How State Regulation of the Internet Violates the Commerce Clause

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Usage of the global Internet computer network is rising exponentially (Waldrop 1994: 880). Not surprisingly, attempts at governmental regulation are not far behind. Although Congress has paid some attention to the Internet in the form of the recently invalidated Communications Decency Act, state regulators seem equally anxious to leave their mark on the burgeoning field of cyberlaw. The Georgia legislature has attempted to prohibit Internet users from "falsely identifying" themselves online.[1] Similar legislation is pending in California.[2] The Minnesota Attorney General, Hubert Humphrey III, seeing no need to enact any new laws regarding the Internet, has hastened to deter what he considers to be online violations of Minnesota law, filing a flurry of lawsuits against out-of-state advertisers and service providers (Eckenwiler 1996: S35). The Illinois Attorney General's office is by all accounts equally eager to get into the cyberspace regulation game.

The potential negative effects of such state regulation on the growth and productivity of the Internet are at the very least alarming. The Internet extends beyond the boundaries of any of the states, and the effects of state regulation will likewise spill over state borders. Such regulatory leakage implicates constitutional doctrines designed to preserve both the sovereignty of the individual states and the coherence of the United States as a whole. Thus, the prospect of states applying haphazard and uncoordinated multijurisdictional regulation to the Internet's seamless electronic web raises profound questions regarding the relationship between the several states. To date, legal challengers to state regulation have primarily posed those questions as issues of personal jurisdiction, that is, as challenges to the states' ability to hale

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[1]Ga. Code Ann. § 16-9-9.1 (1996).

[2]California Senate Bill SB-1533 (1996).

out of state defendants into their courts. However, the recent decision of the federal district court in *ACLU v. Pataki* promises to fuel a new wave of legal challenges to state regulation couched as issues of unconstitutional regulation of interstate commerce.

The Nature of the Net

In *ACLU v. Pataki*, a coalition of public interest organizations successfully challenged New York state's "little CDA" law, which prohibited making sexually explicit materials available online to minors. The court held this to be an unconstitutional burden upon interstate commerce. This holding rests directly upon the unique nature of the Internet. The technological miracle that has provoked these issues is perhaps been best described as a network of networks: local computer systems hooked to regional systems hooked to national or international high-capacity "backbone" systems (Cerf 1991: 72). Each link, or node, in this web is a computer or computer site, all connected to others by a variety of means: fiber optic cable, twisted-pair copper wire, microwave transmission, or other communications media. Each computer in the network communicates with the others by employing machine-language conventions known as TCP/IP, or the Internet Protocols (Schultz 1988: 72). Indeed, it is these protocols that define the network; those machines that talk to one another using IP are the Internet.

The medium defined by these shared protocols is distinctly unlike any other (Krol and Ferguson 1995: 26). There is no centralized control of data routing, or for that matter, of almost any other aspect of the Internet (Negroponte 1991: 106). From a technical standpoint, each computer acts autonomously, coordinating data traffic with its nearest connected neighbors, and guided only by the "invisible hand" that arises from the sum of millions of such independent actions. From a management standpoint, each node is similarly autonomous, answering only to its own systems administrator. This means that there is no central authority to govern Internet usage, no one to ask for permission to join the network, and no one to complain to when things go wrong.

Additionally, the Internet protocol provides for "telepresence," or geographically extended sharing of scattered resources. An Internet user may employ her Internet link to access computers, retrieve information, or control various types of apparatus from around the world. These electronic connections are entirely transparent to the user. The "virtual machine" created by the connection appears to be the one at the user's fingertips—indeed, depending upon local network traffic, a distant facility may prove to be faster and more responsive than one in the next room. Internet users may therefore be completely unaware where an online resource is physically located. Moreover, it is frequently impossible to determine the physical location of a resource or user. Such information is unimportant to the network's function or to the purposes of its creators, and the network's design thus makes little provision for geographic discernment.

This unique medium makes available a vast array of interconnected information, including business information. Increasingly, electronic commerce is becoming an important component of interaction online. Businesses of all types routinely use the Internet for a variety of commercial transactions, and consumer services have begun to appear. At present, commercial traffic on the network generally culminates in an exchange of physical goods, and it is presently possible to access a variety of mail-order catalogs on-line, to arrange for purchase of music, books, fast food delivery, even flowers. The variety and availability of such consumer services is likely to grow, as are attendant facilities for online advertising and marketing.

