent to digital monopsonies. As mentioned earlier, consumer prices may rise if downstream competition is weak, which is probably not the case for Uber as it faces keen competition from Lyft, at least in the United States.[264] However, now that the digital monopsonist need not suppress its demand for the upstream input, drivers in Uber's case, it may no longer have an incentive to raise prices in the downstream market. The monopsonist may not be able to increase downstream prices without curtailing its output, which may require the digital monopsonist to leave some input unused. This would require Uber to deliberately fail to match a rider with a driver to create scarcity. Given that Uber is still subject to competition by other ride sharing apps and taxis, deliberate failure to match riders with drivers would likely push riders to its competitors. Thus, the risk of increased downstream prices is likely lower in the case of a digital monopsonist as compared to a brick-and-mortar monopsonist.

Most of the competitive harm discussed in Part II has little application in the case of Uber's digital monopsony. Given that these are individual drivers instead of suppliers, the waterbed effect is not applicable, with the caveat that multihoming drivers may raise wage demands for Uber's competitors, such as Lyft, in response to the lower wages offered by Uber. Given that the drivers wield little bargaining power, such a scenario seems unlikely. Quality erosion, increased con-

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262. BLACK, HASHIMZADE & MYLES, *supra* note 260, at 692.

263. Hal R. Varian, *Price Discrimination and Social Welfare*, 75 AM ECON. REV. 870, 871 (1985).

264. *See* Janine Perri, *Uber vs. Lyft: Who's Tops in the Battle of U.S Rideshare Companies*, BLOOMBERG SECOND MEASURE (June 15, 2022), https://secondmeasure.com/datapoints/rideshare-industry-overview/.

centration in the supply chain, and reduced investment incentives by suppliers are also irrelevant. The equivalent of these competitive effects in this context would be reduced incentives to train as drivers and reduced incentives to invest in a nicer vehicle, for example. In the context of professional athletes or physicians, a monopsony may lead to under-investment to train to acquire the requisite skills or professional qualifications. The required training can be very time-consuming and costly. The situation is different for Uber drivers. Most people do not learn how to drive specifically to become an Uber driver and do not invest in improving their driving skills to become a better Uber driver. In fact, few specific investments are required to become an Uber driver. Therefore, in the case of Uber, reduced incentives to train can be discounted.

The relevance of reduced incentives to make vehicle investment depends on the proportion of drivers who buy or, more probably, rent a car to serve as an Uber driver. For casual car owners who work as an Uber driver part-time to earn supplemental income, this effect has no application. For those who invest in their car for the specific purpose of driving for Uber, the reduced incentives could be an important issue. Thankfully, the quality, or at least the make, of one's car is listed on the Uber app before a rider places an order. The issue of undetected quality reduction discussed by Ezrachi and de Jong is hence unlikely to arise. Poor safety maintenance could be at issue, which should be reflected in a driver's rating over time. Wealth transfer from the seller to the buyer, or in this case, from Uber drivers to Uber, would arise in any exercise of buyer power and deserves attention only if wealth transfer is deemed a valid ground for antitrust intervention, an assertion rejected previously.

Lastly, creation of downstream market power could arise and prove to be an important concern if Uber's monopsony power is exercised for an exclusionary purpose. The competitive effects of monopsony power would be much less benign if the individual targeting of drivers comes with an exclusionary element, as in the case of the Hell program. Evidence suggests that the Hell program's main purpose is to allow Uber to lock in its drivers by offering them personalized financial incen-

tives.[265] To the extent that Uber succeeds in denying competitors such as Lyft access to drivers, the Hell program may harm competition and consumers alike and deserves antitrust scrutiny, but probably as an exclusionary conduct rather than a buyer power abuse.

IV.
Amazon as a Digital Gatekeeper

A. *Digital Gatekeepers*

Both supermarkets and digital marketplaces, such as Amazon, are two-sided platforms. Amazon is in fact a vertically integrated platform. Amazon's Marketplace is a transaction platform that allows more than two million third-party sellers to sell to consumers,[266] accounting for sixty percent of Amazon's overall sales.[267] Marketplace also serves as an ad-sponsored platform by hosting ads on its website for third-party products.[268] Advertising is an increasingly important source of revenue for Amazon.[269] Lastly, Amazon provides a software platform through its Kindle device and accompanying app, which connects publishers and readers.[270] Amazon's business goes significantly beyond its platform. In addition to being a technology company, it is also a logistics company, an advertising platform, a movie studio, a streaming service, a health care provider, a surveillance machine, and a data harvester.[271] Ac-

265. Thomas K. Cheng & Julian Nowag, *Algorithmic Predation and Exclusion*, 28 Fordham J. Corp. & Fin. L. __ (forthcoming 2022).

266. Lauren Rosenblatt, *'Sold by Amazon' Program Shut Down After WA Attorney General's Antitrust Investigation*, The Seattle Times (Jan. 26, 2022, 6:20 PM), https://www.seattletimes.com/business/sold-by-amazon-program-shut-down-after-wa-attorney-generals-antitrust-investigation/.

267. Chris Shipferling, *What Could the Senate's Tech Antitrust Bill Mean for Amazon Sellers?*, Forbes (Mar. 4, 2022, 7:00 AM), https://www.forbes.com/sites/forbesbusinesscouncil/2022/03/04/what-could-the-senates-tech-antitrust-bill-mean-for-amazon-sellers/?sh=3079460366c2.

268. Mitchell, Knox, & Freed, *supra* note 175.

269. *Id.*

270. Bloodstein, *supra* note 204, at 200.

271. Sara Morrison, *The True Cost of Amazon's Low Prices*, Vox (Jan. 13, 2022, 9:00 AM), https://www.vox.com/recode/22836368/amazon-antitrust-ftc-marketplace.

cordingly, Amazon has been called the "everything company."[272]

Both brick-and-mortar supermarkets and Amazon are retailer gatekeepers that wield significant bargaining power in all-or-nothing negotiations with suppliers and transactional counterparties. Gatekeeper power in the supermarket context has been discussed previously in Part I. Every factor that allows these supermarkets such as Walmart and the big four in the United Kingdom to perform gatekeeping functions applies to Amazon as well.

At the outset, it is important to distinguish between two types of sellers on Amazon.[273] The first type are suppliers, just the same as those that supply the brick-and-mortar supermarkets and retailers.[274] These include developers and manufacturers of products with their own recognized brands such as FarberWare, the kitchenware manufacturer.[275] These suppliers may sell their goods to Amazon directly which, in turn, resells the goods to final consumers.[276] This represents the standard wholesale-retail relationship in which Amazon performs the role of the traditional retailer. These sellers are known as first-party sellers and their products are labeled as "Ship from and sold by Amazon.com."[277] Alternatively, they may sell their goods as third-party sellers in Amazon Marketplace directly to consumers with the goods delivered by the supplier itself or by Amazon.[278] The products are labeled as "Ship from and Sold

272. Clare Duffy, *Amazon Is Everywhere. Here's How the US Could Break It Up*, CNN BUS. (July 28, 2021, 8:35 AM), https://edition.cnn.com/2021/07/28/tech/amazon-antitrust-house-bills-issues/index.html.

273. It is important to note that there seems to be many ways to classify sellers on Amazon.

274. Jennifer Robinson, *How Can Third-Party Sellers Make Money and Sell on Amazon?*, SAGESELLER (Feb. 18, 2021), https://sageseller.com/blog/how-can-third-party-sellers-make-money-on-amazon.

275. Eugene Kim, *As Amazon's Dominance Grows, Suppliers Are Forced to Play by Its Rules*, CNBC (Dec. 21, 2017, 6:30 PM), https://www.cnbc.com/2017/12/21/as-amazons-dominance-grows-suppliers-are-forced-to-play-by-its-rules.html.

276. Robinson, *supra* note 274.

277. Hillary Hoffower, *Fake Products Sold by Places like Walmart or Amazon Hold Risks of Everything from Cyanide to Rat Droppings — Here's How to Make Sure what You're Buying Is Real*, INSIDER (Mar. 29, 2018, 2:23 PM), https://www.businessinsider.com/how-to-find-fake-products-online-shopping-amazon-ebay-walmart-2018-3.

278. *Id.*

by . . . Third-Party Seller" when the third-party seller handles the delivery itself and "Sold by . . . Third-Party Seller and Fulfilled by Amazon" when the delivery is handled by Amazon's logistics service.[279]

The second type of sellers is resellers. These sellers do not produce their products.[280] Instead, they source products from manufacturers, suppliers or other sources and resell them to consumers with Amazon serving as a conduit between the supplier and consumers.[281] These resellers are designated as third-party sellers on Amazon[282] and have different types of business models, including wholesale, private label, and retail arbitrage.[283] The wholesalers purchase products from the manufacturers or distributors in bulk and then sell them on to final consumers, as is the case for most brick-and-mortar retailers.[284] The private label resellers source their own private label products directly from factories, often in China, and resell them to consumers.[285] Finally, the retail arbitrageurs source their products online or from local stores and resell them on Amazon at higher prices to make a profit.[286]

In sum, suppliers as traditionally understood can be either first-party sellers or third-party sellers while resellers are invariably third-party sellers on Amazon. As far as the Amazon ecosystem is concerned, the relevant distinction is whether the product is sold by Amazon directly or by a third party. For the purpose of this Article, however, the focus is on whether the products are developed and produced by the seller. The potential competitive harm that could arise from Amazon's exercise of buyer power is different for the suppliers and the resel-

279. *Id.*

280. Robinson, *supra* note 274.

281. *Id.*

282. *Ordering from a Third-Party Seller*, AMAZON, https://www.amazon.com/gp/help/customer/display.html?nodeId=GEF528GN65XSJ7V8#:~:text=third%2Dparty%20sellers%20are%20independent,through%20the%20Amazon%20checkout%20process (last visited Dec. 13, 2022).

283. Owen Cusworth, *The 3 Types of Sellers on Amazon and How They Make a Profit*, MEDIUM: THE STARTUP (Aug. 5, 2021), https://medium.com/swlh/the-3-types-of-sellers-on-amazon-and-how-they-make-a-profit-4f34f67327af.

284. *Id.*

285. *Id.*

286. Christine Gerzon, *Amazon Arbitrage: How It Works and How You Can Earn from It*, ECOMCREW (July 31, 2022), https://www.ecomcrew.com/amazon-arbitrage/#whatis.

lers because the latter do not develop their own products. The common terminology in the Amazon ecosystem, however, is third-party sellers. Amazon does not differentiate between branded third-party sellers and reselling third-party sellers. All of Amazon's third-party seller policies that may constitute buyer power abuses apply to both. Therefore, for the sake of simplicity, this Article will refer to resellers as third-party sellers. Branded third-party resellers are implicitly excluded from the term third-party seller when discussing competitive harm of buyer power abuses.

Similar to the traditional supermarkets, Amazon performs multiple roles. For one, Amazon is a customer of suppliers when it sources products from them. Amazon hosts third-party sellers on its Marketplace. Amazon also competes with some of these sellers by offering private label products.[287] Amazon is in an even more advantageous position in its competition with the suppliers because it knows more about its customers as compared to traditional supermarkets.[288] Amazon's customer information allows it to predict consumer preference and demand more accurately. Amazon does not sell shelf space to suppliers or third-party sellers by charging listing fees or slotting allowances. Instead, Amazon sells advertising, promotion, and logistical services known as Fulfillment by Amazon ("FBA").[289] As discussed below, sellers that purchase advertising on Amazon obtain preferential placement in search results. Advertising and promotional charges and fees for FBA thus effectively function, though not explicitly, as slotting allowances.

Suppliers and third-party sellers are no less reliant on Amazon than are suppliers on traditional supermarkets. If anything, Amazon commands an even larger market share than does the biggest brick-and-mortar retailer, Walmart. Amazon Marketplace reportedly holds a forty percent market share in e-commerce, leading the closest contender, Walmart, by thirty-

287. Kalra and Stecklow, *supra* note 185.

288. *See* Mike Sands, *How Amazon Is Minting a New Generation of Customer-Data-Obsessed Companies*, FORBES (Mar. 2, 2018, 10:21 AM), https://www.forbes.com/sites/mikesands1/2018/03/02/how-amazon-is-minting-a-new-generation-of-customer-data-obsessed-companies/?sh=202d7e8228ed.

289. Amy E. Shehan, *Amazon's Invincibility: The Effect of Defective Third-Party Vendors' Products on Amazon*, 53 GA. L. REV. 1215, 1219–20 (2019).

three percent.[290] This figure refers to all goods bought and sold online, rather than individual product categories such as grocery or toys, where Walmart allegedly holds a twenty percent market share.[291] In a lawsuit brought by the Washington D.C. Attorney General, reportedly the first major antitrust suit against Amazon in the United States,[292] the complaint claimed that seventy-four percent of consumers go directly to Amazon when seeking to purchase a specific product.[293] As such, one can only imagine suppliers' reliance on Amazon for online sales.

The situation is worse for third-party sellers, who face even greater disparity in brand recognition. While consumers recognize and feel attached to a supplier's brand, third-party sellers are essentially fungible. In the eyes of consumers, only reliability and price matter. For a third-party seller that uses FBA, the only relevant attribute is price. The fungibility of third-party sellers means they are even more reliant than suppliers on Amazon and maintain worse bargaining positions vis-à-vis Amazon. In fact, Amazon exacerbates these sellers' dependence by cajoling them to use FBA. This means that apart from ownership of the produced good, essentially everything involved in a sale by a third-party seller is handled by Amazon.[294]

In view of the foregoing, it is clear that Amazon performs an equal, if not a greater, retailer gatekeeper function as compared to traditional supermarkets. Amazon possesses a great deal of buyer power vis-à-vis its suppliers and third-party sellers, as confirmed by media reports,[295] and has exercised this

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290. Morrison, *supra* note 271.

291. Grimes, *supra* note 23, at 580.

292. Joshua Nelson, *Amazon antitrust suit expanded to wholesale operations*, JURIST (Sept. 15, 2021, 12:43 PM), https://www.jurist.org/news/2021/09/amazon-antitrust-suit-expanded-to-wholesale-operations.

293. Gilad Edelman, *A New Antitrust Case Cuts to the Core of Amazon's Identity*, WIRED (May 25, 2021, 4:56 PM), https://www.wired.com/story/amazon-antitrust-lawsuit-cuts-to-core-of-identity.

294. Karen Weise, *Prime Power: How Amazon Squeezes the Businesses Behind Its Store*, N.Y. TIMES (Dec. 19, 2019), https://www.nytimes.com/2019/12/19/technology/amazon-sellers.html; *see also* AMAZON, *FBA storage and fulfillment fees*, https://sell.amazon.com/fulfillment-by-amazon (last visited Apr. 19, 2022).

295. Kalra & Stecklow, *supra* note 185, at 27; MITCHELL, KNOX & FREED, *supra* note 175, at 25.

power to drive hard bargains.[296] The range of reported conduct includes charging excessive fees (or referral fees), prohibiting third-party sellers from selling goods at a lower price on other platforms, imposing unduly harsh contractual terms, alleged tying by requiring third-party sellers to use FBA and purchase advertising, using unfair methods to compete with its own third-party sellers such as outright design copying, using algorithms to steer customers to its own products (otherwise known as self-preferencing in the EU), and misusing sellers' sales data (which was the subject of an EU investigation), and even compelling suppliers to sell an equity stake to Amazon, which will be discussed subsequently.

B. *Amazon's Gatekeeper Bargaining Power*

Buyer power abuses by retailer gatekeepers were prevalent in the pre-digital age.[297] While some jurisdictions such as the United Kingdom and Australia have adopted sector-specific codes of conduct,[298] the United States has taken a relatively hands-off approach. Private label products are widespread, and Amazon is certainly not the first retailer to introduce them. As far as this Author is aware, no jurisdiction has ever penalized a retailer solely for introducing such products. If antitrust authorities have largely ignored buyer power abuses by powerful brick-and-mortar retailers, is there any justification for a different approach with respect to digital gatekeeper platforms? Is there anything unique about digital gatekeepers that bestows their conduct with greater anticompetitive potential on the buyer-side of the market?

To answer these questions, three issues require investigation: (1) whether buyer power needs to be measured differently for digital gatekeeper platforms; (2) whether digital gatekeeper power is stronger or more durable than its brick-and-mortar counterpart; and (3) whether the competitive harm of buyer power abuses identified in Part II are equally applicable to digital gatekeepers.

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296. Mattioli, *supra* note 12, at 4.

297. Foer, *supra* note 93, at 1312–13.

298. Groceries Supply Code of Practice 2009, ¶ 16 (UK), https://www.gov.uk/government/publications/groceries-supply-code-of-practice/groceries-supply-code-of-practice; *Competition and Consumer (Industry Codes—Food and Grocery)* (Cth) reg 2015 sch 19 (Austl.).

The first issue to explore is whether, and how, measurement of buyer power may differ for digital gatekeepers as compared to brick-and-mortar gatekeepers. As far as this Author is aware, digital buyer power is a relatively unexplored issue in the literature. In terms of seller-side market power, Alexandrov argues that "[i]n two-sided markets, firms typically intermediate between buyers and sellers, so that market power measures must reflect firms' interaction both with buyers and with sellers."[299] In two-sided markets, market definition needs to take into account prices charged on both sides of the market.[300] Likewise, assessment of market power also requires us to account for the firm's pricing power on both sides of the market. If a platform cannot raise prices on one side of the market without cutting prices on the other side, it is unlikely to possess market power.

This presents a conundrum. A one-sided firm usually faces suppliers on one side and customers on the other side. Seller-side market power is measured on the customer side and buyer power on the supplier side. For a two-sided platform that sells on both sides, such as a credit card service provider selling payment services to card users and transaction processing to merchants, Alexandrov suggests that one needs to consider its pricing power and hence market share on both sides of the market to determine its seller-side market power.[301] This is consistent with the Supreme Court's decision in *American Express*. There, the Court held that the fact that American Express may have acted anticompetitively on one side of the market does not end the inquiry.[302] One needs to consider the other side of the market to complete the analysis.[303] If one needs to consider both sides to assess seller-side market power, however, it is not clear on which side of the market buyer power should be measured. One possibility is that buyer power needs to be measured on both sides just like seller-side market power. Alternatively, perhaps seller-side market power and buyer power are one and the same concept for digital platforms.

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299. Alexandrov, *supra* note 209, at 775.
300. *Id.* at 775.
301. *Id.* at 782.
302. Ohio v. American Express, 138 S. Ct. 2274, 2287 (2018).
303. *Id.*

Two-sided firms can be classified as symmetrical or asymmetrical. Symmetrical firms are those two-sided firms that have the same kind of interaction with their counterparties on both sides. In the case of credit cards, the credit card company *sells* services to both the card users and the merchants. When the two-sided firm is *selling* on both sides, it makes sense to consider its pricing power on both sides of the market when determining its seller-side market power. The firm needs both sides of the market to function and neither side is more important than the other.

Asymmetrical firms are those two-sided firms that interact differently with their counterparties on the two sides. In other words, they *buy* on one side and *sell* on the other. For example, Uber *buys* labor services from its drivers on one side of the market and *sells* those services to riders on the other side. Because it does not charge a price on both sides, there is no need to consider its pricing power on both sides of the market to determine its seller-side market power. Its buyer power is ascertained on the driver side while its seller-side market power is considered on the rider side. As for Amazon, its buyer power is measured by examining its interaction with its suppliers or third-party sellers, and its seller-side market power is encapsulated by its pricing power over the final consumers who purchase goods on Amazon.

In a way, symmetrical two-sided firms are the genuine two-sided platforms and present the thorniest issues in terms of market definition and measurement of market power. Newspapers and media companies also fall within this category in addition to credit card companies. Newspapers sell papers to readers and advertisements to advertisers. Asymmetrical two-sided firms are two-sided in the sense that they exhibit cross-market indirect network effects, but they do not present the theoretical difficulties in terms of market definition and assessment of market power as do symmetrical two-sided firms. There are distinct buyer and seller sides. For asymmetrical two-sided firms like Amazon, buyer power can be measured from its interaction with the suppliers and the third-party sellers.

The second issue is whether digital gatekeepers such as Amazon have stronger or more durable buyer power than their brick-and-mortar counterparts. Recall that bargaining power in the all-or-nothing context ultimately comes down to

the outside-option payoff of the two parties.[304] The lower the payoff, the less bargaining power one has. To put it differently, bargaining power comes down to whether, and what, alternatives exist for replacing the negotiation counterparty. In the case of retailer gatekeeper power, bargaining power is determined based on the options available to the supplier to replace a retailer and vice versa. This, in turn, depends on the absolute and relative size of the retailer and the supplier, the ability of the retailer to obtain supply to replace a supplier, the competitive position of the retailer and the supplier in their respective markets, and relative customer recognition.[305] If consumers are more attached to the retailer than to the brands, the retailer is more indispensable. If the opposite is true, suppliers will have greater bargaining power.

Multiple factors suggest that Amazon wields even greater bargaining power than the likes of Walmart in the offline world. Despite the size of Walmart and some of the other brick-and-mortar retailers, Amazon is even bigger. As of the time of writing, Amazon is the fifth largest corporation in the world by market capitalization.[306] Walmart is the sixteenth largest by the same metric.[307] In terms of absolute and relative size of the counterparties, Amazon is extraordinary. Though, beyond a certain point, further increase in size is unlikely to give the retailer additional advantage.

In terms of a counterparty's replaceability, it is again important to distinguish between suppliers and third-party sellers. Third-party sellers are the easier case. As mentioned earlier, these sellers are essentially fungible in the eyes of Amazon and consumers.[308] Because they do not produce their own goods and merely source goods from suppliers, they can be easily replaced. Third-party sellers are not present in offline retail. The absence of these sellers in brick-and-mortar retail implies that Amazon possesses greater bargaining power. As for the suppliers, they can be replaced either by another brand or private label products. While the availability of alternative brands should not differ between the online and offline

304. Thomas, *supra* note 66, at 288.

305. Dobson & Chakraborty, *supra* note 120, at 337–38.

306. *Largest Companies by Market Cap*, https://companiesmarketcap.com/ (last visited Apr. 6, 2022).

307. *Id.*

308. *See supra* Part IV.A.

worlds, Amazon may be able to push its private label products over branded products more effectively than do its brick-and-mortar counterparts. Amazon possesses more data about the products it sells, and more importantly, significantly more data about its customers, than do brick-and-mortar retailers.

Studies show that Amazon has deployed pricing algorithms since 2015.[309] One study found that more than one-third of the 1,600 bestselling products on Amazon adopted algorithmic pricing in 2015.[310] Sophisticated algorithmic pricing requires a considerable amount of customer data.[311] Amazon may not yet have enough data to implement personalized pricing, the pinnacle of algorithmic pricing, but it certainly knows a great deal about the preferences and shopping habits of its customers.[312] As a result, Amazon can formulate more effective strategies with respect to its private label products than can its offline rivals. To be sure, Amazon does not offer private label products in every product category but, to the extent it does offer such products, it can replace branded products relatively easily, especially by using search algorithms to steer customers to its own products.[313]

In terms of their respective competitive positions vis-à-vis suppliers and relative customer recognition, a direct comparison between Amazon and brick-and-mortar retailers is difficult. The brick-and-mortar retailers and the digital retailers may operate in different product markets, even though the overlap is increasing and the line between online and offline retailing is diminishing. Many brick-and-mortar retailers also

309. Le Chen et al., *An Empirical Analysis of Algorithmic Pricing on Amazon Marketplace*, PROCEEDINGS OF THE 25TH INTERNATIONAL CONFERENCE ON WORLD WIDE WEB 1339 (2016); Daisuke Wakabayashi, *Does Anyone Know What Paper Towels Should Cost?*, N.Y. TIMES (Feb. 27, 2022), https://www.nytimes.com/2022/02/26/technology/amazon-price-swings-shopping.html; Kathy Kristof, *How Amazon Uses "Surge Pricing," Just Like Uber*, CBS NEWS (July 24, 2017, 10:08 AM), https://www.cbsnews.com/news/amazon-surge-pricing-are-you-getting-ripped-off-small-business/; Emilio Calvano et al., *Algorithmic Pricing What Implications for Competition Policy?*, 55 REV. OF INDUS. ORG. 155, 156 (2019).

310. Chen et al., *supra* note 309.

311. Gaultier, Ittoo & Van Cleynenbreugel, *supra* note 232, at 412.

312. Wakabayashi, *supra* note 309.

313. Kalra & Stecklow, *supra* note 185.

compete in the e-commerce market,[314] while Amazon only has a limited presence in offline retail, with less than one hundred physical locations at present (without including Whole Foods).[315] Moreover, the relevant geographic market for brick-and-mortar retailers is, by nature, local or regional, whereas the geographic market for online retail is national or global.

Available information suggests that Amazon's competitive position is comparable to, or stronger than, Walmart's. Amazon and Walmart accounted for nearly identical percentages of retail sales in the United States in 2020, with Walmart at 9.5% and Amazon at 9.2%.[316] As mentioned earlier, Amazon accounts for forty percent of the e-commerce market.[317] Walmart's corresponding market share in brick-and-mortar retail is likely lower.[318] If even an eight or ten percent market share gives a retailer significant bargaining power vis-à-vis its suppliers, Amazon's share in the e-commerce market allows it to overwhelm any supplier in contractual negotiations, a reality that copious media reports confirm.[319]

Another related factor to consider is relative customer recognition, which is contingent on their competitive positions. A retailer that is more readily recognized by consumers is likely to occupy a stronger competitive position. Amazon and Walmart are each household names and no evidence suggests that one receives greater customer recognition than the

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314. The Economist Intelligence Unit, *Brick-and-Mortar Retailers Fight Back: Winning Strategies to Compete with Online-only Players*, https://www.mastercard services.com/sites/default/files/2018-09/brick-and-mortar-retailers-fight-back.pdf (last visited Apr. 7, 2022).

315. AMAZON, *Amazon Physical Stores Locations*, https://www.amazon.com/find-your-store/b/?node=17608448011 (last visited Apr. 7, 2022).

316. *Amazon and Walmart are Nearly Tied in Full-Year Share of Retail Sales* (Mar. 11, 2021), https://www.pymnts.com/news/retail/2021/amazon-walmart-nearly-tied-in-full-year-share-of-retail-sales.

317. Morrison, *supra* note 271.

318. *Who are the top 10 Grocers in the United States?*, https://www.foodindustry.com/articles/top-10-grocers-in-the-united-states-2019/ (last visited Apr 7, 2022); Melissa Repko, *Walmart drew one in four dollars spent on click and collect — with room to grow in 2022*, CNBC (Dec. 30, 2021, 7:00 AM), https://www.cnbc.com/2021/12/30/walmart-drew-one-in-four-dollars-on-click-and-collect-market-researcher.html.; Jinjoo Lee, *Walmart Gets Back to Basics*, WALL ST J. (May 18, 2021, 1:41 PM), https://www.wsj.com/articles/walmart-gets-back-to-basics-as-grocery-sales-grow-11621353489.

319. Mattioli, *supra* note 12; MITCHELL, KNOX & FREED, *supra* note 175.

other. One distinction between Amazon and Walmart, in terms of customer recognition, is, again, the existence of third-party sellers. These sellers command little brand name recognition and merely convey goods. While some suppliers may be able to leverage their brand recognition to resist retailer bargaining power, third-party sellers are completely at the mercy of Amazon.

Overall, it seems that Amazon's bargaining power vis-à-vis its suppliers is at least comparable to, or even greater than, that of the largest brick-and-mortar retailers such as Walmart. Amazon's bargaining power vis-à-vis third-party sellers is overwhelming. The purpose of this inquiry is not to compare Amazon and Walmart for its own sake but, rather, to illustrate the advisability of intervention against Amazon's buyer power abuses. Given the result of this comparison, it seems that if intervention against buyer power abuses by dominant brick-and-mortar retailers is defensible, there exist equally strong, if not stronger, grounds to act against Amazon. The greater is Amazon's buyer power, the more likely it is that its buyer power abuses would cause competitive harm, and the lower the risks that intervention would be frivolous.

C. *Buyer Power Abuses by Amazon*

The buyer power abuses of which Amazon has been accused are too many to be fully catalogued in this Article. These allegations can be grouped into six categories: (1) excessively low purchase prices; (2) unduly harsh contractual terms; (3) MFN clauses, often the platform's countermeasure to its suppliers' reaction to its demands for low prices; (4) tying; (5) unfair competition with its own suppliers, and (6) coerced investment. The first two categories of abuse are clearly exploitative in nature, as they amount to extraction of surplus from Amazon's suppliers and third-party sellers. MFN clauses and tying are exclusionary practices. MFN clauses render it impossible for competitors and potential new entrants to compete with Amazon by undercutting Amazon's prices.[320] Tying threatens to leverage Amazon's market power in the online marketplace to related markets such as logistics and online advertising. Amazon's alleged conduct that constitutes unfair

320. Pinar Akman, *A Competition Law Assessment of Platform Most-Favored-Customer Clauses*, 12 J. COMPETITION L. & ECON. 781 (2016).

competition falls beyond the scope of traditional competition law and would mostly be regulated as unfair trade practices. Coerced investment does not lend itself to an obvious classification, as it could be considered an instance of surplus extraction (although in this instance the surplus is not extracted from a target's profit but from its share capital).

1. *Excessively Low Purchase Prices*

The first two categories of abuses are exploitative in nature. The first category is the classic monopsony abuse of offering excessively low purchase prices. Its main purpose is to extract surplus from the supplier. The practice is similar to the imposition of unduly harsh contractual terms in its chiefly exploitative aim. Ultimately many contractual terms can be translated into monetary terms such that imposition of unduly harsh contractual terms is tantamount to demanding a lower price.

The excessively low purchase prices are manifested differently for the suppliers and the third-party sellers. For the suppliers, it appears as the usual low wholesale prices. The National Grocers Association ("NGA") reports that Amazon has extracted significantly lower wholesale prices from suppliers than those offered to independent grocers.[321] Oftentimes, Amazon's wholesale prices are lower than the independent grocers' retail prices.[322] The NGA describes an anecdote in which "one NGA member tried to offer diapers to an employee at cost, only to learn that the employee was paying a lower price for diapers on Amazon than the NGA member was paying at wholesale."[323] To the extent that the low wholesale prices offered to Amazon eats into a supplier's margin and undermines its profitability, it may need to raise prices on other buyers to recoup its losses, triggering the waterbed effect discussed in Part II.A.

Amazon has a different relationship with the third-party sellers. Amazon does not take ownership of the goods. Instead, it provides these sellers with access to final consumers. It resembles a supplier selling its products on consignment at a supermarket or department store except that, with Amazon, the

321. NAT'L GROCERS ASS'N, *supra* note 127, at 12.
322. *Id.*
323. *Id.*

goods are not physically transferred to Amazon unless the seller uses FBA.[324] Amazon makes money from the third-party sellers by charging a commission, known as the "referral fee," from their sales. The fee has been described as "a tax no seller can avoid."[325] The referral fee varies by product category. The standard rate is fifteen percent.[326] For some products, such as cameras and consumer electronics, the rate is lower at eight percent.[327] For other products, such as clothing, the rate is higher at seventeen percent.[328] The standard rate of fifteen percent has remained the same since the inception of the Amazon Marketplace in 2000, despite the astronomical expansion of Marketplace's business volume over the years.[329]

Amazon's extraction does not end with referral fees. Two optional services, if used, will improve a seller's positioning on the site significantly: advertising and FBA. Amazon offers sellers its own warehousing and logistical services.[330] Advertising has become an increasingly important part of Amazon's business and takes up an increasing amount of space on its search result page.[331] Amazon pressures third-party sellers to use these services by demoting in the search results those that do not.[332] Together, the fees and charges could amount to thirty percent of a third-party seller's sales.[333] Fees charged to third-party sellers generated $120 billion of revenue for Amazon in 2020.[334] Amazon's profit margin on third-party fees is at about twenty percent, which is four times higher than its profit mar-

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324. AMAZON, *Fulfillment by Amazon*, https://sell.amazon.com/fulfillment-by-amazon (last visited Apr. 7, 2022).

325. MITCHELL, KNOX & FREED, *supra* note 175.

326. AMAZON, *Selling on Amazon Fee Schedule*, https://sellercentral.amazon.com/gp/help/external/200336920 (last visited Apr. 6, 2022).

327. *Id.*

328. *Id.*

329. MITCHELL, KNOX & FREED, *supra* note 175.

330. Pamela Danziger, *Amazon's Third-Party Marketplace Is Its Cash Cow, Not AWS*, FORBES (Feb. 5, 2021), https://www.forbes.com/sites/pamdanziger/2021/02/05/amazons-third-party-marketplace-is-its-cash-cow-not-aws/?sh=7ebc504621c0.

331. Jordan Novet, *Amazon has a $31 billion a year advertising business*, CNBC (Feb. 3, 2022), https://www.cnbc.com/2022/02/03/amazon-has-a-31-billion-a-year-advertising-business.html.

332. MITCHELL, KNOX & FREED, *supra* note 175.

333. *Id.*

334. Danziger, *supra* note 330.

gin from its own retail sales.[335] Finally, this business is essentially risk-free for Amazon. Amazon bears none of the costs of product development, sourcing, marketing, and promotion, nor is it exposed to the risk of failure. It makes money whenever a third-party seller makes a sale.

Evidence suggests that the largest beneficiary of third-party sales on Amazon is Amazon itself. Stacy Mitchell, Ron Knox and Zach Freed observe a high churn of third-party sellers on Amazon over time. In other words, most sellers do not last very long on Amazon. Two-thirds of the revenue earned by third-party sellers is attributed to those sellers which joined the site within the last three years.[336] Sellers that have been on the site for more than five years account for only ten percent of overall revenue.[337]

Amazon's offering excessively low wholesale prices and charging excessively high referral fees would constitute an exercise of buyer power in the classic sense and may trigger all the competitive effects highlighted in Part II, including the waterbed effect, quality erosion, increased concentration in the supply chain, creation of downstream market power, reduced investment incentives by upstream suppliers, and wealth transfer.

Unlike the situation of Uber drivers, where most of these effects have little salience, they are genuine concerns in Amazon's case. It is again important to distinguish between suppliers and third-party sellers. While these effects can afflict suppliers, they have little application to third-party sellers, which do not develop and manufacture products. Third-party sellers do not have direct control over the quality of the products they sell. They do not invest in product development and there can be no issue with increased concentration as these sellers are numerous and fungible and entry barriers into this market are low. The only remaining effect is wealth transfer, which is universal in every instance of exercise of buyer power. Thus, to the extent that Amazon's buyer power is more targeted at third-party sellers than the suppliers, its exercise may have fewer deleterious effects.

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335. MITCHELL, KNOX & FREED, *supra* note 175.
336. *Id.*
337. *Id.*

2. *Unduly Harsh Contractual Terms*

Secondly, and related to excessive pricing, is the exploitative abuse of imposing unduly harsh contractual terms. Amazon is not singularly guilty of this practice. For example, supermarkets have long been accused of the same.[338] These terms include a unilateral right to amend or terminate the contract without the counterparty's consent, forced arbitration, delayed payments, and other highly unfavorable terms. The imposition of such harsh contractual terms is a direct manifestation of Amazon's buyer power, the sole purpose of which is to extract the most advantage from the counterparty.

For one, Amazon may impose delayed payment terms on its suppliers. The standard payment term is reportedly ninety days.[339] A supplier needs to offer a half percent discount if it wishes to accelerate the payment term by fifteen days to seventy-five days, and a one percent discount for a further reduction of fifteen days to sixty days.[340] Suppliers need to pay for the privilege of getting paid at a reasonable time. Amazon's use of forced arbitration clauses, which makes it impossible for its suppliers and third-party sellers to band together to pursue redress against Amazon, has also faced scrutiny.[341] An Amazon third-party seller has specifically stated that he is prevented by this clause from bringing an antitrust claim against Amazon.[342] Unfortunately, the enforceability of class action waivers has been confirmed by the Supreme Court.[343] Unsurprisingly, Amazon has been described by Joe Hansen, a co-founder of BuyBox Experts, an Amazon account management and brand-

338. Dobson, *supra* note 34, at 257–58; Mills, *supra* note 40, at 151–52.

339. Edward Devlin, *Amazon grocery suppliers protest new terms on Vendor Central platform*, THE GROCER (Mar. 5, 2021), https://www.thegrocer.co.uk/finance/amazon-grocery-suppliers-protest-new-terms-on-vendor-central-platform/653897.article.

340. *Id.*

341. Annie Palmer & Lauren Feiner, *DC attorney general goes after Amazon's first-party business in amended antitrust complaint*, CNBC (Sept. 13, 2021, 10:55 AM), https://www.cnbc.com/2021/09/13/dc-attorney-general-targets-amazons-first-party-business-in-amended-antitrust-complaint.html.

342. Spencer Soper, *Amazon is accused of forcing up prices for independent merchants in antitrust complaint*, L.A. TIMES (Nov. 8, 2019, 11:46 AM), https://www.latimes.com/business/technology/story/2019-11-08/amazon-antitrust-complaint.

343. See AT&T Mobility LLC v. Concepcion, 563 U.S. 333 (2011).

ing consultant, as the "toughest negotiator" in all of retail, online and offline.[344]

Other contractual terms imposed by Amazon on its suppliers and third-party sellers would strike most as unduly harsh or unfair as well. In the brick-and-mortar context, slotting allowances, delayed payment, and the constant threat of delisting prevail. In addition, there are regular demands for retroactive discounts, rebates, and additional payments for "advertisements, promotions, new store openings, remodeling of stores, [and] use of packing boxes"[345] that were not stipulated in the original supply agreement.[346] Retailers are notoriously secretive about their contractual arrangement with suppliers, which are often protected by confidentiality obligations. Amazon is no exception.[347]

A case in the Paris Commercial Court lifted this shroud of secrecy, shedding light on Amazon's contractual practices. The Court found these clauses unfair under French law governing unfair commercial practices and ordered Amazon to amend the offending terms within 180 days.[348] The offending clauses run the gamut. One clause gives Amazon the right to amend the contract and its policies at any time, at its entire discretion without consulting or giving notice to the counterparty.[349] Another clause gives Amazon the right to suspend or terminate the contract or stop providing service at any time for any reason and with immediate effect, so long as notice is given.[350] Yet another clause empowers Amazon to restrict or suspend supplier access to any of Amazon's websites or delay or suspend its sales at its entire discretion.[351] Finally, another clause absolves Amazon from any liability for damage

344. Kim, *supra* note 275.

345. VANDER STICHELE & YOUNG, *supra* note 115, at 17.

346. *Id.*

347. *Bundeskartellamt obtains far-reaching improvements in the terms of business for sellers on Amazon's online marketplaces*, BUNDESKARTELLAMT (July 17, 2019), https://www.bundeskartellamt.de/SharedDocs/Meldung/EN/Pressemitteilungen/2019/17_07_2019_Amazon.html.

348. Marie-Laure Pidoux & Claire Bouchenard, *Amazon fined €4 million for breach of unfair contract terms rules*, OSBORNE CLARKE (Oct. 28, 2019), https://marketinglaw.osborneclarke.com/general/amazon-fined-e4-million-breach-unfair-contract-terms-rules.

349. *Id.*

350. *Id.*

351. *Id.*

caused to a supplier's good due to Amazon's mishandling in storage or delivery.[352]

These clauses deprive suppliers and third-party sellers of security in their relationships with Amazon and allow Amazon to sever its relationship with any supplier or third-party seller immediately and for any or no reason. This puts enormous pressure on the suppliers and the third-party sellers to yield to Amazon's demands. In the brick-and-mortar context, the suppliers' chief fear is the constant threat of immediate delisting.[353] Such a threat is particularly disruptive and potent if the supplier has made relation-specific investments in order to serve a certain retailer. Precisely for this reason, the United Kingdom and Australia impose certain procedural due process requirements for delisting of suppliers in the grocery market context.[354] The EU has adopted regulation with a similar effect.[355]

It is unclear whether antitrust law has any role to play in regulating unduly harsh contract terms. Imposing such terms itself does not seem exclusionary. Regulating excessively low purchase prices and the imposition of unduly harsh contractual terms would be a direct affront to pure buyer power, given the absence of competitive effects. It is truer in the case of policing contractual terms because a supplier generally does not react to harsh contractual terms by imposing harsher terms on other buyers. Unduly harsh contractual terms do not trigger the competition-distorting waterbed effect that excessively low prices sometimes do. Nor is it clear that these terms will inflict the competitive harm delineated in Part II. While some of the terms, such as retroactive discounts or rebates and additional fees and charges, are financial in nature and may produce the same financial impact on the sellers as excessively low wholesale prices, others, such as forced arbitration, do not. It is difficult to argue that these clauses lead to quality erosion or reduced investment incentives for upstream suppliers.

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352. *Id.*

353. VANDER STICHELE & YOUNG, *supra* note 115.

354. Groceries Supply Code of Practice 2009 (UK), *supra* note 299, ¶ 16 (UK); *Competition and Consumer (Industry Codes—Food and Grocery)*, *supra* note 299, at 19.

355. Commission Regulation 2019/1150, of the European Parliament and of the Council of 20 June 2019 on promoting fairness and transparency for business users of online intermediation service, art. 4, 2019 O.J. (L 186) 58.

Perhaps because of this lack of competitive effect, most jurisdictions have chosen to regulate unduly harsh contractual terms through other laws. As mentioned earlier, the United Kingdom and Australia have resorted to sector-specific codes of conduct.[356] In addition, laws govern unfair contract terms that specifically apply to small businesses and unconscionable business conduct in Australia.[357] France has applicable laws as well, as illustrated in the Paris Commercial Court case referenced in this Part. Lastly, the EU has adopted Regulation 2019/1150 that endeavors to promote fairness and transparency for businesses users on online platforms.[358] The Regulation requires an online intermediary to provide a specific period of notice and an opportunity to appeal through an internal complaint-handling process before terminating a supplier.[359] It also requires an online intermediary to provide reasons before restricting or suspending a supplier's access to the platform.[360] While the specific details may vary, most of these laws, regulations, and codes of conduct focus on similar issues.

3. *MFN Clause/Fair Pricing Policy*

Thirdly, suppliers may respond to the low wholesale prices required by a powerful buyer by raising prices on other buyers, triggering the waterbed effect. Because of the different ways in which third-party sellers interact with Amazon, these sellers do not raise prices on other buyers. Instead, they may lower their prices on other platforms.[361] This is the opposite of the waterbed effect. As opposed to harming other buyers, the third-party sellers' response, in this instance, disadvantages Amazon and enhances competition. Amazon tries to forestall

356. Groceries Supply Code of Practice 2009 (UK), *supra* note 298, ¶ 16; *Competition and Consumer (Industry Codes—Food and Grocery)* (Austl.), *supra* note 299, at 19.

357. Competition and Consumer Act 2010 (Cth) sch 2 (Austl.).

358. Commission Regulation 2019/1150, of the European Parliament and of the Council of 20 June 2019 on promoting fairness and transparency for business users of online intermediation service, art. 4, 2019 O.J. (L 186) 58.

359. *Id.*

360. *Id.*

361. *Germany and United Kingdom: Antitrust Cases against Amazon formally closed*, European Commission Network (May 2013), https://ec.europa.eu/competition/ecn/brief/05_2013/amaz_deuk.pdf.

this by imposing a price parity provision, under which sellers are not allowed to sell their products significantly more cheaply elsewhere.[362] This policy was officially rescinded, first in the EU in 2013 after the authorities in the United Kingdom and Germany launched an investigation into such policy[363] and then in the United States in 2019 when the FTC threatened to do the same.[364] Amazon has adopted something more subtle, the Fair Pricing Policy.

Under the Fair Pricing Policy, instead of an outright prohibition, a third-party seller will suffer a plethora of negative consequences if Amazon detects lower prices of a seller's products elsewhere. These include demotion in the search results, removal of the Prime badge, and forfeiture of the all-important "Buy Now/Add to Cart" button on its product page.[365] In the extreme case, the seller can be ejected from the platform completely.[366] The "Buy Now/Add to Cart" button is critical to a third-party seller's profitability and survival. Reportedly, eighty-two percent of Amazon's sales and an even higher percentage of mobile purchases are made through this "buy box."[367] Although it is still possible to make sales without the box, the alternative process is cumbersome enough to put off most consumers.[368] Third-party sellers argue that the Fair Pricing Policy is equivalent in effect to the rescinded price parity provision.[369]

Amazon has defended this Policy by arguing that the third-party sellers have the right to set prices for their products and that Amazon should have the right to *not* highlight products that are not priced competitively.[370] They further argue that the Policy helps to ensure that consumers will obtain the

362. Bloodstein, *supra* note 204, at 209–10.

363. *Amazon to alter pricing policy for traders*, BBC (Aug. 29, 2013), https://www.bbc.com/news/business-23881202.

364. Hirsh Chitkara, *Amazon may face antitrust court battle over fair pricing*, PROTOCOL (Mar. 15, 2022), https://www.protocol.com/bulletins/amazon-pricing-antitrust.

365. Edelman, *supra* note 293.

366. Chitkara, *supra* note 364.

367. Eyal Lanxner, *The Amazon Buy Box: How It Works for Sellers, and Why It's So Important*, BIGCOMMERCE, https://www.bigcommerce.com/blog/win-amazon-buy-box/#what-is-the-amazon-buy-box (last visited Apr. 6, 2022).

368. *Id.*

369. Edelman, *supra* note 293.

370. Palmer & Feiner, *supra* note 341.

lowest prices possible on Amazon.[371] While this may be true, Amazon achieves this not by driving down the prices on its website, but by preventing price cuts on other platforms, which is hardly pro-competitive.

The exclusionary potential of Amazon's policy is clear. While it ensures that Amazon always offers the lowest prices, it eliminates the incentives of third-party sellers to reduce prices elsewhere. This also eliminates the incentives of other platforms to lower commission fees because doing so would not translate into lower product prices.[372] Given Amazon's prominence in e-commerce, other websites or new entrants will almost certainly have to undercut Amazon to attract sellers and customers. The policy has effectively foreclosed this avenue for potential new entrants and competitors. A former third-party seller on Amazon declares that "[b]ecause of its size and strength, and because sellers can't keep their prices low on their own channels, Amazon is literally inflating the entire online economy".[373]

The Fair Pricing Policy constitutes an MFN clause or, as according to Pinar Akman, a price matching guarantee.[374] The critical difference between these two is that MFN clauses allow a buyer to protect itself by making sure that it receives the cheapest price from a seller.[375] In the supply context, a retailer would usually demand an MFN clause to extract a favorable wholesale price. The impact of such clauses on consumers is indirect. In contrast, a price matching guarantee ensures price parity among sellers. It protects a seller's interest by guaranteeing that no one else can or will offer a lower price.[376] It usually arises in the context of consignment sales or through an agency model, where the price-setting power ultimately lies with the supplier and not the retailer.[377] This is true in Ama-

371. Mike Leonard, *Amazon Loses Antitrust Ruling in Consumer 'Fair Pricing' Case*, BLOOMBERG LAW (Mar. 15, 2022, 12:39 PM), https://news.bloomberglaw.com/antitrust/amazon-loses-antitrust-ruling-in-consumer-fair-pricing-case.

372. Edelman, *supra* note 293.

373. *Id.*

374. Akman, *supra* note 320, at 786.

375. *Id.* at 781–82.

376. *Id.* at 789.

377. *How to create a listing on Booking.com*, HOSTHUB (Aug. 10, 2021), https://www.hosthub.com/guides/how-to-create-a-listing-on-booking-com/;

zon's case and a slew of cases in Europe involving hotel booking websites.[378] The impact of such guarantees on consumers is direct. The clauses practically ensure alignment of prices across all platforms and sales channels and remove all incentives for competing platforms to reduce their commission or fees, as any reduction will have no impact on the final price. Strictly speaking, MFN clauses are not a typical buyer power abuse. They are, however, very often imposed by a powerful buyer or platform eager to shield itself from price competition.

The Fair Pricing Policy has already attracted antitrust scrutiny and was implicated in two lawsuits. In one suit brought in a state court, Judge Hiram Puig-Lugo of the Superior Court of the District of Columbia granted Amazon's motion to dismiss a complaint brought by the Washington D.C. Attorney General.[379] Meanwhile, Judge Richard Jones of the U.S. District Court for the Western District of Washington allowed a proposed class action brought by consumers over this policy to go forward.[380] Judge Jones distinguished Amazon's policy from similar fair pricing agreements that have been upheld by other courts in the past on the ground that it requires third-party sellers to raise the price of products sold on cheaper alternative platforms.[381]

A policy similar to the Fair Pricing Policy, but which applies to Amazon's suppliers or first-party sellers, is called the "Minimum Margin Agreement,"[382] under which a supplier guarantees Amazon a minimum profit or is obliged to account for the shortfall with the delivery of additional products.[383] It has been alleged that this policy has the same effect as the Fair Pricing Policy by eliminating the suppliers' incentives to allow their goods to be sold at a lower price elsewhere.[384] Doing so

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How to List on Expedia — Step-by-Step Guide, HOSTAWAY, https://www.hostaway.com/how-to-list-on-expedia-step-by-step-guide/.

378. Akman, *supra* note 320, at 796–97, 800–03.

379. Rhea Binoy, *U.S. court dismisses D.C. antitrust lawsuit against Amazon*, REUTERS (Mar. 21, 2022, 6:12 AM), https://www.reuters.com/business/retail-consumer/us-court-dismisses-dc-antitrust-lawsuit-against-amazon-2022-03-19/.

380. Leonard, *supra* note 371.

381. *Id.*

382. Palmer & Feiner, *supra* note 341.

383. Nelson, *supra* note 292.

384. Palmer & Feiner, *supra* note 341.

would cause Amazon to cut its prices, which would lower Amazon's margin and force the supplier to make up the shortfall. Suppliers can forestall price cutting on other platforms by raising their wholesale prices. The "Minimum Margin Agreement" effectively gives suppliers a contractual incentive to set in motion the waterbed effect. This practice was also covered by the suit brought by the Washington D.C. Attorney General.[385]

4. *Tying*

The fourth category of potential abuse is tying. Tying refers to Amazon's coercing or cajoling its third-party sellers to purchase advertising and logistical services from it. The obvious anticompetitive concern here is Amazon leveraging its market power in e-commerce into related markets such as logistics and online advertising.

Numerous reports describe Amazon's tactic of making it highly advantageous for sellers to buy advertisements and use FBA, which has allowed FBA to grow rapidly in recent years. Amazon, reportedly, delivers half of the items ordered on its site, up from fifteen percent two years prior, and has surpassed the U.S. Postal Service in the market for large e-commerce parcel.[386] It delivered one-fifth of all e-commerce deliveries in 2019 and is expected to surpass UPS and Fedex in 2022.[387] This is hardly surprising given that eighty-five percent of the top 10,000 sellers on Amazon rely on Prime shipping, which is delivered by FBA.[388] Given Amazon's market share in online retail overall, this surely represents a very high volume of parcels.

FBA was introduced in 2006. Though few sellers signed up for it initially. Many of them preferred to use alternative warehouse operators and parcel carriers.[389] By now, FBA has become highly successful, reportedly accounting for half of Amazon's revenue from third-party sellers.[390] Amazon achieved this not by offering a superior service at a lower price; FBA often charges higher rates than its competitors.[391]

385. *Id.*
386. MITCHELL, KNOX & FREED, *supra* note 175.
387. *Id.*
388. *Id.*
389. *Id.*
390. *Id.*
391. *Id.*

Amazon predictably denied the allegation, arguing that comparable logistics options are often fifty to eighty percent more expensive.[392] This, however, is contradicted by a third-party seller, who indicated that FBA fees increased by twenty percent between 2015 and 2019 and were thirty-five percent more expensive than comparable services.[393] Amazon grew FBA by using heavy-handed tactics to push its third-party sellers to use it. Amazon has allegedly embedded a preference for FBA users in its algorithm that allocates the all-important "Buy Box," which essentially amounts to a default seller designation for a particular product, among the sellers.[394] The European Commission is investigating Amazon for this practice.[395] Amazon has denied this allegation, retorting that the more favorable rankings for products using FBA are not the result of bias but a reflection of FBA's reliability.[396] This denial is contradicted by the decision of the Italian Competition Authority, which fined Amazon almost $1.3 billion for favoring users of FBA on its website.[397] In its decision, the Italian authority required Amazon to give third-party sellers who do not use FBA the same sales and visibility opportunities.[398]

Amazon has also strategically curtailed the Seller Fulfilled Prime ("SFP") program. Under this program, a seller can earn the Prime badge if it can meet the two-day shipping commitment offered to Prime members using outside parcel delivery services.[399] The Prime badge is very important because shipping is free for Prime members and Prime products receive preferential treatment in the allocation of the "Buy Box."[400] Starting in late-2019, Amazon began pressuring sellers to switch to FBA by making it increasingly difficult to stay within SFP. It threatened to revoke the Prime badge for minor fail-

392. Soper, *supra* note 342.
393. *Id.*
394. MITCHELL, KNOX & FREED, *supra* note 175.
395. Alina Selyukh, *Amazon Faces Antitrust Charges From European Regulators*, NPR (Nov. 10, 2020, 8:56 AM), https://www.npr.org/2020/11/10/879643610/amazon-faces-antitrust-charges-from-european-regulators.
396. Victor Malachard, *5 things you need to know about the Amazon antitrust probe*, NOZZLE (Feb. 9, 2022), https://insights.nozzle.ai/amazon-antitrust-probe.
397. Satariano, *supra* note 8.
398. *Id.*
399. MITCHELL, KNOX & FREED, *supra* note 175.
400. Morrison, *supra* note 271.

ures.[401] It imposed a more onerous on-time delivery rate of 98.5 percent on SFP sellers as compared to the 83.4 percent mark that Amazon's own FBA achieves.[402] Failure to achieve this rate would result in the forfeiture of the Prime status.[403] Finally, during the holiday season in 2019, it categorically required its sellers to use FBA.[404]

Perhaps the most sinister aspect of Amazon's conduct regarding FBA is that Amazon charges a much higher rate for products ordered from other platforms.[405] For many small sellers, it is simply not cost-effective to maintain multiple warehousing and delivery capacities. Such is especially the case when some sellers reportedly generate at least eighty-one percent of their revenue from Amazon.[406] Given that sellers are practically required to use FBA in order to sell on Amazon, one can imagine that most of them rely on FBA to fulfill their entire logistics needs. Amazon, however, charges a much higher rate for delivering a product ordered on other sites such as eBay. It reportedly charges sixty-six percent more for delivering a shirt or a book ordered from eBay as opposed to its own website.[407] This has the predictable impact of pushing customers to Amazon. eBay loses customers not due to its inefficiency, but due to its lack of logistics service. This aspect of Amazon's conduct is clearly exclusionary, and the applicable theory of harm is not premised on leveraging. Rather it is an instance of Amazon resorting to tying to protect its own market power in the primary market.

Amazon's attempt to leverage its position in online retail to other lines of business is not limited to logistics. It has replicated the same strategy in advertising.[408] Most of its advertisements are sponsored brand and product advertisements interspersed in its organic search results.[409] Amazon began its digital advertising business in 2012, but only began to focus on it

401. MITCHELL, KNOX, & FREED, *supra* note 175.
402. *Id.*
403. *Id.*
404. *Id.*
405. *Id.*
406. Chitkara, *supra* note 364.
407. MITCHELL, KNOX, & FREED, *supra* note 175.
408. Morrison, *supra* note 271.
409. MITCHELL, KNOX, & FREED, *supra* note 175.

in recent years.[410] It has increased the amount of resources devoted to advertisements and reduced that dedicated to search results.[411] As a result, an increasing proportion of product page views come through ad clicks.[412] Sellers are under enormous pressure to advertise because failure to do so may cost them favorable rankings in the search results.[413] Amazon's algorithms create a positive feedback loop for advertised products; the algorithms rank products with greater sales higher.[414] Once a seller advertises a product, which brings in some initial sales, Amazon's algorithms rank it higher, which gets the product more customer attention, which begets more sales, so on and so forth. In fact, it has been reported that Amazon required a third-party seller to spend $1.8 million on advertising before it would address the seller's counterfeit problem.[415] Amazon has predictably denied the allegation.[416]

Amazon has gone one step further and pursued the strategy of tying FBA and advertising together with its coveted "Buy Box." In order to advertise a product, a seller must have secured a "Buy Box" for it, which, in turn, is partly dependent on the seller using FBA.[417] Amazon secures customers for FBA by taking advantage of sellers' desire to advertise their products to jumpstart the positive feedback loop, which ties sellers more tightly to Amazon by making sales through other platforms more costly. Sellers become increasingly reliant on Amazon, which makes them more susceptible to its bargaining power and exploitation.

The correct characterization of this conduct depends on the counterparty at issue. If these requests were made to a supplier, they would constitute reciprocal dealing because Ama-

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410. *A Short History Of Amazon Advertising Part 1: 2012 – 2016*, PODEAN, https://www.podean.com/a-short-history-of-amazon-advertising-part-1-2012-2016 (last visited Apr. 7, 2022).

411. MITCHELL, KNOX & FREED, *supra* note 175.

412. *Id.*

413. Morrison, *supra* note 271.

414. MITCHELL, KNOX & FREED, *supra* note 175.

415. Molly Wood, *Amazon hasn't had much antitrust scrutiny compared to other tech giants. That may be about to change.*, MARKETPLACE (Apr. 21, 2021), https://www.marketplace.org/shows/marketplace-tech/amazon-hasnt-had-much-antitrust-scrutiny-compared-to-other-tech-giants-that-may-be-about-to-change.

416. *Id.*

417. MITCHELL, KNOX & FREED, *supra* note 175.

zon is essentially conditioning its purchase from a supplier on the supplier's purchases of advertising and logistical services. In the case of a third-party seller, the conduct amounts to tying because Amazon ties the sale of its Marketplace platform services with its advertising and FBA. Given that much of the conduct seems to be targeted at third-party sellers—a supplier's products are delivered by Amazon by default—the ensuing analysis will treat Amazon's conduct as tying.

Whether Amazon's conduct amounts to tying depends on whether the pressure it exerts on suppliers to use FBA amounts to coercion under tying law. Flat-out compulsion would certainly constitute coercion. The case is not as clear for Amazon's other tactics involving the "Buy Box" and the Prime badge. Amazon's FBA practice has apparently not drawn the attention of U.S. antitrust enforcers apart from an FTC investigation into Amazon's treatment of third-party sellers, the scope of which has not been made public and may cover these practices.[418] It has, however, attracted the scrutiny of the European Commission. On November 10, 2020, the European Commission announced an investigation into Amazon's conduct of pressuring sellers to use FBA through its manipulation of the "Buy Box" algorithm and its control over access to Prime users.[419] An EU investigation into Amazon's practice is arguably facilitated by the developing EU jurisprudence on self-preferencing emanating from its case against Google.[420] Coercion is not needed to establish self-preferencing.[421] The only penalty decision for Amazon's tying practices this Author is aware of is the Italian Competition Authority's decision mentioned in the Introduction.[422]

In the United States, where the jurisprudence on self-preferencing is yet to develop and may never take hold—as the FTC's abandoned investigation into Google's self-preferencing suggests—the coercion requirement under tying law may require reconsideration, at least as applied to digital plat-

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418. Annie Palmer, *What the EU's investigation of Amazon means for U.S. antitrust probes*, CNBC (Nov. 11, 2020), https://www.cnbc.com/2020/11/11/eu-investigates-amazon-what-it-means-for-us-antitrust-probes.html.

419. Eur. Comm'n, *supra* note 7.

420. Case T-612/17, Google LLC v. Comm'n, ECLI:EU:T:2021:763 (Nov. 10, 2021).

421. *Id.* at ¶¶ 513, 51843.

422. Satariano, *supra* note 8.

forms. In the context of a single discrete transaction between a seller and a buyer, the only way to force the buyer to take both the tying and the tied products may be through outright coercion by bundling both products. When the transaction is between a digital platform and its suppliers and third-party sellers, and perhaps even customers, the multi-faceted interaction with these parties affords the platform numerous pressure points. None of the individual tactics, on their own, would amount to coercion. For example, it will be explained in the following Part that sellers that do not use FBA are more likely to face competition from Amazon's private label products, which does not exhibit sufficient compulsion to qualify as coercion. Given the multitude of levers at Amazon's disposal and the high degree of seller dependence on Amazon, which already renders the sellers more susceptible to pressure, Amazon can force suppliers and third-party sellers to succumb without resorting to outright coercion as understood in tying law. The pressure on the counterparty, however, is no less real.

In short, in the context of digital platforms, coercion must be assessed holistically. Individual tactics cannot be viewed in isolation. It is only by adopting a more flexible understanding of coercion that tying law can have meaningful and effective application to digital platforms. Amazon is not the only digital platform that raises this issue. Google, among other platforms, also shines a spotlight on the definition of coercion under tying law through its self-preferencing practices.

5. *Unfair Competition with Third-Party Sellers*

The fifth category of abuse pertains to Amazon's competitive interaction with its third-party sellers, in particular, through the introduction of its own private label products. Amazon is not the only purveyor of private label products. As previously mentioned, some third-party sellers source their own private-label products directly from manufacturers and sell them on Amazon as well.[423] The dynamics and significance are entirely different, however, when Amazon introduces its private label-products to compete with its sellers. While much of this conduct amounts to unfair competition or unfair trade practices in some jurisdictions, it is probably legal in the United States.

423. *See* Part IV.A.

It is financially beneficial for a retailer to develop private label products. A retailer achieves a higher margin from private label products as compared to branded products.[424] A portion of branded product profits go to the manufacturer as brand premium. There is no brand premium for a private label product; most of the profit goes to the retailer. Suppliers earn much less from these products because their role in supply is largely fungible.[425] Furthermore, private label products greatly increase the retailer's bargaining power vis-à-vis a supplier. The existence of private label products increases the outside-option payoff for retailers in their negotiation with suppliers, allowing them to drive harder bargains.[426]

In the brick-and-mortar context, the retailer has many ways to promote its own private label products over branded products. It can give its own products more advantageous shelf space.[427] It can leverage sales data and other information, such as information regarding promotional campaigns of branded products, for the benefit of its own products.[428] Finally, because the retailer ultimately controls the pricing of the products it sells, it can always structure the pricing to give its own products an edge.[429]

The promotion of private label products may appear beyond reproach. After all, antitrust law seldom penalizes a firm for introducing a new product into the market. Courts are loathe to second guess a firm's decision to introduce new products.[430] A range of competitive harm, however, has been attributed to private label products. It has been said that their proliferation reduces product variety.[431] In the extreme case, lesser branded suppliers may be eliminated from the market, leaving only one branded supplier and private label products

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424. Ezrachi, *supra* note 31, at 261.

425. Grimes, *supra* note 23, at 578.

426. Ronald W. Cotterill, *Antitrust Analysis of Supermarkets: Global Concerns Playing Out in Local Markets*, 50 AUSTL. J. AGRIC. RES. ECON. 17, 24 (2006).

427. VANDER STICHELE & YOUNG, *supra* note 115, at 26.

428. William H. Borghesani, Jr., Peter L. de la Cruz & David B. Berry, *Food for Thought: The Emergence of Power Buyers and its Challenge to Competition Analysis*, 4 STAN. J.L. BUS. & FIN. 39 (1999).

429. Ezrachi, *supra* note 31, at 259.

430. Berkey Photo, Inc. v. Eastman Kodak Co., 603 F.2d 263 (2d Cir. 1979).

431. VANDER STICHELE & YOUNG, *supra* note 115, at 29.

in the market.[432] It has also been said that their proliferation renders price comparison between retailers more difficult as there are fewer common products sold by different retailers.[433] Lastly, aggressive promotion of these products may deter product innovation. Suppliers will have scant incentives to engage in product development if they know that their profit will be quickly eroded by copycat private label products.[434] These competitive harms, however, have yet to be recognized by US antitrust law.

There have been reported instances of Amazon copying a supplier's product and offering it as a private label product. According to the U.S. House Antitrust Subcommittee, a third-party seller reported that he was forced to close down his business after Amazon copied his products "down to the color palette" and effectively killed his products by taking away the "Buy Box" and undercutting him on price.[435] Aside from style piracy, Amazon has attempted to tilt competition with its own third-party sellers in its favor in other ways. Amazon has been accused of misusing sales data from these sellers to aid in the sale of its private label products.[436] Amazon initially denied these accusations in sworn testimony to the U.S. Congress, pointing to a company internal policy against such misuse.[437] Amazon, however, launched an internal probe after the veracity of the testimony was challenged by the Wall Street Journal.[438]

The European Commission finds that "very large quantities of non-public seller data are available to employees of Amazon's retail business and flow directly into the automated systems of that business, which aggregate these data and use them to calibrate Amazon's retail offers and strategic business decisions to the detriment of the other marketplace sellers."[439] A similar charge has been leveled at supermarkets in the

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432. Borghesani, Jr., de la Cruz & Berry, *supra* note 428, at 43; Ezrachi, *supra* note 31, at 261.

433. VANDER STICHELE & YOUNG, *supra* note 115, at 29.

434. Ezrachi, *supra* note 31, at 260.

435. Palmer, *supra* note 418.

436. Cecilia Rikap, *Amazon: A Story of Accumulation through Intellectual Rentiership and Predation*, 26 COMPETITION & CHANGE 436, 448–49 (2020).

437. Sonnemaker, *supra* note 7.

438. *Id.*

439. Eur. Comm'n, *supra* note 7.

past.[440] Amazon, however, can do more by steering customers to its own products through its algorithms.[441] One recent study found that Amazon manipulates its search results to favor its own products[442] and senior executives are informed about it.[443] Again, Amazon has denied this allegation.[444] This resembles a supermarket giving its private label products more prominent shelf space, only that Amazon's practice is even more effective.

The best illustration of Amazon's heavy-handed tactics to compete with its third-party sellers can be found in India, one of Amazon's priority markets and where the company struggled to make inroads.[445] Amazon's internal documents illustrate "how Amazon's private-brands team in India secretly exploited internal data from Amazon.in to copy products sold by other companies, and then offered them on its platform."[446] As part of this strategy, Amazon created the Solimo brand.[447] In this instance, not only did Amazon copy the design, it even "planned to partner with the manufacturers of the products targeted for copying" after learning that these manufacturers used a unique process that enhanced the product's quality.[448] Separately, Amazon copied the exact measurements of a competitor's shirts after discovering that its customers strongly preferred its competitor's cutting.[449] Amazon used a technique called "search seeding" to boost the rankings of Solimo products in its search results.[450] It also made use of internal sales data of competing brands on its website to advantage its own

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440. VANDER STICHELE & YOUNG, *supra* note 115.

441. MITCHELL, KNOX & FREED, *supra* note 175.

442. Jon Swartz, *Amazon has mostly avoided antitrust scrutiny, but that may change in 2022*, MARKETWATCH (Jan. 1, 2022), https://www.marketwatch.com/story/amazon-has-mostly-avoided-antitrust-scrutiny-but-that-may-change-in-2022-11640641305.

443. Kalra & Stecklow, *supra* note 185.

444. Morrison, *supra* note 271.

445. Manish Singh, *Forget winning, can Amazon survive in India?*, TECHCRUNCH+ (Jan. 26, 2021), https://techcrunch.com/2021/01/25/india-plays-hardball-with-amazon.

446. Kalra & Stecklow, *supra* note 185.

447. Reiley Pankratz, *Duty to Disclose: Amazon's E-Commerce Platform, Private-Label, and the Need for Disclosure*, 30 KAN. J.L. & PUB. POL'Y 162, 162 (2020).

448. Kalra & Stecklow, *supra* note 185.

449. *Id.*

450. *Id.*

products.[451] In fact, its own employees have accused Amazon of using proprietary data from third-party sellers to gain a competitive edge, despite the company's protestations to the contrary.[452]

Amazon's design piracy is not confined to its own third-party sellers. It extends to its competitors, especially those that refuse to abide by Amazon's wishes. Williams-Sonoma, a furniture and home design retailer, sued Amazon for copying the design of its chairs, lamps, and other products for an Amazon private label brand called Rivet.[453] Allbirds, a sustainable footwear and apparel brand, accused Amazon of copying the design of its wool shoe and producing it with cheaper material after Allbirds refused to sell its products on Amazon.[454] When Quidsi, the baby care online retailer, refused Amazon's overtures to acquire it, Amazon copied Quidsi's products and sold them at a lower price, eventually bankrupting Quidsi and forcing it to sell up.[455]

Feng Zhu and Qihong Liu conducted a robust empirical study of Amazon's private label strategy. Their study covered fifty-eight million products in four categories.[456] They found that Amazon introduced private label products against three percent of the products in these four categories over a ten-month period,[457] a significant percentage over such a short period of time. This comports with the observations of the third-party sellers themselves, half of which reported that Amazon sold competitive products.[458] In fact, evidence suggests that competition with Amazon is viewed by many sellers as inevitable.[459] Zhu and Liu further found that Amazon "is more

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451. *Id.*

452. *Id.*

453. Taylor Telford, *Williams-Sonoma sues Amazon over knockoffs and "strikingly similar" products*, WASH. POST (Dec. 19, 2018), https://www.washingtonpost.com/business/2018/12/19/williams-sonoma-sues-amazon-over-knockoffs-strikingly-similar-products/.

454. Elizabeth Segran, *Allbirds to Amazon: Don't steal our design, steal our sustainable practices*, FAST CO. (Sep. 23, 2019), https://www.fastcompany.com/90407744/allbirds-to-amazon-dont-steal-our-design-steal-our-sustainable-practices.

455. Rikap, *supra* note 436, at 449.

456. Zhu & Liu, *supra* note 183, at 2626.

457. *Id.* at 2620.

458. Rosenblatt, *supra* note 266.

459. *Id.*

likely to enter the spaces of products with higher sales and better reviews and that do not use Amazon's fulfillment service"[460], and "that Amazon is less likely to enter product spaces that require greater seller effort to grow."[461] As previously noted, Amazon also pressures third-party sellers to use FBA.[462] Zhu and Liu concluded that Amazon's entry into a product space discourages a seller from pursuing further growth on the platform[463] and that Amazon's entry does not increase consumer satisfaction with the products.[464]

Available recourse against Amazon's unfair competitive practices seems limited. Its myriad competitive harm notwithstanding, challenging private label products under existing antitrust law is unlikely to succeed. It would be difficult to convince a court on either side of the Atlantic that it is anticompetitive to introduce a new product, albeit a copycat one, into the market. Meanwhile, design copying can be challenged under intellectual property law. Regulating the misuse of proprietary data, at least on the other side of the Atlantic in Europe, appears to have traction. Amazon's misuse of third-party seller data to favor itself is currently the subject of an investigation by the European Commission.[465] Further, a bipartisan group of lawmakers in the U.S. House of Representative has proposed legislation seeking to address this "unfair" competition between Amazon and its third-party sellers.[466] Using an algorithm to favor its own products constitutes self-preferencing, which the General Court affirmed as an infringement of Article 102 of the Treaty on the Functioning of the European Union.[467] Nonetheless, such practice is likely legal under U.S. antitrust law, especially when the conduct cannot be analogized to tying.

460. Zhu & Liu, *supra* note 183, at 2620.
461. *Id.*
462. *See supra* Part V.C.4.
463. Zhu & Liu, *supra* note 183, at 2634.
464. *Id.* at 2632.
465. Eur. Comm'n, *supra* note 7.
466. Duffy, *supra* note 272.
467. Case T-612/17, Google LLC v. Comm'n, ECLI:EU:T:2021:763, ¶ 70 (Nov. 10, 2021).

6. *Coerced Investment*

The last category of abuse is less common but perhaps the most surprising and indicative of Amazon's overwhelming buyer power. Amazon has reportedly demanded an equity stake of up to twenty percent from its suppliers. Amazon has entered into a dozen deals with publicly traded companies for the right to buy their shares at below-market prices.[468] In addition, Amazon has entered into more than seventy-five deals for equity stakes in privately held companies over the last decade.[469] Amazon apparently has been making such demands for a decade but has stepped up the practice.[470] In its March 2021 quarterly report, Amazon reported its stock warrants at $2.8 billion.[471]

These deals are often contingent on the amount of business given by Amazon to the supplier. For example, its deal with Startek Inc., a Colorado-based call center company, stipulates that Amazon will receive the right to acquire 19.9 percent of the company's shares if its business with Startek reaches $600 million before January 23, 2026.[472] The business target in its deal with SpartanNash, a Michigan-based groceries supplier that supplies the Amazon Fresh arm, was $8 billion worth of groceries in seven years.[473] The various actual and potential equity stakes in these companies amount to billions of dollars.[474]

Amazon has focused on a number of business types, ranging from natural gas to call centers. The targets include SpartanNash, Startek, Clean Energy Fuels Corp., a natural gas supplier to Amazon,[475] and Air Transport Services Group and Atlas Air Worldwide Holdings, which lease aircraft to FBA.[476]

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468. Mattioli, *supra* note 12.

469. *Id.*

470. *Id.*

471. Amazon.com, Inc., Quarterly Report (Form 10-Q) (Apr. 30, 2021).

472. StarTek, Inc., Current Report (Form 8-K) (Jan. 24, 2018).

473. SpartanNash Co., Warrant to Purchase Common Stock (Exhibit 10.2) (Oct. 7, 2020).

474. Mattioli, *supra* note 12.

475. Bus. Wire, *Clean Energy Signs Agreement with Amazon for Low and Negative Carbon RNG*, BLOOMBERG (Apr. 19, 2021, 6:00 AM), https://www.bloomberg.com/press-releases/2021-04-19/clean-energy-signs-agreement-with-amazon-for-low-and-negative-carbon-rng.

476. Mattioli, *supra* note 12; *Atlas Air Worldwide Announces Agreement With Amazon To Provide Air Transport Service*, https://www.atlasairworldwide.com/

The investments are significant. Some deals turn Amazon into the company's largest shareholder.[477] Other deals give Amazon the right to nominate a director to the board.[478] Finally, other deals give Amazon the right of first refusal in the event the applicable company receives an acquisition offer.[479]

Executives at these companies acquiesced to Amazon's demand because "they felt they couldn't refuse Amazon's push for the right to buy the stock without risking a major contract."[480] An Atlas executive noted that "[t]here was definitely a sense that if it wasn't agreed to there wouldn't be a deal".[481] Even Amazon's own executives acknowledged that these deals were "unfair and one-sided", noting the suppliers' lack of choice and "that most of the upside went to Amazon."[482] Amazon's apparent rationale is that a supply relationship with Amazon can prove lucrative and provide a significant boost to the company's share prices, and Amazon should be entitled to a share of the upside.[483] Amazon was often right. Atlas' share price increased by twenty-seven percent the day its deal with Amazon was announced.[484] The corresponding jump for SpartanNash's shares was twenty-six percent.[485] Amazon does not seem interested in direct control over its suppliers. It apparently never exercised its right to nominate a director to At-

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2016/05/atlas-air-worldwide-announces-agreement-amazon-provide-air-transport-service/ (last visited Apr. 14, 2022).

477. Mattioli, *supra* note 12.

478. Matt Day, *Amazon Spends $131 Million for Stake in Cargo Airline ATSG*, BLOOMBERG (Mar. 8, 2021, 12:29 PM), https://www.bloomberg.com/news/articles/2021-03-08/amazon-spends-131-million-for-stake-in-cargo-airline-atsg.

479. Chandini Monnappa, *Amazon moves against Future Group over Reliance deal*, REUTERS (Oct. 7, 2020, 11:43 AM), https://www.reuters.com/article/india-reliance-amazon-com-idINKBN26S2MJ.

480. Mattioli, *supra* note 12.

481. *Id.*

482. *Id.*

483. *Id.*

484. Fred Imbert, *Atlas Air shares fly high on Amazon deal announcement*, CNBC (May 5, 2016, 5:21 PM), https://www.cnbc.com/2016/05/05/atlas-air-shares-fly-high-on-amazon-deal-announcement.html.

485. Zacks Equity Rsch., *SpartanNash Deepens Ties With Amazon, Issues Stock Warrant*, NASDAQ (Oct. 12, 2020, 10:08 AM), https://www.nasdaq.com/articles/spartannash-deepens-ties-with-amazon-issues-stock-warrant-2020-10-12.

las' board and when Amazon exercised its warrants for nine percent of Atlas' shares, it quickly sold them.[486]

As far as this Author is aware, this kind of conduct has no current label under antitrust law. It can perhaps be called coerced investment. While heavy-handed, perhaps shockingly so, coerced investment is unlikely to exert competitive harm or distort competition in a meaningful way, unless Amazon uses its equity stakes to cause its suppliers to withhold supply to rival platforms. Such exclusionary uses of Amazon's equity stakes in suppliers has not been reported to date. There is hence no valid grounds for antitrust intervention. Similar to excessive pricing and imposition of unduly harsh contractual terms, this type of conduct seems to be purely exploitative in nature in that its only impact is a wealth transfer from the seller to the buyer. In the case of excessive pricing, wealth is transferred to the buyer through artificial suppression of the purchase price, lowering the seller's profit from the sale. In the case of coerced investment, wealth is transferred from the seller's shareholders to the buyer through share dilution. The impact on the seller is arguably less direct in the case of coerced investment, but no less tangible.

V.
Possible Policy Responses

Of the six categories of buyer power abuses allegedly committed by Amazon—excessively low purchase prices, unduly harsh contractual terms, MFN clauses, tying, unfair competition with third-party sellers, and coerced investment—two of them, MFN clauses and tying, can be readily addressed under existing antitrust law as exclusionary practices. Plaintiffs of course are not certain to prevail, but they at least have a valid cause of action under antitrust law. Further consideration is required for excessively low purchase prices, unduly harsh contractual terms, unfair competition with third-party sellers, and coerced investment. Apart from unfair competition with third-party sellers, the remaining abuses entail direct supplier exploitation.

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486. Mattioli, *supra* note 12.

A. *Supplier Exploitation*

Supplier exploitation is, by its very nature, objectionable. Unless the three exploitative abuses can be shown to lead to the competitive harms delineated in Part II, the only basis upon which they can be condemned is their wealth transfer effect. It was previously argued that wealth transfer is not an appropriate basis for antitrust intervention. Excessively low purchase prices and coerced investment plausibly lead to quality erosion, increased concentration in the supply chain, and reduced investment incentives for upstream suppliers, especially when the equity stake involved is as substantial as twenty percent, as has been reported.[487] It is not clear whether these kinds of competitive harm justify antitrust regulation of essentially exploitative conduct. The U.S. Supreme Court announced in *Verizon Communications, Inc. v. Law Offices of Curtis V. Trinko, LLP* that antitrust law has no role to play in a monopolist's charging of excessively high prices against consumers, declaring that "[t]he mere possession of monopoly power, and the concomitant charging of monopoly prices, is not only not unlawful; it is an important element of the free-market system."[488] Justice Scalia went so far as to suggest that monopoly pricing should be welcomed. It is generally agreed that exploitation of final consumers is beyond the purview of antitrust law.

Proponents of antitrust regulation of supplier exploitation may highlight two important differences between consumer exploitation and supplier exploitation. First, consumer exploitation is pure exploitation in that there is no possible competitive harm. The only undesirable consequence is wealth transfer from final consumers to the seller. Supplier exploitation, in contrast, may distort upstream competition. While the strength of the causal link between the two is open to dispute, a theoretical basis for such a link is clear. Second, all-encompassing digital platforms, such as Amazon, are much harder to dislodge than their brick-and-mortar counterparts because of network effects and data advantages.[489] The digital

487. *Id.*

488. Verizon Commc'ns Inc. v. Law Offs. of Curtis V. Trinko, LLP, 540 U.S. 398, 407 (2004).

489. Bloodstein, *supra* note 204, at 196.

context alters the nature of the buyer power abuses and renders intervention more justifiable.

Importantly, unduly harsh contractual terms may have a less direct and tangible causal link to the competitive harm delineated in Part II, unless the term has substantial financial impact on the supplier's operation. Therefore, regulation of such contractual terms based on these effects is difficult to justify. Jurisdictions such as the EU, United Kingdom, and Australia have adopted fairly wide-ranging regulation of unfair contract terms between large retailers or platforms and their suppliers outside of antitrust.[490] It is doubtful whether the United States has any appetite to go down the same path. The basis for this kind of regulation would involve some notion of unfairness, oppressiveness, or unconscionability. The United States has generally been cautious about embarking on this kind of regulation, especially in the business-to-business context.[491] The question is whether the digital context justifies a more interventionist approach.

B. *A Case for Digital Exceptionalism?*

One common argument for regulation of supplier exploitation is that the digital context justifies more intervention. This argument could be valid for two reasons. The first is that buyer power in the digital context is more durable and, therefore, results in a greater need for antitrust intervention to correct market distortions. The second is that the same conduct in the digital context has greater competitive impact which calls for more urgent redress.

Much has been said about the special nature of market power in the digital economy, how network effects render the

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490. Groceries Supply Code of Practice 2009, SI 16 (UK), https://www.gov.uk/government/publications/groceries-supply-code-of-practice/groceries-supply-code-of-practice; *Competition and Consumer Act 2010* (Cth), sch. 2 (Austl.).

491. Luke R. Nottage, *Form and Substance in US, English, New Zealand and Japanese Law: A Framework for Better Comparisons of Developments in the Law of Unfair Contracts,* 26 VICTORIA U. WELLINGTON L. REV. 247, 258–59 (1996); Jane K. Winn & Mark Webber, *The Impact of EU Unfair Contract Terms Law on U.S. Business-to-Consumer Internet Merchants*, 62 BUS. L. 209, 211–12 (2006); Mark E. Budnitz, *The Federalization and Privatization of Public Consumer Protection Law in the United States: Their Effect on Litigation and Enforcement*, 24 GA. ST. U. L. REV. 663, 663 (2008); Yee Wah Chin, *What Role for Abuse of Superior Bargaining Position Laws?*, 256 N.Y.L.J. 1 (2016).

market power of the Big Tech firms impregnable, and how "big data" allows these firms to monitor competitive threats and respond nimbly.[492] While these arguments are at least partially true, they do not necessarily support more active intervention against supplier exploitation. Durability of market power may substantiate a more robust approach against exclusionary conduct, which entrenches a monopolist's market power.[493] Exploitative conduct, however, does not contribute to a monopolist's market power or buyer power for that matter; it is an exploitation of this power, as the term implies. Policing against such conduct does not augment the contestability of the market. If exploitation of monopoly or buyer power is objectionable, whether the power is more or less durable should make scant difference. If antitrust law condones such exploitation, it should not matter even if such power is immutable and unmovable.

Further, it is not obvious that supplier exploitation should be particularly harmful in the digital setting. A digital platform likely has other ways to exploit a supplier because of the encompassing interaction between them. A digital platform knows significantly more about a supplier's operation and its customers as compared to a brick-and-mortar supermarket by virtue of the data at the digital platform's disposal. Regardless of the number of avenues for exploitation, the extent of exploitation is limited by the amount of buyer power. At a certain point, exploitation will lead to the outside-option payoff becoming attractive enough for the supplier to walk away. Ultimately, the means of exploitation matter less than the amount which the platform extracts from the supplier. Demanding a price twenty percent below the competitive level or a twenty percent equity stake hurts a supplier the same regardless of whether the buyer is digital or brick-and-mortar. In other words, the fact that the exploitation is perpetrated by a digital platform should not make a difference.

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492. Cristian Santesteban & Shayne Longpre, *How Big Data Confers Market Power to Big Tech: Leveraging the Perspective of Data Science*, 65 ANTITRUST BULL. 459 (2020); *Abuse of Dominance in Digital Markets*, ORG. ECON. COOP. & DEV. (2020), https://www.oecd.org/daf/competition/abuse-of-dominance-in-digital-markets-2020.pdf; Kenneth A. Bamberger & Orly Lobel, *Platform Market Power*, 32 BERKELEY TECH. L.J. 1051 (2017).

493. HERBERT HOVENKAMP, FEDERAL ANTITRUST POLICY: THE LAW OF COMPETITION AND ITS PRACTICE §§ 6.2a–6.2b (4th ed. 2011).

Nor is it likely to be the case that quality erosion, increased concentration, or reduced investment incentives caused by supplier exploitation will be worse in the digital context. There is no reason to believe that suppliers to a digital platform are more vulnerable to these types of competitive harm. After all, many of these suppliers supply to both digital platforms and brick-and-mortar retailers. The suppliers are the same, it is the retailer that is different. One may argue that detection of deteriorated quality may be more difficult in the digital context because consumers do not get to inspect the product on the spot. Therefore, it may be easier for a supplier to get away with quality erosion when the product is sold online. The importance of on-the-spot inspection is likely overstated, however, given Amazon's liberal return policy and the availability of customer reviews and ratings.[494] Poor quality will be known even if the product is sold online.

Therefore, a persuasive justification for adopting a different approach to regulating supplier exploitation in the digital economy is lacking. Excessive pricing, either high or low, has been immune from antitrust scrutiny mainly because effective regulation would require a reliable test for determining the excessiveness of the price.[495] Regulation of coerced investment would require a determination of whether the proposed investment terms are excessively advantageous to the buyer. This would require an assessment of whether the exercise price of the warrant is set excessively low, which may in turn necessitate an evaluation of the reasonableness of subsequent movement in stock prices. The only way to sidestep this determination is to prohibit investment by a buyer in a supplier, which would be an overly draconian measure. Unduly harsh contractual terms have been allowed because of the difficulty in defining and calibrating unfairness, oppressiveness, or unconscionability and the general belief that antitrust has no business interfering with contractual terms reached by two businesses in the

494. AMAZON, *Returns and Refunds*, https://www.amazon.com/gp/help/customer/display.html?nodeId=GNW5VKFXMF72FFMR (last visited Apr. 8, 2022).

495. Akman, *supra* note 201; Massimo Motta & Alexandre de Streel, *Excessive Pricing in Competition Law: Never say Never?*, *in* THE PROS AND CONS OF HIGH PRICES 14 (Konkurrensverket ed., 2007); Bruce Lyons, *The Paradox of the Exclusion of Exploitative Abuse*, *in* THE PROS AND CONS OF HIGH PRICES 65 (Konkurrensverket ed., 2007).

commercial context.[496] These policy implementation difficulties are substantial, if not insurmountable. If any arguments justify non-intervention under antitrust law in the brick-and-mortar context, such arguments equally apply to the digital economy.

C. *A Special Case for Retroactive Contractual Amendments*

Retroactive discounts and retroactive imposition of other disadvantageous terms may require special attention, whether online or offline, as such amendments are particularly pernicious and disruptive to suppliers. First, from the fundamental perspective of the spirit of a contract, it is plainly objectionable to allow one party to retroactively alter the contractual terms absent the counterparty's consent.[497] The parties agreed to the terms of the transaction in advance and should abide by them. Detractors may argue that this is fundamentally a problem for, and should be left to, contract law. Contract law, however, is unlikely to provide a satisfactory solution. Many supply contracts give the buyer the power to retroactively amend contract terms without consent.[498] The buyer is thus merely exercising its contractual right and has not committed a breach. Second, and more importantly, even if retroactive amendment constitutes a breach of contract, the supplier is unlikely to sue the powerful retailer. If the supplier were free to stand up for itself, it probably would not have accepted the contractual term in the first place. This Author has argued that in Japan, abuse of superior bargaining position regulation, which scrutinizes retroactive contractual amendments, is most justified as a supplemental contract enforcement mechanism when one of the contractual parties is unable to protect its own interests under contract law.[499]

Second, such retroactive contractual amendment is highly inefficient. It deters investment by the supplier, especially of

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496. Scheelings & Wright, *supra* note 24, at 211–14.

497. *See generally* Samuel Williston, *Mutual Assent in the Formation of Contracts*, 14 ILL. L. REV. 85 (1919); Peter A. Alces, *They Can Do What!? Limitations on the Use of Change-of-Terms Clauses*, 26 GA. ST. U. L. REV. 1099, 1100–01, 1141–42 (2010).

498. VANDER STICHELE & YOUNG, *supra* note 115, at 17.

499. Masako Wakui & Thomas K. Cheng, *Regulating Abuse of Superior Bargaining Position under the Japanese Competition Law: An Anomaly or a Necessity?*, 3 J. ANTITRUST ENF'T 302, 329–33 (2015).

the relation-specific kind.[500] A supplier will be hesitant to make investments when it cannot be sure of the return, especially when these buyers account for such a great proportion of the suppliers' business. Long-term investments are difficult to plan when one's future financial situation is uncertain. It was argued previously that investment in product development can be subject to *ex post* hold-up because the supplier is susceptible to opportunistic behavior once the initial R&D costs are sunk.[501] Reduced product development is clearly welfare-reducing. Recall the economic model by Battagalli, Fumangalli, and Polo that illustrates the classic hold-up scenario where suppliers are reluctant to engage in quality improvement for fear that its investment would be appropriated by the buyer.[502]

Retroactive contractual amendment is the perfect hold-up mechanism for relation-specific investments. To the extent that a buyer demands special packaging or logistical arrangements or other kinds of relation-specific investments, the supplier is especially vulnerable to hold-up through retroactive contractual amendment. The supplier may have agreed to make those investments under the original terms, which would have allowed the supplier to recoup its investments. Once the investments have been made, the buyer turns around and demands a lower price or more rebate, denying the supplier the opportunity to recoup. If the supplier has a choice about these investments in the future, it may refuse to make them.

Therefore, prohibiting contractual clauses that allow one party to retroactively alter the contractual terms without consent is justified both in the online and offline contexts. Additionally, regulating retroactive contractual amendments does not suffer from the same implementation difficulties as other kinds of supplier exploitation prohibitions. The scope of prohibition is very clear-cut. Such prohibition is not subject to ambiguity or matter of degree. Further, it is unnecessary to determine whether the purchase price is excessively low, the investment terms are excessively advantageous, or a particular contractual term is unfair, oppressive or unconscionable. Regulation consists of a simple ban on retroactive amendment of contractual terms without mutual consent. Contractual parties

500. *Id.* at 326–27.
501. *See* Part II.B.
502. Battigalli, Fumagalli & Polo, *supra* note 159, at 47.

do not have any sound justification for demanding such amendment rights given that contracts are based on mutual consent.

Regulating retroactive contractual amendment is beyond the ambit of antitrust law. Some sort of sector-specific code of conduct as exists under UK or Australian law would be needed if regulatory action is deemed necessary. The Australian Food and Grocery Code of Conduct, which is a voluntary industry code, prohibits the unilateral alteration of a contractual term in the supply agreement without the supplier's consent.[503] This, however, still leaves the possibility of coerced consent. The UK Groceries Supply Code of Practice, formally known as The Groceries (Supply Chain Practices) Market Investigation Order 2009, goes one step further. Section 3(1) of the Code of Practice states that "a Retailer must not vary any Supply Agreement retrospectively, and must not request or require that a Supplier consent to retrospective variations of any Supply Agreement."[504] Even a request for consent is prohibited under the Code. Section 3(2) further specifies that retroactive amendment would only be allowed if the "specific change of circumstances (such circumstances being outside the Retailer's control) that will allow for such adjustments to be made" is clearly and unambiguously set out in the supply agreement.[505] The provisions in these two Codes of Conduct are straightforward, which suggests that regulating retroactive contractual amendment is not exceedingly difficult or complicated.

D. *Unfair Competition with Third-Party Sellers*

As for unfair competition with third-party sellers, the introduction of private label products is likely to be beyond the purview of antitrust law. Design copying or piracy is best left to intellectual property law. If the product design at issue is not protected by intellectual property law or the copying at issue is deemed insufficient to infringe the protection, that should be the end of the matter. Antitrust should not unilaterally expand the scope of intellectual property protection.

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503. *Competition and Consumer (Industry Codes—Food and Grocery) (Austl.) supra* note 299, at 9.

504. Groceries Supply Code of Practice 2009 (UK), *supra* note 298.

505. *Id.*

Misuse of supplier data and preferential treatment by the gatekeeper's algorithm amount to instances of conduct where intervention may be warranted, although not necessarily through antitrust law. Platforms such as Amazon usually grant themselves extensive rights to use third-party data for a variety of purposes, including to compete with the third-party seller itself.[506] So Amazon's actions are likely well within the law and compliant with relevant data regulation (and no comprehensive U.S. federal data privacy regulation exists anyway). While refusing to share data in one's exclusive possession has been held to violate antitrust law in the past[507], use of data in one's legal possession to extract a competitive advantage is unlikely to be deemed an antitrust violation under existing law. Cases such as *Verizon Communications, Inc. v. Law Offices of Curtis V. Trinko, LLP* and *Pacific Bell Telephone Co. v. Linkline Communications* have firmly established that absent a duty to deal, a monopolist has no duty to provide adequate assistance to rivals.[508] Therefore, failure to provide rivals the same data access is unlikely to implicate antitrust law. As for preferential treatment by algorithm, unless it can be somehow framed as a tying claim, which would be a difficult task, it is likely to be beyond the scope of antitrust as well. There is also no general antitrust duty to accord equal or fair treatment between a competitor's product and one's own product. If these kinds of conduct are deemed undesirable, as seems to be the consensus, sector-specific legislation like the EU Digital Markets Act may be needed.

The EU Digital Markets Act, which regulates digital platforms and gatekeepers and which is being finalized at the time of writing[509], is an example of such legislation. According to the European Commission's legislative proposal document,

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506. Dana Mattioli, *Amazon Scooped Up Data From Its Own Sellers to Launch Competing Products*, WALL ST. J. (Apr. 23, 2020), https://www.wsj.com/articles/amazon-scooped-up-data-from-its-own-sellers-to-launch-competing-products-11587650015?mod=Article_inline;%20https://www.cnbc.com/2020/04/23/wsj-amazon-uses-data-from-third-party-sellers-to-develop-its-own-products.html.

507. Associated Press v. United States, 326 U.S. 1 (1945).

508. Verizon Commc'ns., Inc. v. Law Off. of Curtis Trinko, LLP, 540 U.S. 398, 410 (2004); Pac. Bell Tel. Co. v. Linkline Commc'ns, Inc., 555 U.S. 438, 450 (2009).

509. *Deal on Digital Markets Act: EU rules to ensure fair competition and more choice for users*, EUR. PARLIAMENT, https://www.europarl.europa.eu/news/

Article 6(1)(a) of the proposed Act will stipulate that a digital gatekeeper shall "refrain from using, in competition with business users, any data not publicly available, which is generated through activities by those business users, including by the end users of these business users, of its core platform services or provided by those business users of its core platform services or by the end users of these business users."[510] Article 6(1)(d) will further stipulate that a digital gatekeeper shall "refrain from treating more favourably in ranking services and products offered by the gatekeeper itself or by any third party belonging to the same undertaking compared to similar services or products of third party and apply fair and nondiscriminatory conditions to such ranking."[511]

Alternatively, and more radically, the Ending Platform Monopolies Act, which is currently in the U.S. House, would split Amazon into two websites and compel Amazon to divest its own products.[512] A divestiture would, of course, solve the problem once and for all but the likelihood of the proposal's adoption is admittedly low.[513] Amazon warned the bill might force it to shut its Marketplace.[514] A better and more pragmatic approach for U.S. legislators is to aim for something along the lines of the EU Digital Markets Act. The American Innovation and Choice Online Act is currently in front of the U.S. Senate Judiciary Committee.[515] If passed, the Act would prohibit Amazon from giving preference to its own products[516] or requiring sellers to purchase other services in order

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en/press-room/20220315IPR25504/deal-on-digital-markets-act-ensuring-fair-competition-and-more-choice-for-users (last visited Apr. 6, 2022).

510. *Proposal for a Regulation of the European Parliament and of the Council on contestable and fair markets in the digital sector (Digital Markets Act)*, COM (2020) 842 final (Dec. 15, 2020), https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52020PC0842&from=EN.

511. *Id.*

512. Ending Platform Monopolies Act, H.R. 3825, 117th Cong. (2022). *See also* Ann Palmer, *Amazon launches website to go on the offensive against Congress' antitrust tech bills*, CNBC (Aug, 20, 2021), https://www.cnbc.com/2021/08/20/amazon-launches-website-to-warn-sellers-about-antitrust-bills.html.

513. Cat Zakrzewski et al., *With clock ticking, battle over tech regulation intensifies*, WASH. POST (June 27, 2022, 7:00 AM) https://www.washingtonpost.com/technology/2022/06/27/antitrust-tech-battle-congress/.

514. Duffy, *supra* note 271.

515. American Innovation and Choice Online Act, S. 2992, 117th Cong. (2022).

516. *Id.* § 3(a)(1).

to be included in the Marketplace.[517] Amazon would also not be able to place its private label products at the top of the search results.[518] The Act has received support from the Department of Justice.[519] Unsurprisingly, Amazon is vigorously fighting the Bill.[520] At the time of writing, the Bill is out of the Senate Judicial Committee[521] but has not received a floor vote.[522] The prospects of passing the Bill are apparently poor. Senate Majority Leader Chuck Schumer told proponents that he would not bring the Bill to the floor unless proponents can show that they have secured the necessary sixty votes.[523]

A recent, and surprising, development could render moot the discussion concerning regulation of Amazon's private label business. Reportedly, Amazon has drastically reduced the number of private label products it carries and may exit the private label business altogether to alleviate regulatory pressure.[524] In short, Amazon may decide that its profits from private label business are not worth all the regulatory attention.

CONCLUSION

Buyer power abuses by digital platforms have received little attention under antitrust law. This Article has attempted to fill the gap in the literature by examining two types of buyer power in the digital context, Uber's digital monopsony and Amazon's gatekeeping power. It argues that the possibility of

517. *Id.* § 3(a)(5).

518. Hal Singer, *Congress must call Amazon's bluff on antitrust*, ROLL CALL (Jan. 28, 2022), https://rollcall.com/2022/01/28/congress-must-call-amazons-bluff-on-antitrust/.

519. U.S. Dep't of Just., Opinion Letter on American Innovation and Choice Online Act, https://buck.house.gov/sites/buck.house.gov/files/2022.03.28-OUT-Nadler%20et%20al.-DOJ%20Views%20Letter-S.%202992%20and%20H.R.%203816.pdf.

520. Morrison, *supra* note 271.

521. Janet H. Cho, *Senate Panel Advances Antitrust Bill Aimed at Apple, Amazon, and Google*, BARRON'S (Jan. 20, 2022), https://www.barrons.com/articles/senate-antitrust-bill-apple-amazon-google-51642718598.

522. Ryan Tracy, *Antitrust Bill Targeting Amazon, Google, Apple Gets Support From DOJ*, WALL ST. J. (Mar. 28, 2022), https://www.wsj.com/articles/doj-backs-antitrust-bill-targeting-amazon-google-apple-11648519385.

523. Chitkara, *supra* note 364.

524. Dana Mattioli, *Amazon Has Been Slashing Private-Label Selection Amid Weak Sales*, WALL ST. J. (July 15, 2022), https://www.wsj.com/articles/amazon-has-been-slashing-private-label-selection-amid-weak-sales-11657849612.

more precise price discrimination may, in fact, reduce the harmful welfare effects of monopsony power and render Uber's digital monopsony less problematic. It further contends that Amazon's gatekeeper power may even exceed that of brick-and-mortar retail giants such as Walmart. It examines the six categories of buyer power abuses allegedly committed by Amazon, and notes that MFN clauses and tying are already subject to antitrust enforcement. Regulation of supplier exploitation presents perhaps insurmountable implementation difficulties and, in any event, should not be addressed by antitrust law. Regulation of retroactive contractual amendments, in contrast, do not share these difficulties and can be effectively regulated. Strong policy arguments support prohibiting such retroactive conduct. Lastly, new legislation is necessary to address misuse of third-party seller data and algorithmic self-preferencing to the extent such practices are deemed worthy of regulation.

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THE RISE AND FALL OF CRYPTOCURRENCY: THE THREE PATHS FORWARD

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In a crash reminiscent of the 1929–1933 stock market crash in which prices on the New York Stock Exchange fell 83% between September 1929 and July 1932 or the 2007–2009 financial debacle in which the Dow Jones Industrial Average declined 54% between October 2007 and March 2009,[1] *crypto market capitalization fell 69% between November 2021 and June 21, 2022, collapsing from an aggregate value of $2.9 trillion to $897 billion.*[2] *Bitcoin, the world's leading cryptocurrency, which traded near $68,000 per coin in November 2021, closed at $20,248 per coin on June 21, 2022 (a decline of 70%).*[3] *Coinbase, the leading crypto exchange, fell from an opening price of $381 to $51.58 on June 21, 2002 (a decline of 86%), prompting an 18% layoff of staff.*[4] *Most spectacularly, TerraUSD, a stablecoin supposedly pegged to a nonvolatile currency (but in fact pegged to a far riskier algorithm), collapsed from $119.18 in to 10 cents in May*

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1. JOEL SELIGMAN, MISALIGNMENT: THE NEW FINANCIAL ORDER AND THE FAILURE OF FINANCIAL REGULATION 1–2 (Wolters Kluwer, 2020).