However, the network also offers novel opportunities for transactions involving information-based goods and services. The Internet already supports access to a wide variety of information utilities including databases and computational facilities, as well as archives of text, music, graphics, and software. Information and information-based services on the network have traditionally been offered for free, but will increasingly be offered on a commercial basis. Unlike transactions involving physical goods, delivery of digitized information products such as music, photographs, novels, motion pictures, multimedia works, and software can be accomplished entirely within the network itself. Such information products already constitute a sizeable portion of the gross national product of developed nations. That portion is likely to increase worldwide, and the Internet will facilitate such increases. As online commerce continues to grow, attempts at governmental regulation are sure to follow.

Competitive Federalism

In the United States, regulatory power is divided "vertically" between the states and the federal government, and "horizontally" among the several states. The latter division of power is of primary concern for the Internet. At first consideration, the value of horizontal federalism may seem elusive: myriad states, each with a different legal structure, would seem to foster chaos in determining interstate legal obligations. At minimum, the reality of operating under a variety of legal regimes introduces complexity and additional costs into both individual and business planning.

However, the benefit of jurisdictional diversity has long been celebrated at least anecdotally in the legal literature: diversity forestalls legal and political stagnation. Within the so-called laboratories of the states,[3] various legal regimes may be composed and field tested in an attempt to evolve optimally efficient regulatory systems. Deficiencies or virtues in the respective state systems are expected to become manifest, leading to a "weeding-out" of undesirable rules and promotion of superior approaches. The implication of the "laboratory" metaphor has been that regulatory schemes that prove successful on a small scale may be adopted on a larger scale, either by other states or by the federal government.

More formal public choice models have built upon this intuitive recognition of the benefits of federalism (Epstein 1992: 147). Public choice theory predicts that representative government will frequently be subject to capture by special interest groups (Olson 1965, Buchanan and Tullock 1962). This arises in part from the low marginal value of voting as compared to the higher marginal value of activities such as lobbying. Voters may tend to be "rationally ignorant" or "rationally indifferent" — because a given vote is so unlikely to affect the outcome of an election that it is frequently not worth individual voters' time and effort to bother learning enough about the issues to cast an informed vote, or even to engage in voting itself. By contrast, special interest groups may see substantial pay-offs from activities that may be characterized as "rent-seeking," that is, expending time and money in order to use governmental mechanisms to secure competitive advantages (Tullock 1967: 232).

As a consequence, jurisdictions may become encrusted with special-interest legislation that not only fails to reflect the interests of the majority of voters, but also burdens a wide variety of business and personal activity (Posner 1992: 638). However, one of the virtues of a federal system is that individuals and businesses may express their preferences in more than one manner: when voting at the ballot box fails, they may opt to "vote with their feet" (Epstein 1987: 1454). Local governments that are captured by special interests, or that otherwise fail to reflect voter preferences, may find themselves losing constituents to more responsive regimes. Conversely, jurisdictions that are responsive to constituent preferences may tend to attract new constituents.

[3]New State Ice Co. v. Liebmann, 285 U.S. 262, 311 (1932) (Brandeis, J., dissenting) (describing the states as the laboratories of democracy).

The production of local public goods and services might thus resemble the production of private goods in a competitive market: competitive pressure from other jurisdictions will prevent any given jurisdiction from offering too much or too little in the way of public services. Jurisdictions that offer too much will experience an influx of immigrants from less generous jurisdictions; jurisdictions that offer too little will experience an exodus to more generous jurisdictions. Migration in or out of the jurisdiction will continue until parity with competing jurisdictions is reached. These forces will tend to act as a check on overproduction or underproduction of local public goods. By "voting with their feet," or exiting, citizens force local politicians toward efficiency in allocation of resources to such goods (See Hirschman 1970). Indeed, just as in classic cartel theory the threat of entry deters monopoly profits, so in public choice theory the threat of "exit" may deter special interest regulation from accumulating (Breton 1991: 40).

Thus, if citizens are free to migrate between jurisdictions, competition for desirable citizen immigrants will arise (Tiebout 1954: 416). Local communities will offer to potential immigrants the most attractive packages of goods and services at the lowest tax rate possible. Similarly, migrants will relocate to jurisdictions offering the maximum package of public goods at the tax rate that the migrant is willing to pay. Local communities may even tailor their offerings to appeal to particular types of immigrants, and immigrants would be expected to sort themselves out into groups of similar means and tastes by jurisdiction.