2. *See* Christina Pazzanese, *So what happened to crypto?*, HARV. GAZETTE (July 13, 2022), https://news.harvard.edu/gazette/story/2022/07/so-what-happened-to-crypto/.

3. *Bitcoin* USD, YAHOO!FINANCE (June 21, 2022), https://finance.yahoo.com/quote/BTC-USD/history?period1=1635724800&period2=1655769600&interval=1d&filter=history&frequency=1d&includeAdjustedClose=true.

4. *See* Nathan Becker, Soma Biswas & Alexander Gladstone, *Coinbase to Lay Off 18% of Staff Amid Crypto Meltdown*, WALL ST. J. (June 14, 2022, 8:11 PM), https://www.wsj.com/articles/crypto-exchange-coinbase-to-lay-off-18-of-staff-11655211069.

2021, including a spectacular 82% fall in 24 hours.[5] *Crypto mania had been succeeded by the "Great Crypto Crash of 2022."*[6]

5. *See* Editorial, *Warnings from the Crypto Crash*, WALL ST. J. (May 12, 2022, 7:29 PM), https://www.wsj.com/articles/warnings-from-the-crypto-currency-crash-stablecoin-liquidity-terrausd-11652390321 ("To drum up demand for its currency, Terra's developers created a 'decentralized lending' platform that offered interest rates up to 20%"); TerraLUNA, COINBASE, https://www.coinbase.com/price/terra-luna#:~:text=terra%20is%20on%20the%20decline%20this%20week.&text=the%20current%20price%20is%20%240.000236,all%20time%20high%20of%20%24119.184624; Connor Sephton, *UST Plummets to $0.38 and LUNA Falls 82% in 24 Hours as Do Kwon Fails to Deliver 'Recovery Plan'*, COINMARKETCAP, https://coinmarketcap.com/alexandria/article/ust-plummets-to-0-38-and-luna-falls-82-in-24-hours-as-do-kwon-fails-to-deliver-recovery-plan.

6. *See* Caitlin Ostroff, *Stablecoin TerraUSD Continues Downward Spiral; Bitcoin Gains*, WALL ST. J. (May 13, 2022, 6:03 PM), https://www.wsj.com/articles/stablecoin-terrausd-continues-downward-spiral-bitcoin-gains-11652447027; Alexander Osipovich & Caitlin Ostroff, *Crash of TerraUSD Shakes Crypto. 'There Was a Run on the Bank.'*, WALL ST. J. (May 12, 2022, 12:10 PM), https://www.wsj.com/articles/crash-of-terrausd-shakes-crypto-there-was-a-run-on-the-bank-11652371839. One newspaper article estimated that Do Kwon, a South Korean entrepreneur, was responsible for the $40 billion crash in Luna and TerraUSD. David Yaffe-Bellany & Erin Griffith, *How a Trash-Talking Crypto Founder Caused a $40 Billion Crash*, N.Y. TIMES (May 20, 2022), https://www.nytimes.com/2022/05/18/technology/terra-luna-cryptocurrency-do-kwon.html; David Yaffe-Bellany, *The Coin That Could Wreck Crypto*, N.Y. TIMES (June 17, 2022), https://www.nytimes.com/2022/06/17/technology/tether-stablecoin-cryptocurrency.html. Two journalists in *The Wall Street Journal* put it mildly: "The crypto party is over." Corrie Driebusch & Paul Vigna, *The Crypto Party Is Over*, WALL ST. J. (June 18, 2022, 12:00 AM), https://www.wsj.com/articles/the-crypto-party-is-over-11655524807. Bill Gates was less restrained and described cryptocurrency as an asset class that is "100% based on the greater fool theory" and "somebody's going to pay more for it than I do." Alyssa Lukpat, *Bill Gates Says NFTs and Crypto Are '100%' Based on Greater Fool Theory*, WALL ST. J. (June 15, 2022, 1:25 PM), https://www.wsj.com/articles/bill-gates-says-cryptocurrencies-and-nfts-are-100-based-on-greater-fool-theory-11655302143.

INTRODUCTION

In March 2022, the Biden Administration issued an Executive Order (the "Order") ordering a comprehensive policy review of digital assets.[7] The Order was notable for seeking coordination in a policy review by over 20 federal executive branch departments and regulatory agencies,[8] explicitly stating that:

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7. Exec. Order No. 14,067, 87 Fed. Reg. 14,143 (Mar. 9, 2022) [hereinafter "Exec. Order on Digital Assets"]. The term *digital asset* was meant to include not only cryptocurrencies, but a wide gamut of derivative products such as stable coins and competitive products such as Central Bank Digital Currencies, popularly known as CBDCs, and tokens, including nonfungible tokens. The Order described the breath of its review in section 9(d): "Regardless of the label used, a digital asset may be, among other things, a security, a commodity, a derivative, or other financial product. Digital assets may be exchange across digital asset trading platforms, including centralized and decentralized finance platforms, or through peer-to-peer technologies."

8. *See id.* §§ 3, 8. Section 3 of the Executive Order delineated:

> The Assistant to the President for National Security Affairs (*APNSA*) and the Assistant to the President for Economic Policy (*APEP*) shall coordinate, through the interagency process described in National Security Memorandum 2 of February 4, 2021 (Renewing the National Security Council System), the executive branch actions necessary to implement this order. The interagency process shall include, as appropriate: the Secretary of State, the Secretary of the Treasury, the Secretary of Defense, the Attorney General, the Secretary of Commerce, the Secretary of Labor, the Secretary of Energy, the Secretary of Homeland Security, the Administrator of the Environmental Protection Agency, the Director of the Office of Management and Budget, the Director of National Intelligence, the Director of the Domestic Policy Council, the Chair of the Council of Economic Advisers, the Director of the Office of Science and Technology Policy, the Administrator of the Office of Information and Regulatory Affairs, the Director of the National Science Foundation, and the Administrator of the United States Agency for International Development. Representatives of other executive departments and agencies (*agencies*) and other senior officials may be invited to attend interagency meetings as appropriate, including, with due respect for their regulatory independence, representatives of the Board of Governors of the Federal Reserve System, the Consumer Financial Protection Bureau (*CFPB*), the Federal Trade Commission (*FTC*), the Securities and Exchange Commission (*SEC*), the Commodity Futures Trading Commission (*CFTC*), the Federal Deposit Insurance Corporation, the Office of the Comptroller of the Currency, and other Federal regulatory agencies.

Section 8 also supported efforts by the G7, G20, the International Finance Stability Board, and FATF (Financial Action Task Force which addresses

"[The Biden Administration] places the highest urgency on research and development efforts into the potential design and deployment options of a United States [Central Bank Digital Currency]."[9]

The Order delineated several objectives and described many challenges relating to digital assets.[10] Particularly, the Order noted the "[c]ybersecurity and market failures at major digital asset exchanges and trading platforms [which] have resulted in billions of dollars of losses,"[11] and, more generally, the increased risks [posed by digital assets] to financial stability.[12] The Order further described digital assets as posing "illicit financial risks," including as a result of "money laundering, cybercrime and ransomware, narcotics and human trafficking and terrorism and proliferation financing"[13] and stated that "[t]he technological architecture of different assets has substantial implications for privacy, national security, the operational security and resilience of financial systems, climate change, the ability to exercise human rights, and other national goals."[14] Finally the Order recognized the implications of digital assets for "energy policy, including as it relates to grid management and reliability, energy efficiency incentives and standards, and sources of energy supply."[15] The Order was tentative in endorsing an approach to resolve this long cavalcade of issues and in determining who, other than through

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money laundering and terrorist financing) "to address the full spectrum of issues and challenges raised by digital assets, including financial stability, consumer, investor and business risks and money laundering, terrorist financing, proliferation financing, sanctions evasion and other illicit activities."

9. *Id.* § 4(a)(i).

10. *See id.* § 2. In section 2, these included (a) protecting consumers, investors and businesses in the United States; (b) protecting United States and global financial stability and mitigating systemic risk; (c) mitigating the illicit financial and national security risks posed by misuse of digital assets; (d) reinforcing United States leadership in the global financial systems and in technological and economic competitiveness; (e) promoting safe and affordable financial systems; and (f) supporting technological advances that promote responsible development and use of digital assets.

11. *Id.* § 2(a).

12. *Id.* § 2(b).

13. *Id.* § 2(c).

14. *Id.* § 2(f).

15. *Id.* § 5(b)(vii)(B).

coordination by the long list of agencies already involved, would lead the remedial effort.[16]

I.
United States Prohibition of Certain Financial Products, Crypto, and its Derivatives

The United States has an extensive history of regulating and, in some cases, prohibiting certain financial products. After the conspicuous failure of the Continental Congress to issue paper money not backed by gold or silver, Article I Section 8 of the U.S. Constitution reserved only for the federal government the express power to coin money.[17] Article I Section 10 expressly prohibited the States from "[making] anything but gold and silver coin a tender in payment of debts."[18]

President Andrew Jackson's veto of the Second Bank of the United States in 1832 was accompanied by a prohibition of any national bank.[19] In 1836, the United States imposed a requirement that only gold and silver could be used to purchase public lands, which the United States then had in abundance.[20] Finally, the United States prohibited paper money in 1836, which lasted until 1863.[21]

Much of the late U.S. 19th century politics were animated by currency wars. Once paper money was introduced, the United States wrestled with questions such as whether the new paper money could be based on silver and gold or, conversely, only on gold.[22] The controversy led to William Jennings Bryan's immortal Cross of Gold speech in 1896, in which he remarked: "You shall not crucify mankind upon a cross of

16. *See generally id.* § 3 (listing multiple agencies that could be included in the interagency process).

17. *See* Seligman, *supra* note 1, at 143–45.

18. The catastrophic mismanagement of the Revolutionary War economy led to its Continental Dollar being worth as little as one cent on a dollar, giving rise to the phrase "not worth a Continental" and the Continental Congress failing to adequately finance Revolutionary War compensation or supply its military. *Id.* at 142–45.

19. *See id.* at 233.

20. *See id.* at 235.

21. *Id.* at 236–37.

22. *See generally id.* at 261–77 (discussing the shifts in monetary and coinage policy in the legislative and executive branches following the Civil War).

gold," and Bryan's subsequent nomination for U.S. President.[23]

In 1900, Congress enacted the Gold Standard Act effectively designating gold to be the monetary standard of the United States, which it would remain until 1971 when President Nixon ended the convertibility of dollars into gold.[24]

Nearly as fundamental changes occurred in the U.S. life insurance and securities industries. In 1905, the New York Armstrong Commission recommended ending tontine life insurance policies in New York which, in 1905, represented 64% of all life insurance in force nationally.[25] Tontine insurance was a negative lottery system, an insurance product in which several individuals would pool investments in a whole life insurance policy (combining a savings plan with death benefit insurance) with only the living individuals entitled to the benefit of the investment after defined term, typically 20 years or more.[26] The Armstrong Commission sharply criticized high-pressure sales tactics and the high costs of tontine insurance marketing practices. In 1905, New York State prohibited tontine insurance altogether, as did other states that followed New York's approach.[27]

The 1929–1933 stock market crash laid bare similar patterns of high-pressure sales tactics, misleading disclosure, and stock market manipulation. As a result, the U.S. Congress passed the Securities Act of 1933 ("Securities Act"), which prohibited sales of most securities to the public without a prior filing of offering documents with what is now the Securities and Exchange Commission ("SEC"),[28] as well as the Securities Exchange Act of 1934 ("Exchange Act"), which required most securities markets to register with the SEC.[29]

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23. *Id.* at 273–76.
24. *See id.* at 277.
25. *Id.* at 346, 358.
26. *See id.* at 346.
27. *See id.* at 359–61.
28. *See* JOEL SELIGMAN, THE TRANSFORMATION OF WALL STREET: A HISTORY OF THE SECURITIES AND EXCHANGE COMMISSION AND MODERN CORPORATE FINANCE 39–40 (Aspen Pub. 3d ed. 2003).
29. *See id.* at 99–100.

Cryptocurrency, as is by now well known,[30] was introduced in a 2008 paper titled: "Bitcoin: A Peer-to-Peer Electronic Cash System," written by Satoshi Nakomoto. Nakomoto, the pseudonym for the author (or authors) of the paper, described a libertarian alternative to the existing U.S. centralized banking system; a system designed to provide electronic transmissions "without relying on trust."[31] In Nakomoto's original vision, people could transfer value directly to each other from anywhere in the world without government-issued currencies, relying on third-party intermediaries, or the need to reconcile records across trading partners.[32] Additional characteristics and features of Nakomoto's envisioned cryptocurrency include the following:

- Bitcoin would be impossible to counterfeit.
- Bitcoin would not require a central bank such as the Federal Reserve System, any central server, or central storage.
- Bitcoin would not require a single administrator, intermediaries, or the need for trade approval.
- Bitcoin transactions could be conducted by anyone, anywhere, and at any time.
- Bitcoin would protect the user privacy.
- Bitcoin would be democratically run.
- Bitcoin system would operate entirely anonymously.
- Bitcoin would provide a means for people without bank accounts to transfer value.[33]

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30. *See, e.g.*, CAROL GOFORTH & YULIYA GUSEVA, REGULATION OF CRYPTOASSETS 10–11 (2d ed. 2022) (discussing the amount of money and alternatives to Bitcoin involved in cryptocurrency); Gregory S. Rowland & Trevor I Kiviat, *Cryptocurrency and Other Digital Asset Funds for U.S. Investors*, *in* GLOB. LEGAL INSIGHTS 54, 54, 63 (Josias N. Dewey ed., 3d. ed. 2021) (mentioning the proliferation of cryptocurrency assets since Bitcoin's introduction); Mary C. Lacity, *Crypto and Blockchain Fundamentals*, 73 ARK. L. REV. 363, 375–82 (2020) (detailing the expansion of cryptocurrencies and cryptocurrency exchanges); Rebecca M. Bratspies, *Cryptocurrency and the Myth of the Trustless Transaction*, 25 MICH. TECH. L. REV. 1, 2, 15 (2018) (noting the thousands of cryptocurrencies that have followed Bitcoin).

31. SATOSHI NAKOMOTO, BITCOIN: A PEER-TO-PEER ELECTRONIC CASH SYSTEM 1 (2008), https://bitcoin.org/bitcoin.pdf.

32. Lacity, *supra* note 30, at 366.

33. *See* GOFORTH & GUSEVA, *supra* note 30, at 7–9; Rowland & Kiviat, *supra* note 30; Lacity, *supra* note 30, at 367–72; Bratspies, *supra* note 30, at 2.

Nakomoto's model was actualized in 2009 when Nakomoto mined the first Bitcoins to be traded.[34] Bitcoin, which remains the largest cryptocurrency in the world, has a market capitalization of $558.13 billion as of June 10, 2022, representing approximately 46% of the $1.20 trillion global crypto market.[35] Bitcoin began with each coin having a value of 0.003 cents.[36] Over time, the value of each Bitcoin has stunningly increased. In November 2021, each Bitcoin was worth a high closing price of over $68,000, before an eventual 70% decline by June 2022.[37] As of January 2022, over 106 million Bitcoin owners held more than 200 million Bitcoin wallets.[38] As originally envisioned, only 21 million Bitcoins will be created.[39]

Each Bitcoin is registered to a Bitcoin address, and each address has a public key and private key that are cryptographically generated.[40] The private key allows the owner to access funds at the address.[41] The public key is used to validate transactions communicated from the address.[42] Private and public keys are stored in each crypto trader's wallet.[43] Miners confirm Bitcoin transactions in each blockchain (as further described in this Section B).[44] Anybody can become a Bitcoin miner but the computational energy and expansive IT hardware required

34. Bratspies, *supra* note 30, at 14.

35. CoinMarketCap, https://www.coinmarketcap.com (last visited June 10, 2022).

36. Bratspies, *supra* note 30, at 16 (detailing first known commercial use and the programmer who valued those bitcoins at 0.003 cents apiece).

37. *See* Megan DeMatteo, *Bitcoin Price History: 2009 to* 2022, Time (Sept. 12, 2022), https://time.com/nextadvisor/investing/cryptocurrency/bitcoin-price-history/.

38. *How Many People Own & Use Bitcoin?*, https://buybitcoinworldwide.com/how-many-bitcoin-users/ (last visited Sept. 28, 2022).

39. Jamie Redman, *Satoshi's 21 Million Mystery: One-Millionth of the Bitcoin Supply Cap is Now Worth $1 Million*, Bitcoin (Mar. 7, 2021), https://news.bitcoin.com/satoshis-21-million-mystery-one-millionth-of-the-bitcoin-supply-cap-is-now-worth-1-million/.

40. Jerry Brito & Andrea Castillo, Bitcoin: A Primer for Policymakers 7 (2d ed. 2016) (providing overview of lifecycle of a bitcoin transaction).

41. *Id.* at 7, 34, 65.

42. *Id.* at 7.

43. *Id.*

44. *Id.* at 7–9.

for Bitcoin mining serve as significant barriers to entry.[45] The miners keep the blockchains unalterable by requiring "Proof of Work" (as further described in Part II) and by creating new chains to protect the system.[46] Miners are rewarded for validating transactions with Bitcoins and fees. All transactions are recorded in a ledger or blockchain, which contains previous "blocks" back to the initial block of a chain.[47] In the Bitcoin system, the blockchain contains a record of every transaction ever conducted in the blockchain.[48] The blockchain ledger enables anyone with access to view any transaction.[49]

Over time, Nakamoto's initial Bitcoin model has evolved considerably. Wallets can now be held by "full clients," who have access to the entire blockchain, or "lightweight clients," who use simplified payment verification and only have access to a local copy of the blockchain.[50] Most cryptocurrency participants do not use full nodes, those responsible for an entire blockchain network, and instead often join mining pools to

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45. *See, e.g.*, Aoyon Ashraf & Eliza Gkritsi, *Why Do Old-Line Businesses Enter Crypto Mining? Simple: Fat Profits*, CoinDesk (Mar. 23, 2022, 1:33 PM), https://www.coindesk.com/layer2/miningweek/2022/03/23/why-do-old-line-businesses-enter-crypto-mining-simple-fat-profits/ (quoting bitcoin miner CEO that "[t]here are a lot more barriers to entry than people realize when mining at an industrial scale (as opposed to home mining where barriers are coming down)").

46. Bitcoin utilized Nakomoto's peer-to-peer currency system. Proof of Work is the consensus algorithm in Bitcoin used to prevent attacks on the system. *Explained: What is Proof of Work (POW) in Blockchain*, Bybit Learn (Dec. 8, 2020), https://learn.bybit.com/blockchain/what-is-proof-of-work-in-blockchain/; Kirsty Moreland, *What is Proof-of-Work*, Ledger Academy (Oct. 23, 2019), https://www.ledger.com/academy/blockchain/what-is-proof-of-work. There are multiple steps in mining. These initially included: (1) A request to transfer a specified number of Bitcoins from one address to another; (2) the request is sent to another Bitcoin address; (3) miners validate that the transferor has sufficient Bitcoin in a wallet to avoid double-spending; (4) the transaction is validated using cryptographic algorithms; (5) the new transaction is added to the end of the blockchain. *See* Brito & Castillo, *supra* note 40; *see, e.g.*, Fergus O'Sullivan, *What is Crypto Mining and How Does it Work?*, How-To Geek (Dec. 12, 2021), https://www.howtogeek.com/771391/what-is-crypto-mining-and-how-does-it-work/.

47. Bratspies, *supra* note 30, at 12.

48. *Id.*

49. *Id.*

50. *See* Andreas M. Antonopoulos, *Mastering Bitcoin*, O'Reilly, https://www.oreilly.com/library/view/mastering-bitcoin/9781491902639/ch01.html (last visited Dec. 13, 2022).

minimize the variance of their income and reduce the expense of maintaining a full node.[51]

As with Continental dollars, tontine insurance, and pre-1933 securities, Bitcoin (and subsequent cryptocurrencies) has faced significant marketing and product integrity issues, as well as severe environmental problems. Bitcoin, which was initially just a payout system, has experienced slow transaction times and high transaction costs, with the Federal Reserve System reporting in January 2022 that Bitcoin is only capable of supporting roughly five transactions per second at a cost of up to $60 per transaction.[52] Bitcoin, and cryptocurrencies generally, have been used in illegal transactions such as money laundering, tax evasion, or the trade of illegal goods.[53] Additionally, bitcoin, and cryptocurrencies generally, remain subject to price volatility. For example, on May 13, 2021, Bitcoin lost 12% of its market capitalization after Elon Musk announced that Tesla would no longer accept Bitcoins.[54]

Bitcoins, and cryptocurrencies generally, are vulnerable to crypto thefts. As of 2017, Reuters estimated $1.2 billion was stolen between 2017 and May 2018.[55] In one notable example,

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51. Bratspies, *supra* note 30, at 22.

52. Bd. of Governors of the Fed. Rsrv. Sys., Money and Payments: The U.S. Dollar in the Age of Digital Transformation 11 n.13, https://www.federalreserve.gov/publications/files/money-and-payments-20220120.pdf [hereinafter "The U.S. Dollar in the Age of Digital Transformation"].

53. *See, e.g.*, *Cryptocurrency Money Laundering Rises 30% in 2021*, Fin. Magnates (Jan. 27, 2022, 7:13 AM), https://www.financemagnates.com/cryptocurrency/news/cryptocurrency-money-laundering-climbs-30-in-2021/ (In 2021, cyber criminals laundered over $8.6 billion in digital currencies). In November 2021, it was reported that the Internal Revenue Service (IRS) Criminal Investigation Unit seized $3.5 billion for tax fraud during Fiscal 2021 including $1 billion linked to the darknet Silk Road. *See* Michael Bellusci, *IRS Seized $3.5B in Cryptocurrency During Fiscal 2021*, CoinDesk (Nov. 18, 2021), https://www.coindesk.com/policy/2021/11/18/irs-seized-35b-in-cryptocurrency-during-fiscal-2021/. In 2021, Werner Vermaak listed 13 countries as the leading tax havens for cryptocurrency including those that entirely or largely exclude crypto trading from capital gains taxation. *See* Werner Vermaak, *Where Are the World's Crypto Tax Havens in 2021?*, CoinMarketCap (2021), https://coinmarketcap.com/alexandria/article/where-are-the-worlds-crypto-tax-havens-in-2021.

54. Rishi Iyenger, *Bitcoin plunges 12% after Elon Musk tweets that Tesla will not accept it as payment*, CNN Bus. (May 13, 2021, 9:43 AM), https://www.cnn.com/2021/05/12/tech/elon-musk-tesla-bitcoin.

55. Gertrude Chavez-Dreyfuss, *About $1.2 billion in cryptocurency stolen since cybercrime group*, Reuters (May 24, 2018, 10:59 AM), https://

reported in February 2022, Ilya Lichtenstein and Heather Morgan reportedly attempted to sell $4 billion worth of Bitcoin, which had been stolen from the cryptocurrency exchange Bitfinex in 2016 when the same Bitcoins were valued at just $71 million. The couple was charged with money laundering in what the *Guardian* labeled the "heist of the century."[56] The incidence of crypto thefts continue.[57]

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www.reuters.com/article/us-crypto-currency-crime/about-1-2-billion-in-cryptocurrency-stolen-since-2017-cybercrime-group-idUSKCN1IP2LU.

56. Edward Helmore, *'Heist of the century': US bitcoin case tests ability to crack down on cybercrime*, THE GUARDIAN (Feb. 14, 2022, 2:00 PM), https://www.theguardian.com/law/2022/feb/14/us-bitcoin-case-cybercrime; *see also* Ali Watkins & Benjamin Weiser, *Modern Crime, a Tech Couple And a Trail of Siphoned Crypto*, N.Y. TIMES, Feb. 13, 2022, at A1; Dustin Volz & Ian Talley, *Justice Department Says It Seized $3.6 Billion Worth of Bitcoin Stolen in 2016 Hack*, WALL ST. J. (Feb. 8, 2022, 9:21 PM), https://www.wsj.com/articles/justice-department-says-it-seized-3-6-billion-in-stolen-cryptocurrency-exchange-hack-11644339381 (roughly 94,000 of 119,754 stolen Bitcoins were recovered); Paul Vigna, *How the Feds Tracked Down $3.6 Billion in Stolen Bitcoin*, WALL ST. J. (Feb. 9, 2022, 5:51 PM), https://www.wsj.com/articles/how-the-feds-tracked-down-3-6-billion-in-stolen-bitcoin-11644447110; David Yaffe-Bellany, *Theft, Fraud and Lawsuits at the World's Biggest NFT Marketplace*, N.Y. TIMES (June 6, 2022), https://www.nytimes.com/2022/06/06/technology/nft-opensea-theft-fraud.html; Paul Vigna, *Search Continues for Source of TerraUSD Bank Run*, WALL ST. J. (June 4, 2022, 11:00 AM), https://www.wsj.com/articles/search-continues-for-source-of-terrausd-crypto-bank-run-11654348117 (focusing on how two digital token firms, luna and TerraUSD collapsed and commenting "[i]n DeFi, it isn't easy to understand who provides money for loans, where the money flows or how easy it is to trigger currency meltdowns. This is one reason regulators are concerned about the impact of DeFi on investors and the broader financial system.")

57. In March 2022, a different set of hackers stole more than $500 million of Ethereum and the stablecoin USDC of the online game, Axie Infinity. Paul Vigna & Sarah E. Needleman, *Hackers Steal $540 Million in Crypto from 'Axie Infinity' Game*, WALL ST. J. (Mar. 29, 2022, 6:13 PM), https://www.wsj.com/articles/hackers-steal-540-million-in-crypto-from-axie-infinity-game-11648585535. Later in April, the United States linked North Korea to the theft, later identified as being worth $615 million. *U.S. Ties North Korean Hacker Group Lazarus to Huge Cryptocurrency Theft*, REUTERS (Apr. 14, 2022, 7:31 PM), https://www.reuters.com/technology/us-ties-north-korean-hacker-group-lazarus-huge-cryptocurrency-theft-2022-04-14/; *see also* David Uberti, *Hackers Stole More Than $600 Million in Crypto. Laundering It Is the Tricky Part*, WALL ST. J. (Apr. 6, 2022, 10:08 AM), https://www.wsj.com/articles/hackers-stole-more-than-600-million-in-crypto-laundering-it-is-the-tricky-part-11649237401; David Uberti, *How Hackers Target Bridges Between Blockchains for Crypto Heists*, WALL ST. J. (Apr. 5, 2022, 5:30 AM), https://www.wsj.com/articles/how-hackers-target-bridges-between-blockchains-for-

Bitcoin faces other weaknesses. Because Bitcoin requires each user to retain a private key, a unique system of 64 numbers and letters, Bitcoin accounts can easily become inaccessible. For example, a Welsh crypto trader allegedly lost access to a Bitcoin account worth roughly $500 million dollars.[58] In addition, bitcoin, and cryptocurrencies generally, face sharp criticism regarding energy consumption. Digiconomist's 2022 Energy Consumption Index estimated that Bitcoin's "network now consumes more energy than a number of countries."[59]

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crypto-heists-11649151001; Mengqi Sun & David Smagalla, *Cryptocurrency-Based Crime Hit a Record $14 Billion in 2021*, WALL ST. J. (Jan. 6, 2022, 6:20 PM), https://www.wsj.com/articles/cryptocurrency-based-crime-hit-a-record-14-billion-in-2021-11641500073 ("The volume of cryptocurrency transactions grew to $15.8 trillion in 2021, up 567% from 2020 . . . . Illicit transactions totaled $14 billion in 2021, up 79% from $7.8 billion the previous year. But illicit transactions only made up 0.15% of cryptocurrency transaction volume in 2021."); Paul Vigna, *Crypto Thieves Get Bolder by the Heist, Stealing Record Amounts*, WALL ST. J. (Apr. 22, 2022, 5:30 AM), https://www.wsj.com/articles/crypto-thieves-get-bolder-by-the-heist-stealing-record-amounts-11650582598. By 2021, cryptocurrency jumped from the seventh riskiest scam in 2020 to the second riskiest. *Cryptocurrency Scams Increased in 2021*, REG.-HERALD (Apr. 12, 2022), https://www.register-herald.com/news/cryptocurrency-scams-increased-in-2021/article_44b4cfea-323c-5038-8dac-5e36678a6808.html.

58. *See* D.T. Max, *Half a Billion in Bitcoin, Lost in the Dump*, NEW YORKER (Dec. 6, 2021), https://www.newyorker.com/magazine/2021/12/13/half-a-billion-in-bitcoin-lost-in-the-dump.

59. *Bitcoin Energy Consumption Index*, DIGICONOMIST, https://digiconomist.net/bitcoin-energy-consumption (last visited Oct. 12, 2022). The report goes on to explain why:

> The machines performing the 'work' are consuming huge amounts of energy while doing so. Moreover, the energy used is primarily sourced from fossil fuels . . . .
>
> . . . .
>
> New sets of transactions (blocks) are added to Bitcoin's blockchain roughly every 10 minutes by so-called miners. While working on the blockchain, these miners aren't required to trust each other. The only thing miners have to trust is the code that runs Bitcoin . . . .
>
> . . . .
>
> The continuous block mining cycle incentivizes people all over the world to mine Bitcoin. As mining can provide a solid stream of revenue, people are very willing to run power-hungry machines to get a piece of it. Over the years this has caused the total energy consumption of the Bitcoin network to grow to epic proportions, as the price of the currency reached new highs . . . .

Id. In 2022, "[a] consortium of environmental groups launched a campaign . . . to change bitcoin's code to decrease . . . energy use." Paul Vigna,

Bitcoin mining's carbon footprint is comparable to New Zealand's for 36.95 million tons of carbon emissions annually.[60] One study estimated that Bitcoin alone could generate enough carbon dioxide to raise global temperatures by 3.6 degrees Fahrenheit in three decades.[61]

In 2015, Ethereum ("ETH"), the second most widely traded cryptocurrency in the world with a market capitalization of $136 billion as of June 21, 2022,[62] was created and attempted to address some of the limitations of Bitcoin.[63] Ethereum popularized smart contracts, the use of cryptocurrencies other than its own ETH, and nonfungible tokens ("NFTs").[64] A fundamental limitation of Bitcoin was that it initially only provided a means to trade with other Bitcoin wallets. Ethereum smart contracts, in contrast, allowed Ethereum wallets to

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Evironmental Groups Pressure Bitcoin Community to Lower Energy Use, WALL ST. J. (Mar. 29, 2022, 1:10 PM), https://www.wsj.com/articles/environmental-groups-pressure-bitcoin-community-to-lower-energy-use-11648509353. In June 2022, the New York State legislature enacted a two-year moratorium on reactivating fossil fuel power plants for cryptocurrency mining. Jimmy Vielkind, *New York Legislature Approves Bill to Limit Cryptocurrency Mining*, WALL ST. J. (June 3, 2022, 12:12 PM), https://www.wsj.com/articles/new-york-legislature-approves-bill-to-limit-cryptocurrency-mining-11654272723. The crypto industry launched an intense lobbying effort to dissuade Governor Hochul from signing the bill creating the moratorium. Luis Ferré-Sadurní, Grace Ashford, Dana Rubinstein & David Yaffe-Bellany, *Fight Looms over New York's Bid to Slow Crypto-Mining Boom*, N.Y. TIMES (June 7, 2022), https://www.nytimes.com/2022/06/07/nyregion/cryptomining-ban-ny.html.

60. Ryan Browne, *Bitcoin's Wild Ride Renews Worries About Its Massive Carbon Footprint*, CNBC (Feb. 5, 2021, 4:32 AM), https://www.cnbc.com/2021/02/05/bitcoin-btc-surge-renews-worries-about-its-massive-carbon-footprint.html?utm_term=autofeed&utm_medium=social&utm_content=Main&utm_source=Twitter#Echobox=1612517697.

61. Patrick J. Kiger, *Cryptocurrency Has a Huge Negative Impact on Climate Change*, HOWSTUFFWORKS (May 17, 2021), https://science.howstuffworks.com/environmental/conservation/issues/cryptocurrency-climate-change-news.htm.

62. *See Historical Data for Ethereum*, COINMARKETCAP, https://coinmarketcap.com/currencies/ethereum/historical-data/ (last visited Oct. 12, 2022).

63. *See What Is Ethereum?*, COINBASE, https://www.coinbase.com/learn/crypto-basics/what-is-ethereum (last visited Oct. 12, 2022).

64. *See* Bratspies, *supra* note 30, at 15, 34, 38. Regarding tokens, see discussion *infra* p. 13.

trade with a wide array of other applications and popularized Decentralized Finance ("DeFi").[65]

Ethereum's innovators were inspired by the same libertarian enthusiasm as Bitcoin's creator(s). As one Ethereum developer put it, in summarizing Ethereum's model: "No lawyers, no bankers, no accountants, everything is outsourced to the blockchain[.]"[66] Similar to Bitcoin, Ethereum represents a vision of a new decentralized world order based on the blockchain.[67] Ethereum also, like Bitcoin, relies on a blockchain, nodes, a 64-character hexadecimal private key, transaction fees, and miners with their Proof of Work.[68] Ethereum blocks are validated approximately every 12 seconds compared with Bitcoin's validation time of approximately ten minutes.[69]

Unlike Bitcoin, which relies on energy intensive Proof of Work, Ethereum switched to a much less energy intensive "Proof of Stake" system.[70] Staking provides a short cut to validation by allowing investors to put their cryptocurrencies in the blockchain by relying on a third-party consensus mechanism to verify a transaction.[71] One opinion writer in the *New York Times* explained the difference in energy consumption between Proof of Work and Proof of Stake as follows:

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65. Fabian Schär, *Decentralized Finance: On Blockchain- and Smart Contract-Based Financial Markets*, 103 FED. RSRV. BANK ST. LOUIS REV. 153, 153–54 (2021).

66. Daniel Rasmussen, *Three Books to Map Crypto's Confusing New Landscape*, WALL ST. J. (Mar. 11, 2022, 11:13 AM), https://www.wsj.com/articles/three-books-to-map-cryptos-confusing-new-landscape-reviews-bitcoin-ethereum-11647015103?page=1.

67. *Id. See generally* LAURA SHIN, THE CRYPTOPIANS: IDEALISM, GREED, LIES, AND THE MAKING OF THE FIRST BIG CRYPTOCURRENCY CRAZE (2022) (discussing some crypto-investors desire to create a decentralized currency that no government can control as the "ultimate cypherpunk act").

68. *Proof-of-Work*, ETHEREUM (Sept. 26, 2022), https://ethereum.org/en/developers/docs/consensus-mechanisms/pow/; *Ethereum Accounts*, ETHEREUM (Sept. 26, 2022), https://ethereum.org/hr/developers/docs/accounts/.

69. *Gary DeWaal Discusses Ether and the Ethereum Blockchain with Forbes*, KATTEN (Apr. 5, 2021), https://katten.com/gary-dewaal-discusses-ether-and-the-ethereum-blockchain-with-forbes.

70. *Proof-of-Stake (POS)*, ETHEREUM (Oct. 10, 2022), https://ethereum.org/en/developers/docs/consensus-mechanisms/pos/.

71. *What Is Staking?*, COINBASE, https://www.coinbase.com/learn/crypto-basics/what-is-staking (last visited Oct. 13, 2022).

> Briefly, [in Proof of Work,] you prove your work by doing those quintillions of calculations. You prove your stake by pledging cryptocoins that you own. As in a company's shareholder vote, the people with the most coins have the biggest say.
>
> The difference in energy consumed per transaction between the [Proof of Work and Proof of Stake] systems is like the difference in height between the world's tallest building and a single screw . . . .[72]

Nonetheless, whatever its weaknesses as a currency and defects as an energy glutton, Bitcoin trading became a hot speculative investment, with Bitcoin described as "digital gold."[73] Bitcoin is traded on futures markets, by stock market exchange traded funds ("ETFs") and by custody services from major securities firms including Fidelity and Coinbase.[74]

The years 2020–2022 belonged to crypto. In February 2022, Statista estimated that 10,397 different cryptocurrencies existed worldwide.[75] In 2021, Pew Research estimated that 16% of U.S. adults, including 31% of those between 18 and 29 years of age, had invested in, traded, or used a cryptocurrency.[76] In 2022, one consumer survey reported that 44% of all crypto owners first purchased crypto within the past year and an additional 31% had purchased crypto within the past one to two years.[77] In 2021, "venture capitalists backed . . . 460

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72. Peter Coy, Opinion, *I Spoke to the Experts. Bitcoin Isn't Going to Change*, N.Y. TIMES (Apr. 20, 2022), https://www.nytimes.com/2022/04/20/opinion/bitcoin-mining-climate-change.html.

73. *See* Ryan Browne, *The Case for Bitcoin as 'Digital Gold' Is Falling Apart*, CNBC (Feb. 25, 2022, 8:07 PM), https://www.cnbc.com/2022/02/23/the-case-for-bitcoin-as-digital-gold-is-falling-apart.html.

74. *See* Karen Hube, *It's Not Just Bitcoin. How to Invest in the Crypto Economy*, BARRON'S (Feb. 26, 2022), https://www.barrons.com/articles/bitcoin-investing-crypto-economy-51645632880.

75. *Number of Cryptocurrencies Worldwide from 2013 to February 2022*, STATISTA (Feb. 2022), https://www.statista.com/statistics/863917/number-crypto-coins-tokens/.

76. Andrew Perrin, *16% of Americans Say They Have Ever Invested in, Traded or Used Cryptocurrency*, PEW RSCH. CTR. (Nov. 11, 2021), https://www.pewresearch.org/fact-tank/2021/11/11/16-of-americans-say-they-have-ever-invested-in-traded-or-used-cryptocurrency/.

77. Allison Whaley, *Paxos Survey Finds Consumers Want Easier Access to Crypto*, PAXOS (Feb. 9, 2022), https://paxos.com/2022/02/09/paxos-survey-finds-consumers-want-easier-access-to-crypto/; *see also* Tara Seigel Bernard, *Everyone Has Crypto FOMO, but Does It Belong in Your Portfolio?*, N.Y. TIMES

blockchain projects, spending nearly $12.75 billion [compared to] . . . $2.75 billion [spent] in 2020" on just 155 projects.[78] Investors included prominent financial institutions and individuals such as Goldman Sachs, JP Morgan, and BlackRock.[79] By 2021, cryptocurrency was used in several popular financial services such as Robinhood, Venmo, and CashApp.[80] Visa and MasterCard were linking credit and debit cards to crypto brokerage sites.[81] Commercial banks and other enterprises today use cryptocurrency in commercial transactions. As of December 29, 2021, approximately 34,000 ATMs worldwide could engage in Bitcoin transactions.[82] In 2021, it was estimated that Bitcoin was accepted by 2,300 businesses.[83] In March 2021, PayPal allowed purchases with Bitcoin and Ethereum.[84] In Jan-

(Mar. 25, 2022), https://www.nytimes.com/2022/03/24/your-money/bitcoin-investing-cryptocurrency.html (a survey of financial advisers found 16 percent "had allocated crypto to their clients' portfolios in 2021, up from 9 percent in 2020").

78. Ephrat Livni, *Tales from Crypto: A Billionaire Meme Feud Threatens Industry Unity*, N.Y. TIMES (Jan. 18, 2022), https://www.nytimes.com/2022/01/18/business/dealbook/web3-venture-capital-andreessen.html.

79. Brandy Betz, *JPMorgan Backs $20M Round for Blockchain Infrastructure Startup Ownera*, COINDESK (Sept. 14, 2022, 9:16 AM), https://www.coindesk.com/business/2022/09/14/jp-morgan-backs-20m-round-for-blockchain-infrastructure-startup-ownera/; Paul Vigna, *How Goldman Sachs, JPMorgan are leading Wall Street's blockchain charge*, FIN. NEWS (Aug. 23, 2022, 7:15 AM), https://www.fnlondon.com/articles/goldman-sachs-jpmorgan-blockchain-onyx-crypto-banking-202208233; Justin Baer, *Wall Street Reluctantly Embraces Crypto*, WALL ST. J. (May 1, 2022, 5:33 AM), https://www.wsj.com/articles/wall-street-reluctantly-embraces-crypto-11651347654 ("Goldman has started executing trades on both over-the-counter bitcoin options as well as futures listed with CME Group Inc., operator of the world's biggest derivatives exchange.").

80. *See* Laura Hautala, *PayPal, Venmo and CashApp simplify cryptocurrency for beginners*, CNET (Nov. 3, 2021, 7:59 PM), https://www.cnet.com/personal-finance/crypto/paypal-venmo-and-cashapp-simplify-cryptocurrency-for-beginners/.

81. Hube, *supra* note 74.

82. Hassan Maishera, *Total Number of Bitcoin ATMs Globally Grows to Around 34,000*, YAHOO! (Dec. 29, 2021), https://www.yahoo.com/video/total-number-bitcoin-atms-globally-104028217.html.

83. Sarah Brady, *What Is Bitcoin and How Does It Work?*, TOM'S GUIDE (July 22, 2022), https://www.tomsguide.com/features/what-is-bitcoin-and-how-does-it-work.

84. *PayPal Launches "Checkout with Crypto,"* PAYPAL NEWSROOM (Mar. 30, 2021), https://newsroom.paypal-corp.com/2021-03-30-PayPal-Launches-Checkout-with-Crypto.

uary 2022, Eric Adams, Mayor of New York City, requested that his first three paychecks be paid in Bitcoin.[85] In April 2022, Fidelity, the nation's largest retirement plan provider, became the first to authorize investors to add Bitcoin to their 401(k) plans.[86] Outside of the United States, other countries are beginning to adapt to cryptocurrency as well.[87]

Beginning with the Bitcoin Market in 2010, there are now more than 500 cryptocurrency exchanges.[88] Some 99% of crypto transactions are made through centralized exchanges ("Centralized Exchange Platforms").[89] Centralized Exchange Platforms revolutionized crypto trading. Coinbase, the largest

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85. Dana Rubinstein et al., *Eric Adams, a Bitcoin Booster, Is Taking First Paycheck in Crypto*, N.Y. TIMES (Jan. 20, 2022), https://www.nytimes.com/2022/01/20/nyregion/eric-adams-bitcoin-cryptocurrency.html.

86. Anne Tergesen, *Fidelity to Allow Retirement Savers to Put Bitcoin in 401(k) Accounts*, WALL ST. J. (Apr. 26, 2022, 10:43 AM), https://www.wsj.com/articles/fidelity-to-allow-retirement-savers-to-put-bitcoin-in-401-k-accounts-11650945661.

87. El Salvador recognized Bitcoin as legal tender, which to date has been little used. Kejal Vyas & Santiago Pérez, *Can Bitcoin Be a National Currency? El Salvador Is Trying to Find Out*, WALL ST. J. (Feb. 17, 2022, 10:59 AM), https://www.wsj.com/articles/bitcoin-national-currency-el-salvador-11645026831. In 2022, Dubai created the Dubai Virtual Assets Regulatory Authority, "reflect[ing] Dubai's vision to become one of the leading jurisdictions for entrepreneurs and investors in blockchain technology." *Dubai Issues Its First Crypto Law Regulating Virtual Assets*, HUNTON ANDREWS KURTH (Apr. 7, 2022), https://www.huntonprivacyblog.com/2022/04/07/dubai-issues-its-first-crypto-law-regulating-virtual-assets/.

88. Kai Sedgwick, *The Number of Cryptocurrency Exchanges Has Exploded*, BITCOIN.COM (Apr. 11, 2018), https://news.bitcoin.com/the-number-of-cryptocurrency-exchanges-has-exploded/.

89. Alex Topchishvili, *Why Decentralized Exchanges Are the Future of Crypto Trading*, MEDIUM (May 16, 2018), https://medium.com/totle/why-decentralized-exchanges-are-the-future-of-crypto-trading-89aac3c81e0. A decentralized exchange, in contrast, does not require a transfer of crypto assets to a third party but is a peer-to-peer system. Andrew Loo, *Cryptocurrency Exchanges*, CORP. FIN. INST. (Aug. 30, 2022), https://corporatefinanceinstitute.com/resources/knowledge/other/cryptocurrency-exchanges/. They are anonymous and do not require an investor to complete a know your customer opening form. *Id.* But they have key disadvantages. An investor who does not remember keys or passwords can lose the total value of the accounts. *Id.* Professor Kristin Johnson generalized about crypto exchanges:

> Coinbase, Gemini, Bittrex and Binance are all examples of centralized exchanges. Users deposit their funds direction into a pooled wallet that is controlled by the exchange; the exchange takes custody of traders' deposited assets, and the exchange directly engages in matching buy and sell orders.

exchange by the end of 2021, "had 89 million retail users, 11,000 institutions[ ] and 210,000 ecosystem partners."[90] Coinbase customers could trade over 150 different cryptocurrencies including Bitcoin, Ethereum, and Dogecoin, use a Visa Debit Card, and even borrow against their accounts using Bitcoin as collateral.[91] Coinbase became a publicly traded company, listing on the Nasdaq on April 14, 2021.[92] A 2022 survey found that 60 percent of trading was conducted by four centralized platforms (Coinbase, 21 percent; PayPal, 20 percent; Robinhood, 10 percent; and Square's Cash App., 9 percent).[93]

To address the volatility of Bitcoin, several cryptocurrencies rely on stablecoins, pegging the value of the cryptocurrency to a stable currency. Tether, the largest stablecoin in the world with a market capitalization of $67 billion as of June 21, 2022, is pegged to the U.S. dollar.[94] Other stablecoins have

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> Centralized exchanges create accounts that store customer funds. The exchanges maintain "hot" wallets connected to the platform's network to facilitate trading. Centralized exchanges generally enable traders to execute, clear, and settle buy/sell orders.

Kristin N. Johnson, *Regulating Decentralized Finance: Cryptocurrency Exchanges*, 62 WM. & MARY L. REV. 1911, 1953 (2021) (footnotes omitted).

90. Shikhar Goel, *How Does Coinbase Make Money — Business Model*, STRATEGY STORY (May 28, 2022), https://thestrategystory.com/2022/05/28/how-does-coinbase-make-money-business-model/.

91. *See* Kevin Voigt, *Coinbase Review 2022: Pros, Cons and How It Compares*, NERDWALLET (Mar. 2, 2022), https://www.nerdwallet.com/reviews/investing/brokers/coinbase#:~:text=0.00%25-,Number%20of%20cryptocurrencies,number%20than%20many%20other%20platforms.

92. Sunil Dhawan, *Coinbase Listing on Nasdaq! Largest US Cryptocurrency Exchange Debuts on Wall Street*, FIN. EXPRESS (Apr. 15, 2021, 10:23 AM), https://www.financialexpress.com/investing-abroad/featured-stories/coinbase-listing-on-nasdaq-largest-us-cryptocurrency-exchange-debuts-on-wall-street/2233344/; *see* Coinbase Global, Inc., Annual Report (Form 10-K) (Feb. 25, 2022).

93. Whaley, *supra* note 77.

94. Darya Rudz, *Tether Burning $11.1 Billion USDT Stablecoins*, COINSPEAKER (June 21, 2022), https://www.coinspeaker.com/tether-burning-11-1-billion-usdt-stablecoins/; MacKenzie Sigalos & Ryan Browne, *Tether, world's biggest stablecoin, cuts its commercial paper holdings to zero*, CNBC (Oct. 13, 2022, 8:43 PM), https://www.cnbc.com/2022/10/13/tether-worlds-biggest-stablecoin-cuts-commercial-paper-to-zero.html#:~:text=the%20world's%20biggest%20stablecoin%2C%20tether,%2Dstyle%20%E2%80%9Cbank%20run.%E2%80%9D&text=via%20Getty%20Images-,Tether%2C%20the%20world's%20largest%20stablecoin%2C%20has%20slashed%20back%

been pegged to fiat currencies like the Euro and can also be pegged to commodities such as gold, silver, oil, or even to other cryptocurrencies. Stablecoins are backed by a fiat currency with the full faith and credit of the issuing government.[95] However, as the experience of TerraUSD painfully illustrates, not all stablecoins are truly stable. Unlike traditional stablecoins, several stablecoins are so-called "algorithmic stablecoins." Algorithmic stablecoins are not backed by specific assets but rely on an algorithmic program to maintain a relationship to the pegged asset.[96]

Crypto tokens have also become increasingly popular. Tokens are digital assets that represent other types of assets both fungible, such as airline frequent flyer miles, and nonfungible, such as NFTs for a particular object like artwork or real estate property.[97] In either case, fungible or nonfungible, the crypto token can be exchanged for the asset.

In 2021, Justin Scheck noted in the *Wall Street Journal* that NFT trading "has also become a haven for fakes and scammers trying to get users' money or access to their newfangled assets[.]"[98] Growth on the NFT market nonetheless was meteoric, from $95 million in 2020 to $25 billion in 2021,[99] led by the Bored Ape Yacht Club, a series of 10,000 digital images of languid simians in various shades.[100] The speculative value of

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20its%20commercial,according%20to%20a%20blog%20post.

95. Adam Hayes, *Stablecoin*, INVESTOPEDIA (May 11, 2022), https://www.investopedia.com/terms/s/stablecoin.asp.

96. *See* Ostroff, *supra* note 6; Hayes, *supra* note 95. *See generally* Monika Ghosh, *Everything You Need to Know About Stablecoins and How They Work*, JUMPSTART (June 2, 2021), https://www.jumpstartmag.com/stablecoins-and-how-they-work/.

97. *See* Devin Finzer, *The Non-Fungible Token Bible: Everything You Need to Know About NFTs*, OPENSEA: BLOG (Jan. 10, 2020), https://opensea.io/blog/guides/non-fungible-tokens/.

98. Justin Scheck, *OpenSea's NFT Free-for-All*, WALL ST. J. (Feb. 12, 2022, 12:00 AM), https://www.wsj.com/articles/openseas-nft-free-for-all-11644642042.

99. Elizabeth Howcroft, *NFT Sales Hit $25 Billion in 2021, but Growth Shows Signs of Slowing*, REUTERS (Jan. 11, 2022, 10:50 AM), https://www.reuters.com/markets/europe/nft-sales-hit-25-billion-2021-growth-shows-signs-slowing-2022-01-10/.

100. Bored Ape Yacht Club, OPENSEA, https://opensea.io/collection/boredapeyachtclub (last visited Oct. 2, 2022). Most of us own portfolios of stocks and bonds. Adventurous investors are sprinkling in Bored Apes and CryptoPunks. These cartoonish sounding characters are not anything like

limited edition artistic NFTs is highly volatile and the unregulated trading markets are subject to the same risks of manipulation and fraud that plague other forms of cryptocurrency.[101] By May 2022, the sale of NFT digital tokens had declined 92% from a peak of 225,000 tokens in September 2021 to 19,000 tokens.[102]

II.
Potential Responses to Crypto

A. *Prohibition*

One option available to lawmakers in response to crypto proliferation is flat prohibition.

In September 2021, China, acting through its People's Bank, banned all digital currencies and deemed all virtual currency transactions, including services that provide foreign exchange to Chinese citizens, illegal.[103] The Chinese ban fo-

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traditional investments – they have no physical properties, do not pay dividends or interest and provide no claims to future cash flows. But they are among the most popular nonfungible tokens or NFTs, a type of digital collectible or digital asset. Prized NFTs now cost more than a new Ferrari – Bored Apes are going for an average minimum price of $248,000 on trading platform OpenSea. A CryptoPunk recently sold for $11.75 million. Abby Schultz, *'Covid Alien' CryptoPunk Sells for $11.75 million in Sotheby's Sale*, Barron's (June 10, 2021, 10:49 AM), https://www.barrons.com/articles/covid-alien-cryptopunk-sells-for-10-million-in-sothebys-sale-01623336573.

101. Zachary Small, *Can an Art History Frame Help Expand the NFT Market?*, N.Y. Times (Apr. 14, 2022), https://www.nytimes.com/2022/04/14/arts/design/nft-art-market-sothebys.html; Lewis White, *Most NFT Sales Are People Buying Their Own NFTs, Evidence Suggests*, Stealth Opinion (Feb. 11, 2022, 9:54 AM), https://stealthoptional.com/crypto/nft-sales-nft-wash-trading.

102. Paul Vigna, *NFT Sales are Flatlining*, Wall St. J. (May 3, 2022, 7:15 AM), https://www.wsj.com/articles/nft-sales-are-flatlining-11651552616.

103. Amy Qin & Ephrat Livni, *China Cracks Down Harder on Cryptocurrency With New Ban*, N.Y. Times (Sept. 24, 2021), https://www.nytimes.com/2021/09/24/business/china-cryptocurrency-bitcoin.html; Ralph Jennings, *How China's Ban on Cryptocurrency Will Ripple Overseas*, Voice of America (Oct. 2, 2021, 3:06 AM), https://www.voanews.com/a/how-china-s-ban-on-cryptocurrency-will-ripple-overseas-/6254329.html; Francis Shin, *What is Behind China's Cryptocurrency Ban?*, World Econ. F. (Jan. 31, 2022), https://www.weforum.org/agenda/2022/01/what-s-behind-china-s-cryptocurrency-ban/ (People's Bank emphasized curtailing financial crime and proscribing capital flight); David Pan, *China Steps Up Crypto Clampdown with Threat of Jail Sentences*, Bloomberg (Feb. 25, 2022, 7:14 AM), https://www.bloomberg.com/news/articles/2022-02-25/china-steps-up-crypto-clampdown-with-threat-of-jail-sentences#xj4y7vzkg; Anne Stevenson-Yang, *Crypto vs. China's Digital Cur-*

cused solely on cryptocurrency. In January 2022, China concluded that NFTs could continue to be traded in China.[104] Paradoxically, the gravitation of Bitcoin mining from China, where mining relied in part on hydropower, to other nations such as the U.S. and Kazakhstan, where mining is more reliant on fossil fuels, appears to have aggravated the negative environmental consequences of cryptocurrency mining.[105]

While U.S. law does ban specified products and behaviors thought to bring about negative externalities, such as the consumption of illegal drugs, the case for proscribing cryptocurrency solely on the grounds that it is speculative, or even risky, is not persuasive. Securities and other investments in the United States often are speculative, but the basic aim of U.S. securities regulation is to facilitate disclosure of material facts relevant to an investment, rather than blanket prohibition.[106] The federal securities laws long ago rejected "merit" regulation of securities issuance, that is, regulation based on an SEC Commissioner's view of the "soundness" of a particular investment.[107] Any crypto regulatory efforts should take the same basic approach, focusing on disclosure rather than prohibi-

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rency: Never the Twain Shall Meet, FORBES (Jan. 12, 2022, 8:51 AM), https://www.forbes.com/sites/annestevenson-yang/2022/01/12/crypto-vs-chinas-digital-currency-never-the-twain-shall-meet/?sh=1e6a66107555 ("China dislikes the energy consumption and greenhouse gasses associated with cryptocurrency mining").

104. Dorian Batycka, *How the Chinese Government Is Trying to Reinvent the NFT Market Without Cryptocurrency and With State Control Instead*, ARTNET (July 5, 2022), https://news.artnet.com/market/china-nft-market-2137934 ("With cryptocurrencies and traditional NFTs backed by tokens like Ethereum banned in China, the country is offering certain services that, . . . , could allow access for those willing to conform to compliance and current regulations[.]").

105. *See, e.g.*, Hiroko Tabuchi, *China Banished Cryptocurrencies. Now, 'Mining' is Even Dirtier*, N.Y. TIMES (Feb. 25, 2022) https://www.nytimes.com/2022/02/25/climate/bitcoin-china-energy-pollution.html.

106. *See, e.g.*, LOUIS LOSS, JOEL SELIGMAN & TROY PAREDES, SECURITIES REGULATION 776–79 (Wolters Kluwer, 6th ed. 2021). SEC Chair Gensler put this simply in an interview reflecting on his first year as Chair: "You want to raise money from the public and the public wants to take the risk, that's fine, as long as you register with the SEC and you give them full and fair disclosure and don't lie to them." Ephrat Livni, *Gary Gensler Reflects on First Year as the S.E.C. Chair*, N.Y. TIMES (Apr. 16, 2022), https://www.nytimes.com/2022/04/16/business/dealbook/gary-gensler-sec.html.

107. SELIGMAN, *supra* note 1, at ch. 1.

tion, regardless of whether or not cryptocurrency is a deemed to be a security.

At least two aspects of cryptocurrency, as exemplified by Bitcoin, are unique as compared to other financial instruments and could serve as potential justifications for lawmakers seeking to prohibit crypto.

First, energy consumption by Bitcoin miners poses a significant threat to the United States, especially in view of a climate change crisis that President Biden has labelled "the existential threat of our times."[108] The climate change crisis in part involves a reduction of energy consumption and was a reason that China banned cryptocurrency.[109]

The United States should address excessive energy consumption in crypto products by prohibiting those products that require more than a specified level of energy consumption. This approach would resemble early regulation of life insurance policies, by which lawmakers successfully eliminated the tontine insurance component of life insurance policies, while preserving life insurance generally.[110] Similarly, by focusing on energy consumption levels, the United States could prohibit particularly energy consumptive crypto products, without prohibiting *all* crypto products. Additionally, a "phase-in" of such a prohibition would permit Bitcoin and other excessive energy consumers to restructure their business model in line with regulatory requirements while ultimately banning only those crypto products that are unable to reduce their respective energy consumption levels below the specified amount.

Even a selective prohibition of this sort would likely face opposition from some in the federal government or particular States, such as Texas, that have welcomed crypto miners for

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108. Jennifer Dlouhy & Josh Wingrove, *Biden Calls Climate Change 'Existential Threat of Our Times'*, BLOOMBERG (Dec. 19, 2020, 3:00 PM), https://www.bloomberg.com/news/articles/2020-12-19/biden-calls-climate-change-existential-threat-of-our-time#xj4y7vzkg.

109. Isabella Kaminski, *Chinese court rules bitcoin mining harms the climate*, CLIMATE HOME NEWS (July 21, 2022, 10:22 AM), https://www.climatechangenews.com/2022/07/21/chinese-court-rules-bitcoin-mining-harms-the-climate/#:~:text=A%20Chinese%20court%20has%20quashed,targets%20and%20energy%2Dintensive%20activities.

110. *See supra* text accompanying notes 25–27.

one reason or another.[111] Crypto serves as a significant source of potential revenue, as sales of cryptocurrency held by investors may be taxed as property transactions and subject to ordinary income taxation or held and taxed as a capital asset.[112] Nonetheless, the extreme step of prohibition, or at least selective prohibition, can be justified by the excessive energy demands of Bitcoin and other cryptocurrencies.

The second basis for prohibiting cryptocurrencies, cited in China's ban and equally applicable in the United States, involves crypto's secrecy which can, in turn, facilitate illegal transactions including tax evasion, money laundering, and the financing of international terrorists.[113] Here, too, a selective

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111. Nicholas Pongratz, *Texas Crypto Mining Leads to Rising Power Bills for All*, BeInCrypto (Mar. 16, 2022), https://beincrypto.com/texas-crypto-mining-leads-to-higher-power-bills-for-all/. By December 2021, "thirty-three states and Puerto Rico have pending legislation in the 2021 legislative season. Seventeen states enacted legislation or adopted resolutions." Heather Morton, *Cryptocurrency 2021 Legislation,* NCSL (Dec. 16, 2021). By April 2022, Florida, Kentucky and Wyoming had passed laws making it easier to create or operate a crypto company in their states. *See* Eric Lipton & David Yaffe-Bellany, *Crypto Industry Helps Write, and Pass, Its Own Agenda in State Capitols*, N.Y. Times (Apr. 10, 2022), https://www.nytimes.com/2022/04/10/us/politics/crypto-industry-states-legislation.html; *see generally* Goforth & Guseva, *supra* note 30, at ch. 14. For state-by-state summary of state rules as of March 15, 2021, see Matthew Kohen, *State Regulations on Virtual Currency and Blockchain Technologies*, Carlton Fields (Apr. 9, 2021), https://www.carltonfields.com/insights/publications/2021/state-regulations-on-virtual-currency-and-blockchain-technologies-(updated-march-2021).

112. *See* Lyle Doly, *Sold Crypto in 2021? 5 Things to Know about your Taxes*, The Ascent (Feb. 17, 2022), https://www.fool.com/the-ascent/cryptocurrency/articles/sold-crypto-in-2021-5-things-to-know-about-your-taxes/. The Biden administration is contemplating additional tax revenue. In 2022, the White House estimated that closing the crypto reporting gap could net up to $28 billion in new tax revenue over the next 10 years. *See* Joint Comm. on Tax'n Rep. 33-21, *Estimated Revenue Effects of the Provisions in Division H of an Amendment in the Nature of a Substitute to H.R. 3684* (2021); Robert W. Wood, *IRS Gives Crypto Tax Warning: Don't Forget to Report*, Forbes (Mar. 20, 2022, 1:49 PM), https://www.forbes.com/sites/robertwood/2022/03/20/irs-gives-crypto-tax-warning-dont-forget-to-report/; Brady Dale, *Biden Targets Crypto Wealth for $11 Billion in New Tax Revenue*, Axios (Apr. 4, 2022), https://www.axios.com/2022/04/04/biden-targets-crypto-wealth-for-11-billion-in-new-tax-revenue.

113. *See* James Fanelli, *Cryptocurrency Guru Sentenced to More Than Five Years in Prison over North Korea Trip*, Wall St. J. (Apr. 13, 2022, 3:53 PM), https://www.wsj.com/articles/cryptocurrency-guru-sentenced-to-more-than-five-years-in-prison-over-north-korea-trip-11649789150 (detailing an unsuccessful

prohibition is preferable to a general one. The United States could prohibit all crypto products that do not provide law enforcement agencies with the access necessary to detect violations of and enforce its criminal laws. This type of prohibition would cut to the heart of the libertarian "trust no one" view of government and dampen the appeal of guaranteed and complete anonymity offered by Bitcoin and similar cryptocurrencies.[114] Bitcoin's anonymity invites crime. Its approach is exceptional. In the United States, enforcement either as facilitated by federal enabling laws or with appropriate subpoenas generally provides agencies with access to crime records of crimes. It provides no comfort whatever that after several days the United States was able to recover some or all of the ransomware that Colonial Pipeline paid in Bitcoin to ransomware operations in 2021.[115] This is exactly backwards. The fact that Bitcoin generally is untraceable invites crime.

B. *Regulation*

Another option in responding to crypto mania, and the predominant U.S. response to this point, is increased regulation. In the absence of a clear national policy, several federal agencies today are engaged in those regulatory efforts.

Bitcoin was unusual in that it was created without raising any funds.[116] Subsequent cryptocurrency projects have sought investor support through initial coin offerings ("ICOs"), Security Token Offerings ("STOs"), and initial exchange offerings ("IEOs"). In an ICO, the investor provides funds to the issuer and receives tokens or coins in exchange. Fundraising via these various offering methods has been substantial. Between 2014 and 2018, ICOs raised approximately $14 billion. In 2018 alone, 119 STOs raised over $17 billion. Since 2018,

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effort to instruct North Korea on how to circumvent sanctions using the blockchain). *But see* Jon Sindreu, *If Crypto Can't Be Used to Evade Russian Sanctions, What Is the Point?*, WALL ST. J. (Apr. 12, 2022, 7:43 AM), https://www.wsj.com/articles/if-crypto-cant-be-used-to-evade-russian-sanctions-what-is-the-point-11649763827 (referencing uncertainty as to how widespread crypto has been in sanctions evasion).

114. *See* NAKOMOTO, *supra* note 31.

115. *See* Nicole Perlroth et al., *Pipeline Investigation Upends Idea That Bitcoin Is Untraceable*, N.Y. TIMES (June 9, 2021), https://www.nytimes.com/2021/06/09/technology/bitcoin-untraceable-pipeline-ransomware.html.

116. *See* Lacity, *supra* note 30, at 390.

IEOs allow investors to fund transactions with coins and buy tokens.[117] AirDrops provide an alternative way to create a new crypto product – an issuer simply distributes free tokens to existing accounts to launch a product.[118] The Bored Ape Yacht Club[119] did so in March 2022, quickly becoming among the most well-known NFTs and briefly saw the value of ApeCoins double.[120]

As cryptocurrency has soared in popularity and secured investor funds, the intensity of regulatory concern has increased. In August 2021, in remarks to the Aspen Security Forum, SEC Chair Gary Gensler recognized that: "Right now, [the SEC does not] have enough investor protection in crypto. Frankly at this time, it's more like the Wild West. . . . The asset class is rife with fraud, scams and abuse in certain applications."[121] Gensler stressed:

> In my view, the legislative priority should center on crypto trading, lending and DeFi platforms. . . . Right now large parts of the field of crypto are sitting astride of – not operating within – regulatory frameworks that protect investors and consumers, guard against illicit activity, ensure for financial stability, and yes, protect national security.[122]

Under the broad definition of security in 2(a)(1) of the Securities Act and 3(a)(10) of the Securities Exchange Act, the

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117. *See* Marco Dell'Erba, *From Inactivity to Full Enforcement: The Implementation of the "Do No Harm" Approach in Initial Coin Offerings*, 26 MICH. TECH. L. REV. 175 (2020). *But see* Amiah Taylor, *Watch Out for "Rug Pull" Scam That's Tricking Investors Out of Millions*, FORTUNE (Mar. 3, 2022), https://fortune.com/2022/03/02/crypto-scam-rug-pull-what-is-it/ (In 2021, dishonest crypto developers who absconded with funds stole $2.8 billion from investors, 31 percent of all crypto scam revenue that year).

118. Andrey Sergeenkov, *What Is a Crypto Airdrop?*, COINDESK (Jan. 18, 2022, 10:31 AM), https://www.coindesk.com/learn/what-is-a-crypto-airdrop/.

119. *See* The Bored Ape Yacht Club, *supra* note 100.

120. *See* Vishal Chawla, *Someone Borrowed 5 Bored Apes to Claim $1.1 Million of APE Tokens*, THE BLOCK (Mar. 18, 2022, 9:49 AM), https://www.theblock.co/post/138410/someone-borrowed-5-bored-apes-to-claim-1-1-million-of-ape-tokens; *Historical Price Chart of ApeCoin*, COINMARKETCAP, https://coinmarketcap.com/currencies/apecoin-ape/ (last visited Oct. 2, 2022).

121. Gary Gensler, Chairman, Sec. Exch. Comm'n, Remarks Before the Aspen Security Forum (Aug. 3, 2021).

122. *Id.*

SEC has authority to regulate crypto products when they satisfy the Howey test.[123] In this test, the SEC and the courts have concluded that a crypto platform or coin is an investment contract, which is defined as a type of security.[124] In *SEC v. W.J. Howey Co.*, the U.S. Supreme Court held that a combination of a small real estate investment in an orange grove and a service contract employing the seller or a third party to manage the cultivation and sale of the oranges was an investment contract under the Securities Act when there was (i) an investment of money, (ii) in a common enterprise, and (iii) an expectation of profits from the efforts of the promoter or a third party.[125] Whether *Howey* is satisfied and, thus, whether a crypto product is deemed a "security" subject to applicable regulation, usually turns on whether a transaction in a crypto product creates an expectation of profits because of the managerial efforts of others, such as the organizer of the crypto platform or token program.[126]

In 2021, Cornerstone Research published a summary of SEC Cryptocurrency Enforcement.[127] Through the end of 2021, the SEC had brought 97 cryptocurrency-related litigation claims and administrative actions, issued 20 trading suspensions, and imposed approximately $2.35 billion in total monetary penalties against digital asset market participants.[128] Gensler, in his 2021 remarks to the Aspen Security Forum,

123. *See* SEC v. W.J. Howey Co., 328 U.S. 293 (1946).

124. *See* William Hinman, Director, Sec. Exch. Comm'n, Remarks at the Yahoo Finance All Markets Summit: Crypto (June 14, 2018) (for staff amplification of analysis of when a crypto product was a security); Press Release, U.S. Sec. & Exch. Comm'n, Joint Statement on Activities Involving Digital Assets (Oct. 5, 2019) https://www.sec.gov/news/public-statement/cftc-fincen-secjointstatementdigitalassets (recognizing that digital assets include instruments that may qualify under applicable U.S. laws as securities, commodities, and security- or commodity-based instruments such as futures or swaps).

125. *See* W.J. Howey Co., 328 U.S. at 298–99.

126. *See Framework for "Investment Control" Analysis of Digital Sales*, U.S. SEC. & EXCH. COMM'N (Apr. 3, 2019), https://www.sec.gov/corpfin/framework-investment-contract-analysis-digital-assets.

127. CORNERSTONE RSCH., SEC CRYPTOCURRENCY ENFORCEMENT (2021), https://www.cornerstone.com/wp-content/uploads/2022/01/SEC-Cryptocurrency-Enforcement-2021-Update.pdf.

128. *Id.* at 1.

took pride in the fact that the SEC, up to such point, had not yet lost a case.[129]

In July 2017, the SEC published the notable investigation report, "Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934: The DAO" ("DAO Report").[130] The SEC ultimately determined not to pursue an enforcement action against the DAO, a decentralized autonomous organization, including the German corporation "Slock.it" and other parties.[131] A DAO is different in operation from a corporation with leadership centralized in a board of directors and senior executives. The DAO Report addressed ICOs, tokens, smart contracts, and the federal securities law requirements for crypto products to register both as a security and as an exchange, as applicable.

In April and May 2016, the DAO offered and sold approximately 1.15 billion DAO Tokens in exchange for 12 million Ether, the virtual currency used on the Ethereum Blockchain.[132] When the DAO offering was closed, the DAO was valued at $150 million:

> All funds raised were to be held at an Ethereum Blockchain "address" associated with The DAO and DAO Token holders were to vote on contract proposals, including proposals to The DAO to fund projects and distribute The DAO's anticipated earnings from the projects it funded. The DAO was intended to be "autonomous" in that project proposals were in the form of smart contracts that exist on the Ethereum Blockchain and the votes were administered by the code of The DAO.[133]

The DAO created DAO Tokens proportional to the amount of Ether paid. DAO intended to earn profits by funding projects that provided DAO Token holders a return on their investment. For a project to be considered for funding with DAO, contractors were required to submit proposals to

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129. *See* Gensler, *supra* note 121.

130. Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934: The DAO, Exchange Act Release No. 81,207, 5 SEC Dock. 117 (July 25, 2017) [hereinafter DAO Report].

131. *Id.*

132. Rosario Girasa, Regulation of Cryptocurrencies and Blockchain Technologies 76 (2018).

133. *See* DAO Report, *supra* note 130.

DAO that included a written smart contract that would be included in the Ethereum Blockchain and posted on the DAO website.[134] Each DAO proposal was required to be approved by one or more of DAO's curators, individuals chosen by Slock.it, before being submitted to a shareholder vote.[135]

Applying the *Howey* test, the SEC Report concluded that DAO tokens were "securities," in pertinent part, because investor profits were derived from the managerial efforts of Slock.it, its co-founder, and the DAO curators, while DAO token holder voting rights were limited.[136]

DAO was required to register its initial coin offering under § 5 of the Securities Act because DAO had not established a valid exemption. The Report also found that the DAO system was an "Exchange" under § 3(a)(1) and Rule 3b-16(a) of the Exchange Act because it was an:

> [O]rganization, association, or group of persons . . . considered to constitute, maintain, or provide "a marketplace or facilities for bringing together purchasers and sellers of securities or for otherwise performing with respect to securities the functions commonly performed by a stock exchange," if such organization, association, or group of persons: (1) brings together the orders for securities of multiple buyers and sellers; and (2) uses established, non-discretionary methods (whether by providing a trading facility or by setting rules) under which such orders interact with each other, and the buyers and sellers entering such orders agree to the terms of the trade.[137]

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134. Alex Ivanovs, *What is a DAO? Examples of DAO Crypto Projects*, GEEKFLARE (Aug. 28, 2022), https://geekflare.com/finance/dao-crypto-projects/.

135. DAO became newsworthy when an unknown individual or group diverted approximately $50 million, or one-third of the total Ether raised in the DAO 2016 offering. MARY C. LACITY, BLOCKCHAIN FOUNDATIONS: FOR THE INTERNET OF VALUE 286 (2020).

136. DAO Report, *supra* note 130, at 13.

137. *Id.* at 16–17. DAO did not satisfy any of the available exemptions from Rule 3b-16(a) such as that provided by Alternative Trading Systems. Subsequently, the SEC proposed to amend Rule 3b-16 which will facilitate Commission cases against cryptocurrency exchange platforms. *See SEC Appears to Target Crypto Trading Venues with Proposed Stealth Regulation*, DENTONS (Feb. 15, 2022), https://www.dentons.com/en/insights/alerts/2022/febru-

In December 2021, there were more than 4,000 decentralized anonymous organizations or DAOs with an aggregate value of $13 billion.[138] In August 2021, Gensler reported that nearly three-fourths of trading on all crypto trading platforms involved a Stablecoin and a token.[139] The SEC also supported the "Report on Stablecoins" ("Stablecoin Report") released in 2021 by the President's Working Group on Financial Markets, the Federal Deposit Insurance Corporation ("FDIC"), and Of-

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ary/15/sec-appears-to-target-crypto-trading-venues-with-proposed-stealth-regulation.

In 2022, after Coinbase Global refused to voluntarily register with the SEC as an exchange, the Commission initiated a study of ways to register crypto trading platforms as exchanges. Paul Kiernan, *SEC Weighs Path Forward for Crypto Trading Platforms*, WALL ST. J. (Apr. 4, 2022, 4:03 PM), https://www.wsj.com/articles/sec-weighs-path-forward-for-crypto-trading-platforms-11649101184; *see also* Alex Gailey, *The SEC Announced New Crypto Regulation Initiatives This Week. Here's What Investors Should Know*, NEXTADVISOR (Apr. 5, 2022), https://time.com/nextadvisor/investing/cryptocurrency/sec-new-crypto-regulation-gensler/ (announcing plans to register and regulate crypto exchanges); SEC Staff Accounting Bulletin No. 121, 87 Fed. Reg. 21015 (Apr. 11, 2022) (expressing staff views on accounting for entities that have obligations to safeguard crypto assets); Mark R. Hake, *XRP Crypto Looks Stronger Now That Ripple Has Gained Ground Fighting the SEC*, INVESTOR PLACE (Apr. 25, 2022, 9:57 AM), https://investorplace.com/2022/04/xrp-crypto-could-benefit-from-an-end-to-the-end-of-the-sec-lawsuit-by-q1-next-year/ (discussing Ripple Labs' ongoing litigation with the SEC).

Particularly after the 2022 Crypto Crash, private litigation increased. *See, e.g.*, James Fanelli, *Crypto Industry Sees Surge in Lawsuits as Investor Losses Pile Up*, WALL ST. J. (June 1, 2022, 8:00 AM), https://www.wsj.com/articles/as-crypto-losses-hit-investors-litigation-picks-up-11654084801; Anne Tergesen, *Suit Targets a Hurdle to Crypto in 401(k)s*, WALL ST. J. (June 2, 2022, 9:42 AM), https://www.wsj.com/articles/401-k-provider-sues-labor-department-over-handling-of-crypto-in-retirement-plans-11654177362?no_redirect=true; *see also* Tiffany Hsu, *All Those Celebrities Pushing Crypto Are Not So Vocal Now*, N.Y. TIMES (May 17, 2022), https://www.nytimes.com/2022/05/17/business/media/crypto-gwyneth-paltrow-matt-damon-reese-witherspoon.html (the Crypto Crash has increased scrutiny of stars and online influencers who promote crypto); David Yaffe-Bellany, *A Crypto Emperor's Vision: No Pants, His Rules*, N.Y. TIMES (May 14, 2022), https://www.nytimes.com/2022/05/14/business/sam-bankman-fried-ftx-crypto.html (Sam Bankman-Fried raised more than $40 billion in fewer than three years by the age of 30).

138. Eric Lipton & Ephrat Livni, *Reality Intrudes on a Utopian Crypto Vision*, N.Y. TIMES (Mar. 8, 2022), https://www.nytimes.com/2022/03/08/us/politics/cryptocurrency-dao.html ("Many DAOs were wrestling with challenges, including huge financial losses from software flaws and hacks, internal divisions and allegations of improper diversion of community funds.").

139. Gensler, *supra* note 121.

fice of the Comptroller of the Currency.[140] By October 2021, the market capitalization of Stablecoins issued by the largest Stablecoin issuers exceeded $127 billion.[141] The Stablecoin Report highlighted:

> Stablecoins and stable-coin related activities present a variety of risks. Speculative digital asset trading, which may involve the use of stablecoins to move easily between digital asset platforms or in decentralized finance (DeFi) arrangements, presents risks related to market integrity and investor protection. These market integrity and investor protection risks encompass possible fraud and misconduct in digital asset trading, including market manipulation, insider trading, and front running, as well as a lack of trading or price transparency.[142]

Now the Working Group recommends that Congress promptly enact legislation to ensure that stablecoins are subject to federal regulation.[143] In 2021, the Department of Treasury ("DOT") announced that it would require any transfer of $10,000 or more in cryptocurrency to be reported to the Internal Revenue Service.[144]

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140. *See* U.S. Dep't of Treasury, President's Working Group on Financial Markets, Fed. Deposit Ins. Corp. & the Off. of the Comptroller of the Currency (Nov. 2021), https://home.treasury.gov/system/files/136/StableCoinReport_Nov1_508.pdf [hereinafter "Stablecoin Report"].

141. *Id.* at 7.

142. *Id.* at 1.

143. *Id.* at 16.

144. U.S. Dep't of Treasury, The American Families Plan Tax Compliance Agenda (2021). In May 2021, the Department of Treasury stated in The American Families Plan Tax Compliance Agenda that the President's tax proposal sought to include additional resources for the IRS to address the growth of crypto assets: "Although cryptocurrency is a small share of current business transactions, such comprehensive reporting is necessary to minimize the incentives and opportunity to shift income out of the new information reporting regime." *Id.* at 21.

> Despite constituting a relatively small portion of business income today, cryptocurrency transactions are likely to rise in importance in the next decade, especially in the presence of a broad-based financial account reporting regime. Within the context of the new financial account reporting regime, cryptocurrencies and cryptoasset exchange accounts and payment service accounts that accept cryptocurrencies would be covered.

Id.

A number of other federal regulatory agencies have taken parallel steps. In 2014, the Commodity Futures Trading Commission ("CFTC") defined virtual crypto currencies as a "Commodity" subject to CFTC oversight under the Commodity Exchange Act.[145] The CFTC position can be harmonized with the SEC enforcement position under *Howey*. When a cryptocurrency such as Bitcoin or Ethereum is used solely for peer-to-peer transactions, it does not satisfy the investment contract requirement that profits be generated from the efforts of others since the decentralized owners of Bitcoin and Ethereum control the governance of the systems.[146]

Since registering TechExchange in 2014 to trade Bitcoin swaps, the CFTC has registered crypto futures markets often relying on self-certification, rather than prior review by a regulatory agency.[147]

In February 2022 testimony to the U.S. Senate Committee on Agriculture, CFTC Chair Rostin Behnam noted that the CFTC had brought nearly 50 enforcement actions in the digi-

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145. Commodity Futures Trading Comm'n v. McDonnell, 287 F. Supp. 3d 213, 217 (E.D.N.Y. 2018) (affirming CFTC jurisdiction over virtual currencies as commodities and concurrent jurisdiction depending on facts and circumstances of the SEC, the Department of Justice and state criminal agencies, the DOT or FinCen, the IRS and state regulation, or a combination of agencies); Commodity Futures Trading Comm'n v. My Big Coin Pay, Inc., 334 F. Supp. 3d 492, 498 (D. Mass. 2018) (finding Bitcoin engages in futures trading in virtual currencies).

146. In 2016, the CFTC brought an enforcement action against a Bitcoin exchange that was offering unregistered futures. *In re* BFXNA, Inc., CFTC Docket No. 16-19 (June 2, 2016); *see generally* CFTC Retail Commodity Transaction Involving Digital Assets, 85 Fed. Reg. 37734, 37734–35 (June 24, 2020).

147. *See* Press Release, CME Group, CME Group Self-Certifies Bitcoin Futures to Launch Dec. 18 (Dec. 1, 2017), https://www.cmegroup.com/media-room/press-releases/2017/12/01/cme_group_self-certifiesbitcoinfuturestolaunchdec18.html; Press Release, Cboe, Global Markets, Inc., Cboe Submits Product Certification for Bitcoin Futures (Dec. 1, 2017), https://ir.cboe.com/sites/cboe-ir-v1/files/cboe/news-and-events/press-releases/2017/cboe-xbt-self-certification-statement-12-1-17.pdf. For background on CFTC self-certification, see U.S. COMMODITY FUTURES TRADING COMM'N, CFTC BACKGROUNDER ON OVERSIGHT OF AND APPROACH TO VIRTUAL CURRENCY FUTURES MARKETS (Jan. 4, 2018), https://www.cftc.gov/sites/default/files/idc/groups/public/%40customerprotection/documents/file/backgrounder_virtualcurrency01.pdf; U.S. COMMODITY FUTURES TRADING COMM'N DIGITAL ASSETS PRIMER (2020), https://www.cftc.gov/media/5476/DigitalAssetsPrimer/download; Johnson, *supra* note 89, at 1987.

tal asset space since 2014, but required additional resources to adequately address the digital sector.[148]

In October 2021, Deputy Attorney General Lisa Monaco announced that the Department of Justice ("DOJ") had begun a new "Civil Cyber-Fraud Initiative."[149] The initiative is similar to the work of the DOT's "Financial Crimes Enforcement Network" ("FinCEN"), which is intended "to safeguard the financial system from illicit use, combat money laundering and its related crimes including terrorism, and promote national security through the strategic use of financial authorities and the collection, analysis, and dissemination of financial intelligence."[150] FinCEN focuses on money laundering, Domestic and Foreign Financial Transactions Reporting Requirements, and the Bank Secrecy Act, which FinCEN has used to characterize virtual currencies as a type of reportable account.[151]

While the foregoing efforts are extensive and appropriate, they alone are inadequate to provide effective comprehensive regulation of crypto products, and important gaps and omissions remain in the current regulatory scheme. For instance, no agency is currently charged with coordination of crypto regulatory efforts, systematic examination of crypto products,

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148. *Testimony of Chairman Rostin Behnam Regarding "Examining Digital Assets: Risks, Regulation and Innovation" Before the S. Comm. on Agric., Nutrition, and Forestry*, 117th Cong. (2022) (statement of Rostin Behnam, Chairman, Commodity Futures Trading Comm'n).

149. Press Release, Dep't of Just., Deputy Attorney General Lisa O. Monaco Announces New Civil Cyber-Fraud Initiative (Oct. 6, 2021), https://www.justice.gov/opa/pr/deputy-attorney-general-lisa-o-monaco-announces-new-civil-cyber-fraud-initiative.

150. *Mission*, FIN. CRIMES ENF'T NETWORK, https://www.fincen.gov/about/mission.

151. *See* GOFORTH & GUSEVA, *supra* note 30, at 133–34, 167; U.S. DEP'T. OF TREASURY, FIN. CRIMES ENF'T NETWORK, FIN-2013-G001, GUIDANCE FOR APPLICATION OF FINCEN'S REGULS. TO PERS. ADMINISTERING, EXCHANGING, OR USING VIRTUAL CURRENCIES 1 (2013). Bitcoin was characterized as money subject to the criminal money transmitting and money laundering statute, 18 U.S.C. § 1960, in *United States v. Faiella*, 39 F. Supp. 3d 544 (S.D.N.Y. 2014). *See also* United States v. Murgio, 209 F. Supp. 3d 698, 707 (S.D.N.Y. 2016) (criminal convictions for engaging in an unlicensed money transmitting business, trading Bitcoin). In 2015, FinCEN assessed a $700,000 fine for violations of the Bank Secrecy Act and failing to maintain an adequate anti-money laundering program against Ripple Labs, Inc. and a subsidiary in its first civil enforcement action. Press Release, U.S. Dep't. of Treasury, Fin. Crimes Enf't Network, FinCEN Fines Ripple Labs Inc. in First Civil Enforcement Action Against a Virtual Currency Exchanger (May 5, 2015).

or the development and prescription of forward-looking solutions in this fast-evolving space, which appears to introduce new issuers and products on a daily basis.

As was the case in the Dodd–Frank Act of 2010 ("Dodd–Frank"),[152] which created a new Bureau of Consumer Financial Protection ("CFPB"),[153] the case for a new standalone agency to address crypto products is strong. Crypto products are different in kind than existing currencies, securities, and commodities. Agencies regulating consumer finance before the establishment of the CFPB had long expressed the concern that coordinated regulation among the agencies in a setting where regulators prioritized their own individual concerns would not lead to the effective regulation that a standalone agency could produce. Bank regulators, for example, prioritized the safety and solvency of banks over consumer protection.[154] The same problems now threaten crypto regulation.

Two alternatives exist to a new standalone crypto product regulatory agency. The first is to continue relying on the plethora of existing agencies to regulate crypto. As mentioned, this type of multi-regulatory agency approach was widely ineffective and criticized[155] in the aftermath of the 2007–2009 financial crisis, which originated in the housing industry but ultimately led to the systemic financial crisis.[156] The crisis resulted in stock prices falling 54%, global stock market losses of $35 trillion, the U.S. unemployment rate more than doubling from

152. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010).

153. *See* SELIGMAN, *supra* note 1, at 1,122–25.

154. *See id.* at 1,124 (quoting Elizabeth Warren characterizing the limits of the Federal Reserve System, Office of the Comptroller of the Currency and Office of Thrift Supervision in making the case for the CFPB: "[T]heir main mission is to protect the financial stability of banks and other financial institutions, not to protect consumer.").

155. *See, e.g.*, U.S. DEP'T. OF TREASURY, BLUEPRINT FOR A MODERNIZED FINANCIAL REGULATORY STRUCTURE (2008) (urging consolidation of specified regulators); BIPARTISAN POL'Y CTR., DODD-FRANK'S MISSED OPPORTUNITY: A ROAD MAP FOR A MORE EFFECTIVE REGULATORY ARCHITECTURE (2014) (urging consolidation of specific bank and investment regulators); The Volcker Alliance, Reshaping the Financial Regulatory System: Long Delayed, Now Crucial (2015) (criticizing the "highly fragmented, outmoded and ineffective" existing system of financial regulation in the United States).

156. *See* SELIGMAN, *supra* note 1, at 17–18.

4.5 to 10.1%, and the U.S. federal deficit exploding from $459 billion in 2008 to $1.413 trillion in 2009.[157] The separate-regulator model employed to address the financial crisis was beset by ineffectual communication and coordination between the regulatory agencies, regulatory arbitrage in which private banks, securities, and commodities firms sought the most accommodating regulator, and consequential gaps and omissions in examinations, investigations, and enforcement.[158] There is little reason to believe that the same problems would not plague crypto regulation efforts if no single agency is placed in charge of the industry.

The consensus view concerning the inability of a system of largely separate regulatory agencies to address a systemic financial crisis led to the enactment of Dodd–Frank and its creation of a Financial Stability Oversight Council ("FSOC").[159] The FSOC members included representatives from several agencies, including the Secretary of Treasury, the Comptroller of the Currency, the Director of the Treasury's Bureau of Consumer Financial Protection, the Chair of the SEC, the Chair of the FDIC, the Chair of the CFTC, the Director of the Federal Housing Finance Agency, and the Chair of the National Credit Union Administration.[160]

FSOC represents a halfway house to effective regulation. The FSOC is largely advisory and can attempt to persuade, but usually cannot direct, constituent agencies to adopt new standards.[161] From the perspective of former Secretaries of the Treasury, Tim Geithner and Hank Paulson, and former Federal Reserve Chair Ben Bernanke, Dodd–Frank failed to simplify the ludicrously byzantine mess of U.S. financial regulation.[162]

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157. *Id.* at 2.

158. *See id.* at 119–24, ; U.S. GOV'T ACCOUNTABILITY OFF., GAO-13-180, FINANCIAL REGULATORY REFORM: FINANCIAL CRISIS LOSSES AND POTENTIAL IMPACT OF DODD-FRANK (2013). *See generally* THE FINANCIAL CRISIS INQUIRY COMMISSION, THE FINANCIAL CRISIS INQUIRY REPORT: FINAL REPORT OF THE NATIONAL COMMISSION ON THE CAUSES OF THE FINANCIAL AND ECONOMIC CRISIS IN THE UNITED STATES (2011).

159. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010).

160. *Id.*

161. LOSS, SELIGMAN & PAREDES, *supra* note 107, at 515–30.

162. BEN BERNANKE, TIMOTHY GEITHNER & HENRY PAULSON, FIREFIGHTING: THE FINANCIAL CRISIS AND ITS LESSONS 112–29 (2019) ("We would have liked

The Government Accountability Office summarized the deficiencies of the post Dodd–Frank model of financial regulation in 2016, citing repeated examples in which fragmented U.S. regulatory structures complicated securities and derivatives regulation (which duties were split between the SEC and the CFTC), limited insurance oversight, provided inconsistent safety, soundness, and consumer protection oversight, delayed regulatory action, complicated the U.S. position in international negotiations, and limited the country's capacity to fully and effectively monitor systemic risk.[163]

A single regulatory agency, in contrast, could address the full gamut of current crypto products including those now regarded as "currencies," "securities," "commodities," or none of the above. Such an agency could also provide regulatory oversight to new products such as coins, tokens, and NFTs, trading platforms (whether currently regulated by the SEC, CFTC, or not at all), and alternative means of trading through securities broker-dealers, commodities futures dealers, mutual funds, and ETFs. The new agency could also focus on new products, trading platforms, and other means of trading likely to emerge in the future and hold a seat or otherwise be represented on the Financial Stability Oversight Board.

Under a single regulator model, a new enabling law would be enacted to provide comprehensive regulation of all crypto products and means of crypto trading and would particularly focus on current gaps and omissions in the regulatory scheme. As is always the case with new financial regulations, the proof is in the details and in developing the new enabling law, Congress would likely seek testimony from some, or all, of the current agencies involved in crypto regulation, including

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to see more restructuring of the antiquated financial regulatory system, . . . with . . . several redundant agencies consolidated to create more consistency and accountability. But . . . this felt like a war of choice rather than a war of necessity.")

163. *See* U.S. GOV'T ACCOUNTABILITY OFF., GAO-16-175, FINANCIAL REGULATION: COMPLEX AND FRAGMENTED STRUCTURE COULD BE STREAMLINED TO IMPROVE EFFECTIVENESS (2016).

those acting under the Biden administration,[164] as well as stakeholders in the crypto industry.[165]

Ultimately, an effective enabling law should provide for registration of all "crypto products" whether denominated as "currency," "security," "commodity," "property," or any other instrument. The intent of a broad, generic definition would be to include all current cryptocurrencies, coins, including ICOs and whether in the form of stablecoins or otherwise, tokens, including NFTs, and other digital assets used as crypto products. Such a broad definition would also be sufficiently elastic to cover new crypto products under any, and all, future labels.

Three aspects of a new crypto product registration system are particularly consequential. First, lawmakers must craft definitions carefully.[166] Besides a capacious definition of "crypto products," the new act would need to broadly define the "issuer" of new products to distinguish between those responsible for initiating the new product and mere investors. For example, in a DAO, mere members would be excluded from the definition of "issuer" but those who organized the DAO or registered the DAO would be covered. Other definitions would address important gatekeepers involved in preparing and marketing new crypto products. In existing federal securities law, this would include underwriters, dealers, accountants, attorneys, and other experts who certify aspects of a registration statement.[167] The chosen terminology of the new act is less important than ensuring that all relevant intermediaries in the sales and marketing process are covered. Currently, sponsors are pivotal but undefined actors in the sale of many securities offerings.[168] Sponsors in the marketing and sale of new crypto products should be included as intermediaries, subject to regulation, when they are compensated for their efforts.

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164. *See* Exec. Order on Digital Assets, *supra* note 7.

165. *See* LOSS, SELIGMAN & PAREDES, *supra* note 106, at 457–515 (discussing that the SEC had considerable success with such a broad approach involving the industry when it developed rules for crowdfunding securities offerings).

166. *See generally id.* at 1101–504 (detailing the Securities Act of 1933 approach to definitions).

167. See *id.* at 647–1138, for a discussion of distribution techniques, the basic prohibitions of §5, and the registration procedure of the Securities Act.

168. *See generally* Andrew Tuch & Joel Seligman, *The Further Erosion of Shareholder Protection: Expanded Exemptions, SPAC Mergers and Direct Listings*, IOWA L. REV. (forthcoming 2022).

Secondly, the new act should provide for considerable disclosure, similar to the federal securities law disclosure requirements. With the sale of new registered crypto products, effective regulation would include requiring public disclosure of the specific business and property of the new product, and whether the registrant, its key intermediaries, or its governing board (if applicable) are involved in any legal proceedings. Further required disclosure would cover information about the registrant's assets (crypto or otherwise), other financial data including the actual or potential dilution of crypto product values, discussion by the management of the registrant of their analysis of the financial and competitive conditions, conflicts of interest and compensation of the issuers, other intermediaries, and management of the firm, and finally, all other "material" information.[169]

Important characteristics of the current securities registration model under the Securities Act include a waiting period before a new security can be sold to the public, fraud remedies for material misrepresentations or material omissions, which can be enforced by the SEC, DOJ (in criminal cases), and private investors, as well as a stop order procedure by which the SEC can prevent the sale of a given security to the public when the registration statement is deemed inadequate.[170] The current model provides a framework for crypto registration, but challenging issues would need to be resolved for crypto products, specifically, concerning whether a waiting period is necessary and whether new product disclosures should be limited to a disclosure document. The crypto model should also carefully consider the elements of fraud, related remedies, and enforcement options, which have all proved controversial under the Securities Act and Exchange Act.[171]

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169. Sec. Act Rel. 5893, 13 SEC Dock. 1217, 1218 (1977); Report of the Advisory Comm. on Corp. Disclosure to the SEC, House Comm. on Interstate & Foreign Commerce, 95th Cong., 1st Sess. 428–469 (Comm. Print 95-29 1977). See LOSS, SELIGMAN & PAREDES, *supra* note 106, for a discussion of Regulations S-K and S-X, which address SEC textual and financial disclosures.

170. See LOSS, SELIGMAN & PAREDES, *supra* note 106, at 147–708, for a discussion of SEC, DOJ, and private enforcement of the federal securities laws. See *id.* at 1098–101, for a discussion of the SEC stop order procedure under the Federal Securities Act.

171. *See* Private Securities Litigation Reform Act of 1995, Pub. L. No. 104-67, 109 Stat. 737; LOSS, SELIGMAN & PAREDES, *supra* note 106, at 314–17 (dis-

Regulation should not be limited to an initial registration statement and the provision of fraud remedies. Rather, crypto products should be subject to continuous periodic disclosure requirements, employing the same basic framework for textual and financial disclosure as would be used in the initial disclosure requirements similar to those in the federal securities laws,[172] recordkeeping, voting and confidentiality provisions.[173]

Third, the act would need to carefully design exemptions. For example, if the Federal Reserve System implements a Central Bank Digital Currency ("CBDC") as described in Section C, the CBDC would be regulated by the Federal Reserve, rather than by the new single crypto products regulatory agency. The act may also consider exempting *de minimis* offerings[174] and secondary trading, that is the resale of initial crypto product offerings, which normally would not require registration under the existing federal securities laws.[175] Lawmakers must also contemplate how exemptions would be designed, if at all, for initial founders and designers of crypto products before they are sold to the public. The Securities Act, in its definition of "sale" in § 2(a)(3), permits underwriters to engage in preliminary negotiations with issuers[176] and allows founders and designers of new products to receive unregistered stock in private offerings.[177] Comparable provisions would need to be customized for crypto products. Unlike the current federal securities model[178], the crypto model should not exempt intrastate offerings. Such an exemption would

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cussing how the Private Securities Litigation Reform Act cut back on private rights of action).

172. *See* LOSS, SELIGMAN & PAREDES, *supra* note 106, at 776–79 (discussing the disclosure philosophy).

173. For a discussion of broker-dealer recordkeeping requirements and voting under the federal securities laws (via proxies), see LOUIS LOSS, JOEL SELIGMAN & TROY PAREDES, SECURITIES REGULATION 3–15, 454–555 (5th ed. 2018). For a discussion on confidentiality provisions of the Acts, see *id.* at 1005–08.

174. These can be compared to limited offerings under the federal securities laws. *See generally* LOSS, SELIGMAN & PAREDES, *supra* note 106, at 325–517.

175. For a discussion of § 4(a)(1) of the Securities Act, see *id.* at 523–31.

176. *Id.* at 817–18.

177. *Id.* at 325–523.

178. 15 U.S.C. § 77c(a)(11).

make little sense in the crypto space, as crypto products are inherently designed to be bought and sold globally.[179]

Regulation would also reach trading platforms, whether denominated exchanges or otherwise. As previously discussed, hackers and thieves frequently target such platforms in carrying out illegal activities.[180] Pursuant to the Exchange Act, exchanges are registered with the SEC whether in the form of organized exchanges, such as the New York Stock Exchange, or securities dealer trading in the over-the-counter market, such as the Nasdaq.[181] Crypto platforms or exchanges, like securities exchanges, should be subject to substantive regulation, reporting requirements, and fraud liability with relevant exemptions for, as one example, *de minimis* trading.[182]

Finally, the new regulatory regime would need to consider the role, if any, of self-regulatory organizations as well as broker-dealer regulation. Unlike securities trading, where the Financial Industry Regulatory Authority buttresses SEC and DOJ enforcement,[183] no comparable self-regulatory organization

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179. *See e.g.*, Exec. Order on Digital Assets, *supra* note 7 ("With respect to digital assets, my Administration will seek to ensure that . . . appropriate global financial system connectivity and platform and architecture interoperability are preserved; and the safety and soundness of the global financial system and international monetary system are maintained.").

180. *See* discussion, *supra* notes 56–58; SELIGMAN, *supra* note 28, at 19–20 (quoting President Roosevelt's speech scorning "the reckless promoter, the Ismael or Insull whose hand is against every man's" as a need for securities regulation).

181. *See* LOSS, SELIGMAN & PAREDES, *supra* note 173, at 18. In January 2022, the Commission proposed rule amendments to expand the federal securities law's definition of *exchange* to require some Cryptoplatforms to be subject to SEC regulation either as exchanges or as Alternative Trading Systems. *See* Press Release, U.S. Sec. & Exch. Comm'n, SEC Proposes Amendments to Include Significant Treasury Markets Platforms Within Regulation ATS (Jan. 26, 2022), https://www.sec.gov/news/press-release/2022-10. If the amendments are adopted, there will inevitably be lengthy litigation concerning the SEC's authority to regulate Cryptoplatforms, potentially motivating the cryptocurrency industry's focused opposition on the rule. *See* Paul Kiernan, *Cryptocurrency Firms Push Back Against Proposal to Police Treasury Markets*, WALL ST. J. (Apr. 28, 2022, 12:35 PM), https://www.wsj.com/articles/cryptocurrency-firms-push-back-against-proposal-to-police-treasury-markets-11651064581. In any event, it will not reach cryptoplatforms subject to the CFTC, *see supra* notes 146–148, or possibly some that will remain unregulated.

182. *See* LOSS, SELIGMAN & PAREDES, *supra* note 173, at 2–3, 6–7, 9–10, 98, 390–91.

183. *See id.* at 215–17, 190–91.

currently governs crypto products. Nonetheless, it is unclear that such a self-regulatory organization is actually needed. When the SEC and CFTC began jointly regulating the swap markets after Dodd–Frank Act was passed,[184] they did so without a new self-regulatory organization.[185] As for broker-dealer regulation, the SEC currently has separate oversight of broker-dealers.[186] Certain aspects of broker-dealer regulation, such as regulation of margin or loans to investors, would likely need to be retained, but given the frequency with which crypto trading is initiated without intermediaries,[187] the need for robust broker-dealer regulation in a new comprehensive regulatory scheme would be limited.

Importantly, crypto firms and crypto investors have strong incentives to actually seek additional federal regulation. For example, regulation would be accompanied by the creation of a customer protection corporation for crypto products, similar to the current Securities Investor Protection Corporation ("SIPC"), which would charge covered crypto firms an annual assessment (in SIPC, $^1/_2$ of 1%) and create a fund to insure each crypto customer account up to a specified amount (in SIPC, up to $500,000 for each account).[188]

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184. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010).

185. *See* LOSS, SELIGMAN & PAREDES, *supra* note 173, at 809–10, 824–25, 836.

186. For a discussion of registration, exemptions and discipline, see *id.* at 587–89, 608–09. For a discussion of broker-dealer substantive regulation, including margin or loans to investors, see *id.* at 70–71, 77–90.

187. *See* Kate Ashford, *What is Bitcoin and How Does It Work?*, FORBES (June 8, 2022, 5:12 PM), https://www.forbes.com/advisor/investing/cryptocurrency/what-is-bitcoin/#:~:text=bitcoin%20is%20a%20decentralized%20digital,cryptographic%20proof%20instead%20of%20trust.%E2%80%9D ("Bitcoin is a decentralized digital currency that you can buy, sell and exchange *directly, without an intermediary like a bank.*").

188. For a discussion of SIPC, see LOSS, SELIGMAN & PAREDES, *supra* note 173, at 268–80, for a discussion of SIPC. In June 2022, United States Senators Cynthia Lummis and Kirsten Gillibrand proposed the Lummis-Gillibrand Responsible Financial Innovation Act, S. 4356, 117th Cong. (2022), which among other things generally transferred authority to regulate cryptoproducts deemed to be "securities" to the Commodity Futures Trading Commission and relied on digital asset exchanges and futures commission merchants to be the primary regulator of segregation of digital assets, trading in registered digital assets, and standards and procedures to ensure the safety of customer money, assets and property.

C. *Competition with Crypto*

A third distinct approach to addressing crypto proliferation, and which the Federal Reserve System recently proposed, is direct competition.

In January 2022, the Board of Governors of the Federal Reserve System ("Federal Reserve" or "Federal Reserve System") published a research paper, "Money and Payments: The U.S. Dollar in the Age of Digital Transformation," which the Fed called "the first step in a public discussion between the Federal Reserve and stakeholders about Central Bank Digital Currencies (CBDCs)."[189] The paper defined a CBDC "as a digital liability of a central bank that is widely available to the general public. In this respect, it is analogous to a digital form of money."[190] Notably, "a CBDC would be a liability of the Federal Reserve, not of a commercial bank."[191]

The Fed acknowledged:

> While the existing U.S. payment system is generally effective and efficient, certain challenges remain. In particular, a significant number of Americans currently lack access to digital banking and payment services. Additionally, some payments – especially cross-border payments – remain slow and costly.
>
> Digital financial services and commercial bank money have become more accessible over time, and increasing numbers of Americans have opened and maintain bank accounts. Nonetheless, more than 7 million – or over 5 percent of U.S. households – remain unbanked. Nearly 20 percent more have bank accounts, but still rely on more costly financial services such as money orders, check-cashing services, and payday loans.[192]

Two months later in his comprehensive Executive Order,[193] President Biden ordered the Federal Reserve to go further, stating in part:

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189. *See* THE U.S. DOLLAR IN THE AGE OF DIGITAL TRANSFORMATION, *supra* note 52.

190. *Id.* at 1.

191. *Id.* at 3.

192. *Id.* at 8.

193. *See* Exec. Order on Digital Assets, *supra* note 7.

> A United States CBDC may have the potential to support efficient and low-cost transactions, particularly for cross-border funds transfers and payments, and to foster greater access to the financial system, with fewer of the risks posed by private sector-administered digital assets. A United States CBDC that is interoperable with CBDCs issued by other monetary authorities could facilitate faster and lower-cost cross-border payments and potentially boost economic growth, support the continued centrality of the United States within the international financial system, and help to protect the unique role that the dollar plays in global finance.
>
> . . . .
>
> The Chairman of the Board of Governors of the Federal Reserve System (Chairman of the Federal Reserve) is encouraged to continue to research and report on the extent to which CBDCs could improve the efficiency and reduce the costs of existing and future payments systems, to continue to assess the optimal form of a United States CBDC, and to develop a strategic plan for Federal Reserve and broader United States Government action, as appropriate, that evaluates the necessary steps and requirements for the potential implementation and launch of a United States CBDC. The Chairman of the Federal Reserve is also encouraged to evaluate the extent to which a United States CBDC, based on the potential design options, could enhance or impede the ability of monetary policy to function effectively as a critical macroeconomic stabilization tool.[194]

A CBDC to compete with existing crypto products is unlikely alone to persuade many investors to seek a government organized competitive product. The CBDC would more di-

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194. *Id; see, e.g.*, Paul Kiernan, *Yellen Renews Call for Stablecoin Regulation After TerraUSD Stumble*, WALL ST. J. (May 10, 2022), https://www.wsj.com/articles/yellen-renews-call-for-stablecoin-regulation-after-terrausd-stumble-11652208165 (testifying after crypto crash described in text accompanying note 1); *cf.* Emily Parker, *China's Digital Yuan Shows Why We Still Need Cryptocurrencies Like Bitcoin*, CNN (Feb. 4, 2022, 2:09 PM), https://www.cnn.com/2022/02/04/perspectives/china-digital-yuan-cryptocurrency-bitcoin/index.html. *See generally* note 44.

rectly impact banks and other depository institutions. To proceed with a CBDC, the Federal Reserve likely will prioritize the interaction and coordination between new means of payments and existing payment systems that operate through private banks. The new CBDC could do relatively little in bringing the unbanked 5% of the U.S. population into a new system. It is unclear how many of the "unbanked" will seek a new payment system.

Notwithstanding, President Biden's motivation in pressing the Federal Reserve to act has cogency. If other leading nations adopt their own versions of a CBDC, the United States may need to adopt the same to maintain its competitive position in global finance. This issue is currently being studied.[195] As the Federal Reserve System explained in its January 2022 report, the United States already maintains a sophisticated payment system that may be able to coordinate with other national CBDCs.[196]

Conclusion

This essay proposes three separate approaches to crypto products, each of which can be implemented consistent with the other approaches.

First, given the unique challenges of Bitcoin, the leading cryptocurrency, and other cryptocurrencies employing a similar model, the United States should consider prohibiting crypto products that engage in excessive energy consumption and do not provide U.S. law enforcement agencies with sufficient access to records for the purpose of investigating crimes. Neither of these prohibitions pose existential threats to crypto products but, rather, would create strong incentives for such products to lower energy use and comply with any new federal legislation requiring access to records.

Second, the United States should establish a single crypto regulatory agency rather than relying on the multiple agencies currently tasked with regulating crypto products. This agency could enforce the energy use and criminal compliance mandates included in any new legislation and would, like the SEC, have a broad mandate to register both crypto products and

195. *See* Exec. Order on Digital Assets, *supra* note 7.

196. *See* The U.S. Dollar in the Age of Digital Transformation, *supra* note 52, at 7–9.

trading platforms, and to enforce new regulations with appropriate anti-fraud, examination, and inspection powers. Critically, a single regulator would reduce the problem of wholly inadequate or ineffective regulation that plagues the multiple regulator model. The new crypto products regulator would, presumably, have a seat or presence on the Financial Stability Oversight Council.

Third, there is still much to learn with respect to a new Central Bank Digital Currency. The need for a CBDC largely depends on the creation of CBDCs abroad and the accompanying need for U.S. compatibility. At this time, it is uncertain how many countries will adopt their own version of a CBDC or whether adoption by the United States is even necessary to ensure compatibility with other systems. While a U.S. CBDC might play a modest role in competing with existing crypto products, the potential U.S. CBDC is largely a payment system, best left to the Federal Reserve to administer in coordination with a new standalone crypto regulatory agency.

Only a comprehensive approach creating a new standalone agency armed with a full panoply of regulatory powers when combined with appropriate prohibitions and a designated role for the Federal Reserve System is most likely to achieve optimal results.

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FINDERS BUT NOT KEEPERS: THE REGULATION OF UNLICENSED FINDERS IN SMALL PRIVATE CAPITAL RAISES

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Small businesses and start-ups desperately need outside capital investment in order to survive, particularly during their tenuous early phases of growth. Linking up small enterprises with investors willing to help them grow is a difficult task. It often falls outside the experience and competency of business owners struggling to keep up with daily demands. Investment capital finders play a vital role in survival and success of small business. They receive consideration for steering investors toward deals and enterprises that are beneath the interest of big private equity and venture capital firms. Finders receive consideration for their important service, but SEC rules loom as a constant threat to their activities. Bent on protecting big investment firms, the SEC (a) ignores finders as a distinct business class; (b) lumps their activities in under the inaccurate heading of "broker-dealers"; (c) makes it unclear whether some finders must even register as such; and (d) metes out

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harsh punishments when it adjudges that a finder's activities have crossed the undefined boundaries of broker-dealer territory. Thus, finders face a two-edged regulatory sword: either register as broker-dealers at considerable cost, or forego registration at considerable peril. Recissions, disgorgements, fines, and sometimes even criminal liability can follow an SEC pronouncement of unlicensed broker-dealer activity. In this article, we argue that a more rational finder regime is long overdue at the federal level.

That regime should be modelled on the successful regulatory framework which is now well established in the state of California. California recognizes finders and their activities as distinct from broker-dealers. Finder registration is easy and inexpensive in California. California finder regulation is far less onerous than broker-dealer rules imposed by the SEC. They serve the purpose which the SEC so far fails to achieve: to protect small businesses and small-deal investors alike. A similar regime enacted nationwide would obviate overlapping state rules. It would serve the public's vital interest in fostering the small-business sector, the bedrock of America's economy.

Introduction

Many small businesses walk an equity tightrope. The ability to raise investment capital can mean the difference between expansion and extinction for a small business which relies upon growth to survive. Yet—caught up in quotidian affairs—finding investors who can take the enterprise to the next level is something entrepreneurs and small business owners have neither the bandwidth nor the expertise to do.

Enter the "Finder." The function of a finder, at its most basic, is to link businesses seeking equity with investors, and the finder gets a fee in return. Finders may need to register with the U.S. Securities and Exchange Commission ("SEC"). Sometimes they must register with other regulatory bodies as well, often under the rubric of brokers or dealers. This process can require significant time, and incur significant costs. Small businesses may need outside professional help if they are to

meet capital requirements, but the costs associated with SEC registration can outstrip the finder's own profits. Thus, many finders avoid operating in this space—or simply risk the consequences of ignoring registration.

The SEC provides inadequate guidance in this area, despite a long history of commentators raising the problem. In a largely unsuccessful proposal (that has since been ignored) the SEC belatedly addressed the issue of finder registration in 2020. Even if a clear definition of finder is ultimately codified,[1] federal rules will likely remain unclear. Finders can only discern their regulatory obligations by navigating a ream of cases and inconsistent no-action letters.[2] At its heart, the problem is that many participants in the industry do not understand how overbroad registration requirements can be, or the severity of the consequences when these provisions are breached.

We believe California, a long-time leader in venture capital investment, has implemented a more rational regime at the state level than the SEC's. The California regime makes a clear distinction between finder and broker-dealer activities, and it provides an intrastate broker-dealer registration exemption for operators acting exclusively as finders according to state rules. In this article, we aim to set forth both the current federal rules and the current California rules, and argue that federal lawmakers should use California as a model for enacting a clearer and fairer regulatory framework for finders and broker-dealers alike.

I.
How Does it Work?

A. *Small Business and the U.S. Economy*

It is almost trite to say that funding and growing small businesses is critical to the U.S. economy. But this is more than just a political talking point. Many people are unaware of just how critical this vast and diverse sector is to the nation's economic life. A few statistics might help.

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1. *See* Notice of Proposed Exemptive Order Granting Conditional Exemption from the Broker Registration Requirements of Section 15(a) of the Securities Exchange Act of 1934 for Certain Activities of Finders, Exchange Act Release No. 34-90112 (Oct. 7, 2020).

2. This confusion is often exacerbated by the lack of detailed reasoning provided in many of these letters.

Small businesses:[3]

- represent 99.7% of all employer firms, and employ approximately 50% of all private sector employees (roughly 120 million employees);
- pay more than 45% of US payrolls;
- comprise 97% of all exporters (as at 2008);[4] and
- comprise 99.9% of all businesses in the U.S., with 39% of them owned by women.[5]

When it comes to the financing and growth of small businesses:

- Angel investors provide 90% of outside equity raised by start-ups and are usually their only source of seed funding;[6]
- 75% to 80% are self-financed through savings and personal loans, or borrowings from family and friends;[7] and
- 50% fail within five years, with the most common reason being a lack of capital.[8]

Because small businesses are clearly the engine room of the U.S. economy, finders play a vital role in keeping us moving ahead at full steam.

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3. Small businesses are businesses with less than 500 employees.

4. Jeffery D. Chadwick, *Finders Sleepers: Why Recent State Regulation of Financial Intermediaries Should Rouse the Federal Government From its Slumber* 12 RICH. J.L. & PUB. INT. 57, 75 (2008), https://scholarship.richmond.edu/jolpi/vol12/iss1/6.

5. *Small Business Statistics*, U.S. CHAMBER OF COM., https://www.chamberofcommerce.org/small-business-statistics (last visited Aug. 15, 2020).

6. In 2013, angels invested $25 billion in 71,000 companies. GREGORY C. YADLEY, NOTABLE BY THEIR ABSENCE: FINDERS AND OTHER FINANCIAL INTERMEDIARIES IN SMALL BUSINESS CAPITAL FORMATION 1 (June 3, 2015), https://www.sec.gov/info/smallbus/acsec/finders-and-other-financial-intermediaries-yadley.pdf.

7. *See Small Business Statistics*, *supra* note 5.

8. G. Dautovic, *Examining What Percentage of Small Businesses Fail*, FORTUNLY (Feb. 4, 2022), https://fortunly.com/articles/what-percentage-of-small-businesses-fail/#gref.

II.
FINDER OR BROKER-DEALER? HOW DOES IT WORK?

A. *Federal Legislation*

Section 15(a)(1) of the *Securities Exchange Act 1934* ("Exchange Act") provides:

> It shall be unlawful for any broker or dealer which is either a person other than a natural person or a natural person not associated with a broker or dealer which is a person other than a natural person (other than such a broker or dealer whose business is exclusively intrastate and who does not make use of any facility of a national securities exchange) to make use of the mails or any means or instrumentality of interstate commerce to effect any transactions in, or to induce or attempt to induce the purchase or sale of any security (other than an exempted security or commercial paper, bankers acceptances, or commercial bills) unless such broker or dealer is registered in accordance with subsection (b) of this section.[9]

The term "broker" is defined in Section 3B(4)(A) of the Exchange Act:

> The term "broker" means any person[10] engaged in the business of effecting transactions in securities for the account of others.

Exceptions from the broker definition[11] are detailed in Section 3B(4)(B) for certain banking activities.[12] The term "dealer" is defined in Section 3(5)A as:

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9. 15 U.S.C. § 78o. *See* Couldock & Bohan, Inc. v. Societe Generale SEC Corp., 93 F.2d 220, 230 (2000) (discussing the registration requirements and the interplay of Federal and State requirements).

10. The term "*person*" is defined in Section 3(9) as "a natural person, company, government, or political subdivision, agency, or instrumentality of a government." Securities Exchange Act of 1934 § 3(9), 15 U.S.C. § 78c.

11. A territorial approach is adopted (both for broker-dealers and customers located in the United States) in respect of foreign broker dealers under Rule 15a-6. *See* SEC. EXCH. COMM'N, GUIDE TO BROKER-DEALER REGISTRATION (Apr. 2008), https://www.sec.gov/reportspubs/investor-publications/divisionsmarketregbdguidehtm.html [hereinafter "GUIDE TO BROKER-DEALER REGISTRATION"].

12. Securities Exchange Act §3(6). The term "*bank*" is defined in Section 3(6) of the Exchange Act.

> The term "dealer" means any person engaged in the business of buying and selling securities (not including security-based swaps, other than security-based swaps with or for persons that are not eligible contract participants) for such person's own account through a broker or otherwise.[13]

Exceptions to the dealer definition include persons trading certain securities on their own account, and certain banking activities.

The term "security" is defined broadly in Section 3(10) to include notes, debentures, stock and treasury stock, derivative securities and investment contracts.[14] Some of the other terms used in the broker and dealer definitions are not defined at all. For example, the term "engaged in the business" is used extensively throughout the legislation, but is not defined in either the Exchange Act or in the rules promulgated under the Act. The term "effecting transactions" raises a similar issue. Courts have criticized this weakness on several occasions, yet there has been no concerted effort to address vague language in the legislation.[15]

In *SEC v. Kenton Capital, Ltd.*,[16] the U.S. District Court for the District of Columbia considered the meaning of "engaged in the business" in the context of the broker registration provisions. Several factors were examined:

> 'Engaged in the business' is not defined by statute. Cases and SEC No-Action letters interpreting the phrase have indicated that regularity of participation is the primary indicia of being "engaged in the business" . . . Regularity of participation has been demonstrated by such factors as the dollar amount of the securities sold. . . and the extent to which advertisement and investor solicitation were used. . . A corpo-

13. Securities Exchange Act §3(5)(B)–(C).

14. The courts have interpreted the meaning of "*security*" broadly. Determining whether a particular arrangement meets the definition of can be a complicated process in itself and is beyond the scope of this paper. *See generally* SEC v. W.J. Howey Co., 328 U.S. 293 (1946).

15. This is evidenced by the need to resort to indicia outlined in the cases. *See* SEC v. Kramer, 778 F. Supp. 2d 1320, 1337 (M.D. Fla. 2011).

16. SEC v. Kenton Cap. Ltd., 69 F. Supp. 2d 1, 12–13 (D.D.C. 1998).

ration could be a broker even though securities transactions are only a small part of its business activity.[17]

In particular, the court found that a single isolated case of advertising may not be enough to require registration, while active or substantial solicitation is a strong indication of business engagement.[18] It is important to note that statutes are largely agnostic as to the scale of broker-dealer activity. It need only be a business; the fact that the activity amounts to just a small part of that business would be irrelevant to the registration requirement.[19]

The "*engaged in the business*" test remains a live issue. The SEC continues to use it in complaints against those it deems broker-dealers[20] attempting to skirt registration. It is worth noting that while the SEC does not require associated persons of broker-dealers (e.g., employees or independent contractors working within a broker-dealer business) to be separately registered, the agency requires their supervision by a person who is registered.[21] In regards to registration, litigants argue that the SEC interprets its powers broadly, drafts its rules vaguely, and overreaches.[22]

B. *Finders*

There is currently no federal legislative definition of a capital "finder,"[23] and no clear distinction between a finder

17. *Id.*

18. The Court left open the possibility that a single transaction could amount to 'engaged in the business' if it ". . . comprised a first step in a larger enterprise." *Id.* at 13.

19. *See* Securities Exchange Act §3(5)(A).

20. *See* Complaint at 9, SEC v. Keener, 2020 WL 1434134 (S.D. Fla. Mar. 24, 2020), https://www.sec.gov/litigation/complaints/2020/comp24779.pdf.

21. There are a number of regulations dealing with associates that should be considered. GUIDE TO BROKER-DEALER REGISTRATION, *supra* note 11.

22. *See* Complaint at 2, Platform Real Est. Inc. v. SEC, No. 19-CV-2575 (S.D.N.Y 2020) (where the complainant took the view that the SEC had misunderstood the registration requirements in Section 15(a) of the Exchange Act, and that registration of finders was not required where no use was to be made of securities exchanges or over the counter trading). A subsequent attempt to relitigate was dismissed by the NY District Court. *See id.*

23. *See* Release No. 34-90112, *supra* note 1, at 22–23 (aims to remedy the lack of definition of the word finder).

and a broker-dealer. Any person or organization deemed a broker-dealer by the SEC must be registered, regardless of whether they consider themselves a finder or not. Failure to register carries significant consequences (discussed below).[24] Thus (a) the onus is on the finder to determine whether their activities require registration with the SEC; and (b) this self-identification must be made in the absence of clear guidance.

A more consistent approach towards "success-based compensation" has emerged from recent court decisions regarding SEC no-action letters. But courts often consider these letters just one element among many in deciding whether a finder is obligated to register with the Financial Industry Regulatory Authority ("FINRA"). Finders are bedevilled by the fact that many older no-action letters appear to conflict, and contain little explanation of the reasoning which led courts to conclude registration was not necessary. Finders are not always aware that no-action letters are nonbinding and can be withdrawn.[25] It is risky for a finder to do business under the assumption that a court will not change its stance. In fact, courts have done so without being encumbered with precedent and without clear explanation.

As recently as April 2020,[26] state regulators, such as New York's, have attempted to clarify the definition of "finder" within their own purview. But intrastate finder provisions can create more problems than they solve; critics have noted significant conflict between rules from one state to another. However well-intentioned, these finder provisions can create yet another roadblock for small businesses desperate for invest-

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24. *See* In the Matter of Ranieri Partners, LLC, Exchange Act Release No. 69091 (Mar. 8, 2013).

25. *See e.g.*, Dominion Res., Inc., SEC No-Action Letter, 2000 SEC No-Act. LEXIS 304 (Mar. 7, 2000) [hereinafter "Dominion Res., SEC No-Action Letter"]. The less than satisfactory reasons given in that letter included "technological advances, including the advent of the internet, as well as other developments in the securities markets[.]" *Id.* This leaves open the possibility that further technological advances could result in the revocation of other no-action letters.

26. Press Release, Letitia James, N.Y. Att'y Gen., Attorney General James Moves to Modernize and Streamline Securities Filings in NYS (Apr. 6, 2020), https://ag.ny.gov/press-release/2020/attorney-general-james-moves-modernize-and-streamline-securities-filings-nys.

ment capital. Many are ill equipped to navigate the complexity of rules in interstate commerce.[27]

C. *Exceptions to Registration Requirements*

There are a few scenarios where broker-dealer registration is not required at the federal level. This article discusses some of the more common of these situations.[28] But we cannot overstress the fundamental problem: while the SEC demands strict adherence to its rules in order to avoid federal penalties, those rules are often vague, ill-constructed, or—as in the case of no-action letters—persuasive but not precedential. We strongly recommend that finders engage an attorney who is competent in the area rather than merely assume they fall within the parameters of any exception.

1. *Intrastate Broker-dealers*

Intrastate broker-dealers can claim a narrow exemption to the registration requirement. A person who (a) conducts all of their business in one state and (b) does not use a national securities exchange does not have to register with the SEC.[29] But this exemption leaves finders with the burden of ascertaining where all of their customers are "located" according to the guidelines of the Exchange Act. This will often require significant and costly inquiry on the part of the finder and a significant duty of disclaimer to their clients.

Rules 147 and 147A of the Securities Act of 1933 ("Securities Act") provide additional guidance on the requirements of this exemption.[30]

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27. *See* Matthew W. Bower, *Using "Finders" to Find Capital: Avoiding Problems for Your Company*, VARNUM LAW INSIGHTS (July 28, 2021), https://www.varnumlaw.com/newsroom-publications-using-finders-to-find-capital-avoiding-problems-for-your-company; *see also* Pransky v. Falcon Grp., Inc., 874 N.W.2d 367, 384 (Mich. Ct. App. 2015) (where the Michigan Court of Appeals held that finders (as defined under the Michigan Uniform Securities Act) were not required to register in Michigan as a broker-dealer, agent or investment advisor).

28. Others not included here include funding portals for crowdfunding arrangements and merger and acquisition brokers involved in selling whole businesses.

29. Note that the position taken by the SEC will not have an impact on the relevant State legislation that may require registration.

30. Exemptions to Facilitate Intrastate and Regional Securities Offering, Securities Act Release No. 33-10238; Exchange Act No. 34-79161, 81 Fed.

2. *"Associated Persons" of Brokers*

"Associated persons"[31] of broker-dealers do not have to register, provided they are properly supervised by a registered person. Typically, employees and independent contractors are considered associated persons.[32]

3. *Business Limited to Exempted Securities*

The term "exempted security" is defined in Section 3(12)(A) of the Exchange Act by reference to specific classes of securities. Government and municipal securities typically fall into this category. Exempted securities are not subject to the same regulations. The mere fact that a security is exempt from registration under the Exchange Act does not imply that the security automatically falls within the meaning of the exemption.[33] For example, a person selling securities under Regulation D offerings must still be registered as a broker-dealer.

A broker-dealer that deals only in commercial paper, banker's acceptances or commercial bills does not need to register under the Exchange Act. However, broker-dealers involved with some classes of exempted securities, while not required to register as broker-dealers, may still be required to register under other provisions of the Exchange Act.[34]

4. *Issuers Exemption*

Issuers selling their own securities on their own account are generally not considered brokers or dealers, and thus are not required to register with the SEC. But issuers must still take precautions regarding associated persons involved in the sale of securities on the issuer's behalf, commonly the issuer's employees. Associated persons should not receive commissions on the sale, and may only engage in certain delineated activities.[35]

Reg. 83494, 83495, 83494 (Nov. 21, 2016), https://www.sec.gov/rules/final/2016/33-10238.pdf.

31. *See* Securities Exchange Act §3(18) (defined broadly to include partners, directors, employees and any persons controlled (directly or indirectly) by a broker-dealer).

32. *See* In re William V. Giordano, Exchange Act Release No. 36742 (Jan. 19, 1996), https://www.sec.gov/litigation/admin/1996/34-36742.pdf.

33. *See* GUIDE TO BROKER-DEALER REGISTRATION, *supra* note 11.

34. *See, e.g.*, Securities Exchange Act § 15.

35. 17 C.F.R. § 240.15a-6.

5. *Foreign Broker-dealers*[36]

As a general rule, all broker-dealers located in the United States that are involved in broker-dealer activities—even if those activities are directed only at foreign investors—must register with the SEC. Broker-dealers located offshore must also register if they aim any of their activities at persons within the United States.[37] The Exchange Act contains a specific provision addressing certain foreign broker-dealers that limit their activities in accordance with Exchange Act Rule 15a-6, such as effecting unsolicited transactions, certain dealings with major U.S. institutional investors or foreign residents temporarily in the United States, among others.[38]

III.
WHY IS IT AN ISSUE?

It is common knowledge that small businesses struggle to attract capital, most of all during their early phases of growth. The launch phase of a small business is when the highest need for capital dovetails with the lowest level of competence when it comes to capital raising, and most start-ups fail. Thus, many start-ups engage finders as much for *what* they know as for *who* they know: their relationship with investors willing to consider small, early-stage ventures. This is an important attribute; they must network to survive. The American Bar Association ("ABA") has emphasized that finders play a critical role for the American economy. Without their involvement, an even greater percentage of small businesses would never be successful in raising enough capital to stay in business.[39]

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36. *Id.*

37. *See* GUIDE TO BROKER-DEALER REGISTRATION, *supra* note 11.

38. *Frequently Asked Questions Regarding Rule 15a-6 and Foreign Broker-Dealers,* U.S. SEC. AND EXCH. COMM'N (Mar. 21, 2013), https://www.sec.gov/divisions/marketreg/faq-15a-6-foreign-bd.htm (commentary on the administration of Exchange Act Rule 15a-6).

39. "Early stage" refers to raising amounts of less than $5 million. These small deals are less attractive to venture capital funds, or licensed members of NASD, as the returns are too limited to justify the risk. *See* Task Force on Private Placement Broker-Deals, ABA Section of Business Law, *Report and Recommendations of the Task Force on Private Placement Broker-dealers*, 60 BUS. LAW. 959 (June 20, 2005), https://www.sec.gov/info/smallbus/2009gbforum/abareport062005.pdf [hereinafter "A.B.A. Report"].

The U.S. Small Business Administration reported that an astonishing 25% of start-ups have no capital whatsoever. An additional 20% have insufficient capital, which is commonly reported as the main roadblock to their growth and success.[40] Statistics for start-up capital sources reveal that 64% of start-ups used personal or family savings as capital; only 18% succeeded in obtaining financing from banks or other lending institutions.

The federal government has, until recently, refused to even consider legitimizing the burgeoning role of unregistered financial intermediaries in the capital-raising process,[41] despite repeated pleas from the small-business community.[42] The ABA has stated that there is a major disconnect between the various laws and regulations applicable to brokerage activities and the common practices employed in the vast majority of early-stage business capital raising.[43] Businesses want the cheapest, most efficient means of raising capital, while the Exchange Act aims to provide security for investors. This sets up an inevitable clash between theory and practice. The SEC's legislative aim was set forth in *SEC v. Kramer*, where the court stated that:

> The Exchange Act is intended 'to protect investors. . . through regulation of transactions upon securities exchanges and in over-the-counter markets' against manipulation of share process. . . The broker-dealer registration requirement is of the utmost importance in effecting the purpose of the [Exchange] Act 'because registration facilitates both discipline 'over those who may engage in the securities business' and oversight 'by which necessary standards may be estab-

40. Concept Release on Harmonization of Securities Offering Exemptions, Securities Act Release No. 33-10649, Exchange Act Release No. 34-86129, Investment Company Act Release No. 33512, 84 Fed. Reg. 30,460 (June 18, 2019), https://www.sec.gov/rules/concept/2019/33-10649.pdf.

41. *See* Release No. 34-90112, *supra* note 1.

42. In 2015, Yadley noted that private placement broker proposals were decades old. 6 years later, at the time of this writing, Yadley's arguments carry even greater weight. YADLEY, *supra* note 6, at 3.

43. *See Frequently Asked Questions Regarding Rule 15a-6 and Foreign Broker-Dealers*, *supra* note 38, at 1.

> lished with respect to training, experience and records'.[44]

Thus, the SEC scrutinizes activities that resemble operating a securities business, only mindful of investor interests. The difficulty for finders lies in the fact that their activities often occupy a grey area between formally managing investor money, like a brokerage would, and mere networking. Agency rules are blind to common reality. Most businesses are small, most businesses are beneath the notice of ordinary venture capital, and most businesses are looking for modest investments from their local communities—not the high-net-worth individual on a superyacht.

IV.
The SEC's Approach – When Is Registration Required?

Reaching a consensus on the generally agreed definition of "finder" is challenging. It has been defined in academic literature as ". . . a person, be it a company, service or individual, who brings together buyers and sellers for a fee, but who has no active role in negotiations, and may not bind either party to the transaction"[45] and by the New York Court of Appeals as:

> . . . a finder is not a broker, although they perform some related functions. Distinguishing between a broker and finder involves an evaluation of the quality and quantity of services rendered. The finder is required to introduce and bring the parties together without any obligation or power to negotiate the transaction in order to earn the finder's fee.[46]

Determining whether a particular participant in the financial markets is a true "finder" who does not need to be registered—rather than a broker who does—is often a question of degree. Merely labelling oneself "finder" is not enough.[47] A

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44. *See* Kramer, 778 F. Supp. 2d at 1337.

45. *See* Guide to Broker-Dealer Registration, *supra* note 11.

46. Ne. Gen. Corp. v. Wellington Advert., Inc., 82 N.Y.2d 158, 162–63 (N.Y. 1993).

47. *See* Ernest E. Badway, *NY State Attorney General Targets Finders and Business Brokers in Pandemic Rule-Making*, Fox Rothschild LLP (July 16, 2020), https://www.foxrothschild.com/publications/ny-state-attorney-general-targets-finders-and-business-brokers-in-pandemic-rule-making.

prosecutor at the SEC or the U.S. Department of Justice would readily prosecute an individual who receives commission-based compensation in the twenty to thirty percentage range for bringing an investor to a company, if that individual is not registered, or if the commission was not disclosed to the potential investor. The evolving attitude of the SEC in this area may be discerned from the multitude of no-action letters the SEC has published. Although no-action letters are not legal precedent, they do carry some weight. In a footnote in the 2008 decision *Torsiello Capital Partners LLC v. Sunshine State Holding Corporation,* Judge Herman Cahn stated:

> Securities and Exchange Commission no-action letters are prepared by SEC staff counsel; they are purely advisory and do not constitute binding precedent. . . However, they may be found "persuasive" in the interpretation of the federal securities laws and regulations. . .[48]

While each matter is considered on its particular facts,[49] the SEC consistently focuses on several factors in determining whether a person is an unregistered broker-dealer rather than a true "finder."[50] These include:

A. Receipt of transaction-based compensation;
B. Involvement in the securities transaction;
C. Solicitation of investors; and
D. Evidence of prior securities business activities.

The SEC appears to repeatedly take the stance that triggering any of these four elements can be sufficient to require registration.

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48. Torsiello Cap. Partners LLC v. Sunshine State Holding Corp., 2008 N.Y. Misc. LEXIS 2879 (N.Y. Sup. Ct. 2008).

49. New York Supreme Ct. Justice Herman Cahn noted,

> In determining whether SEC registration is required, the courts look to a variety of factors, including: the receipt of transaction-based compensation as opposed to a flat fee; the rendering of advice about the structure, price or desirability of a securities transaction; the finding of investors actively rather than passively; advertisement or solicitation on behalf of the issuer of the securities; becoming involved in negotiations between an issuer and investors; engaging in the foregoing with regularity; being an employee of the issuer, and possessing client funds and securities.

See id. at 12–13.

50. *See* Release No. 34-90112, *supra* note 1.

A. *Receipt of Transaction-Based Compensation*

The single most important factor to the SEC in making the finder/broker-dealer distinction appears to be whether there was any consideration in the nature of a commission, a success-based fee, or any fee relatable to the number of introductions made on their client's behalf. This element comes up frequently in SEC no-action letters.[51] The SEC outlined the importance of this element in *Partial Denial of No-action Request of 1st Global, Inc* (May 7, 2001):

> Receipt of transaction-based compensation related to securities transactions is a key factor that may require an entity to register as a broker-dealer. . . Persons who receive transaction-based compensation generally have to register as Broker-dealers under the Exchange Act because, among other reasons, registration helps ensure that persons with a "salesman's stake" in a securities transaction operate in a manner consistent with customer protection standards. . .[52]

The fact that the commission's recipient is a member of an internal corporate sales team does not obviate the registration requirement.[53]

It is important to note that the SEC extends its prohibition against receiving transaction-based compensation to any sharing of such commission with an unregistered person, even if the commission was paid to a registered broker-dealer. This can severely complicate ordinary business arrangements with professional advisors such as CPAs.[54] But compensation related to assets under management are unlikely to require registration; thus, the cost and burden falls to the finder to care-

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51. *See, e.g.*, FundersClub, Inc. and FundersClub Mgmt. LLC., SEC Staff No-Action Letter, 2013 SEC No-Act. LEXIS 271 (Mar. 26, 2013), https://www.sec.gov/divisions/marketreg/mr-noaction/2013/funders-club-032613-15a1.pdf.

52. Partial Denial of No-Action Request of 1st Global Inc., SEC Staff No-Action Letter (May 7, 2001), https://www.sec.gov/divisions/marketreg/mr-noaction/2001/1st-global-050701-15a.pdf [hereinafter "1st Global Inc., SEC No-Action Letter"].

53. *See* SEC v. Hansen, 1984 WL 2413, at *10 (S.D.N.Y Apr. 6, 1984) (receipt of commission, rather than salary, was noted as an indication of broker activity).

54. 1st Global Inc., SEC No-Action Letter, *supra* note 52.

fully consider the circumstances of each separate arrangement.[55]

While there are instances in which transaction-based compensation alone was insufficient to require registration, those instances appear to be exceptions to the rule and not something the SEC is likely to accept at the present time.[56]

B. *Involvement in the Securities Transaction*

Commentary and attempted definitions of finders, while varying in many respects, generally agree that a finder's role is limited to facilitating introductions. Finders do not have a stake in the transaction. Evidence of greater involvement in the transaction is likely to be seen by the SEC as an indication that the purported finder is actually an unregistered broker or dealer. Such activities can include:

- Providing documentation,[57] advice and information;[58]
- Assisting in negotiating a deal;
- Advising on the merits of a proposal;[59]
- Recommending or designing financing methods or recommending an investment;[60]

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55. *See* Dana Inv. Advisors, Inc., SEC Staff No-Action Letter, 1994 WL 718968 (Oct. 12, 1994).

56. *See* Paul Anka, SEC Staff No-Action Letter, 1991 WL 176891 (July 24, 1991). In addition to the Paul Anka letter there are instances of the courts viewing transaction-based compensation by itself as insufficient to require registration under Section 15(a). *See* Kramer, 778 F. Supp. 2d at 1339. However, the SEC does not appear to share this position. *See, e.g.*, Brumberg, Mackey & Wall, P.L.C., SEC Staff No-Action Letter, 2010 WL 1976174 (May 17, 2010) (stating receipt of transaction based compensation was sufficient grounds to require registration). In the event Release No. 34-90112, *supra* note 1, is adopted, this position will change for some finders.

57. For an relevant arrangement with pro-forma documentation where a No-Action Letter was granted, see AngelList LLC, SEC Staff No-Action Letter, 2013 WL 1279194 (Mar. 28, 2013).

58. In the Matter of William M. Stephens, Exchange Act Release No. 30417 (Mar. 8, 2013).

59. May-Pac Mgmt. Co., SEC Staff No-Action Letter, 1973 WL 10806 (Dec. 20, 1973); Chadwick, *supra* note 4.

60. Cornhusker Energy Lexington, LLC. v. Prospect St. Ventures, 2006 WL 2620985, at 6 (D. Neb. Sept. 12, 2006).

- Participating in a selling group, underwriting, carrying an inventory or having a regular clientele of customers.[61]

Ordinary tax, legal and business consulting will not usually require registration, provided there is no transaction-based compensation.[62] The usual fixed fee or time-based charging methods are less likely to attract SEC scrutiny. More entrepreneurial arrangements (e.g., a consultant sets up an entire telemarketing program to solicit investors) come with great risk for both the finder and the company. Finders working under a variable-fee, equity, or percentage-based arrangement should seriously consider obtaining a no-action letter, and there are instances in which courts decided that finder involvement was insufficient to require registration.[63] Insofar as a consistent scheme can be inferred from no-action letters, the SEC appears to consider it a qualitative question to be determined case-by-case using the factors discussed above. Staking one's enterprise on the hope of getting similar treatment by the SEC—as divined from past no-action letters—is to risk an adverse finding in the individual case, together with the consequences.

C. *Solicitation of Investors*

The SEC is likely to frown on any activity that involves soliciting third parties, especially if it involves emailed or written material.

In *SEC v. Kramer*, the United States District Court for the Middle District of Florida considered the defendant's degree of solicitation in determining whether the defendant was operating as an unregistered broker. The court concluded that re-

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61. Dana G. Fleischman et al., *'Finders' and the 'Issuers Exemption': The SEC Sheds New Light on an Old Subject*, LATHAM & WATKINS LLP (Apr. 24, 2013), https://web.archive.org/web/20150829084216/http://www.lw.com/thoughtLeadership/sec-finders-issuers-exemption.

62. A.B.A. Report, *supra* note 39, at 980. The references in the report, while favourable to the applicant, date from the 1970's and early 1980s. Given the age of these letters specific advice should be sought if there is any uncertainty.

63. *See* Kramer, 778 F. Supp. 2d at 1340. In *Maiden Lane Partners v. Perseus Realty Partners*, the court was unable to determine whether the involvement of the "finder" in that instance was sufficient to qualify them as a broker, and thus require registration. 2011 WL 2342734 (Mass. Super. Ct. May 31, 2011).

gistration was not required in that instance, noting that the "solicitation" was limited to discussing an investment with close friends and family, and directing them to a website. However, the court did outline a number of elements that, had they been evidenced, might have led to a different result:

- Participation in the purchase or sale of securities;
- Providing advice or other information about the investment;
- Advertising or distributing promotional material for the investment;
- Sponsoring a seminar or social event at which he promoted the investment;
- Hiring employees to contact potential investors regarding the investment;
- Calling potential investors (other than family or close friends); or
- Encouraging a broker to sell the investment.[64]

The elements above suggest an active form of solicitation. If any of these elements are present, a finder is likely to have a problem.

D. *Evidence of Prior Securities Business Activity*

Any evidence that the finder has previously been involved in the securities industry as a broker is closely reviewed by the SEC under the supposition that it could be evidence of a *de facto* securities business. In such cases, the SEC's aim is to weed out unregistered brokers who might be "flying under the radar"[65] and to prevent past offenders from gaining backdoor access to the industry, thereby putting investors at risk.[66]

1. *Risk to Finders*

A principal issue for many unregistered brokers is that they have preconceived ideas of what broker-dealers are, and they do not consider themselves as falling within this category. Many do not grasp the breadth of activity that could trigger a

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64. *See* Kramer, 778 F. Supp. 2d at 1340.

65. YADLEY, *supra* note 6, at 2–3 ("[I]t is the position of the SEC . . . that a person who accepts a fee for introduction of capital more than once is probably 'engaged in the business of selling securities for compensation' and required to be registered as . . . a broker-dealer.").

66. A.B.A. Report, *supra* note 39, at 980.

registration requirement. Examples of individuals who could unwittingly breach the requirement include transaction lawyers, insurance agents, real estate brokers, private fund advisors, investment bankers, business consultants, investor networks and CPAs.[67] Even some crypto assets can be deemed "securities" depending on their structure, and crypto promoters may be surprised to learn they must register as broker-dealers.[68]

Thus, it is critical for promoters, large and small, to obtain legal advice before they consider raising capital for another business. Failure to comply with registration requirements can trigger severe consequences. Noncompliance can cripple an entity's ability to raise additional finance, and in some circumstances it can even lead to prison[69] time. Experienced attorneys can be vital in keeping operators and advisors informed of the SEC's current position insofar as that position can be discerned from recent no-action letters. The fact that an activity was deemed to fall outside the broker-dealer rubric in the past does not imply that the same activity will escape SEC regulation in the future; thus, an experienced attorney can give clients a cleareyed risk assessment.[70]

2. *Why Not Just Register?*

Businesses who hire finders to raise capital must evaluate whether their relationship with the consultant finder complies

67. *Id.* at 11.

68. A detailed analysis of the registration requirements relating to crypto-assets is beyond the scope of this article, however the treatment of digital assets has been considered on numerous occasions by the SEC, and a number of no-action letters have been issued. *See, e.g.*, TurnKey Jet, Inc., SEC Staff No-Action Letter (Apr. 3, 2019), https://www.sec.gov/divisions/corpfin/cf-noaction/2019/turnkey-jet-040219-2a1.htm.; Pocketful of Quarters, Inc., SEC Staff No-Action Letter (July 25, 2019), https://www.sec.gov/corpfin/pocketful-quarters-inc-072519-2a1 (showing how treatment of digital assets has been considered on numerous occasions by the SEC); SEC, *Framework for 'Investment Contract' Analysis of Digital Assets*, https://www.sec.gov/corpfin/framework-investment-contract-analysis-digital-assets (last modified Apr. 3, 2019) (providing a good analysis by the SEC Strategic Hub for Innovation and Financial Technology of the core issues involved with the treatment of digital assets).

69. *See* Securities Exchange Act, § 32(a).

70. Dominion Res., SEC No-Action Letter, *supra* note 25 (showing how if it is not unknown for the SEC to withdraw no-action letters).

with SEC rules in each separate case. The difficulty is often compounded when consultants also carry on a broader financial advisory practice, dealing with registered broker-dealers or otherwise assisting in deal structuring and receiving success fees. For agents, the question is often, "Why not just register anyway?" and similarly for small businesses, "Why not just use a registered broker-dealer?"

In answer, finders often complain of an onerous and expensive broker-dealer registration process. A 2015 presentation[71] by Gregory Yadley, a member of the SEC Advisory Committee on Small and Emerging Businesses, outlined some of finders' most common issues. Initial costs related to a finder's legal, accounting, and compliance needs alone often exceed $150,000, with ongoing annual costs of around $100,000. Yadley suggested that an exemption or a separate registration process could be adopted specifically for finders. Yadley noted the exceptional burden for small operators, especially when added to the usual costs of establishing a business: staff, insurance, rent, office equipment and so on.

Finders also face a major disincentive with respect to the monumental compliance obligations that attach post-registration.[72] These include complying with antifraud provisions to prevent misstatements or misleading omissions, complying with the duty of fair dealing, ensuring that "suitability" requirements are met (that is, only recommending specific investments or overall investment strategies that are suitable for their customers), ensuring compliance with the duty of best execution (seeking the most favourable terms available under the circumstances), providing customer confirmation details at or before the time of completing a transaction, disclosing credit terms where relevant, maintaining liquidity levels (generally $250,000 or 2% of aggregate debit items for those carrying customer accounts), complying with restrictions on short sales and other trading requirements. Overall, these duties impose a significant burden upon operators whose business relies upon transaction-based compensation.[73]

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71. YADLEY, *supra* note 6.

72. GUIDE TO BROKER-DEALER REGISTRATION, *supra* note 11, §§ 7–8.

73. Complaint at 20, Platform Real Estate Inc. v. SEC, 2020 U.S. Dist. LEXIS 137844 (S.D.N.Y 2020) (No. 19 Civ. 2575) (demonstrating the overwhelming nature of the requirements for a small business)

Most small businesses seeking investors are looking for investments of less than $5 million,[74] but the more established brokerage firms often set floors of $25 million.[75] This is because, in most respects, the time, risks, and transaction costs to brokers are similar between smaller and larger deals. Further, an ongoing trend toward broker conglomeration means that many broker dealers who might have once worked with smaller deals have since merged with larger operators. This results in a funding gap for smaller businesses which are denied access to traditional markets so they are funnelled into non-traditional streams.

3. *The 2020 SEC Proposal on Finders*

On October 7 2020, the SEC finally proposed a change that would effectively allow for a limited federal exemption for finders, provided that individuals who seek the exemption meet a strict subset of conditions.[76] The proposed change[77] would create two classes of finders—Tier I and Tier II—and would finally codify "no-action" relief for finders that fall into one of these two categories.[78] This remains a mere proposal; and, given the extensive qualifications required for the exemption, the impact of the proposal in its current form is question-

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> Registering with the SEC as a broker places a heavy burden on small businesses. Initially registration with the SEC requires filing an application form BD together with a statement of financial condition. Once registered, a broker-dealer is required to have audited financial statements, engage compliance personnel and sophisticated counsel, comply with specific record keeping provisions, anti-money laundering statutes, suspicious transaction reporting, and undergo burdensome compliance examinations by various regulators. Broker-dealers are subject to rigorous net worth and capital requirements or make large security deposits with clearing firms.

Id.

74. Laura Anthony, *The Payment of Finders' Fees – An Ongoing Discussion*, SECURITIES LAW BLOG (July 5, 2017), http://securities-law-blog.com/2017/07/05/the-payment-of-finders-fees-an-ongoing-discussion.

75. Chadwick, *supra* note 4, at 60.

76. SEC Release No. 34-90112, *supra* note 1.

77. Securities Exchange Act §§ 15(a)(2), 36(a)(1) (referring to the specific sections upon which the changes rely).

78. *Finders Proposed Exemptive Order: Overview Chart of Tier I Finders, Tier II Finders and Registered Brokers*, U.S. SEC. AND EXCH. COMM'N, https://www.sec.gov/files/overview-chart-of-finders.pdf.

able. Most notably, relief is only available to finders that are natural persons and investors that are "accredited investors."[79]

For the proposed exemption to apply, finders in either tier would have to meet the following prerequisite conditions:

- **Private issuers**: the issuer must be an entity that is not required to file reports under Section 13 or Section 15(d) of the Exchange Act (any issuer with publicly traded securities does not fall within the exemption);
- **Registration exemptions**: the issuer is seeking to conduct the securities offering in reliance on an applicable exemption from registration under the Securities Act;[80]
- **Solicitation**: the finder does not engage in general solicitation;
- **Accredited Investors**: the potential investor must be an "accredited investor";[81]
- **Documentation**: the finder must provide services pursuant to a written agreement with the issuer. The agreement must include a description of the services provided and of all compensation;
- **Association**: the finder cannot be an "associated person" of a broker-dealer;[82] and

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79. SEC Release No. 34-90112, *supra* note 1, at 19–20; *See* Accredited Investor Definition, Securities Act Release No. 34-89669, (Aug. 26, 2020), https://www.sec.gov/rules/final/2020/33-10824.pdf (expanding the definition of 'accredited investor').

80. *See* SEC Release No. 34-90112, *supra* note 1, at 18.

> An issuer's failure to comply with the conditions of an exemption from registration under the Securities Act for an offering would not, in itself, affect the ability of a Finder to rely on the proposed exemptive order provided the Finder can establish that he or she did not know and, in the exercise of reasonable care, could not have known, that the issuer had failed to comply with the conditions of an exemption.

Id.

81. The finder's "reasonable belief" that an investor satisfies the "accredited investor" requirements will be sufficient, however the "reasonableness" of such a belief will depend on the facts and circumstances of each offering and investor. *Id.* at 19.

82. Securities Exchange Act § 3(a)(18). The SEC explains that this requirement has been included to avoid investor confusion and the potential use of abusive sales tactics if associated persons were to be included. SEC Release No. 34-90112, *supra* note 1, at 22.

- **Disqualification**: the finder cannot be subject to a "statutory disqualification", within the meaning of Section 3(a)(39) of the Exchange Act.

The permitted activities of finders that satisfy the requirements outlined in Release 34-90112 will differ depending on whether they qualify as Tier I or Tier II finders. Both tiers would be permitted to receive transaction-based compensation without being required to register as a broker-dealer.[83]

Tier I finders would be limited to ". . .providing contact information of potential investors in connection with only a single capital raising transaction by a single issuer in a 12-month period."[84] Finders falling into this category may only provide names, telephone numbers, e-mail addresses and social media information regarding potential investors to issuers. Tier I finders would not be permitted to have any further contact with potential investors regarding the issuer.

Tier II finders would be able to provide certain solicitation activities on behalf of issuers. Because Tier II finders would be subject to less restrictions than Tier I finders, it is expected that most finders would likely seek to qualify for the Tier II exemption. However, a number of key limitations would be imposed upon their activities. Tier II finders would only be able to: (1) identify, screen, and contact potential investors; (2) distribute issuer offering materials to investors; (3) discuss issuer information included in any offering materials, as long as the finder does not provide advice regarding the valuation or advisability of the investment; and (5) arrange or participate in meetings with the issuer and the investor.

Because Tier II finders would be able to engage in a broader range of activities, the Commission has proposed that these finders must also satisfy specific disclosure requirements. The finders must provide the following information:

- Their name and the name of the issuer;
- The relationship between the finder and the issuer;
- A statement that the finder is being compensated for his or her services and a description of the services;
- Any material conflicts of interest; and

83. SEC Release No. 34-90112, *supra* note 1, at 23, 27.
84. *Id.* at 22–23.

- A statement affirming that the finder is acting on behalf of the issuer and is not acting as an associated person of a broker-dealer.[85]

The Tier II finder would also need to obtain a dated written acknowledgement of receipt of the required disclosures from the investor.[86]

Both categories of finders would still be subject to the anti-fraud provisions of the securities laws. Also, as with other provisions of the Exchange Act, the proposal would not affect state registration requirements. Finders would still need to be conscious of applicable state laws.[87]

The new proposal received swift criticism, with only three out of the five then-serving Commissioners in support and the two dissenting Commissioners issuing public statements outlining their concerns[88] on the same day that Release No. 34-90112 was published. SEC Commissioner Caroline A. Crenshaw argued that the proposed exemption would allow finders to engage in activities that the SEC has traditionally classified as brokerage activities, and that it would water down the significant investor protections contained in the current regime. Commissioner Crenshaw described this as a "radical departure" from established requirements.[89] Under the proposal, for example, Tier II finders would be allowed to directly contact investors on behalf of issuers and even discuss offering materials with investors. These activities have typically been regarded as core broker activities. The only limitation that the proposal provides is that the finders cannot "provide advice as to the valuation or advisability of the investment." Critics argue

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85. *Id.* at 25–26.

86. *Id.* at 26–27.

87. Duane Wall et al., *Permitted Finder Activities: SEC Proposes Long-Awaited Exemption*, WHITE & CASE (Oct. 15, 2020), https://www.whitecase.com/publications/alert/permitted-finder-activities-sec-proposes-long-awaited-exemption (referring to a summary of the key elements of SEC Release No. 34-90112).

88. Allision Herren Lee, *Regulating in the Dark: What We Don't Know About Finders Can Hurt Us,* U.S. SEC. AND EXCH. COMM'N (Oct. 7, 2020), https://www.sec.gov/news/public-statement/lee-proposed-finders-exemption-2020-10-07; *see also* Caroline A. Crenshaw, *Statement on Proposed Exemptive Relief for Finders,* U.S. SEC. AND EXCH. COMM'N (Oct. 7, 2020), https://www.sec.gov/news/public-statement/crenshaw-finders-2020-10-07.

89. Crenshaw, *supra* note 88.

that finders would have virtually no limits regarding the amount of praise and hype they could give to promote an investment in respect to a start-up, provided they do not conclude their sales pitch with a recommendation to invest."[90]

Commentators outside the SEC voiced similar concerns. William F. Galvin, Secretary of the Commonwealth of Massachusetts, the top securities regulator in the state, wrote in a letter to the SEC arguing that the proposed exemption would enrich sellers seeking to skirt regulation and would lead to inevitable conflicts of interest if and when finders are tempted to cross the line between networking and promotional activities: "While some may argue that finders are different from broker-dealers or agents of brokerage firms based on claims that they are not in the business of effecting transactions in securities, both the nature of their activities and sound policy under the securities laws call for them to be registered."[91] The North American Securities Administrators Association, an industry group, summed up much of the investment community's concern: "This is another instance in which the Commission seeks to expand the private markets with no commensurate effort either to protect investors from the evident risks of fraud, or to understand how an exemption could be abused."[92]

Proponents of the proposal have argued that, because it would only allow finders to solicit accredited investors, the activities permitted would not pose a threat to the investors involved. However, opponents argue that, although accredited investors are presumed to require less protection than typical investors, recent studies have indicated that this is not the case and significant protection is still required.[93] The rationale for "stripping" the protections for accredited investors while re-

90. Lee, *supra* note 88.

91. William F. Galvin, Comment Letter on Proposed Exemptive Order Granting Conditional Exemption from the Broker Registration Requirements of the Securities Exchange Act (Nov. 12, 2020), https://www.sec.gov/comments/s7-13-20/s71320-8011759-225411.pdf.

92. Lisa Hopkins, Comment Letter on Proposed Exemptive Order Granting Conditional Exemption from the Broker Registration Requirements of Section 15(a) of the Securities Exchange Act of 1934 for Certain Activities of Finders (Nov. 12, 2020), https://www.nasaa.org/wp-content/uploads/2020/11/NASAA-Comment-Letter-on-SEC-Finders-Proposal-111220.pdf.

93. SEC Release No. 34-90112, *supra* note 1.

taining them for others runs contrary to the policy evident in recent SEC publications.

SEC's Acting Chair Allison Herren Lee voiced another concern which many share: while supporters of Release No. 34-90112 have argued the proposal would benefit businesses owned by women and minorities, Lee called these arguments speculative. "The release," Lee stated, "contains no empirical evidence supporting that supposition, and nothing in the proposed order is tailored to that purpose. It simply asserts that this change broadly applies to all businesses, large and small."[94] Commentators have noted that, given the sharp divergence of views by SEC commissioners on the current text of Release No. 34-90112 and the likelihood of significant comment from interested parties, the final form of any relief adopted by the SEC could be significantly different from that outlined in the current proposal.[95]

V.
What Are the Consequences of a Breach?

So, why does this even matter? Why should finders follow internal debate at SEC rather than seek profit with an ask-forgiveness-not-permission attitude?

This is a question many small players in the market face. Cash-strapped, mid-sized enterprises, advisors trying to expand their client base, investment firms with in-house sales teams, and other participants in the financial sector might wonder if the consequences of failing to register could outweigh the costs of compliance. The answer often comes as a shock to issuers and finders alike: failure to register could result in fines, disgorgement, bad actor disqualification,[96] rescission of investment arrangements and, as a corollary, potential bankruptcy. The fact that the issuer or finder may not even be aware that their conduct has violated a law or act is largely irrelevant.[97] The SEC requires issuers and finders to conduct "reasonable

94. Lee, *supra* note 88.

95. Duane Wall et al., *supra* note 87.

96. This becomes relevant when considering the availability of Regulation 506(d) relief. *See* Disqualification of Felons and Other "Bad Actors" from Rule 506 Offerings, 78 Fed. Reg. 44730 (July 24, 2013) (codified at 17 C.F.R. pts. 200, 230, 239 (2014)).

97. Wonsover v. SEC, 205 F.3d 408, 414 (D.C. Cir. 2000) (quoting Gearhart & Otis, Inc. v. SEC, 348 F.2d 798, 803 (D.C. Cir. 1965)).

inquiry" as to whether their activities trigger the registration requirement, and failure to do so can suffice for a finding of "wilfulness."[98]

Issuers can have a particularly tough time when it comes to deciding whether to use a registered broker or a cheaper unregistered operator to help them find capital. The fact that many unregistered finders operate openly, sometimes advertising their services, and that neither the SEC nor FINRA has the resources to police the finder industry, makes it nearly impossible for attorneys to convince small issuers that they should avoid such entities.[99] But, however spotty, SEC policing and enforcement is real. A review of enforcement cases by the ABA revealed that SEC enforcement of broker registration named both the issuer and the broker-dealer in suits, and often included multiple counts.[100] SEC compliance actions can be triggered by Form D disclosures of sales commissions and finder's fees,[101] tips from disgruntled investors or competitors, and routine examinations.[102]

A. *Consequences for Issuers*

The most common consequences for issuers using an unregistered broker-dealer are:

- Prosecution;
- Rescission of investment contracts;
- Disgorgement and fines; and
- "Bad actor" consequences.

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98. *Id.* at 414.

99. Laura Anthony, *Attorney Laura Anthony Explains the Payment of Finders' Fees*, THE HUFFINGTON POST, (July 27, 2020, 9:51 PM), https://www.huffpost.com/entry/attorney-laura-anthony-explains-the-payment-of-finders_b_596e350be4b05561da5a5aed.

100. *See* A.B.A. Report, *supra* note 39, at 997.

101. *Form D*, U.S. SEC. AND EXCH. COMM'N, https://www.sec.gov/about/forms/formd.pdf.

102. *See* Matt Kuhn & Arina Shulga, *Finders and Unregistered Broker-dealers: Understanding the Risks and Recent Developments*, STRAFFORD MEDIA (May 15, 2019, 1:00 PM), http://media.straffordpub.com/products/finders-and-unregistered- broker-dealers-understanding-the-risks-and-recent-developments-2019-05-15/presentation.pdf.

1. *Prosecution*

There are two principal areas of issuer prosecution in unregistered broker-dealer actions: (1) actions for fraud; and (2) actions for aiding and abetting a breach of the Exchange Act.

Actions for fraud generally arise in the context of failure to disclose commissions paid to unregistered broker-dealers. The SEC requires disclosure of all compensation paid in relation to a capital raising under Section 10(b) of the Exchange Act[103] and Rule 10b-5. Rule 10b-5 imposes liability for making a materially false or misleading statement, or omitting material facts, in connection with the purchase or sale of securities.[104]

In most cases, fraud claims will be brought not only against the issuing company but also against participating officers and directors of the issuer.[105] For example, in *SEC v. W.P.Carey & Co. LLC et al.*[106] both the former CFO and a former Chief Accounting Officer were named as parties to the proceedings.[107] It is also common for the SEC to prosecute issuers under Section 20(e) of the Exchange Act for aiding and abetting violations.[108] Commentators note that prosecuting the issuing company may be a more effective deterrent

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103. Rule 10b-5 is promulgated by the SEC pursuant to its rule making power under section 10(b) of the Exchange Act. Section 10(b) of the Exchange Act makes it unlawful:

> To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, or any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

15 U.S.C. § 78j(b). This has long been interpreted as requiring full disclosure of finder compensation in relation to statements regarding securities. *See* SEC v. Great American Industries, Inc. 407 F.2d 453 (1968).

104. 17 C.F.R. § 240.10b-5.

105. Anthony, *supra* note 99.

106. Complaint at 1, SEC v. W.P. Carey & Co. LLC, No. 08-CV-2846 (S.D.N.Y. filed Mar. 18, 2008).

107. *Id.* at 6–7.

108. Section 20(e) of the Exchange Act reads in part "any person that knowingly or recklessly provides substantial assistance to another person in violation of a provision of this title, or of any rule or regulation issued under this title, shall be deemed to be in violation of such provision to the same extent as the person to whom such assistance is provided." Securities Exchange Act, *supra* note 10, at § 20(e).

than prosecuting an unlicensed person, who may be difficult to track down.[109]

2. *Rescission*

Section 29(b) of the Exchange Act provides, in part, that contracts made in violation of the substantive provisions of the Act:

> . . . shall be void[110]. . . as regards the rights of any person who, in violation of any such provision, rule, or regulation, shall have made or engaged in the performance of any such contract.

In effect, this means that investors can recover their funds if they were materially misled by a broker or finder.[111] This provision can extend to circumstances where the finder did not inform the investor that they were unlicensed since the legislative protections an investor may have assumed were available were not in fact available. Section 29(b) requires an action to be brought within one year from the discovery of the violation or within three years of the actual sale of the securities, whichever is later. Accordingly, for at least three years after using an unregistered broker-dealer, the issuer could have a contingent liability on their books.

The operation of Section 29(b) was considered by a U.S. District Court in *Celsion Corp. v. Stearns Management Corp.*[112] In that case, Celsion Corp. sought rescission of a series of common stock purchase warrants that it issued to the Stearns Mgt. Corp. and others without the assistance of a registered broker. Although the court applied the three-year time limit in deciding that rescission was not available, it did observe that rescission was a private cause of action and that, since the Exchange Act was intended to protect investors against the manipulation of stock prices, registration of broker-dealers was of utmost importance. *Celsion Corp. v. Stearns Management Corp* makes it

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109. Anthony, *supra* note 99.

110. This has been read as "voidable" at the option of the innocent party by the U.S. Supreme Court. *See* Mills v. Elec. Auto-Lite Co., 396 U.S. 375, 387–88 (1970).

111. Additionally, investors can recover their funds where an agreement cannot be performed without violating securities laws. *See* Berckeley Inv. Grp. Ltd v. Colkitt, 455 F.3d 195 (3d Cir. 2006).

112. Celsion Corp v. Stearns Mgmt., 157 F.Supp.2d 942 (N.D. Ill. 2001).

clear that but for the three-year technicality, rescission would have been available.

The 2012 bankruptcy of Neogenix Oncology, Inc. is an example of the possible consequences that follow when a party invokes its right of rescission. After a round of financing for the start-up company, the SEC requested information related to the payment of finder's fees to unregistered third parties. Management at Neogenix was unable to quantify the potential rescission liability. This liability could include not only investment amounts but also interest. Management could not complete preparation of the financial statements, which in turn could not be reviewed by the independent auditor. Because of the unsigned accounts, SEC investigation, and potential rescission liability, the company could not raise additional funds. Chapter 11 bankruptcy became necessary. Although subsequent arrangements allowed the business of Neogenix to be restructured into a clean entity, entities in similar situations may not be able to easily restructure themselves since Chapter 11 bankruptcy is a costly, time-consuming activity that can severely disrupt day-to-day operations.[113]

3. *Disgorgement and Fines*

The imposition of fines and court-ordered disgorgement can have a major impact both from a financial and reputational perspective: Who wants to invest in a business that plays fast and loose with the law?

The purpose of disgorgement is generally to return the perpetrator to the position in which they would have been had the breach not occurred. However, disgorgement can be treated as a penalty for certain legislative purposes.[114] The Supreme Court has acknowledged that disgorgement that does not exceed a wrongdoer's net profits can qualify as equitable relief.[115] Separate provisions in the Exchange Act allow appro-

113. Alexander J. Davie, *Neogenix Oncology: A Good Case Study on Securities Law (Non) Compliance by a High Growth Company: Part 1: How it all Happened*, STRICTLY BUSINESS LAW BLOG, (Oct. 5, 2012), https://www.strictlybusinesslawblog.com/2012/10/05/neogenix-oncology-a-good-case-study-on-securities-law-noncompliance-by-a-high-growth-company-part-1-how-it-all-happened/.

114. A.B.A. Report, *supra* note 39, at 998; *see also* Kokesh v. SEC, 137 S. Ct. 1635, 1645 (2017) (characterizing disgorgement as a penalty for statute of limitations purposes).

115. *See* Liu v. SEC, 140 S. Ct. 1936, 1937 (2020).

priate equitable relief from the imposition of penalties,[116] the specific powers of accounting, and disgorgement in administrative and cease-and-desist proceedings.[117]

The SEC generally pursues disgorgement in conjunction with other actions such as penalties. For example, the SEC proceeding *In the Matter of Edwin Shaw LLC*[118] involved the sale of limited liability company membership interests in a New York taxi and livery company to foreign investors as part of the EB-5 immigrant investor program. Under the arrangement, a principal of Edwin Shaw LLC, who was not registered as a broker-dealer, marketed the interests and received an administrative fee for each successful investment, which was funded out of the investments themselves. Shaw was censured, received a cease-and-desist order in respect of future violations of Section 15(a) of the Exchange Act, was ordered to disgorge $400,000, paid prejudgment interest of $54,209.20, and received a civil penalty of $90,535.

4. *"Bad Actor" Determination*

Regulation D offerings, especially through Rule 506,[119] are a major source of capital raisings for smaller operators due to the limited regulatory burdens when compared with other types of raisings.[120] The popularity of Rule 506(b) is borne out by the statistics. In 2018, the amount raised by Rule 506(b) offerings was $1.5 trillion, much larger than the $1.4 trillion raised through registered offerings.[121] In 2021, the SEC's office of the Advocate for Small Business Capital Formation reported that the amount raised by 506(b) offerings was a whop-

116. *See* Securities Exchange Act of 1934 at § 32[78ff](a) (providing for equitable relief, whereas the penalty regime carries up to 20 years imprisonment and fines of $5 million for natural persons and $25 million for corporations).

117. *See* Securities Exchange Act of 1934 at §§ 21B(e), 21C(e).

118. Edwin Shaw, LLC, Exchange Act Release No. 82805 (Mar. 5, 2018), https://www.sec.gov/litigation/admin/2018/34-82805.pdf.

119. Securities Act of 1933 § 230.506, 15 U.S.C. § 77d.

120. *See* YADLEY, *supra* note 6, at 1-2.

121. Concept Release on Harmonization of Securities Offering Exemptions, *supra* note 40, at 78.

ping $1.9 trillion with both initial public offerings and follow-on registered offerings totaling just over $1.7 trillion.[122]

It is vital for smaller operators to keep the Rule 506(d) avenue open for raising funds as they grow. While several requirements must be met in order to rely on Rule 506, for current purposes, there has been no "bad actor" disqualification.[123] But one important requirement detailed in Rule 506(d) has broad application: no exemption is available if, among other things, the issuer, its predecessors, directors, general partners, managing members, certain executives and participating officers, or any beneficial owners of 20% or more of the voting equities has been convicted of offenses (or received certain specified orders from the SEC) in connection with the sale or purchase of a security, arising out of a business as a broker or dealer, or a breach of anti-fraud provisions. This means that an earlier adverse finding arising from the use of an unregistered broker may well result in losing the Rule 506 advantage. The time limit for prior convictions stretches back ten years, and, given the extension of the requirement to any beneficial owner of 20% or more of the company, a prior conviction could spell disaster for a growing business which relied upon the benefit.

B. *Consequences for Finders*

Many of the consequences faced by issuers are also faced by finders, albeit in a slightly different way. Consequences include:

- Prosecution and fines;
- Disgorgement; and
- Rescission of contracts.

122. U.S. SEC. & EXCH. COMM'N, OFF. ADVOC. FOR SMALL BUS. CAP. FORMATION, ANNUAL REPORT FOR FISCAL YEAR 2021, at 11 (2021), https://www.sec.gov/files/2021-OASB-Annual-Report.pdf.

123. U.S. SEC. & EXCH. COMM'N, *Disqualification of Felons and Other "Bad Actors" from Rule 506 Offerings and Related Disclosure Requirements* (Sep. 19, 2013), https://www.sec.gov/info/smallbus/secg/bad-actor-small-entity-compliance-guide#P9_40.

1. *Prosecution*[124] *and Fines*

The most common prosecution is for breach of Section 15(a) and any attendant breaches (often including fraud under Section 10(b)).[125] Case law has shown[126] that when a prosecution is initiated against an unregistered finder, the SEC will generally pursue a range of remedies including interest, disgorgement[127] (where appropriate) and other actions.

The SEC also uses "follow-on" administrative proceedings which include administrative bars to acting in certain capacities, such as a promoter or finder engaging in activities with brokers related to the issuing or sale of securities.[128]

The 2020 case *SEC v. Biongiorno* provides a recent example of the types of penalties the SEC could impose.[129] The case involved defendants acting as unregistered brokers soliciting investors to buy shares in microcap issuers. The complaint alleged the defendants used aliases in soliciting purchasers, received transaction-based compensation, issued false receipts to obfuscate commissions compensation and (at least in one case) misappropriated client funds. Penalties sought by the SEC included permanent restraining orders for breaching multiple sections of the Exchange Act, including Sections 15 and 10; a prohibition from directly or indirectly soliciting for the sale or purchase of securities (or owning a company that does the same); disgorgement of funds on the basis of unjust enrichment; and civil penalties.

A key takeaway from recent cases is that, while monetary penalties can be significant, the real sting comes in the form of the administrative actions: an administrative bar can effectively

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124. *See* A.B.A. Report, *supra* note 39, at 972 (explaining that States have brought more than 100 actions per year against finders breaching the State security laws).

125. A wilful breach of the Exchange Act can incur a penalty of up to 20 years in prison and fines of $5 million for individuals, or $25 million for corporations. *See* 15 U.S.C. § 78ff(a).

126. *See* Blackstreet Cap. Mgmt., LLC, Exchange Act Release No. 77959 (June 1, 2016); Complaint at 13, SEC. v. Goodman, 2018 WL 6651445 (S.D. Fla. 2018).

127. Blackstreet Cap. Mgmt., *supra* note 126.

128. *See, e.g.*, Wallace, Exchange Act Release No. 83052 (Apr. 16, 2018) (SEC proposing a bar on the Respondent acting as, *inter alia*, a finder or promoter).

129. Complaint at 12, SEC v. Bongiorno, 2020 WL 8259226 (N.D. Ohio 2020).

end a finder's business and any further involvement in the securities industry.

2. *Disgorgement*

As discussed in the "Consequences for Issuers" Section *supra*, disgorgement of gains obtained through unlawful or unjust means is a common remedy pursued by the SEC, particularly where a matter involves fraud.[130] There are numerous examples of such penalties, and even persons not directly involved in fraudulent activities can still be required to disgorge funds.[131] The following matters involve multiple different factual scenarios in which disgorgement was considered appropriate.

The 2013 administrative decision *In the Matter of Ranieri Partners, LLC*[132] involved charges against the New York based private equity firm Ranieri Partners, a former senior executive, and an associate[133] who was operating as an unregistered broker-dealer by actively soliciting investors, receiving transaction-based compensation, sending documentation to potential investors and providing confidential information related to other investors. There was no allegation of fraud. The consequences for the "finder"—unregistered broker-dealer—were several administrative measures, including a cease-and-desist order, and bars on association with certain financial industry participants. The court also ordered the disgorgement of over $2.4 million and prejudgement interest.[134] The disgorgement amount was referable to the amount of transaction-based compensation received by the unregistered broker-dealer.

In the Matter of Retirement Surety LLC[135] ended with a very different arrangement. In that case, approximately $11 million in nine-month promissory notes were issued by a number of

130. *See* SEC v. Materia, 745 F.2d 197, 201 (2d Cir. 1984) (describing disgorgement as within the "catalogue of permissible equitable remedies" available to the SEC).

131. *See* SEC v. Cross Financial Services, Inc., 908 F. Supp. 718 (C.D. Cal. 1995).

132. In the Matter of Ranieri Partners, *supra* note 24.

133. In the Matter of William M. Stephens, *supra* note 58, at 2.

134. This was waived based upon Respondent's financial condition. *Id.* at 7.

135. Retirement Surety LLC, Exchange Act Release No. 1250, at 1 (ALJ Apr. 18, 2018), https://www.sec.gov/alj/aljdec/2018/id1250ce.pdf.

non-registered persons who received 5% commission. When the issuer failed to pay investors under the promissory notes, it engaged the unregistered brokers to contact investors and procure forbearance agreements, for which the brokers received an additional 4% commission. While the forbearance agreements were not securities per se, the profits from extending the terms of the notes were viewed as derivative of the original unregistered sales, and the additional commission was therefore included in the disgorgement amount.

In *SEC v. Hidalgo Mining Corp., et al*,[136] Florida-based mining corporation Hidalgo sold investment contracts in the form of unregistered securities to investors, raising approximately $10.35 million. Neither the company officers nor sales staff were registered as broker-dealers. The staff generally received 10% commission on sales, but there was no disclosure to investors regarding any commissions. The settlement involved permanent injunctions, civil penalties, prejudgment interest, and disgorgement of the commissions by both the company and the principals.

3. *Rescission and Return of Fees*

As detailed above,[137] Section 29(b) of the Exchange Act makes contracts voidable at the option of the innocent party, provided that the innocent party adheres to the strict timelines prescribed by the Act (three years from the offense or one year from the date of discovery of the violation). Courts have applied Section 29(b) not only to contracts that directly violate the terms of the Exchange Act but also to cases where the means of performing the contract involve a violation, such as the use of an unregistered broker.[138]

The consequences of rescission for an unregistered broker-dealer could include a requirement to return commissions, fees and expenses, or, where payment has not yet been

136. Complaint at 1–2, SEC v. Hidalgo Mining Corp., Exchange Release No. 23903 (S.D. Fla. filed Aug. 4, 2017) (No. 17-cv-80916), https://www.sec.gov/litigation/complaints/2017/comp23903.pdf.

137. *See* discussion, *supra* note 58.

138. *See e.g.*, Reg'l Props., Inc. v. Fin. & Real Est. Consulting Co., 752 F.2d 178, 184 (5th Cir. 1985) (applying Section 29(b) to a contract performed by an unregistered broker).

made by the issuer, a refusal to pay in accordance with the agreement.[139]

The consequences of a rescission under Section 29(b) come into focus in the unreported decision of Torsiello Capital Partners LLC v. Sunshine State Holding Corporation,[140] in which the Supreme Court of New York considered Section 29 and the return of a retainer fee on the basis of "unjust enrichment." Sunshine had engaged an advisory firm, First International, to provide advice and banking services for a private placement of Sunshine's securities. First International prepared documents to assist with the security sale, made calls to potential investors, and held meetings. Its finders were unregistered brokers, and their efforts were unsuccessful. When the shares were later sold, First International and Torsiello, as affiliates and successors in interest, sought to enforce the original contract, which carried a retainer of $50,000 and a fee of 3.5% of the purchase price. The Supreme Court found for Sunshine on the basis that the contract was voidable pursuant to Section 29(b),[141] and the retention of the retainer would constitute unjust enrichment. The Court stated:

> . . . [T]he contract is void ab initio by virtue of the plaintiff's lack of registration as a securities broker with the SEC and, therefore, the contract has been rescinded. Therefore, Sunshine is entitled to the return of the $50,000 retainer fee. . .[142]

Family members in receipt of the funds may be required to return monies on the basis of unjust enrichment, even if the family members were not parties to the securities law violation. This is illustrated in the 1993 case *SEC v. Antar*,[143] which in-

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139. Couldock & Bohan, Inc., 93 F.2d at 235; *see also* Transamerica Mortg. Advisors v. Lewis, 444 U.S. 11, 19 (1979) (noting "[w]hen Congress declared. . .. . .that certain contracts are void, it intended that the customary legal incidents of voidness would follow, including the availability of a suit for rescission or for an injunction against continued operation of the contract, and for restitution.").

140. *See* Torsiello Cap. Partners LLC, 2008 N.Y. Misc. LEXIS 2879, at *29.

141. *Id.* at *16 ("Inasmuch as the contract required First International and its affiliates to provide the types of services that require licensing by the SEC as a securities broker, and they did perform such services while not so licensed, the contract is void ab initio and rescindable").

142. *Id.* at *29.

143. *See* SEC v. Antar, 831 F. Supp. 380, 402 (D.N.J. 1993).

volved an action against the Antar's wife and children even though there had been no securities law violations on their part. Rather, the action against them was for their possession and custody of proceeds from Antar's sale of stock, which had violated the securities laws.

The Court laid out the key principles in such cases:

> [T]he touchstone is whether the non-party's claim to the property is legitimate, not whether the party is innocent of fraud or wrongdoing . . .[144]The nominal defendants cannot keep money that is not theirs. . . Unjust enrichment is present here. The nominal defendants should not be allowed to retain funds that are the products of Eddie Antar's securities fraud. Their enrichment came at the expense of defrauded investors.[145]

The takeaway is that rescission carries consequences not only for the unregistered broker-dealer but also potentially for their family.

VI.
What Does a Prospective Finder Need to Do?

These and other cases demonstrate that the consequences of breaching the Exchange Act's registration requirements can be devastating for both finders and issuers. The following steps outline a process for protecting finders and their clients from inadvertent breaches of the law.

A. *Step 1: Gathering Facts*

It is essential to ensure a grasp of the relevant facts and circumstances because the registration requirement is a fact-driven question. Ask: what is done or proposed to be done, and how will it be carried out?

Preliminary issues include the following:

- Whether the finder is registered as a broker-dealer and whether they are likely to be an "associated person" of a registered broker-dealer;
- What each party to the arrangement expects to get out of the arrangement. Record these expectations in an

144. *Id.* at 399.
145. *Id.* at 402.

agreement that is reviewed prior to execution. Existing contracts should also be reviewed to ensure that a breach has not already occurred. Ask whether there any indemnification clauses, and if so, whether there are enough resources or insurance to cover an indemnifiable event;
- What the precise activities are that will be performed by each party; and
- How remuneration will be calculated and paid.

B. *Step 2: Consider the Specific Facts in Light of Section 15*

Next, analyse whether the SEC would interpret the proposed activities as requiring registration. In particular, consider the questions of transaction-based compensation, involvement in the transaction, and solicitation.

1. *Transaction-Based Consideration*

This is the principal issue that needs to be addressed. There is likely no breach of this requirement where the finder:
- Introduces investors and issuers[146] without any further involvement in the process;[147] and
- The remuneration is a fee referable to time-based rates, a flat fee for the whole service, or fees on a "per-introduction" basis, provided that the success or failure of a particular introduction does not factor into the payment mechanism.

Any form of transaction-based compensation is likely to trigger action by the SEC.

2. *Involvement in the Transaction*

The cases and no-action letters discussed in this article demonstrate that any involvement in the transaction itself is

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146. Apex Glob. Partners, Inc. v. Kaye/Bassman Int'l Corp., 2009 WL 2777869, at *3 (N.D. Tex. Aug. 31, 2009) ("Merely bringing together the parties to transactions, even those involving the purchase and sale of securities, is not enough" to warrant broker registration under Section 15(a)").

147. Victoria Bancroft, SEC Staff No-Action Letter, 1987 WL 108454, at *2 (Aug. 9, 1987) describes activities as "limited merely to the introduction of parties." In that case the applicant did not participate in the establishment of the purchase price or any other negotiations between the parties and only received a flat fee for the introductions. *See also* A.B.A. Report, *supra* note 39, at 19.

considered to be the activity of a broker-dealer, which requires registration. Accordingly, a finder should not:

- Provide advice on the merits, or any detailed information,[148] such as corporate analysis, information memoranda, etc.;
- Be involved in negotiating the issue or sale, or have any input regarding transaction documentation or marketing materials;
- Be involved in any aspect of facilitating an investment or purchase, including handling funds or assisting with third party legal, financial, or business advisors;[149]
- Participate in any negotiations (including during the closing of the sale); or
- Assist purchasers in obtaining financing, other than uncompensated introductions to third party lenders.

3. *Active Solicitation*

The role of the finder is to facilitate introductions rather than convince investors that a particular investment is appropriate for them. Finders may receive transaction-based compensation referred to as what the SEC calls the "*salesman's stake*." Accordingly, a finder should:

- Only facilitate introductions and provide basic outline information (not analysis);
- Not advertise;
- Not distribute promotional material or hold seminars where the investment is promoted; and
- Not engage in broad "cold-calling" as introductions should only be made to suitable potential investors.

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148. The Dominion Resources no action letter was withdrawn on July 3, 2000, which had previously permitted the entity to undertake a number of activities, including analysing the financial needs of issuers, designing financing methods and securities that fit those needs, recommending lawyers to prepare the documents, participating in negotiations, and arranging meetings with banks for financing and underwriting. Dominion Res., SEC No-Action Letter, *supra* note 25. Transaction based fees were also involved. The withdrawal letter did not specify which of the factors had led to the withdrawal and would result in a registration requirement today.

149. Commentators note that uncompensated introductions to third party lenders should not be a problem. Eric R. Smith, *Finders May Pose Risk in Private Capital Raising*, VENABLE, LLP INSIGHTS (July 15, 2020), https://www.venable.com/insights/publications/2013/03/finders-may-pose-risk-in-private-capital-raising.

C. *Step 3: If Uncertainty Remains*

After fact-gathering and analysis in light of Section 15, there may still be uncertainty regarding the registration requirements, especially for more complex arrangements. In such cases, seeking advice from an attorney experienced in securities law may be necessary.

The consequences of breaching the registration provisions are severe. If there is any doubt, it is worthwhile to register or to reconsider the services offered (for a finder) or consider using a registered broker or a finder with a limited suite of services (for an issuer).

VII.
California: A More Rational Regime

The difficulties finders confront are not new. Market participants are forced to make a hard choice: either face expensive, laborious registration, along with subsequent expensive, laborious compliance duties, or run the risk of harsh penalties in a regulatory system that lacks clear guidelines. Although the SEC has finally circulated a proposal for finder exemption, it received only limited support from the Commissioners and triggered considerable pushback from the investor side of the industry.

Seeking to remedy the SEC's vague definition of broker-dealers and lack of definition for finders, some states have implemented their own legislative fixes.[150] The fact that the states of California and Texas have crafted their own regimes demonstrates the weight of the issue, especially given the economic significance of these two states. California and Texas represent tens of billions of dollars in venture capital investment each year, and if they were sovereign nations, they would be the sixth- and tenth-largest economies in the world by gross product.[151] Of particular note is the Californian regime, which has proven successful in addressing many of the issues sur-

150. As well as California, these include Texas (Tex. Admin. Code § 115.1(a)(9)), Michigan (MCL § 451-2102), and South Dakota (SD Codified L § 47-31B-401), with New York reviewing the treatment of finders under State law. *See* Investor Protection Bureau proposal dated April 15, 2020, https://ag.ny.gov/ipb-rule-change.

151. *See* Mark J. Perry, *Economic Output: If States Were Countries, California Would be France*, Newsweek (June 11, 2016, 8:00 AM), https://

rounding finders. California Corporations Code Section 25206.1, passed in 2015, offers a rational regime for distinguishing finders from broker-dealers, registering finders, and regulating finder activities and compliance.[152] While the California model is not above critique, it is more precise than the SEC's regime, and it has produced better results, providing a preferable alternative to the one outlined in the current SEC proposal.

We argue that (1) the SEC must define "finder" and finder activities more clearly and rationally than it does in Release No. 34-90112; (2) the SEC should exempt finders from SEC broker-dealer registration so long as they adhere to new SEC guidelines; and (3) the SEC should use the California regime as a model for making these changes. A more rationalized finder regime implemented at the federal level would foster small business growth and provide small businesses with a wider range of options to raise capital, particularly outside the realm of homogenized, big-deal oriented institutional lenders.

A. *California's Finders Regime*

Legislators in California sought to address the longstanding problem of raising capital for small businesses by allowing unregistered persons to legally act as finders under a set of conditions that are clearer than the SEC's broker-dealer registration requirements.[153]

B. *History of California Corporations Code Section 25206.1*

Before Section 25206.1, California's regime resembled the federal one in that it only permitted registered broker-dealer firms to be compensated for connecting an investor with an investment opportunity.[154] At that time, the only protection an investor had against an unregistered broker-dealer was Corporations Code Section 25501.5, which allows a person who "purchases a security from or sells a security to a broker-dealer that is required to be licensed and has not, at the time of sale of purchase . . . to bring an action for rescission of the

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www.newsweek.com/economic-output-if-states-were-countries-california-would-be-france-467614.

152. *See* CAL. CORP. CODE § 25206.1.

153. Assemb. Comm. On Banking & Fin., A.B. 667, at 5 (Cal. 2015).

154. *Id.*

sale or purchase, if the plaintiff or defendant no longer owns the securities."[155]

In April 2013, Assemblyman Donald Wagner proposed a bill that would exempt a "finder" from the then existing broker regime upon meeting certain requirements.[156] It would have allowed any person who met specific requirements to be classified as a finder instead of as a broker-dealer.[157] Although the bill failed to pass the Senate Appropriations Committee, in July 2015, Wagner presented a substantially similar bill, which passed without opposition.[158] That bill became California's new finder statute, Section 25206.1.[159]

The stated purpose of Section 25206.1 was to eliminate the risks for issuers and investors raising capital through finders by clearly defining the limits and bounds of a finder.[160] The bill's sponsors recognized that,

> Under current law . . . the scope of permitted activities for a finder is poorly defined, often resulting in inadvertent violations of broker-dealer registration requirements. In fact, there is no statutory definition of finder, nor is there any regulation of finders. This lack of clear guidance puts finders and the businesses that rely upon them for crucial funding in jeopardy. It also impedes the State's ability to regulate finders and to hold them accountable.[161]

The bill passed through the Senate Committee on Banking and Financial Institutions with no opposition.[162] The Committee members unanimously supported imposing regulatory requirements upon finders to ". . . ensure better market transparency, proper accountability, and additional investor protection while at the same time facilitating capital formation for

155. CAL. CORP. CODE § 25501.5(a)(1).
156. S. Comm. on Banking & Fin. Insts., A.B. 667 (Cal. 2015).
157. A.B. 713, 2013-2014 Reg. Sess. (Cal. 2013).
158. AB-667 Votes, Cal. Leg. Info., (2015), https://leginfo.legislature.ca.gov/faces/billVotesClient.xhtml?bill_id=201520160AB667.
159. CAL. CORP. CODE § 25501.5(a)(1).
160. Assemb. Comm. on Banking and Fin., A.B. 667, at 8 (Cal. 2015).
161. *Id.*
162. S. Comm. on Banking & Fin. Insts., A.B. 667, at 9 (Cal. 2015).

business entities in California."[163] The bill also passed through the Senate Rules Committee with no opposition.[164]

However, the Senate did make two amendments.[165] The Senate requested that the bill expand the commissioner's authority to make, amend, and rescind rules in order to carry out the provisions. The Senate also amended the bill to empower the commissioner to "classify securities, persons, and matters within his or her jurisdiction and prescribe different requirements for different classes." Thus, the following text was added to the bill:

> The commissioner may from time to time make, amend, and rescind such rules, forms, and orders as are necessary to carry out the provisions of this law, including rules and forms governing applications and reports, and defining any terms, whether or not used in this law, insofar as the definitions are not inconsistent with the provisions of this law. For the purpose of rules and forms, the commissioner may classify securities, persons, and matters within his jurisdiction, and may prescribe different requirements for different classes.[166]

Section 25206.1 created a regulatory framework to govern the activities and accountability of finders, and it provided statutory and regulatory certainty for both finders and the businesses that rely upon them.[167]

The California legislature hoped that the bill would encourage persons who act as finders to comply with the bill's requirements by providing much-needed clarity regarding permissible and impermissible finder activities.[168] Those who operate within the bill's parameters have assurance that they do not need to obtain a broker-dealer license. However, those who do not meet the bill's definition may need to obtain licensing as broker-dealers.

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163. *Id.* at 6.
164. *Id.* at 7.
165. *Id.* at 6.
166. *Id.*
167. S. Comm. on Appropriations A.B. 667, at 1 (Cal. 2015). A simple framework is something that remains lacking in the Federal sphere and is likely to persist even in the event Release No. 34-90112 was to be adopted in its current form.
168. S. Comm. on Banking & Fin. Insts., A.B. 667, at 5 (Cal. 2015).

California is not the only state that has enacted legislation dealing with finders[169]; other states, including Texas, Michigan, and Minnesota, have done the same. Notably, both the Texas and Michigan finder statute are relatively similar to California's in that they place substantial limits upon the activities in which a finder can permissibly engage. This approach appears to have been adopted in SEC Release No. 34-90112. Michigan's position is somewhat different, requiring a person defined as a "finder" under Michigan law to register as an investment advisor and limiting the person's activities to ". . .locating, introducing, or referring potential purchasers or sellers."[170] Similarly, Texas limits finders to participating in the introduction of accredited investors.[171]

The California finder statute received mixed reviews.[172] Those who supported passage believed that the requirement that all parties must reside in California would cause the SEC to turn a blind eye to the exemption.[173] However, critics argue that it is just as cumbersome as the SEC's regime.[174] The Californian law imposes many conditions, including both reporting and filing obligations, upon finders,[175] and those who fail to follow the strict requirements are still subject to the same penalties as unregistered broker-dealers. Additionally, the ex-

169. Assemb. Comm. on Banking & Fin., A.B. 667, at 7 (Cal. 2015).

170. MICH. COMP. LAWS § 451.2102 (2002).

171. For a discussion of the history and practicalities of the Texas finder provisions, see generally John R. Fahy, *The New Texas "Finder" Securities Broker Registration*, TEX. J. BUS. L. 341, 341–42 (2005–2006).

172. *See, e.g.*, Amit Singh, *California Creates Finders Fee Exemption for Unregistered Persons*, STARTUPBLOG (Aug. 16, 2015), https://www.startupblog.com/blog/californiafinderrule; Christina Pearson, *A Limited Exception – California Enacts New Rules Governing Exemption for Finders in Securities Transactions*, JD SUPRA, (Aug. 10, 2017), https://www.jdsupra.com/legalnews/a-limited-exception-california-enacts-26316/; Will Marshall, *California Exemption of Little Help*, SAN DIEGO CNTY. BAR ASSOC. (2015), https://www.sdcba.org/index.cfm?pg=BusinessandCorporate201709.

173. The SEC has shown a tendency to defer to state law in purely intrastate transactions. *See Intrastate Offerings*, U.S. SEC. & EXCH. COMM'N (Sept. 6, 2022), https://www.sec.gov/smallbusiness/exemptofferings/intrastateofferings.

174. Marshall, *supra* note 172 ("The California finder exemption fails to align with the practical realities of how such finders operate and their tolerance for compliance burdens, thereby significantly reducing the usefulness of this exception.").

175. *See* CAL. CORP. CODE, § 25206.1.

emption seeks to prohibit the activities of a true finder.[176] Finders are not allowed to participate in the offering through "negotiating, advising or making any disclosures to the potential purchaser other than very limited information."[177] Because Section 25206.1 is so extensive, many critics doubted that it would solve the problems that it was enacted to fix.

C. *Goals of Section 25206.1*

Section 25206.1 was enacted to create "regulatory certainty for finders and business owners, by codifying a set of activities that will be legal when performed by persons without a broker-dealer's license, who meet the bill's definition of a finder."[178] Prior to the statute, there was much uncertainty at the State level regarding the activities a person without a broker-dealer's license could legally perform. As with the federal regime, most of the confusion stemmed from the law's lack of a definition for "finders" as a separate class of persons.[179]

Since finders are an "essential component of an efficient capital market,"[180] having a clear definition of what a finder is and what activities he or she may engage in provides "greater accountability, investor protection, and regulatory oversight."[181]

D. *Greater Accountability*

One of the primary purposes of Section 25206.1 was to clear up ambiguities surrounding finders, thus enabling the State to hold finders accountable.[182] Before, the lack of clear guidance regarding finders caused businesses to inadvertently put their businesses in jeopardy when seeking capital.[183] By providing the badly needed clarification, Section 25206.1 increases the accountability of both businesses and finders.

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176. Marshall, *supra* note 172.

177. Will Marshall, *California Finder Exemption of Little Help*, UBM LAW GROUP, LLP (Oct. 23, 2016), https://ubmlaw.com/california-finder-exemption-of-little-help/.

178. S. Comm. on Banking & Fin. Insts., A.B. 667, at 8 (Cal. 2015).

179. *See* Assemb. Comm. on Appropriations A.B. 667, at 2 (Cal. 2015).

180. S. Comm. on Banking & Fin. Insts., A.B. 667, at 9 (Cal. 2015).

181. *Id.*

182. Assemb. Comm. on Banking & Fin. Insts., A.B. 667, at 7 (Cal. 2015).

183. S. Comm. on Banking & Fin. Insts., A.B. 667, at 8 (Cal. 2015).

To start, Section 25206.1 defines a "finder"[184] as "a natural person who, for direct or indirect compensation, introduces or refers one or more accredited investors . . . to an issuer . . . solely for the purpose of a potential offer or sale."

It also establishes a framework of requirements for "finders" to legally receive transaction-based compensation in California.[185] First and foremost, in order for the exemption to apply, the issuer, the finder, and the investors must all be located in California.[186] Second, prior to engaging in any activities relating to securities transactions, the finder must file an initial statement of information and pay a $300 fee.[187] The statement of information must include:[188]

- The name and complete business or residential address of the finder; and
- The mailing address of the finder, if different from the business or residential address.

In addition, the finder must file a renewal statement with the Department of Business Oversight and pay a $275 fee.[189]

Finally, the finder must act within a strict subset of rules detailed in the statute. It is crucial for businesses to understand the legal limits of finders within California because they too can be penalized if the finder acts outside the permissible bounds. The following restrictions apply to finders in California:[190]

- Finders must only refer accredited investors to the issuer;
- Finders are unable to provide services to an issuer for the offer or sale of securities that exceed fifteen million dollars in aggregate;
- Finders cannot participate in negotiating the terms of the offer or sale;
- Finders may not offer advice regarding the advisability of investing in, purchasing, or selling the securities;

184. CAL. CORP. CODE, § 25206.1.
185. S. Comm. on Banking & Fin. Insts., A.B. 667, at 1, 7 (Cal. 2015).
186. CAL. CORP. CODE, § 25206.1.
187. *Id.*
188. *Id.*
189. *Id.*
190. *Id.*

- Finders may not conduct any due diligence (meaning the suitability of the investor or the condition of the issuer) for any party to the transaction;
- Finders cannot sell or offer for sale any securities that are owned, directly or indirectly, by the finder;
- Finders cannot receive, directly or indirectly, any funds in connection with the issuer transaction; and
- Finders cannot participate in the transaction or knowingly receive any compensation in connection with the sale, unless authorized by permit or exempt from qualification under California law.
- Finders must also adhere to strict rules when providing information to potential investors. Finders are only allowed to disclose the following information:[191]
- The name, address, and contact information of the issuer;
- The name, type, price, and aggregate amount of any securities being offered in the issuer transaction; and
- The issuer's industry, location, and years in business.

The finder must keep all records for transactions in which he participated as a finder for a period of five years.[192]

If the finder fails to follow any of these requirements or restrictions, he or she is no longer eligible for the exemption and will be subject to the same penalties imposed by the SEC upon those who are operating as unregistered-broker dealers.[193]

E. *Investor Protection*

Providing "clear guidance for finders and the businesses that rely on their services" is essential to ensuring that businesses are protected.[194] In the past, the lack of clarity has caused businesses and finders alike to become subject to penalties through inadvertent violations.[195] Small businesses often relied on finders engaged in technically illegal broker-dealer conduct which exposed them to a risk of severe conse-

191. *Id.*
192. *Id.*
193. *Id.*
194. Assemb. Comm. on Appropriations, A.B. 667, at 3 (Cal. 2015).
195. S. Comm. on Banking & Fin. Insts., A.B. 667, at 8 (Cal. 2015).

quences.[196] Yet, from both an economic and social perspective, finders are often the only option available for small business issuers to attain the capital they need to expand their businesses. Section 25206.1 seeks to provide the assurance and protection necessary for businesses to confidently utilize finders without fear of repercussion.

F. *Regulatory Oversight*

The sponsors of the Californian bill hoped that a new regulatory structure would incentivize unregistered persons to register as finders and thus bring previously unregulated activity within the government's control.[197] By creating a specific class of person and defining a subset of regulated activities for "finders," the Department of Business Oversight ("DBO") regulates finders who may previously have avoided oversight.[198]

G. *Federal Preemption and the New California Exemption*

Finders operating under the California exemption must be cautious of the fact that the SEC still has not changed its stance on unregistered persons receiving transaction-based compensation.[199] Thus, the exemption applies only to transactions in which the issuers, finders, and investors all reside and transact within California.[200] It does not provide relief from the SEC's strict policies nor does it exempt finders from adhering to every other state's broker-dealer requirements.[201]

In addition, it is possible that the SEC could take the position that the federal preemption doctrine applies and could prosecute a California finder paid lawfully under California state law.[202] Furthermore, the possibility remains that this state statute could be challenged and overturned in federal court. Outside of California, the finder is still considered an unregistered broker-dealer in violation of Section 15(a) of the Ex-

196. *See generally* Mark Hiraide, *Ready Capital,* L.A. Law, at 21, 24 (Feb. 2017).
197. Assembly Comm. on Appropriations, A.B. 667, at 4–5 (Cal. 2015).
198. *Id.* at 2.
199. *See* Guide to Broker-Dealer Registration, *supra* note 11.
200. *See* Cal. Corp. Code, § 25206.1.
201. Hiraide, *supra* note 196.
202. *See* U.S. Const. art. VI, § 2.

change Act.[203] As a result, both the finder and issuer could be subject to the significant penalties available to federal regulators.[204]

Until the SEC changes its current policy on finder's fees, both issuers and finders run the risk of being penalized by the SEC for any transactions that occur outside of California.

CONCLUSION

If the federal experience with unregistered finders tells us anything, it is that the current regime is clearly not working. The fact that no statutory definition of "finder" even exists under the Exchange Act speaks to an antiquated system which lags behind the rapidly changing investment market it purports to regulate. The amalgamation of smaller broker-dealers into larger operators means that servicing smaller businesses is less attractive for big-deal investors, while the need for new capital by growing companies remains. This leaves many cash-strapped smaller businesses with a simple, unenviable choice: engage with an unregistered broker-dealer and run the risk of dire consequences, or face bankruptcy. As commentators and the numerous cases referenced in this paper attest, many growing businesses continue to choose the former.

But it doesn't have to be this way. The SEC's tentative recognition of the finder versus broker-dealer distinction and of the need to exempt some finders from broker-dealer registration could pave the way for a more rational federal regime. That new federal regime should look to that of California. California's finder regulation has been operating successfully for half a decade, and the fact that Texas and Michigan finder statutes share such similar provisions to California's demonstrates that a California-based model could have successful nationwide application. Many commentators acknowledge that it is far less onerous and expensive compared to broker-dealer registration with the SEC.[205] The specificity of California's

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203. *See* U.S. SEC. & EXCH. COMM'N, BROKER-DEALERS (Mar. 10, 2016), https://www.sec.gov/divisions/marketreg/mrbdealers.shtml.

204. Daniel L. McAvoy et al., *Revenge of the Rat Pack; SEC Proposes Finders Exemption*, NAT'L L. REV. (Nov. 5, 2020), https://www.natlawreview.com/article/revenge-rat-pack-sec-proposes-finders-exemption.

205. Rick Randel, *Finders Keepers,* RANDEL L. BLOG (May 17, 2016), https://www.randellaw.com/finders-keepers; *see also* Chris Myers, *Reasons to Be Wary*

finder criteria is a major selling point; its clear guidelines free operators from the cost of residual uncertainty—the "worry cost" —that finders face within the federal regime.

While California's provisions are not perfect, they provide a working model which should serve as a template for the SEC. California balances the dual policy objectives of providing investor protection through oversight and facilitating capital investment in the small businesses and start-ups that help to make California the economic dynamo it is today: the number one state for venture capital investment in the nation.[206] Under a rationalized regime, free from broker-dealer restrictions, finders and the small businesses they support can thrive.

In short, finders, keepers.

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of California's Finder Exemption, HOLLAND & HART (Apr. 1, 2016), https://www.hollandhart.com/reasons-to-be-wary-of-californias-finder-exemption.

206. Andrew DePietro, *The Best and Worst States For Entrepreneurs In 2020*, FORBES (Nov. 13, 2019), https://www.forbes.com/sites/andrewdepietro/2019/11/13/best-worst-states-entrepreneurs-2020.

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UNRESOLVED LABOR DISPUTES UNDER THE USMCA'S RAPID RESPONSE MECHANISM: PROBING THE APPLICABILITY OF THE ATS IN LIGHT OF *NESTLÉ V. DOE*

WALTER BONNÉ*

In 2018, former President Donald Trump signed the United States-Mexico-Canada Agreement (USMCA), also known as NAFTA 2.0, fulfilling a campaign promise to renegotiate "the worst trade deal ever made." NAFTA 2.0 contains major changes that are consequential to trade relations in North America. Most notably, in a concession to congressional Democrats, the agreement contains improved labor standards and an updated labor dispute settlement mechanism—the Rapid Response Mechanism (RRM)—which was designed to cure the antiquated, ineffective labor dispute settlement body created by the original NAFTA agreement. In light of two highly publicized labor dispute settlements involving U.S. owned auto-parts manufacturers in Mexico, known as 'Maquiladoras,' the RRM appears to be a success. But while these two settlements certainly illustrate a historic victory for labor rights, the RRM, as it currently stands, contains loopholes that leave labor abuse and human rights victims without adequate remedy. This Note, while highlighting the strengths of the RRM, argues that it nonetheless contains gaps that leave employees in both Mexico and the U.S. without adequate remedy when their labor rights are violated. This Note probes the viability of remedying such violations through the Alien Tort Statute given recent Supreme Court precedent that narrows the statute's applicability via the presumption against extraterritoriality doctrine. While recent Supreme Court precedent in Nestlé v. Doe limits the statute's viability in certain contexts, this Note contends that vindicating labor violations through litigation

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in U.S. courts is the best way to ensure that the USMCA's goals are fulfilled and to ensure that the benefits of globalization are achieved for everyone.

INTRODUCTION

Globalization, the "interdependence of the world's economies, cultures, and populations, brought about by cross-border trade," has changed the world considerably over the last thirty years.[1] One key phenomenon of globalization is the export of

1. Melina Kolb, *What is Globalization? And How Has the Global Economy Shaped the United States?*, PETERSON INST. INT'L ECON. (Aug. 24, 2021), https://www.piie.com/microsites/globalization/what-is-globalization.

cheap labor from developed, high-income states to developing, low-income states.[2] Proponents argue that the reallocation of workforces by multi-national corporations provides income to impoverished communities that otherwise lack employment opportunities, while critics argue that this reallocation merely provides a windfall to multi-national corporations by allowing them to evade human rights standards through low wages and dangerous working conditions.[3]

Nowhere is this dichotomy more present than at the United States-Mexico border, where both nations, for the better part of the twentieth century, have enacted various policies encouraging the movement of labor across state lines.[4] Most notably, the United States provides temporary visas to Mexican workers in order to attract low-cost seasonal and daily labor,[5] while Mexico operates the "Maquiladora Program," which incentivizes foreign corporations to set up wholly owned subsidiary factories in Mexico—"Maquiladoras"—that can take advantage of lower labor standards while also receiving preferential tariff treatment.[6] Maquiladoras, which attract foreign investment and local employment opportunities, proliferated after the enactment of the North American Free Trade Agreement (NAFTA),[7] which created the largest free-trade area in the

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2. Paul Krugman, *In Praise of Cheap Labor*, SLATE (Mar. 21, 1997), https://slate.com/business/1997/03/in-praise-of-cheap-labor.html.

3. *Id.*

4. *The History of the Maquiladora Program in Mexico*, TETAKAWI (Feb. 10, 2020), https://insights.tetakawi.com/the-history-of-the-maquiladora (discussing the shift from the 'Bracero Program' to the 'Maquiladora Program').

5. Claire Klobucista & Diana Roy, *U.S. Temporary Foreign Worker Visa Programs*, COUNCIL ON FOREIGN RELS. (last updated Apr. 25, 2022, 3:25 PM), https://www.cfr.org/backgrounder/us-temporary-foreign-worker-visa-programs. *See also* Michael A. Clemens & Lant Pritchett, *Temporary Work Visas: A Four-Way Win for the Middle Class, Low-Skill Workers, Border Security, and Migrants*, CTR. FOR GLOB. DEV. (Apr. 2013), https://www.cgdev.org/sites/default/files/archive/doc/full_text/CGDBriefs/3120183/time-bound-labor-access.html (discussing the benefits of temporary work visas). *See also* Tula Connell, *Unknown Men Kidnap, Beat, and Threaten to Kill Mexican Worker Rights Activist*, SOLIDARITY CTR. (May 18, 2012), https://www.solidaritycenter.org/unknown-men-kidnap-beat-and-threaten-to-kill-mexican-worker-rights-activist/ (discussing the kidnapping and torture of a Mexican worker rights activists, whose "kidnapping is only the latest in a series of systematic attacks.").

6. The History of the Maquiladora Program in Mexico, *supra* note 4.

7. North American Free Trade Agreement, Dec. 17, 1992, 32 I.L.M. 289.

world.[8] But despite these perceived economic benefits, wages in Mexico decreased after the ensuing explosion of Maquiladoras,[9] which are consistently accused of violating human rights and labor standards based on poor working conditions, below average wages, and labor violence.[10] Moreover, the conditions for Mexican employees working on U.S. soil under temporary visa programs also allegedly violate generally accepted standards of labor and human rights.[11] Inadequate labor conditions of this nature subsequently degrade labor standards for workers throughout the U.S.[12] Furthermore, the negotiating interests of NAFTA's parties—for Mexico, prioritizing its comparative advantage of cheap labor, and for the United States, prioritizing its national sovereignty to regulate its own labor standards—contributed to the ineffectiveness of NAFTA's dispute settlement mechanism, which left victims of labor violations without proper legal remedies.[13]

Issues of this nature have been central to U.S. politics for both labor activists lobbying for improved labor standards and

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8. The History of the Maquiladora Program in Mexico, *supra* note 4.

9. *Fracaso: NAFTA's Disproportionate Damage to U.S. Latino and Mexican Working People*, PUB. CITIZEN'S GLOB. TRADE WATCH & THE LAB. COUNCIL FOR LAT. AM. ADVANCEMENT (Dec. 2018), https://www.citizen.org/wp-content/uploads/Public-Citizen-LCLAA_Latinos-and-NAFTA-Report.pdf.

10. *See* Mia Alemán, *Maquiladoras, Human Rights, and the Impact of Globalization on the US-Mexico Border*, FOREIGN AFFAIRS REVIEW (June 16, 2022), https://jhufar.com/2022/06/16/maquiladoras-human-rights-and-the-impact-of-globalization-on-the-us-mexico-border/ ("To keep production costs low, Maquila workers suffer the consequences as middleman minorities, operating under harsh work environments with low wages, forced overtime, and illegal working conditions for minors.").

11. *See, e.g.*, Raymond G. Lahoud, *Some Immigrants Uncomfortable Reporting Labor Violations*, NAT'L L. REV. (Apr. 1, 2022), https://www.natlawreview.com/article/some-immigrants-uncomfortable-reporting-labor-violations (describing the reluctance immigrants often exhibit during federal investigations of labor violations); Joe Yerardi, *Cheated at Work*, CTR. FOR PUB. INTEGRITY (Mar. 11, 2022), https://publicintegrity.org/topics/inequality-poverty-opportunity/workers-rights/cheated-at-work/ (discussing the widespread wage theft practice by U.S. employers).

12. Daniel Costa, *Temporary Work Visa Programs and the Need for Reform*, ECON. POL'Y INST. (Feb. 3, 2021), https://www.epi.org/publication/temporary-work-visa-reform/ ("That in turn degrades labor standards for workers in a wide range of industries. Reforming work visa programs, therefore, would help to improve working conditions and raise wages for all workers.").

13. Rainer Dombois, *The North American Agreement on Labor Cooperation: Designed to Fail?*, 6.1 PERSPECTIVES ON WORK 19, 20 (2002).

protectionist domestic interests lobbying against the loss of American jobs. Central to this debate was former President Trump, who vowed during his campaign to rewrite NAFTA, which he deemed "one of the worst trade deals" in history.[14] In 2020, the former president signed the United States-Mexico-Canada Agreement (USMCA), and at the insistence of congressional democrats, included in the agreement heightened labor standards and an innovative labor dispute settlement mechanism[15] known as the Rapid Response Mechanism (RRM).[16] The RRM provides "for expedited enforcement of workers' free association and collective bargaining rights at the facility level."[17]

Indeed, the RRM appears to be a significant improvement to the antiquated labor dispute settlement mechanism under NAFTA. The RRM has already achieved two highly publicized, successful remediations of labor disputes involving U.S.-owned Maquiladoras in Mexico.[18] Despite these successes, this Note contends that the RRM still has loopholes that leave victims of labor abuse without an adequate remedy.[19] But recognizing the unlikelihood of a reformed USMCA given the transactional costs associated with inter-state negotiation,[20] this Note explores avenues of relief via the U.S. courts, particularly through the Alien Tort Statute (ATS).[21] This Note probes

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14. Ana Swanson & Jim Tankersley, *Trump Just Signed the U.S.M.C.A. Here's What's in the New NAFTA*, N.Y. TIMES (Jan. 29, 2020), https://www.nytimes.com/2020/01/29/business/economy/usmca-deal.html.

15. *Id.* ("In response to the concerns of congressional Democrats, it sets up an independent panel that can investigate factories accused of violating labor rights and stop shipments of that factory's goods at the border.").

16. OFF. OF THE U.S. TRADE REP., CHAPTER 31 ANNEX A; FACILITY-SPECIFIC RAPID-RESPONSE LABOR MECHANISM, https://ustr.gov/issue-areas/enforcement/dispute-settlement-proceedings/fta-dispute-settlement/usmca/chapter-31-annex-facility-specific-rapid-response-labor-mechanism.gov (last visited Feb. 10, 2022).

17. *Id.*

18. U.S. DEP'T OF LAB.: BUREAU OF INT'L LAB. AFFS., USMCA CASES, https://www.dol.gov/agencies/ilab/our-work/trade/labor-rights-usmca-cases (last visited Apr. 9, 2022).

19. *See infra* Section III.B.

20. *See* Charlotte De Bruyne & Itay Fischendler, *Negotiating Conflict Resolution Mechanisms for Transboundary Water Treaties: A Transaction Cost Approach*, 23 GLOB. ENV'T CHANGE 1841 (2013) (discussing the transaction costs of negotiating conflict resolution mechanisms in transboundary water treaties).

21. 28 U.S.C. § 1350.

whether victims of labor violations on both sides of the border can utilize the ATS in light of the recent Nestlé, Inc. v. Doe decision that significantly limited the reach of the ATS under the Court's presumption against extraterritoriality doctrine.[22]

This Note is comprised of five parts. Part II provides a background on the history of labor policy in North America and the creation of Maquiladoras in Mexico. It also highlights the history of abuse in Maquiladoras and the inability of NAFTA to properly resolve labor disputes due to the ineffectiveness of its dispute settlement mechanism. Part III provides background on the recently enacted USMCA, its enhanced labor provisions, and the highly anticipated RRM, along with an overview of recent victories for labor rights at the Maquiladoras. Part III then argues that the RRM, while a significant improvement, still contains notable loopholes with respect to the remediation of individual rights south of the border and the resolution of labor disputes north of the border. Part IV provides a background on the ATS and its history enforcing human rights violations abroad, as well as the Supreme Court's recent limitation of its use under the Court's presumption against extraterritoriality doctrine. Part IV then probes whether the ATS can effectively fill the gap left over by the RRM's loopholes, considering the presumption against extraterritoriality and the Court's recent holding in *Nestlé*.

This Note concludes that the ATS is likely an effective mechanism for the enforcement of labor violations north of the border but may face an uphill battle for labor victims south of the border. However, while the holding in *Nestlé* certainly appears to restrict the ability of Mexican employees to bring suit in U.S. courts under the ATS, plaintiffs in Maquiladoras may still be able to argue—based on factual distinctions, theories of agency law, primary versus secondary liability, the direction of international law, and domestic law among developed states—that U.S. corporate complicity and its domestic conduct are sufficient to meet the ambiguous threshold set forth in *Nestlé*.

22. Nestlé USA, Inc. v. Doe, 141 S. Ct. 1931 (2021).

I.
Background on Maquiladoras and Labor Dispute Settlement

A. *A History of Maquiladoras Before NAFTA*

To contextualize the innovation behind the RRM, it is important to review the history of North American labor rights and how those rights were shaped by trade relations between the United States and Mexico. The "Bracero Program," which began in 1942 through a series of domestic statutes and diplomatic agreements between the two states, allowed millions of Mexican agricultural workers to gain seasonal employment on farms in the U.S. while simultaneously resolving U.S. labor shortages stemming from World War II.[23] Due to the desperate economic situation in Mexico, Mexican laborers were willing to endure arduous, low-paying work that U.S. residents were unwilling to perform.[24] However, due to the growth of mechanization, evidence that the Bracero Program fueled illegal immigration and worker abuse, and lobbying by protectionist labor organizations in the United States, the United States terminated the Bracero Program 1964.[25]

To address the resulting high rates of unemployment, encourage foreign investment, and grow its domestic markets, the Mexican Government developed the Maquiladora Program.[26] Maquiladoras are low-cost factories or manufacturing plants, commonly located in Mexico close to the U.S. border, that are owned by foreign corporations—typically U.S. corporations—and benefit from preferential tariff programs that permit them to cheaply import raw goods from the United States, manufacture those raw goods into final products at a reduced labor cost, and then cheaply export those products back across the border to the United States[27] Through the Ma-

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23. *1942: Bracero Program*, Libr. of Cong., https://guides.loc.gov/latinx-civil-rights/bracero-program (last visited Mar. 27, 2022).

24. *About*, Bracero Hist. Archive, https://braceroarchive.org (last visited Mar. 27, 2022).

25. *1942: Bracero Program*, *supra* note 23; Philip Martin, *Mexican Braceros and US Farm Workers*, Wilson Ctr. (July 10, 2020), https://www.wilsoncenter.org/article/mexican-braceros-and-us-farm-workers.

26. *The History of the Maquiladora Program in Mexico*, *supra* note 4.

27. Will Kenton, *Maquiladora*, Investopedia (June 22, 2021), https://www.investopedia.com/terms/m/maquiladora.asp#toc-history-of-maquiladoras.

quiladora program, "all raw materials imported into the country for manufacturing purposes became duty-free with one stipulation: the final product had to be exported back to the country of origin or to a third party."[28]

The number of Maquiladoras along the United States-Mexico border remained relatively limited until 1994, when the United States, Canada, and Mexico entered into NAFTA, which created the world's largest free trade area along the United States-Mexico border, linking 400 million people that produced over $11 trillion in goods and services.[29] Under NAFTA, Mexico's reputation and visibility as a manufacturing partner for multi-national companies skyrocketed, and the quantity of Maquiladoras proliferated as a result of the waived Mexican import duties and preferential rates on duties.[30] While the precise quantifiable benefits of NAFTA and Maquiladoras have been debated, employment grew by 110% in the communities along the border in the six years after NAFTA, compared with 78% in the previous six years,[31] and two-way trade between the U.S. and Mexico increased by 465 percent from 1993 to 2015.[32]

One of the primary benefits of Maquiladoras for U.S. and multi-national corporations is access to cheap labor in Mexico. However, with cheap labor comes an assortment of problems. Critics of Maquiladoras argue that they exploit local populations by providing extremely low wages, often below the poverty line,[33] and expose workers to numerous health risks due

28. *The History of the Maquiladora Program in Mexico*, *supra* note 4.

29. *Id.*

30. *Id.*

31. JOSEPH E. STIGLITZ, MAKING GLOBALIZATION WORK 65 (W. W. Norton & Co. ed., 2006).

32. Trade volumes between the U.S. and Mexico, in millions, was $85,224 in 1993, and $481,543 in 2015. This is a 465% nominal increase, and a 255% real increase. *See* David Floyd, *NAFTA's Winners and Losers*, INVESTOPEDIA (Jan. 11, 2022), https://www.investopedia.com/articles/economics/08/north-american-free-trade-agreement.asp#:~:text=trade%20Volumes&text=that%20combined%20%241.0%20trillion%20in,adjusted%E2%80%94increase%20was%20125.2%25.

33. In 1998, Maquiladora workers made on average 70 pesos a day, or $8.50. *Mexico: Wages, Maquiladoras, NAFTA*, MIGRATION DIALOGUE (Feb. 1998), https://migration.ucdavis.edu/mn/more.php?id=1451_0_2_0. In 2019, that number increased to 176.20 pesos a day, or $9.28. Mark Stevenson, *Mexican President AMLO Unleashes Labor Unrest at Border Maquiladora Factories*, EL PASO TIMES (Feb. 3, 2019), https://www.elpasotimes.com/story/

to unsafe working conditions and inadequate housing.[34] Based on studies conducted in the 1990s, nearly 70% of Maquiladora workers were migrants from central Mexico, and nearly two thirds of Maquiladora employees are women,[35] many of whom suffered human rights abuses related to women's health and mandatory pregnancy testing.[36] Gender violence was also pervasive. For example, in the 1990s, media outlets widely reported the notorious "Maquiladora Murders," where over three-hundred Mexican women and girls were murdered in one border city alone.[37]

Labor rights were practically non-existent because labor unions, while existing on paper, had been designed to benefit employers without the participation or knowledge of the workers themselves. These unions were aptly named "Paper Unions."[38] Some of them had the ability to sell control over members and their collective contracts to employers without employee knowledge. Others only received payment from employers while their constituent employees lacked agency over any employment decisions.[39] Labor activists were reportedly subjected to gross human rights violations intended to intimidate them from organizing.[40] Such allegations included la-

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news/2019/02/03/mexico-border-factories-maquiladora-strike-follows-minimum-wage-increase/2762912002/.

34. *See* Stephanie Navarro, *Inside Mexico's Maquiladoras: Manufacturing Health Disparities*, STANFORD, https://med.stanford.edu/content/dam/sm/schoolheltheval/documents/StephanieNavarro_HumBio122MFinal.pdf (last visited Feb. 4, 2022) (discussing "[d]aily health threats that Maquiladora workers face including handling toxic chemicals, using unsafe equipment and poorly designed workstations, working in extreme heat or cold and in conditions of poor ventilation and lighting, working in spaces with harmful noise levels, and performing work according to dangerously high production quotas.").

35. *Id.*

36. *See* Mexico's Maquiladoras: Abuses Against Women Workers, HUMAN RIGHTS WATCH (Aug. 17, 1996, 12:00 AM), https://www.hrw.org/news/1996/08/17/mexicos-maquiladoras-abuses-against-women-workers#.

37. Elvia R. Arriola, *Accountability for Murder in the Maquiladoras: Linking Corporate Indifference to Gender Violence at the U.S. Mexico Border*, 5 SEATTLE J. SOC. JUST. 603, 603 (2007).

38. Cirila Quintero Ramírez, Fi*ghting for Independent Unions in the Maquilas*, NACLA (Apr. 24, 2014), https://nacla.org/news/2014/4/24/fighting-independent-unions-maquilas.

39. *Id.*

40. *See* Dan La Botz, *Farm Labor Organizer is Murdered in Mexico*, LABOR NOTES (Apr. 29, 2007), https://labornotes.org/2007/04/farm-labor-orga-

bor violence like kidnapping and torture.[41] Employer-affiliated protection unions retained at the behest of the Maquiladoras frequently agreed to low wages and miserable working conditions without consulting the workers they allegedly represented.[42]

B. *Labor Disputes Under NAFTA*

In response to accusations of labor abuse, NAFTA's negotiating parties "considered labor issues of such paramount importance" that they executed a side agreement known as the North American Agreement on Labor Cooperation (NAALC).[43] The NAALC included objectives such as the recognition of eleven basic labor principles covering working conditions, labor standards, and other labor rights including freedom of association, right to organize, and right to collective bargaining.[44] The NAALC required parties to "promote compliance with and effectively enforce its labor laws through appropriate government action," as well as access to "fair, equita-

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nizer-murdered-mexico ("While the murder of labor activists was common in Mexico in the late 1960s and 1970s, few have been murdered in recent years.").

41. *See* Connell, *supra* note 5 (discussing the kidnapping and torture of a Mexican worker rights activists, whose "kidnapping is only the latest in a series of systematic attacks."); *see also Protest Torture Attack on Labor Activists' Family in Mexico*, INTERNATIONALIST (May 2018), http://www.internationalist.org/protesttortureattackonmexicolaboractivists1805.html.

42. Tom Conway, *An Accomplice to Murder*, UNITED STEEL WORKERS (Oct. 21, 2019), https://www.usw.org/blog/2019/an-accomplice-to-murder ("These fake unions agree to low wage rates and miserable working conditions without bothering to consult the workers they're supposed to represent.").

43. Magdeline R. Esquivel & Leoncio Lara, *The Maquildaora Experience: Employment Law Issues in Mexico*, 5 L. & BUS. REV. AMS. 589, 590 (1999), https://scholar.smu.edu/cgi/viewcontent.cgi?referer=https://www.google.com/&httpsredir=1&article=1772&context=lbra.

44. North American Agreement on Labor Cooperation, Dec. 17, 1992, 10 Stat. 2057, 32 I.L.M. 1499, arts. 2, 3, 4, 5, 6, 7 & annex 1 (entered into force Jan. 1, 1994) [hereinafter NAALC] (The eleven labor principles in NAALC are the (1) freedom of association and protection of the right to organize, (2) the right to bargain collectively, (3) the right to strike, (4) prohibition on forced labor, (5) child labor protections, (6) minimum labor standards with regard to wages, hours and conditions, (7) non-discrimination in employment, (8) equal pay for equal work, (9) health and safety protection, (10) workers compensation, (11) protection of the rights of migrant workers).

ble, and transparent" enforcement proceedings including "administrative, quasi-judicial, judicial, or labor tribunals" for labor disputes.[45]

Despite this optimistic language, the labor provisions in NAFTA and the NAALC were unenforceable and ineffective.[46] This was largely because they asked each party to enforce its own domestic labor law[47] while providing inadequate dispute settlement procedures for complaining parties.[48] The inadequacy of dispute settlement procedures can be attributed to the domestic interests of the three negotiating parties, who did not want to expose "their labor institutions to external pressure and sanctions" or have their "national sovereignty re-

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45. *Id.*

46. Jamieson L. Greer et al., *Companies Face Risk From the USMCA's New Rapid Response Mechanism to Enforce Labor Rights*, KING & SPALDING (July 15, 2020), https://www.kslaw.com/news-and-insights/companies-face-risk-from-the-usmcas-new-rapid-response-mechanism-to-enforce-labor-rights ("Historically, NAFTA included unenforceable provisions on labor protections that were limited and largely ineffective.").

> Much of the criticism of the NAALC has focused on its lack of supranational standards, the negotiated rather than adjudicated nature of the application and enforcement process, the absence of trade sanctions penalties against a Party country found to have engaged in many types of systemic violations of the Agreement, and the preclusion of any penalties directed at employers whose blatant violations of workers' rights establish the party country's systematic breach of its obligations.

Marley S. Weiss, *Two Steps Forward, One Step Back-Or Vice Versa: Labor Rights Under Free Trade Agreements from NAFTA, Through Jordan, via Chile, to Latin America, and Beyon*d, 37 U.S.F.L. REV. 689, 698 (2002).

47. Franz Christian Ebert & Pedro A. Villarreal, *The Renegotiated "NAFTA": What is in it for Labor Rights?*, EJIL BLOG (Oct. 11, 2018), https://www.ejiltalk.org/the-renegotiated-nafta-what-is-in-it-for-labor-rights/ ("At its core, it required parties to enforce their own domestic labor law, set up a Commission for Labor Cooperation, and established a complaint mechanism for third parties. It also allowed, in certain cases, for state-to-state arbitral dispute settlement with possibilities to impose limited fines as a last resort measure."); Lance Compa, *NAFTA's Labor Side Accord: A Three-Year Accounting*, 3 L. & BUS. REV. AM. 6, 7 (1997) ("Instead, the NAALC stresses sovereignty in each country's internal labor affairs, recognizing 'the right of each Party to establish its own domestic labor standards.").

48. Kimberly A. Nolan García, *Labor Rights Enforcement Under the NAFTA Labor Clause: What Comes Next Under a Potential Renegotiation?*, WILSON CTR. (May 3, 2017), https://www.wilsoncenter.org/article/labor-rights-enforcement-under-the-nafta-labor-clause-what-comes-next-under-potential.

stricted on labor matters"[49] but also wanted to preserve Mexico's comparative advantage as the region's source of unskilled, low-cost labor.[50]

As a result, a complaining party had to go through multiple levels of dispute settlement before being able to possibly invoke fines or trade sanctions.[51] Under NAALC, each country was required to set up a National Administrative Office (NAO) within its Ministry of Labor, which could review labor complaints arising in other countries upon its own initiative or in response to a complaint lodged by a nongovernmental organization.[52] After a complaint was filed, a labor minister could then request consultation with the minister of the other country to engage in high-level discussions regarding the alleged labor violation.[53] Following the ministerial consultation, a country could then invoke a review by a panel of experts at the NAALC, who could then make a recommendation for dispute resolution by an arbitral panel, which could investigate and develop an action plan to respond to an "alleged persistent pattern of failure . . . to effectively enforce occupational safety and health, child labor or minimum wage standards."[54] The formal dispute settlement mechanism excluded participation by aggrieved workers and only provided for state-to-state par-

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49. Dombois, *supra* note 13, at 20.

50. Danielle Trachtenberg, *Local Labor-Market Effects of NAFTA in Mexico: Evidence from Mexican Commuting Zones* (Inter-Am, Dev. Bank, Working Paper No. 1078, 2019), https://publications.iadb.org/publications/english/document/Local_Labor-Market_Effects_of_NAFTA_in_Mexico_Evidence_from_Mexican_Commuting_Zones_en.pdf. Trachtenberg went on to comment:

> Relative to the United States and Canada, Mexico specialized in unskilled-labor-intensive manufacturing industries . The implementation of NAFTA increased the ability of all three countries to engage in regional product-sharing, with Mexico serving as the region's source of unskilled-labor-intensive intermediate inputs and a center for processing and assembly of final goods to be exported to the north.

Id.

51. Esquivel & Lara, *supra* note 43, at 592–93.

52. Esquivel & Lara, *supra* note 43, at 592; Dombois, *supra* note 13, at 20 ("The NAALC assigns an important function to nongovernmental organizations and their transnational networks: these organizations identify labor problems and lodge complaints, thereby contributing to the legacy of the NAALC.").

53. Esquivel & Lara, *supra* note 43, at 592.

54. *Id.* at 593.

ticipation in the arbitration.[55] Furthermore, only three subjects were arbitrable: child labor, minimum wage and hour laws, and occupational safety and health. At the final enforcement stage, the arbitral panel had the power to fine a country up to $20 million or reimpose pre-NAFTA tariffs up to the fine amount if the violating country failed to pay.[56] However, through the course of NAFTA, no complaint ever made it to the arbitration stage.[57] During the first seven years of NAFTA, twenty-three labor complaints were filed, and none resulted in sanctions or enforcement action.[58] Violation of freedom of association, one of the most important labor rights, was only subject to ministerial consultations, without any possibility of arbitration or penalties.[59] Furthermore, under NAFTA's dispute settlement procedures, there were multiple avenues for a party to "block the establishment of a panel, thereby preventing resolution of the dispute."[60]

Critics have described the NAALC labor resolutions as "promises to talk about labor violations and not punish them with trade sanctions."[61] The labor dispute settlement provisions in NAFTA resulted in zero arbitrations or trade sanctions across the life of NAFTA,[62] despite continued deterioration of labor conditions in Maquiladoras. As a result of the NAALC's lack of teeth, labor rights in Mexico remained stagnant. For

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55. David A. Gantz et al., *Labor Rights and Environmental Protections Under NAFTA and Other U.S. Free Trade Agreements*, 42.2 U. MIA. INTER-AM. L. REV. 297, 319–20 (2011).

56. *Id.* at 319.

57. Nolan García, *supra* note 48; Gantz et al., *supra* note 55, at 319–20.

58. *NAFTA Labor Accord Ineffective*, HUMAN RIGHTS WATCH (Apr. 15, 2001), https://www.hrw.org/news/2001/04/15/nafta-labor-accord-ineffective.

59. Nolan García, *supra* note 48.

60. Nina M. Hart, *USMCA: A Legal Interpretation of the Panel-Formation Provisions and the Question of Panel Blocking*, CONGRESSIONAL RESEARCH SERVICE (Jan. 30, 2020), https://sgp.fas.org/crs/row/IF11418.pdf.

61. Nolan García, *supra* note 48.

62. *Id.* García went on to say:

> These changes would strengthen labor rights enforcement by making violations subject to trade sanctions, which is not currently the case under NAFTA . . . the long road to trade sanctions for most cases, and the inability to get to them at all for freedom of association cases, is the main reason why the protection of labor rights in North America overall has been slow and limited to certain rights.

Id.

example, during the course of NAFTA, corporations like Sony often fired employees who raised labor concerns and frequently employed riot police to physically assault and intimidate employees who protested, while enjoying continued political protection from Mexican authorities.[63] In 2016, Maquiladora workers at plants owned by multiple U.S. corporations protested $30 per week wages, unsafe working conditions, sexual harassment, and discrimination.[64] In response, those U.S. corporations initiated a spree of mass firings, specifically targeting those workers engaged in union activity.[65]

By 2012, ninety percent of Mexican collective bargaining agreements were still classified as "protection contracts," which are created through the "practice of official unions or corrupt lawyers negotiating a union contract without the knowledge of workers."[66] Government complicity was frequent, with Mexican labor boards arbitrarily rejecting union registration, providing employers with the names of union applicants who employers could then target for firing, and then failing to respond to legal claims of unjust dismissal.[67] Complaints filed under NAALC cited labor violations including "favoritism toward employer controlled unions; firing for workers' organizing efforts; denial of collective bargaining rights; forced pregnancy testing; mistreatment of migrant workers; life-threatening health and safety conditions; and other violations of the eleven 'labor principles.'"[68] Despite the many complains, NAFTA's structural and institutional inefficiencies did not lead to any successful remediations.

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63. David Bacon, Health, Safety, and Workers' Rights in the Maquiladoras, 22 J. Pub. Health Pol'y 338, 339 (2001).

64. Cathy Feingold, *Worker Protests in Ciudad Juárez Shine a Light on Ongoing Workers Rights Violations in Mexico*, AFL-CIO (Jan. 11, 2016), https://aflcio.org/2016/1/11/worker-protests-ciudad-juarez-shine-light-ongoing-workers-rights-violations-mexico.

65. *Id.*

66. *Protecting Workers' Rights to Freedom of Association & Collective Bargaining in Mexico*, FAIR LAB. ASSOC. (Feb. 14, 2012), https://www.fairlabor.org/protecting-workers-rights-to-freedom-of-association-collective-bargaining-in-mexico/.

67. *Id.*

68. *NAFTA Labor Accord Ineffective*, *supra* note 58.

II.
USMCA's Novel Rapid Response Mechanism

From the outset, USMCA negotiators sought to modernize NAFTA's antiquated labor mechanisms. At the insistence of U.S. congressional democrats, labor provisions from the NAALC that had resided in a side letter of NAFTA were moved to the main body of the agreement, pushing issues like the right to organize under the USMCA's normal dispute settlement procedures.[69] Most notably, the USMCA set up an "innovative Facility-Specific Rapid Response Labor Mechanism between the United States and Mexico," designed to be better equipped to investigate Maquiladoras accused of violating labor rights and enforce compliance through the use of penalties.[70] The RRM was added into the USMCA to improve wages and foster stronger unions in Mexico in order to improve labor rights and reduce incentives for companies to offshore U.S. jobs.[71]

The RRM can be initiated under the USMCA if a party believes in good faith that "workers at covered facilities are being denied the right of free association and collective bargaining."[72] Specifically, it provides for "expedited enforcement of workers' free association and collective bargaining rights at the facility level," and therefore has numerous benefits compared to the old labor dispute settlement process under NAFTA.[73]

One innovative feature of the RRM is that it is not solely state-to-state. Instead, any member of the public can submit a

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69. Swanson & Tankersley, *supra* note 14.

70. Off. of the U.S. Trade Representative, *supra* note 16. There is also a Facility Specific Rapid Response Labor Mechanism between Canada and Mexico. *See* United States–Mexico–Canada Agreement, annex 31-B, art. 31-B.10, Oct. 1, 2018, 134 Stat. 11 (entered into force July 1, 2020) [hereinafter USMCA].

71. David Shepardson & David Lawder, *U.S. Reaches Deal with Mexican Auto Parts Factory in USMCA Labor Complaint*, Reuters (Aug. 10, 2021), https://www.reuters.com/business/us-reaches-deal-with-mexican-auto-parts-subsidiary-tridonex-2021-08-10/ ("The new 'rapid-response' labor enforcement mechanism was negotiated into the United States-Mexico-Canada Agreement (USMCA) on trade to try to foster stronger unions and drive up wages in Mexico to reduce incentives for companies to move jobs south of the U.S. border.").

72. USMCA, *supra* note 70, annex 31-A, art. 31-A2.

73. Off. of the U.S. Trade Rep., *supra* note 16.

petition alleging a denial of right, which can result in enforcement directed toward the specific facility responsible for the violation, as opposed to the state party where the facility is located.[74] The RRM's "rapidness" is another key component of its novelty.[75] While the NAFTA mechanism often languished at various stages of the settlement process due to government inaction, the RRM provides for an expedited process in which the Interagency Labor Committee must review a claim within thirty days and decide whether there is "sufficient, credible evidence of a denial of rights."[76] If the Interagency Labor Committee finds a "denial of rights," it then requests the government of the covered facility[77] to conduct its own assessment, and if that government agrees, it then has forty-five days to make its determination.[78] In contrast to NAFTA, if that government refuses to conduct a review or conducts a review and finds no violation, the other party may request a panel to conduct a separate review under the USMCA, which can result in a ten-day consultation period between the parties for remediation, avoiding the inaction problem of NAFTA.[79] Unlike NAFTA, which often died at various stages of the settlement

74. Aaron R. Hutman, *The U.S.M.C.A.'s Rapid Response Mechanism for Labor Complaints: What to Expect Starting July 1, 2020*, GLOBAL TRADE & SANCTIONS LAW (July 1, 2020), https://www.globaltradeandsanctionslaw.com/the-usmca-rapid-response-mechanism-for-labor-complaints/.

75. M. Angeles Villarreal, *The United States-Mexico-Canada Agreement (USMCA)*, CONGRESSIONAL RESEARCH SERVICE 36 (Dec. 28, 2021) ("The implementation of the labor provisions, which include the novel rapid response mechanism meant to resolve labor disputes rapidly, is one of the primary areas of interest for some Members of Congress.").

76. Hutman, *supra* note 74.

77. USMCA, *supra* note 70, annex 31-A, art. 31-A.1. ("Covered Facility means a facility in the territory of a Party that (i) produces a good or supplies a service traded between the Parties; or (ii) produces a good or supplies a service that competes in the territory of a Party with a good or a service of the other Party, and is a facility in a Priority Sector . . . Priority Sector means a sector that produces manufactured goods, supplies services, or involves mining."); Art. 31-A.15, fn. 4. ("For greater certainty, manufactured goods include, but are not limited to, aerospace products and components, autos and auto parts, cosmetic products, industrial baked goods, steel and aluminum, glass, pottery, plastic, forgings, and cement.").

78. Hutman, *supra* note 74.

79. *Id.*

process due to parties blocking the formation of panels, the RRM specifically prevents panel blocking.[80]

Some of the largest advantages of the RRM include its arbitrable subject matter and enforcement capabilities. Unlike NAFTA, the RRM can call for a review of violations to the rights of free association, collective bargaining, and other labor rights that were provided for in NAALC but lacked an adequate forum for adjudication and enforcement under the old NAFTA mechanism.[81] If the labor panel determines that a denial of rights occurred at a covered facility, the other country "may impose remedies including (a) suspension of preferential treatment of goods manufactured at the covered facility; (b) imposition of 'penalties' on the covered facility; and (c) denial of entry for such goods, which can be invoked if a covered facility has received at least two prior denial of rights determinations."[82] In addition, these penalties can be directed toward the individual facility responsible for the labor violation, whereas in NAFTA, the penalties are imposed solely on the state.[83] Penalties are also permitted when a USMCA party fails to act in good faith with regard to the RRM.[84]

In these ways, RRM appears to correct many of the problems present in NAFTA's old labor dispute settlement procedures. It expands the arbitrable subject matter, allows for participation by aggrieved workers and individual facilities, requires expedited review and enforcement with finite time frames to avoid the obstruction and infinite delay by state parties, and provides realistic enforcement mechanisms to ensure compliance.

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80. *USMCA: Labor Provisions*, CONGRESSIONAL RESEARCH SERVICE (last updated Jan. 20, 2022), https://crsreports.congress.gov/product/pdf/IF/IF11308 ("Prevention of panel blocking in dispute settlement. Ensures the formation of a panel in dispute cases where a party refuses to participate in the selection of panelists.").

81. Hutman, *supra* note 74.

82. *Id.*

83. Nina M. Hart, *USMCA: Legal Enforcement of the Labor and Environmental Provisions*, CONGRESSIONAL RESEARCH SERVICE (May 14, 2021), https://crsreports.congress.gov/product/pdf/R/R46793.

84. *Id.*

A. *Successful Application of the RRM*

Since the enactment of the USMCA, the RRM has been put to work twice to initiate expedited enforcement action against specific factories in Mexico that reportedly denied workers the rights of freedom of association and collective bargaining under Mexican law.[85]

1. *GM Silao*

On May 12, 2021, one day after Democratic lawmakers sent a letter to the General Motors (GM) CEO regarding "disturbing reports of gross labor rights violations at a General Motors plant in Silao, Mexico,"[86] United States Trade Representative (USTR) Katherine Tai asked the Interagency Labor Committee of Mexico to review whether GM workers were "being denied the right of free association and collective bargaining."[87] The USTR's request was the first time any country used the novel RRM, and alleged "serious violations of . . . workers' rights in Silao . . . in connection with a recent worker vote, organized by the existing union, to approve their collective bargaining agreement."[88] Specifically, workers at the plant were asked to vote whether or not they recognized the union of which they were purportedly members.[89] The union that allegedly represented the workers engaged in a practice known as "protection contracts,"[90] where the union deducted fees from employee's salaries even though many of the employees were not aware that they were even part of the

85. U.S. DEP'T OF LAB.: BUREAU OF INT'L LAB. AFFS., *supra* note 18.

86. Letter from U.S. Reps. Dan Kildee, Bill Pascrell Jr., & Earl Blumenauer, H. Comm. on Ways & Means, to Mary Barra, Chief Exec. Officer, Gen. Motors Co. (May 11, 2021), https://dankildee.house.gov/sites/dankildee.house.gov/files/5-11-21%20-%20Oversight%20Letter%20to%20GM%20on%20Silao%20Labor%20Response.pdf.

87. Press Release, Off. of the U.S. Trade Rep., United States Seeks Mexico's Review of Alleged Worker's Rights Denial at Auto Manufacturing Facility (May 12, 2021), https://ustr.gov/about-us/policy-offices/press-office/press-releases/2021/may/united-states-seeks-mexicos-review-alleged-workers-rights-denial-auto-manufacturing-facility-0.

88. *Id.*

89. Mark Stevenson, *US Files First Trade Complaint with Mexico Under USMCA*, ABC NEWS (May 12, 2021, 7:25 PM), https://abcnews.go.com/International/wireStory/us-files-trade-complaint-mexico-usmca-77651571.

90. For a definition of "protection contracts," see *infra* note 149 and accompanying text.

union.[91] After the vote, allegations arose that the union destroyed the "no" votes.[92]

On July 8, 2021, the U.S. and Mexico announced, in the first ever successful use of the RRM, a comprehensive plan that would guarantee GM workers the ability to vote on their collective bargaining agreement and remediate the denial of their rights of free association and collective bargaining.[93] Specifically, the plan laid out steps to ensure an election free from interference for the over 6,000 workers at the facility.[94] Seven months later, the workers overwhelmingly voted in favor of a new, independent union that had recently been organized by workers of the plant.[95] Supporters credited the RRM with vindicating labor rights in Mexico while preventing the outsourcing and depression of American wages.[96]

2. *Tridonex*

On May 10, 2021, the American Federation of Labor and Congress of Industrial Organizations (AFL-CIO), the Service Employees International Union (SEIU), Public Citizen, and the Mexican union Sindicato Nacional Independiente de Trabajadores de Industrias y de Servicios Movimiento 20/32 (SNITIS) filed a complaint against the Mexican auto parts factory Tridonex, a subsidiary of U.S.-based Cardone Industries, accusing it of violating labor rights guaranteed under the USMCA.[97] The complaint alleged that through "mass firings,

91. Stevenson, *supra* note 89.

92. *Id.*

93. Press Release, U.S. Dep't of Lab., US, Mexico Announce Enforcement of Worker Protection Agreement (July 9, 2021), https://www.dol.gov/newsroom/releases/ilab/ilab20210709?_ga=2.35181154.2137891952.1634056431-862597107.1634056431.

94. *Id.*

95. Danielle Noel, *GM Silao Facility Workers Vote Overwhelmingly in Favor of the SINTTIA Union*, AFL-CIO (Feb. 4, 2022), https://aflcio.org/2022/2/4/gm-silao-facility-workers-vote-overwhelmingly-favor-sinttia-union.

96. Press Release, U.S. Sen. Sherrod Brown, Senators Brown, Wyden Release Joint Statement Following Vote for Independent Union by General Motors Workers in Silao, Mexico (Feb. 3, 2022), https://www.brown.senate.gov/newsroom/press/release/brown-wyden-release-statement-vote-independent-union-general-motors-workers-silao-mexico.

97. Press Release, Pub. Citizen, New Lawsuit Filed Against Mexican "Tridonex" Subsidiary of U.S. Autoparts Maker Targeted in First USMCA Labor Case Brought by Unions (July 23, 2021), https://www.citizen.org/news/new-lawsuit-filed-against-mexican-tridonex-subsidiary-of-u-s-autoparts-

refusal to recognize an independent union and imprisonment of [a] union lawyer",[98] the company and state officials had denied workers the right to organize with SNITIS. Specifically, the complaint alleged that the workers were not able to elect union leaders or ratify their collective bargaining agreement and that in retaliation for the attempted organizing, over 600 workers had been fired from Tridonex.[99]

On August 10, 2021, the USTR and Tridonex announced a settlement of these labor violations via the RRM.[100] The settlement agreement required Tridonex to provide severance and six months back pay to at least 154 dismissed workers, totaling over $600,000.[101] Among several other promises, the agreement required Tridonex to:

> Support the right of its workers to determine their union representation without coercion, including by protecting its workers from intimidation and harassment and welcoming election observers in the plant leading up to and during any vote; Provide training to all Tridonex workers on their rights to collective bargaining and freedom of association; Remain neutral in any election for union representation at its facility; Maintain and strengthen safety protocols to protect its workers from COVID-19 and financially support any employees who are unable to report to work due to COVID-19 exposures or infection; Revise its procedures and train its managers on fair workforce reduction procedures; [and] Maintain and staff an employee hotline phone number to receive

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maker-targeted-in-first-usmca-labor-case-brought-by-unions-public-citizen/; Press Release, Off. of the U.S. Trade Rep., United States Reaches Agreement with Mexican Auto Parts Company to Protect Workers' Rights (Aug. 10, 2021), https://ustr.gov/about-us/policy-offices/press-office/press-releases/2021/august/united-states-reaches-agreement-mexican-auto-parts-company-protect-workers-rights.

98. *Id.*

99. Thomas Kaplan, *Complaint Accuses Mexican Factories of Labor Abuses, Testing New Trade Pact*, N.Y. TIMES (May 10, 2021), https://www.nytimes.com/2021/05/10/business/economy/mexico-trade-deal-labor-complaint.html.

100. United States Reaches Agreement with Mexican Auto Parts Company to Protect Workers' Rights, *supra* note 97.

101. *Id.*

> and respond to complaints of violations of workers' rights in the facility.[102]

As part of the agreement, the Mexican government also agreed to "help facilitate workers' rights training for employees, monitor any union representation election at the facility, and investigate any claims by employees of workers' rights violations."[103] The agreement between the United States and Tridonex was applauded by multiple stakeholders and leaders as a successful application of the RRM.[104] Less than seven months after the agreement, in an election closely watched by the U.S. government, the employees of Tridonex overwhelmingly voted to appoint SNITIS to be its new, independent union.[105] The RRM was credited to have laid the groundwork for this overwhelming victory in labor rights.[106]

B. *The RRM's Limitations*

The RRM, compared to pre-USMCA labor standards and the original NAFTA labor dispute system, represents a historic win for labor rights along the U.S.–Mexico border. Workers in Maquiladoras finally have a mechanism capable of remediating labor grievances through rapid review and enforcement capabilities. But despite the improvement, there are still significant loopholes in the USMCA that can leave workers without a proper remedy.

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102. *Id.*

103. *Id.*

104. Press Release, U.S. Rep. Rosa DeLauro, Chair DeLauro Applauds Historic Victory for Workers at Tridonex Auto Parts Factory in Mexico (Mar. 1, 2022), https://delauro.house.gov/media-center/press-releases/chair-delauro-applauds-historic-victory-workers-tridonex-auto-parts; Press Release, Richard Neal, Chairman, H. Ways & Means Comm., Neal, Blumenauer Statement on Agreement Reached Under USMCA Rapid Response Mechanism with Mexican Auto Parts Facility (Aug. 11, 2021), https://waysandmeans.house.gov/media-center/press-releases/neal-blumenauer-statement-agreement-reached-under-usmca-rapid-response.

105. Daina Beth Solomon, *Independent Union Wins Workers' Vote at Mexico's Tridonex Plant*, REUTERS (Mar. 1, 2022, 1:06 AM), https://www.reuters.com/article/mexico-labor/update-1-independent-union-wins-workers-vote-at-mexicos-tridonex-plant-idINL1N2V40DO.

106. Press Release, U.S. Sen. Sherrod Brown, Brown, Wyden Release Statement Following Vote for Independent Union By Tridonex Workers in Mexico (Mar. 1, 2022), https://www.brown.senate.gov/newsroom/press/release/brown-wyden-statement-vote-independent-union-tridonex-workers-mexico.

1. *Remediation of Individual Harm*

The RRM was designed to remediate a specific facility's labor issues at a macro level, as opposed to remedying labor violations directed toward individual workers. This is evident in the language of the USMCA, which states that "[n]o Party shall fail to effectively enforce its labor laws through a *sustained or recurring course of action or inaction* in a manner affecting trade or investment between the Parties."[107] A footnote to the text of the USMCA further clarifies that "[f]or greater certainty, a 'sustained or recurring course of action or inaction' is 'sustained' if the course of action or inaction is consistent or ongoing, and is 'recurring' if the course of action or inaction occurs periodically or repeatedly and when the occurrences are related or the same in nature."[108] To further clarify the USMCA's avoidance of individual incidents, the footnote concludes that a "course of action or inaction does not include an isolated instance or case."[109]

The Labor Advisory Committee on Trade Negotiations and Trade Policy (LAC) points out that this leaves a significant loophole for "single egregious acts that fail to form a sustained or recurring course . . . even though such acts could be used to coerce thousands or tens of thousands of workers not to exercise their labor rights."[110] Critics point out that under the USMCA's language, murdering a trade union activist to intimidate thousands of employees against exercising their labor rights would lack RRM coverage because the single murder would constitute an "isolated instance" failing to satisfy the "sustained or recurring course of action" standard.[111] Even worse, gross human rights abuses such as a single mass murder of fifty employees may lack coverage under this language.[112] If

107. USMCA, *supra* note 70, art. 23.5(1) (emphasis added).

108. *Id.* art. 23.5 (1) n. 10.

109. *Id.*

110. LAB. ADVISORY COMM. ON TRADE NEGOTS. & TRADE POL'Y, REPORT ON THE IMPACTS OF THE RENEGOTIATED NORTH AMERICAN FREE TRADE AGREEMENT 21 (2018), https://aflcio.org/sites/default/files/2018-09/LAC%20Report%20NAFTA%20Final%20Final%20PDF.pdf.

111. Owen E. Herrnstadt, *Why NAFTA's 2.0 Current Labor Provisions Fall Short*, ECON. POL'Y INST. (Mar. 28, 2019, 8:30 AM), https://www.epi.org/blog/why-naftas-2-0-current-labor-provisions-fall-short/.

112. LAB. ADVISORY COMM. ON TRADE NEGOTS. & TRADE POL'Y, *supra* note 110.

fifty employees attempting to organize are murdered in a single incident, Mexico could refuse to allow RRM review by arguing that "no related or identical tragedy occurred," and therefore, the single mass murder was not "sustained," "recurring," "consistent," or "ongoing."[113]

This lack of remedy is not a hollow concern; there are numerous allegations of anti-union thugs murdering employees that attempt to organize. In a single incident in 2019, at least three labor leaders were murdered at Mexico's Media Luna Gold Mine.[114] In 2007, an organizer for the Farm Labor Organizing Committee (FLOC) was bound hand and foot and beaten to death, allegedly by labor contractors.[115] And in 2018, a labor activist was killed during a workers' strike at the Torex Gold Mine.[116]

Furthermore, in individual instances like this, employees are often unable to enforce their rights domestically. The Mexican government declined to investigate the Luna Gold Mine murder[117] despite a lawsuit and request for investigation.[118] In fact, "violence against labor organizers is seldom investigated, much less prosecuted," despite new domestic laws in Mexico establishing courts to adjudicate labor disputes.[119] As part of

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113. *Id.*

114. Press Assocs. Union News Serv., Murders of Latin American Labor Leaders Anger Unions and Lawmakers, People's World (Nov. 26, 2019, 2:39 PM), https://www.peoplesworld.org/article/murders-of-latin-american-labor-leaders-anger-unions-and-lawmakers/.

115. La Botz, *supra* note 40.

116. *Mexico: Labour Activist Quintín Salgado Killed Amidst Workers' Strike at Torex Gold Mine; Company Comments*, BUS. & HUM. RTS. RES. CTR. (Feb 5, 2018), https://www.business-humanrights.org/en/latest-news/mexico-labour-activist-quint%C3%ADn-salgado-killed-amidst-workers-strike-at-torex-gold-mine-company-comments/.

117. Conway, *supra* note 42 ("Police haven't bothered to look for Oscar, so his family, friends and fellow workers conducted their own search. Local thugs have warned them to call it off. . . . Oscar's family members, who are now in hiding, demanding that the government investigate his disappearance.").

118. Ben Davis, U*SW Calls on Mexican Government to Locate Disappeared Union Activist*, UNITED STEEL WORKERS (Oct. 1, 2019), https://www.usw.org/news/media-center/releases/2019/usw-calls-on-mexican-government-to-locate-disappeared-union-activist.

119. Conway, *supra* note 42 ("But violence against labor organizers is seldom investigated, much less prosecuted, and Mexico's highly publicized new labor law hasn't changed that. . . . [I]t establishes courts to adjudicate labor disputes.").

USMCA negotiations, Mexico was required to enact domestic legislation overhauling its labor laws. Part of this overhaul included the establishment of "independent labor courts . . . responsible for the adjudication of labor disputes."[120] However, the Independent Mexico Labor Expert Board (IMLEB), which was established to assess the progress of Mexican labor reforms, concluded that "efforts have been hampered by missed deadlines in the states, conservative forecasts resulting in inadequate resources, and a backloaded rollout of federal and local conciliation centers and labor courts."[121] The IMLEB determined that this botched rollout resulted in a "confusion among workers . . . prolonging the time Mexican workers are subjected to the old, failed labor justice system."[122] The failure of the new labor courts, in conjunction with an already failing criminal justice system that results in impunity for over 90% of crimes,[123] leads to the conclusion that the RRM will fail to remedy a significant portion of violent labor abuse.

2. *Labor Rights North of the Border*

The RRM was not just created to remediate labor violations in Mexico; it was also established to remediate labor violations occurring in the United States.[124] Since World War I, well before the first official Bracero Program, the U.S. government continuously operated various forms of temporary worker programs that permitted agricultural laborers from

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120. INFOGRAPHIC: MEXICO'S NEW LABOR REFORM, WILSON CENTER (Apr. 18, 2019), https://www.wilsoncenter.org/article/infographic-mexicos-new-labor-reform.

121. INDEP. MEX. LAB. EXPERT BD., REPORT TO THE INTERAGENCY LABOR COMMITTEE PURSUANT TO SECTION 734 OF THE USMCA IMPLEMENTATION ACT 26 (July, 7, 2021), https://www.maquilasolidarity.org/sites/default/files/attachment/IMLEB%20Report%20and%20Separate%20Stmt%20of%20Members%20Fortson%20et%20al.%202021.07.7.pdf.

122. *Id.* at 27.

123. María Novoa, T*he Wheels of Justice in Mexico Are Failing. What Can Be Done?*, AMERICAS QUARTERLY (July 9, 2020), https://www.americasquarterly.org/article/the-wheels-of-justice-in-mexico-are-failing-what-can-be-done/.

124. USMCA, *supra* note 73, annex 31-A, art. 31-A.1 ("The United States and Mexico are agreeing to this annex . . . [t]he purpose of the Facility Specific Rapid Response Labor Mechanism, including the ability to impose remedies, is to ensure remediation of a Denial of Rights . . . for workers at a Covered facility . . . [t]his annex applies only as between Mexico and the United States.").

Mexico to work on U.S. farms through daily or seasonal work visas.[125] Temporary foreign workers have long supported the U.S. economy during times of labor shortages while also improving the economy during periods of upturn by accepting jobs with conditions and salaries that domestic workers are unwilling to accept.[126] Despite the economic benefits, temporary workers from Mexico have also been the source of political ire due to lobbying from domestic labor interests and protectionist groups opposed to immigration.[127]

The number of temporary worker visas has sharply increased in recent decades, with over 800,000 visas granted in 2019.[128] In practice, migrant workers seeking temporary employment in the U.S. "have limited rights and face challenges including illegal recruitment fees and debt bondage, lower wages, employment that ties them to a single employer, lack of protections in the workplace, family separation, . . . and no path to permanent residence or citizenship."[129] Although temporary migrant workers are authorized to work in the United States, their rights still mirror those of unauthorized immigrants in the sense that they "suffer and fear retaliation and deportation if they speak up about wage theft, workplace abuses, discrimination, or other substandard working conditions."[130]

In 2021, after six people were killed and dozens more were injured in a serious industrial accident at a poultry plant in Georgia, the U.S. Department of Labor launched a workplace safety investigation.[131] The investigation uncovered safety violations that placed the plant's workers at significant risk.[132] Perhaps most worrisome, the investigation found that many foreign workers were reluctant to accept medical aid and refused to participate in the investigation for fear of retaliation.[133] These results were consistent with a report published by the Center for Public Integrity, which found that foreign

125. Klobucista & Roy, *supra* note 6.
126. *Id.*
127. *Id.*
128. *Id.*
129. Costa, *supra* note 12.
130. *Id.*
131. Lahoud, *supra* note 11.
132. *Id.*
133. *Id.*

workers, despite having full rights under U.S. law to confidentially report labor violations, declined to do so out of fear of reprisal.[134]

Despite widespread evidence of labor violations committed by U.S. employers against temporary migrant workers on U.S. soil, the RRM has unique and significant limitations for use in the United States.[135] Specifically, with respect to U.S. facilities, "a claim can be brought only with respect to an alleged Denial of Rights owed to workers at a covered facility under an enforced order of the National Labor Relations Board [(NLRB)]."[136] In addition, the "covered facility" must be in a "priority sector."[137] From 2016 to 2020, of the approximately 164 U.S. facilities subject to an NLRB enforced order, approximately five constituted a "priority sector."[138] In addition, despite the fact that 71% of the 2.4 million farmworkers laboring in the United States are classified as non-U.S. citizens, with the overwhelming majority from Mexico, agricultural facilities are entirely excluded from the definition of priority sector.[139] Given the gaping loophole regarding agricultural facili-

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134. *Id.*

135. Hutman, *supra* note 74 ("The Rapid Response Mechanism has limitations for use in the United States that do not apply for Mexico. Specifically, a claim can only be brought against a U.S. facility where it is covered by a U.S. National Labor Relations Board order.").

136. USMCA, *supra* note 70, annex 31-A, art. 31-A.2 n. 2 ("With respect to the United States, a claim can be brought only with respect to an alleged Denial of Rights owed to workers at a covered facility under an enforced order of the National Labor Relations Board.").

137. USMCA, *supra* note 70, annex 31-A, art. 31-A.15 ("Covered Facility means a facility in the territory of a Party that (i) produces a good or supplies a service traded between the Parties; or (ii) produces a good or supplies a service that competes in the territory of a Party with a good or a service of the other Party, and is a facility in a Priority Sector . . . Priority Sector means a sector that produces manufactured goods, supplies services, or involves mining."); *id.* art. 31-A.15 n. 4 ("For greater certainty, manufactured goods include, but are not limited to, aerospace products and components, autos and auto parts, cosmetic products, industrial baked goods, steel and aluminum, glass, pottery, plastic, forgings, and cement.").

138. Hutman, *supra* note 74.

139. *Id.* ("In addition, the Covered Facility must be in a 'priority sector.' Priority sectors are those sectors that manufacture goods, supply services, or involve mining (agriculture is not included)."); *Selected Statistics on Farmworkers (2015-16 Data)*, FARMWORKER JUSTICE, https://www.farmworkerjustice.org/wp-content/uploads/2019/05/NAWS-Data-FactSheet-05-13-2019-final.pdf ("According to the NAWS, approximately 75% of farmworkers

ties and the fact that RRM jurisdiction would have only covered five U.S. facilities from 2016 to 2020, it appears that temporary migrant workers in the U.S. are all but foreclosed from obtaining relief through the RRM.

Unfortunately, this prediction has held up so far. Before Tridonex and GM Silao, the first USMCA labor complaint was filed against the U.S. by women organized through Centro de los Derechos (CDM), alleging gender-based discrimination directed toward migrant workers in the recruitment and hiring processes for U.S. agricultural jobs.[140] CDM, joined by a binational coalition of civil society organizations and two migrant women,[141] submitted the complaint to Mexico's Labor Ministry requesting RRM remediation against the United States.[142] Specifically, the complaint alleged that "women applying for visas in the United States are being disproportionately channeled into obtaining H2B labor visas instead of H2A agricultural visas, which does not allow them access to higher paying jobs in agriculture," and that the United States "is not enforcing the provision of the USMCA agreement, which protects workers to exercise their labor rights in a climate free from violence, threats, and intimidation."[143] Although U.S. and Mexican officials met and discussed the complaints in June 2021, the "dispute appears not to have moved beyond the consultation phase of the dispute resolution mechanism."[144] In March 2022, after 373 days without any promises or calls to

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are immigrants, the overwhelming majority form Mexico. About 29% of the farmworkers are United States citizens, 21% are lawful permanent residents and another 1% have other work authorization.").

140. Evy Peña, *Migrant Worker Women File First Complaint Against the U.S. Government Under the United States-Mexico-Canada Agreement*, CENTRO DE LOS DERECHOS DEL MIGRANTE, INC. (Mar. 23, 2021), https://cdmigrante.org/migrant-worker-women-file-first-complaint-against-the-us-government-under-the-united-states-mexico-canada-agreement/.

141. *Id.*

142. Amended Petition on Labor Law Matters Arising in the United States Submitted to the Labor Policy and Institutional Relations Unit Through the General Directorate of Institutional Relations in the Secretariat of Labor and Social Welfare of the Mexican Government (Mar. 23, 2021), https://cdmigrante.org/wp-content/uploads/2021/03/USMCA-Amended-Peition-and-Appendices_March-23-2021_reduced.pdf.

143. M. Angeles Villarreal, CONG. RSCH. SERV., R44981, THE UNITED STATES-MEXICO-CANADA AGREEMENT (USCMA), at 37 (Dec. 28, 2021), https://sgp.fas.org/crs/row/R44981.pdf.

144. *Id.*

action from the U.S. government, the CDM filed additional evidence of discrimination and sexual violence, but received no response from the U.S. government.[145] Clearly, relief for Mexican migrant workers employed at U.S. facilities appears all but precluded under the current RRM regime.

3. *Incapacity of the RRM to Remedy All Labor Violations*

The RRM is admittedly a vast improvement over the ineffective dispute resolution system created under NAFTA, and the Tridonex and GM Silao cases certainly appear promising. But the RRM has serious gaps nonetheless. There are simply too many serious labor violations happening in Mexico for the RRM to facilitate real, permanent change as it stands.[146] From 2008 to 2012, after conducting twenty-seven independent external monitoring and verification visits in Mexico, the Fair Labor Association (FLA) found that 41% of the audits cited Freedom of Association noncompliance.[147] As of December 2021, Mexican labor officials and experts estimated that of the over 500,000 registered collective bargaining agreements in Mexico, 80-90% were "protection contracts."[148] Protection contracts are union contracts formed without the knowledge or consent of the workers covered by the agreement, usually at the behest of the corporation and in direct conflict with the

145. *Migrant Worker Women Submit First-Ever Petition Against the U.S. Under the USMCA*, CENTRO DE LOS DERECHOS DEL MIGRANTE, INC. (last updated Mar. 31, 2022), https://cdmigrante.org/migrant-worker-women-usmca/. As of April 17, 2022, the U.S. Department of Labor does not have information available on its website regarding this complaint. See U.S. Department of Labor: Bureau of International Labor Affairs, USMCA Cases, (last visited Apr. 17, 2022).

146. Daniel Rangel, *USMCA: A New Frontier for Labour Rights in Trade Deals*, BUS. & HUM. RTS. RES. CTR. (July 28, 2021), https://www.business-humanrights.org/es/blog/usmca-a-new-frontier-for-labour-rights-in-trade-deals/ ("Although promising, the RRM cannot by itself spur better working conditions and higher wages in Mexico. It would be impossible to elevate every case of infringement of the rights to organise in Mexico to the level of an international dispute. There are simply too many cases.").

147. *Protecting Workers' Rights to Freedom of Association & Collective Bargaining in Mexico*, *supra* note 66.

148. *Legitimating Collective Bargaining Agreements in Mexico: What Have We Learned to Date?*, MAQUILA SOLIDARITY NETWORK at 3 n.1 (Dec. 2021), https://www.maquilasolidarity.org/sites/default/files/attachment/Legitimating_CBAs_in_Mexico_Dec_2021.pdf.

interests of the employees.[149] Considering the sheer quantity of labor violations in Mexico, it is simply impossible for the RRM to successfully remediate every labor rights infringement.

Furthermore, even when labor violations are successfully raised and remediated through the RRM, workers may still fall through the cracks. Take Tridonex, for example, which is seen by many as the RRM's triumphant victory for labor rights. According to the AFL-CIO, Tridonex terminated the employment of over 600 workers after they attempted to organize with an independent labor union.[150] However, according to Tridonex's agreement with the USTR, Tridonex only has to provide six months of back pay to at least 154 workers dismissed from the factory.[151] While it is not entirely clear why upwards of 400 employees may miss out on relief under the terms of the RRM-imposed settlement, the Tridonex case was still publicized as the RRM's flagship, symbolic success. If the Tridonex case, observed by people around the world and remediated with the full strength of the USTR, cannot provide full and adequate relief, then the RRM clearly has limitations.

III.
Remedying Unresolved Labor Violations Through the ATS

While the RRM appreciably improves the impotent labor dispute mechanisms created by NAFTA, there are still loopholes. Most notably, it fails to remediate labor violations against temporary workers from Mexico in U.S. facilities and fails to remediate individual instances of labor violations at the micro-level occurring in Mexican facilities. Furthermore, because of the sheer quantity of labor violations currently occurring at Mexican facilities, the RRM may prove insufficient even at remedying labor violations properly under its jurisdictional purview. Therefore, Mexican laborers on both sides of the border will need alternate avenues to vindicate their rights. This Note probes the feasibility of remedying these rights through the ATS in U.S. courts, especially in light of recent U.S. Su-

149. *Id.*

150. Villarreal, *supra* note 75. ("According to the AFL-CIO, over 600 workers were fired from their positions at Tridonex, as a result of attempting to organize with SNITIS.").

151. Office of the United States Trade Representative, *supra* note 100.

preme Court precedent limiting the ATS' reach under the Court's presumption against extraterritoriality doctrine.

A. *Background on the ATS and the Presumption Against Extraterritoriality*

1. *The ATS and Human Rights Abroad*

The ATS provides original jurisdiction to federal district courts for "any civil action by an alien for a tort only, committed in violation of the law of nations or a treaty of the United States."[152] The ATS, adopted in 1789, allows non-U.S. citizens to file civil suits in federal court for torts committed in violation of international law.[153] The ATS was rarely used from the time of its drafting until the late 1900s because during that the time, international law mainly focused on the regulation of diplomatic relations and the outlawing of crimes such as piracy.[154] However, as international law expanded to include the protection of human rights, the ATS gained "renewed significance in the late twentieth century . . . giv[ing] survivors of egregious human rights abuses, wherever committed, the right to sue the perpetrators in the United States."[155] In the 1980s, the ATS began to be successfully used to prosecute cases including "torture, state-sponsored sexual violence, extrajudicial killing, crimes against humanity, war crimes and arbitrary detention."[156] For example, in the 1980 case *Filartiga v. Pena-Irala*, the Second Circuit found that non-U.S. citizen plaintiffs could sue a foreign police inspector that was currently present in the U.S. under the ATS to recover damages for torture that had occurred abroad.[157] The Second Circuit reasoned that because the plaintiffs were aliens, torture is a tort, and torture violates customary international law, the claim fit the requirements of the ATS.[158]

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152. 28 U.S.C. § 1350.

153. *The Alien Tort Statute*, CTR. FOR JUST. & ACCOUNTABILITY, https://cja.org/what-we-do/litigation/legal-strategy/the-alien-tort-statute/ (last visited Apr. 17, 2022).

154. *Id.*

155. *Id.*

156. *Id.*

157. Filartiga v. Pena-Irala, 630 F.2d 876 (2d Cir. 1980).

158. William S. Dodge, *The Surprisingly Broad Implications of Nestlé USA, Inc. v. Doe for Human Rights Litigation and Extraterritoriality*, JUST SECURITY (June 18, 2021), https://www.justsecurity.org/77012/the-surprisingly-broad-impli-

Beginning in 2004 with *Sosa v. Alvarez-Machain*,[159] the Supreme Court began limiting the reach of the ATS.[160] In *Sosa,* the Court found that the ATS did not create separate grounds for suits alleging violations of the law of nations. Instead, ATS claims "based on the present-day law of nations [must] . . . rest on a norm of international character accepted by the civilized world and defined with a specificity comparable to the features of the 18th-century paradigms we have recognized."[161] The Court reasoned that the ATS, when first enacted, was only meant to allow claims related to offenses against ambassadors, violation of safe conducts, and piracy, which at the time were universal, specific, and obligatory norms.[162] Therefore, claims alleging violations of international law must implicate international legal norms that are (1) universally recognized; (2) obligatory in nature; and (3) specific.[163] The Court in *Sosa* found that the ATS is a jurisdictional statute that does not prescribe substantive law, meaning that federal courts are not required to recognize just any tort that infringes on individual rights under international law; instead, justiciable torts are limited to those that violate norms which are universally recognized, obligatory, and specific.[164] The Court found that Alvarez-Machain's claim of arbitrary detention failed to meet this standard.[165]

2. *The Presumption Against Extraterritoriality and Corporate Liability*

The presumption against extraterritoriality, an interpretive principle, instructs federal courts to avoid applying U.S.

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cations-of-nestle-usa-inc-v-doe-for-human-rights-litigation-and-extraterritoriality/ ("In 1980, the Second Circuit held in Filartiga v. Pena-Irala, 630 F.2d 876 (2d Cir. 1980), that non-U.S. citizen plaintiffs could use the ATS to sue a foreign police inspector who had come to the United States to recover damages for torture that occurred abroad, reasoning that the plaintiffs were 'aliens,' that torture is a tort, and that torture violates modern customary international law.").

159. Sosa v. Alvarez-Machain, 542 U.S. 692 (2004).

160. *See* Dodge, *supra* note 158 (summarizing multiple cases, beginning with Sosa, that limit the reach of the ATS)

161. Sosa, 542 U.S. at 725.

162. *Id.* at 732.

163. *Id.*

164. *Id.*

165. *Id.* at 738.

statutes abroad, unless there is clear congressional intent indicating otherwise.[166] Justification for this presumption derives from both principles of comity and the idea that, absent clear legislative intent, Congress, when enacting statutes, generally focuses on domestic concerns.[167] In *RJR Nabisco, Inc. v. European Community*, the Court refined a two-step test that memorializes these interests.[168] First, under the presumption that all statutes only apply at the domestic level, the Court assesses whether the presumption against exterritoriality has been rebutted by asking "whether the statute gives clear, affirmative indication that it applies extraterritorially."[169] If the Court finds that the statute was not meant to apply extraterritorially, the Court proceeds to step two by examining the statute's "focus" to determine whether "the case involves a domestic application of the statute."[170] Here, the Court asks whether plaintiffs established that "the conduct relevant to the statute's focus occurred in the United States . . . even if other conduct occurred abroad."[171]

Over the last decade, the Court has used the presumption against extraterritoriality to limit the ATS' reach in cases regarding corporate liability. In *Kiobel v. Royal Dutch Petroleum*, the Court explicitly held that the ATS does not rebut the presumption against extraterritoriality.[172] Here, citizens of Nigeria alleged that Dutch, British, and Nigerian corporations aided and abetted the Nigerian government in committing violations of customary international law during oil exploration.[173] While the Court declined to answer whether corpora-

166. RESTATEMENT (FOURTH) OF THE FOREIGN RELS. L. § 203 (Am. L. Inst. 2018). *See e.g.*, *US Courts Retreat From Applying Major Federal Statutes to Extraterritorial Activity*, NORTON ROSE FULBRIGHT (Dec. 2018), https://www.nortonrosefulbright.com/en/knowledge/publications/ae5cfa02/us-courts-retreat-from-applying-major-federal-statutes-to-extraterritorial-activity.

167. James Janison, *Justifying the Presumption Against Extraterritoriality: Congress as a Foreign Affairs Actor*, 53 J. INT'L L. & POL. ONLINE F. 1 (2020).

168. RJR Nabisco, Inc. v. Eur. Cmty., 136 S. Ct. 2090, 2101 (2016).

169. *Id.* at 337.

170. *Id.*

171. *Id.*

172. Kiobel v. Royal Dutch Petroleum Co., 569 U.S. 108, 124 (2013) ("Nothing about this historical context suggests that Congress also intended federal common law under the ATS to provide a cause of action for conduct occurring in the territory of another sovereign.").

173. *Id.* at 111.

tions could ever be sued under the ATS, the Court found that the ATS fails to rebut the presumption against extraterritoriality under the first step because these claims did not "touch and concern the territory of the United States . . . with sufficient force to displace the presumption against extraterritorial application."[174] The Court found that "mere corporate presence" in the U.S. failed to constitute a domestic application of the statute under the second step.[175] In *Jesner v. Arab Bank, PLC*, non-U.S. Citizens claimed that they, or their relatives, were victims of terrorist attacks in Israel and that Arab Bank facilitated the terrorist attacks by allowing the terrorists to maintain bank accounts and transfer funds.[176] The Court rejected this claim, finding that under the presumption against extraterritoriality, ATS claims do not extend to foreign corporations.[177]

Most recently, in *Nestlé USA, Inc. v. Doe*, the Court again limited the scope of the ATS through the presumption against extraterritoriality, but this time as applied to corporate defendants based in the United States.[178] Here, six Malian plaintiffs who had been forcibly trafficked as children to work on farms in Côte d'Ivoire alleged that defendant corporations Nestlé and Cargill aided and abetted child slavery by purchasing cocoa from farms that utilized child slavery.[179] The Court rejected this claim under the *RJR* two-step test. First, the Court determined that "the ATS does not rebut the presumption of domestic application."[180] Under the second step, the Court found the plaintiffs "impermissibly seek extraterritorial application of the ATS" because "[n]early all the conduct they allege aided and abetted forced labor–providing training, equipment, and cash to overseas farmers–occurred in Ivory Coast."[181] The Court explained that "[p]leading general corporate activity, like 'mere corporate presence,' does not draw a sufficient connection between the cause of action respondents seek and domestic conduct."[182] The crux of the holding was

174. *Id.* at 124–25.
175. *Id.* at 125.
176. Jesner v. Arab Bank, PLC, 138 S. Ct. 1386 (2018).
177. *Id.* at 1407.
178. Nestlé, 141 S. Ct. at 1937.
179. *Id.* at 1933.
180. *Id.* at 1933–34.
181. *Id.*
182. *Id.*

that "general corporate activity common to most corporations" is insufficient domestic activity to constitute a domestic application of the ATS.[183] Specifically, it was insufficient that the defendant's major operational decisions took place in the U.S. because "allegations of general corporate activity—like decisionmaking—cannot alone establish domestic application of the ATS."[184] *Nestlé* has been interpreted to be a sweeping limitation on human rights litigation, marking "the end of the *Filartiga* line of ATS cases against individual defendants whose relevant conduct occurs outside the United States" and limiting "the ATS cause of action to claims against U.S. corporations based on conduct in the United States that goes beyond making decisions about how to conduct operations abroad."[185]

B. *Applying the ATS to the RRM's Unresolved Disputes*

While *Nestlé* on its face appears to limit claims by aggrieved laborers under the ATS, it certainly leaves an opening. While the majority in *Nestlé* failed to address the question of corporate liability, five justices declined to distinguish between corporations and natural persons as defendants.[186] A majority of justices in *Nestlé* explicitly rejected the notion that corporations are immune from suit under the ATS.[187] Therefore, assuming that the other requirements of *Sosa* and *RJR Nabisco* are met, under *Nestlé*, "future plaintiffs will be able to proceed against U.S. corporations under the ATS so long as they can show tortious conduct happening in the United States."[188]

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183. *Id.*

184. *Id.* at 1937.

185. Dodge, *supra* note 158.

186. *Id.* ("Although the majority opinion in Nestlé did not address the question of corporate liability, five justices saw no reason to distinguish between corporations and natural persons as defendants.").

187. Nestlé, 141 S. Ct. at 1940, 1948, 1950 (Gorsuch, J., concurring) ("The notion that corporations are immune from suit under the ATS cannot be reconciled with the statutory text and original understanding."); (Alito, J., dissenting) ("Corporate Status does not justify special immunity."); (Sotomayor, J., concurring) ("As Justice Gorsuch ably explains, there is no reason to insulate domestic corporations from liability for law-of-nations violations simply because they are legal rather than natural persons.").

188. Beth Van Schaack, *Nestlé v. Cargill v. Doe: What's Not in the Supreme Court's Opinions*, JUST SECURITY (June 30, 2021), https://www.justsecurity.org/77120/nestle-cargill-v-doe-whats-not-in-the-supreme-courts-opinions/.

1. *Evaluating Whether Unresolved Labor Violations Are Cognizable Under Sosa*

Before evaluating whether U.S. corporations meet the "domestic conduct" standard required to satisfy the two-step presumption against extraterritoriality test, it is necessary to determine whether the labor violations north and south of the border constitute cognizable claims under the ATS in light of *Sosa*. In *Sosa,* the Supreme Court rejected arguments that claims should "be limited to the three violations of the law of nations that the First Congress had in mind in 1789" and "recognized an implied, federal-common-law cause of action for violations of modern international law that are as generally accepted and specifically defined as the three historical paradigms . . . . "[189] So to determine whether the RRM's unresolved labor violations constitute cognizable claims under the ATS, courts must determine whether these labor violations (1) rest on a norm of international character accepted by the civilized world and (2) are defined with specificity comparable to violations of international law that existed at the time the ATS was enacted: violations of safe conduct, infringement of the rights of ambassadors, and piracy.[190]

Labor rights are backed by a comprehensive body of international law.[191] First, the International Labour Organization (ILO), founded in 1919 with 187 member states, has set and defined standards for fundamental human rights for workers throughout the twentieth century.[192] The ILO has adopted

189. Dodge, *supra* note 158.

190. Virginia Monken Gomez, *The Sosa Standard: What Does It Mean for Future ATS Litigation?*, 33 PEPP. L. REV. 469, 471–72 (2006).

191. Human Rights Watch, *Blood, Sweat, and Fear: Workers' Rights in U.S. Meat and Poultry Plants* (Jan. 2005), https://www.hrw.org/reports/2005/usa0105/usa0105.pdf ("Over the past fifty years, a comprehensive body of international law has developed affirming a range of rights to which all workers are entitled.").

192. *Mission and Impact of the ILO*, INT'L LAB. ORG., https://www.ilo.org/global/about-the-ilo/mission-and-objectives/lang—en/index.htm (last visited Apr. 22, 2022); *ILO: International Labour Organization*, UNITED NATIONS, https://www.un.org/youthenvoy/2013/08/ilo-international-labour-organization/#:~:text=the%20ILO%20was%20created%20in,agency%20of%20the%20United%20Nations (last visited Oct. 7, 2022) ("The ILO was created in 1919, as part of the Treaty of Versailles that ended World War I, to reflect the belief that universal and lasting peace can be accomplished only if its based on social justice.").

185 international labor standards, called "conventions," that protect "workplace health and safety, workers' compensation, workers' organizing rights, and migrant workers' rights."[193] The ILO considers freedom of association as "the bedrock right on which all others rest . . . includ[ing] workers' efforts at organization and association in the workplace and . . . the right to bargain collectively with employers and the right to strike."[194]

The Universal Declaration of Human Rights (UDHR), the International Covenant on Civil and Political Rights (ICCPR), the International Covenant on Economic, Social and Cultural Rights (ICESCR), and the International Convention on the Protection of the Rights of All Migrant Workers and Members of Their Families also all contain provisions protecting some or all of the following labor rights:

(1) a safe and healthful workplace,

(2) compensation for workplace injuries and illnesses,

(3) freedom of association and the right to form trade unions and bargain collectively,

(4) equality of conditions and rights for immigrant workers.[195]

Labor rights related to freedom of association and collective bargaining are what the RRM was designed to resolve, and the main labor violations occur in Maquiladoras south of the border and in labor facilities north of the border.[196] In addition, factories and plants on both sides of the border are alleged to have committed gender and workplace discrimination in their hiring practices.[197] Based on the extensive body of international law that articulates and promotes these rights across a multitude of legal instruments, it is reasonable to conclude that a court may find that these violations constitute appropriate claims under the ATS. In fact, it has been argued

193. Human Rights Watch, *supra* note 191.

194. *Id.*

195. *Id.*; G.A. Res. 217 (III) A, Universal Declaration of Human Rights, at 71 (Dec. 10, 1948); G.A. Res. 2200 (XXI) A, International Covenant on Economic, Social and Cultural Rights, at 49 (Dec. 16, 1966); G.A. Res. 2200 (XXI) A, International Covenant on Civil and Political Rights, at 52 (Dec. 16, 1966); G.A. Res. 45/158, Convention on the Rights of All Migrant Workers and Members of Their Families (Dec. 18, 1990).

196. *See supra* Part II.

197. *See supra* Part II.

that violations of ILO conventions and standards related to child labor are cognizable under the ATS because of "sufficient universal opposition to specific child labor practices to establish a cause of action under customary international law."[198] The frequency of labor standards in the same conventions protecting collective bargaining, freedom of association, equality of conditions, and safe workplaces begs the same conclusion.

Other than arguing that labor violations meet the Sosa standard, there are also other avenues for aggrieved workers to file suit under ATS. First, the murder of labor activists may violate separate international legal principles related to the "universal acceptance that arbitrary deprivations of life constitute serious human rights violations . . . ."[199] If a labor activist is murdered to intimidate unions against organizing, aggrieved employees can focus on the violent conduct as opposed to the labor intimidation. For example, in Mexico, torture has been employed on numerous occasions to intimidate labor activists.[200] The prohibition of torture is one of the most universally recognized human rights, attaining the status of a jus cogens peremptory norm.[201] It is enshrined in multiple conventions, including the U.N. Convention Against Torture, the American Convention on Human Rights, and the Universal Declaration of Human Rights.[202] Furthermore, female employees on the border who are victims of gender discrimination, gender-based violence, and sexual and reproductive health violations

198. Vanessa Waldref, *The Alien Tort Statute After Sosa: A Viable Tool in the Campaign to End Child Labor?*, 31 BERKELEY J. EMP. & LAB. L. 160 (2010) ("This Article argues that recent International Labour Organization (ILO) conventions and declarations that focus on 'core' labor rights and call for an end to the 'worst forms' of child labor illustrate sufficient universal opposition to specific child labor practices to establish a cause of action under customary international law.").

199. Kate Thompson & Camille Giffard, *Reporting Killings as Human Rights Violations*, HUM. RTS. CTR. 3 (2002), https://www.refworld.org/pdfid/4ec105562.pdf.

200. Connell, *supra* note 5; *see also Protest Torture Attack on Labor Activists' Family in Mexico*, *supra* note 41.

201. *Torture*, INTERNATIONAL JUSTICE RESOURCE CENTER, https://ijrcenter.org/thematic-research-guides/torture/, (last visited Apr. 27, 2022).

202. U.N. Convention Against Torture and Other Cruel, Inhuman or Degrading Treatment or Punishment, G.A. Res. 39/46 (Dec. 10, 1984); American Convention on Human Rights, art. 5 (Nov. 22, 1969); G.A. Res. 217 (III) A, Universal Declaration of Human Rights, art. 5 (Dec. 10, 1948).

can pursue claims under the ATS by citing international legal norms outlawing discrimination based on sex, which is currently prohibited in almost every human rights treaty.[203] Because of the pervasive, universal, and obligatory nature of these norms against torture and discrimination based on sex, aggrieved Mexican labor activists are not limited to alleging violations of labor rights but can also pursue ATS claims based on human rights violations committed in the pursuit of labor intimidation.

Second, aside from torts committed in violation of the law of nations, the ATS also provides original jurisdiction for torts "committed in violation of . . . a treaty of the United States."[204] Victims of labor violations and human rights abuses can bring suit under the ATS based on violations of treaties of which the United States is a party, rather than bringing suit under the ATS based on general violations of the law of nations. To provide a few examples, the United States was the principal author, sponsor, and signer of the Universal Declaration of Human Rights, the United States signed and ratified the International Covenant on Civil and Political Rights (ICCPR), and the United States signed the International Covenant on Economic, Social, and Cultural Rights (ICESCR).[205] Furthermore,

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203. *Human Rights and Gender*, UNITED NATIONS AND THE RULE OF LAW, https://www.un.org/ruleoflaw/thematic-areas/human-rights-and-gender/ (last visited Apr. 27, 2022) ("Discrimination based on sex is prohibited under almost every human rights treaty, including the International Covenant on Civil and Political Rights and the International Covenant on Economic, Social and Cultural Rights, which under their common article 3 provide for the rights to equality between men and women in the enjoyment of all rights. In addition, the Convention on the Elimination of Discrimination Against Women (CEDAW) is dedicated to the realization of women's human rights.").

204. 28 U.S.C. § 1350.

205. Human Rights Watch, *International Law: Workers; Human Rights, Government Obligations, and Corporate Responsibility* (Jan. 2005), https://www.hrw.org/reports/2005/usa0105/3.htm ("The United States government has committed itself to protecting [a safe and healthful workplace, compensation for workplace injuries and illnesses, freedom of association and the right to form trade unions and bargain collectively, and the equality of conditions and rights for immigrant workers]. It was a principal author, sponsor, and signer of the Universal Declaration; it has signed and ratified the ICCPR; and it has signed the ICESCR."). While the U.S. has not ratified the ICESCR, "well-settled international law obliges it to respect the terms and purposes of the Covenant and to do nothing to damage them." *Id.*

labor victims can plausibly argue that these actions violate provisions of the USMCA itself.[206] Under this avenue, labor victims may be able to pursue ATS claims against both U.S. and Mexican parties, assuming courts find violations of specific treaty provisions to which corporate defendants were obligated to adhere.

Considering the many international legal instruments outlining human rights and labor norms, aggrieved victims of labor and human rights violations who fall through the cracks of the RRM's remediation mechanism may nonetheless have a cognizable claim under the ATS. While the Sosa standard may appear onerous, there is at least a plausible argument that these violations fit the types of norms that the ATS was meant to address.

2. *Evaluating Whether Unresolved Labor Violations Are Attributable to Domestic Conduct*

After demonstrating that labor or human rights violations meet the *Sosa* standard, plaintiffs must still satisfy *RJR Nabisco*'s two-part presumption against extraterritoriality test. It is already clear under *Kiobel* that the ATS does not rebut the presumption against extraterritoriality.[207] For plaintiffs alleging labor violations in Maquiladoras in Mexico, that poses an obstacle. However, for temporary Mexican workers alleging labor violations on U.S. soil—like the CDM complainants—their suits can likely proceed because they are not seeking to apply the ATS extraterritorially.[208]

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206. CONG. RSCH. SERV., USMCA LABOR PROVISIONS (2022) ("USMCA . . . requires parties to [adopt and maintain in statutes and regulation, and practices, worker rights as stated in the 1998 ILO Declaration on Fundamental Principles and Rights at Work, in addition to acceptable conditions of work with respect to minimum wages, hours of work, and occupational safety and health, [n]ot waive or otherwise derogate from its statutes or regulations, [n]ot fail to effectively enforce labor laws through a sustained or recurring course of action or inaction in a manner affecting trade or investment between parties, [p]romote compliance with labor laws through appropriate government action, such as appointing and training inspectors or monitoring compliance and investigating suspected violations.").

207. Kiobel v. Royal Dutch Petroleum Co., 569 U.S. 108, 124 (2013) ("Nothing about this historical context suggests that Congress also intended federal common law under the ATS to provide a cause of action for conduct occurring in the territory of another sovereign.").

208. *See supra* Section III.A.

For labor and human rights violations occurring in Mexico, plaintiffs will have an uphill battle satisfying step two because of the Court's holding in *Nestlé*. Under step two, plaintiffs must establish that "the conduct relevant to the statute's focus occurred in the United States . . . even if other conduct occurred abroad."[209] Under *Nestlé*, a "mere corporate presence" cannot "establish domestic application of the ATS."[210] Since *Nestlé*, courts have rejected "aiding and abetting" claims against U.S. entities,[211] suits against U.S. corporations that receive supplies from foreign actors violating the Trafficking Victims Protection Reauthorization Act,[212] and claims alleging loan decision-making and oversight in the United States.[213]

On its face, *Nestlé* appears to limit claims by Mexican nationals for alleged labor violations occurring in Mexico. However, there are certain factual distinctions from *Nestlé* that may allow Mexican plaintiffs to argue that its precedent does not apply. *Nestlé* was an aiding and abetting claim related to U.S. corporations who sourced cocoa from farms using child slavery and provided "those farms with technical and financial resources."[214] In this respect, the actual violations were committed by separate foreign actors—the farms— that were distinct from the U.S. entities, and the U.S. corporations allegedly aided and abetted those violations by engaging in an economic relationship with those farms through an exclusive supplier relationship. The domestic conduct alleged by the plaintiffs was that the U.S. corporations, in their U.S. offices, had made a strategic choice to source cocoa from those farms.

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209. Nabisco, 136 S. Ct. at 2101.

210. Nestlé, 141 S. Ct. at 1937.

211. Est. of Alvarez v. Johns Hopkins Univ., No. CV TDC-15-0950, 2022 WL 1138000, at *1 (D. Md. Apr. 18, 2022) (granting summary judgment for Johns Hopkins University after it was alleged that they "aided and abetted or conspired to commit nonconsensual human medical experiments in Guatemala"); Reynolds v. Higginbottom, No. 19-CV-5613, 2022 WL 864537, at *16 (N.D. Ill. Mar. 23, 2022) ("Nothing about a claim under the TVPA suggests that courts should be more willing – outside the "realm of domestic law" – to recognize an implied cause of action for aiding and abetting.").

212. Doe I v. Apple Inc., No. 1:19-CV-03737 (CJN), 2021 WL 5774224, at *1 (D.D.C. Nov. 2, 2021).

213. Jam v. Int'l Fin. Corp., 3 F.4th 405, 412 (D.C. Cir. 2021), *cert. denied*, No. 21-995, 2022 WL 1205953 (U.S. Apr. 25, 2022).

214. Nestlé, 141 S. Ct. at 1935.

But the plaintiffs claiming labor violations in Maquiladoras would not base their claims on aiding and abetting based on third-party relationships with foreign actors. Instead, their claims would be based on conduct occurring at a facility owned by a U.S. corporation. Maquiladoras do not have third party business relationships with U.S. corporations; they are subsidiaries wholly owned by U.S. corporations.[215] U.S. corporations that set up Maquiladoras in Mexico choose to own the facilities outright in order to take advantage of preferential tariff treatment.[216] Take the RRM complaint against GM Silao, for example: GM Silao is a wholly owned subsidiary of U.S.-based General Motors.[217] This is a notable difference under both principles of agency and primary vs. secondary liability—which may provide a substantive advantage over secondary liability claims in *Nestlé*.

For example, if a Maquiladora were a distinct entity that merely supplied goods to the U.S. corporation along the chain of distribution, the U.S. corporation could argue that it only had a buyer-supplier relationship with the Maquiladora and owed no duty to the Mexican employees aggrieved by the supplier.[218] Alternatively, if the Maquiladora and U.S. corporation were separate entities but a court found that the buyer-supplier relationship amounted to a principal-agent relationship, the U.S. corporation could insulate itself from liability by argu-

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215. Kenton, *supra* note 27 ("A maquiladora is a low-cost factory in Mexico that is owned by a foreign corporation.").

216. *What is a Maquiladora in Mexico?*, MANUFACTURING IN MEXICO, https://manufacturinginmexico.org/maquiladora-in-mexico/ (last visited Apr. 27, 2022) ("The Maquiladora Program, which allowed maquiladoras to be 100% foreign owned . . . was created to increase foreign investment and stimulate Mexico's internal market . . . thousands of manufacturing companies, including a substantial number of small to medium-sized American firms, have been able to negotiate the process and establish a maquiladora."); *The History of the Maquiladora Program in Mexico*, *supra* note 4 ("Raw materials can be imported duty- and tariff-free and then export the final product to the company of ownership.").

217. Anthony Esposito & Joseph White, *Game of Chicken: GM Bets on Mexican-Made Pickup Trucks*, REUTERS (Jan. 15, 2018), *https://www.reuters.com/article/us-trade-nafta-autos/game-of-chicken-gm-bets-on-mexican-made-pickup-trucks-idUSKBN1F42G7*.

218. RESTATEMENT (SECOND) OF AGENCY § 14 (AM. L. INST. 1958) ("One who contracts to acquire property from a third person and convey it to another is the agent of the other only if it is agreed that he is to act primarily for the benefit of the other and not for himself.").

ing that Maquiladora officials violating labor rights acted beyond the scope of their authority granted by the U.S. corporation.[219] However, once the Maquiladoras are wholly owned subsidiaries of the U.S. corporations, it becomes much harder for the U.S. corporations to argue that their agents were acting beyond the scope of their authority because, by merely allowing a Maquiladora to operate under the name of its parent corporation, the parent corporation is manifesting assent for the Maquiladoras to act on behalf of its parent.[220] Like an employer-employee relationship, this also opens up the potential for liability under principles of respondeat superior because "[a]n employer is subject to liability for torts committed by employees while acting within the scope of their employment."[221] These differences in foundational principles of agency law can provide additional support for Mexican employees to escape the limitations set forth in *Nestlé*.

Furthermore, allowing parent company liability in this context would align U.S. law with that of the international community.[222] Courts in developed states like the Nether-

219. *Id.* § 219 (2) ("When Master is Liable for Torts of His Servants: A master is not subject to liability for the torts of his servants acting outside the scope of their employment, unless (a) the master intended the conduct or the consequences, or (b) the master was negligent or reckless, or (c) the conduct violated a non-delegable duty of the master, or (d) the servant purported to act or to speak on behalf of the principal and there was reliance upon apparent authority, or he was aided in accomplishing the tort by the existence of the agency relation.").

220. RESTATEMENT (THIRD) OF AGENCY § 2.03 (AM. L. INST. 2006) ("Apparent authority is the power held by an agent or other actor to affect a principal's legal relations with third parties when a third party reasonable believes the actor has authority to act on behalf of the principal and that belief *is traceable to the principal's manifestations*.") (emphasis added).

221. *Id.* § 2.04.

222. Ben Ye, *Okpabi v. Shell and Nestlé USA v. Doe: Trend and Divergence on Parent Company Liability for Human Rights Abuse in the United Kingdom and United States,* 54 N.Y.U. J. INT'L L. & POL. 261, 272 (2021) (discussing how the Nestlé decision "places the United States at odds with trends in other developed countries and developments in international human rights law, as demonstrated in the non-binding U.N. Guiding Principle on Business and Human Rights and the most recent draft of a binding treaty regulating business activities and human rights.").

lands[223] and the United Kingdom (UK)[224] have increasingly moved toward a parent company liability approach where parent companies may be liable for the human rights abuses of their foreign subsidiaries. For example, in Okpabi v. Shell, the UK Supreme Court found that Royal Dutch Shell could be held liable after its Nigerian subsidiary was alleged to have negligently caused an oil spill.[225] U.S. courts may look to this emerging trend among developed states as a reason to differentiate *Nestlé*, finding that parent company liability offers a stronger inference of culpability compared to aiding and abetting through a third-party buyer-supplier relationship.

Despite this difference in agency relationship, it would still be difficult to show intentional decision-making in the United States specifically authorizing individual labor violations in Mexico, especially considering the incentive corporate defendants have to seek dismissal prior to discovery, because an insufficient showing of domestic conduct constitutes sufficient grounds for dismissal. Furthermore, the Court in *Nestlé* failed to clarify the focus of the ATS, the kind of conduct encompassed, and the level of intent required.[226] Due to these ambiguities, plaintiffs should allege a "wide variety of U.S.-based conduct to overcome the bar on extraterritoriality."[227] But this difference in agency relationship, combined with an allegation of primary liability as opposed to secondary liability, can have benefits. For example, a U.S.-based corporation that regularly sends executives to Mexico to manage its wholly

223. *See, e.g.,* Hof's-Den Haag 29 January 2021, JOR 2001, 138 m.nt. van Oostrum en C.H.A. van (Oguru en Efanga/Shell Petroleum NV) (Neth.); Hof's-Den Haag 29 January 2021, RvdW (Dooh/ Shell Petroleum NV) (Neth.); Hof's-Den Haag 26 May 2021 JvdW (Vereniging Milieudefensie,/ Royal Dutch Shell, PLC) (Neth.).

224. Okpabi v. Royal Dutch Shell [2021] UKSC 3 [153] (finding it reasonably arguable that Royal Dutch Shell owed parent company liability over the activities of its Nigerian subsidiary for negligently causing oil spills).

225. *Id. See also* Ye, *supra* note 216, at 265. ("Second, the Supreme Court found, through the allegations pleaded by the claimants and examination of internal documents so far disclosed, that it was reasonably arguable that RDS owed parent company liability over SPDC's activities.").

226. Kayla Winarsky Green & Timothy McKenzie, *Looking Without and Looking Within: Nestlé v. Doe and the Legacy of the Alien Tort Statute*, 25 AM. SOC. OF INT'L L. (July 15, 2021), https://www.asil.org/insights/volume/25/issue/12.

227. *Id.*

owned facility with the operational goal of reducing labor costs may appear to be more relevant to the focus of the ATS than the defendants' conduct did in *Nestlé*. Specific instructions by U.S.-based executives to quell labor unrest may better fit the domestic conduct requirement that the justices in *Nestlé* had in mind. Alternatively, a court may find that "willful blindness"[228] to employee action in pursuit of broader operational goals constitutes knowledge and therefore sufficient domestic conduct. Or perhaps, *Nestlé* will encourage sloppiness on the part of U.S. executives, permitting them to discuss their foreign business practices more openly, which could generate better evidence of domestic conduct for human rights plaintiffs.

Or maybe a future court will distinguish *Nestlé* as limited to secondary liability, finding that corporate complicity based on wholly owned subsidiaries constitutes domestic conduct. Tortious conduct by employees abroad certainly feels more within the scope of the ATS than the aiding and abetting of third-party foreign actors. While the domestic conduct standard under *Nestlé* appears to be an uphill battle for aggrieved workers in the Maquiladoras, future plaintiffs should distinguish their claims based on principles of agency and based on primary liability as opposed to secondary liability.

Conclusion

Reasonable minds can differ as to the ultimate value of imputing U.S. labor standards onto Mexican laborers.[229] Critics of this approach will argue that heightening labor standards and legal remedies would eliminate Mexico's comparative advantage as a source of unskilled, low-cost labor and subsequently incentivize U.S. corporations to remove factories from Mexico or stop providing employment to temporary workers, which would ultimately hurt the Mexican people in the long run. But treating the proliferation of sub-human la-

228. Jason B. Freeman, *Willful Blindness and Corporate Liability*, Freeman Law, https://freemanlaw.com/willful-blindness-and-corporate-liability/ (last visited Apr. 28, 2022) ("Willful blindness is generally defined as an attempt to avoid liability for a wrongful act by intentionally failing to make reasonable inquiry when faced with the suspicion or awareness of the high likelihood of wrongdoing.").

229. Krugman, *supra* note 2.

bor standards as a win-win for both countries is overly simplistic and simply wrong.

For U.S. workers, lowering labor standards for Mexican workers with temporary visas reduces employment opportunities for U.S. citizens and degrades labor standards for U.S. citizens seeking employment.[230] Furthermore, subpar labor standards in the Maquiladoras south of the border incentivize U.S. corporations to offshore jobs traditionally held in the United States, further harming employment opportunities for U.S. citizens.[231] For Mexican workers, the proliferation of Maquiladoras failed to increase wages as hoped for and instead caused a decrease in real wages.[232] Even in terms of the mere number of job opportunities in Mexico, the early years of Maquiladora growth after NAFTA saw a dramatic decrease in the amount of available jobs.[233] Lowering labor standards for Mexican workers on both sides of the border creates lasting damage to all parties involved, without providing the promised benefits of globalization. Even beyond the empirical evidence, Mexico and the United States drafted the UMSCA with the goal of increasing labor standards, and the intent of the negotiating parties should be honored instead of allowing multinational corporations to take advantage of unintended loopholes. At the very least, the parties to the USMCA should be held to the language of their agreement.

Income inequality both among and within nation states is historically high.[234] But the world's growing rate of poverty

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230. Costa, *supra* note 12 ("That in turn degrades labor standards for workers in a wide range of industries. Reforming work visa programs, therefore, would help to improve working conditions and raise wages for all workers.").

231. Pub. Citizen's Glob. Trade Watch & The Lab. Council For Lat. Am. Advancement, *supra* note 9 ("Almost one million U.S. jobs have been certified as lost to NAFTA . . . . U.S. median wages are stagnant, and 40 percent of manufacturing workers who lose jobs to trade face major pay cuts if they find new employment.").

232. *Id.* ("Instead of the higher wages promised, in real terms average annual Mexican wages are down 2 percent, and the minimum wage is down 14 percent from pre-NAFTA levels with manufacturing wages now 40 percent lower than in China.").

233. Stiglitz *supra* note 31, at 65 ("After the early years of growth in the maquiladora region, reemployment there too actually started to decline, with some 200,000 jobs lost in the first two years of the new millennium.").

234. Joe Myers, *These Charts Show the Growing Income Inequality Between the World's Richest and Poorest*, World Economic Forum (Dec. 10, 2021), https:/

and inequality[235] is not an inevitable result of globalization. In fact, globalization has the potential to benefit both developing and developed nations.[236] A better managed system of globalization that prioritizes adequate living standards over simple market efficiency will provide economic and social benefits for everyone and improve resiliency in the face of global crises like the COVID-19 pandemic.[237]

The RRM is a significant step toward a better managed system of globalization, especially considering what preceded it under NAFTA. And while its strengths should certainly be recognized, it is also important to recognize its flaws, which are not merely theoretical. There are already real parties, like the Mexican migrant women organizing with the CDM, that are currently unable to attain relief.[238] Because of the large transaction costs of renegotiating regional treaties,[239] it is unlikely that the USMCA will be revisited anytime soon. Therefore, it is imperative to identify alternate avenues for victims of labor violations to obtain relief. For the CDM women facing

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/www.weforum.org/agenda/2021/12/global-income-inequality-gap-report-rich-poor/.

235. Joseph E. Stiglitz, *COVID Has Made Global Inequality Much Worse*, SCIENTIFIC AMERICAN (Mar. 1, 2022), https://www.scientificamerican.com/article/covid-has-made-global-inequality-much-worse/.

236. STIGLITZ, *supra* note 31, at xv-xvi ("In *Making Globalization Work*, I attempt to show how globalization, properly managed, as it was in the successful development of much of East Asia, can do a great deal to benefit both the developing and developed countries of the world.").

237. Henry Farrell & Abraham Newman, *This Is What the Future of Globalization Will Look Like*, FOREIGN POLICY (July 4, 2020), https://foreignpolicy.com/2020/07/04/this-is-what-the-future-of -globalization-will-look-like/ ("In a hyperglobalized economy, it made sense for individual firms to focus heavily on increasing efficiency and achieving market dominance—actions that led to greater returns and rising stock prices. But these trends also generated systemic vulnerabilities, imperiling fragile supply chains in times of crisis and tempting governments to target dominant companies for their own advantage, creating new risks for citizens and states. To move forward from our current crisis of globalization, we need to build something better in its stead: a system that mitigates the risks of economic and political dependency and supports a new vision of global society. Rather than withdrawing from globalization, we would remake it so that it focused on different problems than economic efficiency and global markets.").

238. Villarreal, *supra* note 143 and accompanying text.

239. *See* De Bruyne & Fischendler, *supra* note 20 (discussing the transaction costs of negotiating conflict resolution mechanisms in transboundary water treaties).

gender discrimination based on hiring practices in the United States, the ATS appears to be a sufficient avenue for relief, assuming the violations meet the *Sosa* standard. For aggrieved workers in the Maquiladoras, the viability of an ATS claim is more uncertain. But considering the agency relationship involved and the potential for claims of primary liability, there is still a chance that a U.S. court would be open to hearing a claim brought by aggrieved Mexican employees under the ATS. Perhaps, under the current regime, this is the best possible outcome to promote livable human rights standards for those that provide an important contribution to our global supply-chain and to ensure that all participants can properly enjoy the benefits of globalization. When certain participants are excluded from the benefits of globalization, the very least we can do is ensure they have their day in court.