Businesses, too, may "vote with their feet," locating their operations in jurisdictions that offer the most attractive set of local public goods. This in turn implies that jurisdictions may tailor their offerings to attract businesses, or to attract certain kinds of desirable businesses, or even to repel undesirable businesses. One example of such competition may be seen in the "Delaware phenomenon," the empirical observation that a large number of corporations choose to incorporate under the laws of Delaware (Bebchuck 1992: 1435). Much of this effect is now believed to result from interstate competition in "law as a product" (Romano 1985: 225). Delaware appears to have attracted the lion's share of incorporations because the Delaware legal system has specialized in corporate law, offering additional certainty to firms seeking incorporation. Delaware offers not merely a highly developed statutory system, but also a court system with a high degree of expertise in resolving corporate conflicts, and a considerable body of case precedent governing such conflicts. Thus, the total package of Delaware's law succeeds in the incorporation marketplace as a superior product.

Similar interstate competition in the market for other "law products" are predicted by the competitive federal model.

Competition and Cooperation

However, the competitive law model assumes that jurisdictions are tightly compartmentalized so that no external costs or benefits accrue from the local provision of public services. If jurisdictions are "leaky," then individuals could perhaps enjoy the positive benefits of a neighboring jurisdiction's policy without actually incurring the cost of migrating there (Stiglitz 1983: 19). More significantly, in a world of "leaky" borders, jurisdictions could lower the costs of regulation to local firms by imposing all or part of those costs on neighboring jurisdictions. This type of activity might serve to attract firms to a particular jurisdiction, but not necessarily by generating a net gain in efficiency (Posner 1992: 638).

The states may attempt to avoid such a race by entering a cooperative agreement that forbids such a "race to externalize" (Trachtman 1993: 73). However, as in the case of classic economic cartels, such a governmental cartel is likely to be highly unstable (Stigler 1977: 44). If cooperative strategies prove impossible or unworkable, rational competitors may have yet another option. If "horizontal" cooperation between jurisdictions proves unstable, the creation of a "third party" standing in a vertical relationship to the competitors may be necessary (Breton 1991: 48–49). Especially where externalities exist, centralized decisionmaking, rather than interjurisdictional competition, may be required to achieve an efficient outcome. Stated in game theoretic terms, knowing that their own rational short-term competitive preferences will inevitably lead to their own detriment in the long term, states may choose to voluntarily surrender all or part of their decisionmaking power to a third party.

This is in essence the strategy adopted by the individual states of the United States in acquiescing to their constitutional compact that creates a centralized federal government. As the colonial parties to the Articles of Confederation quickly found, certain activities are poor subjects for a cooperative agreement, because it is too attractive to "defect" from the agreement. The solution was to shift regulation of such activities to a central government under the federal constitution (Epstein 1987: 1455). However, under the federal constitution, even when some types of interstate regulation have been centralized, the benefits of interstate competition have also been preserved to the extent deemed practical. Because competitive benefits will be lost in whichever markets are centralized, centralization must be considered a drastic measure taken only where no such efficiencies are to be had; that is, where externalities prevent the development of competition in the first instance.

However, in order for competitive benefits to be maintained, jurisdictional compartmentalization is essential. Thus, the federal compact not only "vertically" transfers certain powers to the federal government, it also defines the "horizontal" relationships between the states that are party to the compact. Significant portions of the constitution appear designed to preserve the jurisdictional conditions necessary for competition in "law as a product." In particular, the Commerce Clause in its dormant aspect forms a constitutional barrier against jurisdictional overreaching by the states. The unprecedented interconnectivity created by the Internet poses new challenges to the jurisdictional aspects of this provision; if the Commerce Clause is to continue serving its proper function in an online environment, its role as a buffer for competitive federalism must be kept firmly in mind.

Instruments of Commerce

This suggests that constitutional parameters for the proper limits of state Internet regulation may be found in dormant commerce analysis (Eckenwiler 1996: S35), and this was the theory adopted by the court in the *Pataki* case. The Commerce Clause of the United States constitution grants to Congress the power to regulate interstate commerce. In its negative or "dormant" aspect, the commerce clause limits the ability of states to impede the flow of interstate commerce (Tribe 1988: § 6-3). Most especially, the dormant commerce clause enjoins the states from the practice that prompted the clause's adoption, a practice endemic under the Articles of Confederation: economic protectionism.

Under the dormant commerce clause, states are not totally barred from regulation of commerce, but a state may not discriminate against articles of commerce from outside the state solely on the basis of the articles' geographic origin. Neither may a state sacrifice the unity of the national market in order to reap purely local benefits. Tariffs and taxes against out of state commerce are almost per se prohibited, but more subtle non-tariff barriers may be prohibited as well. States may have legitimate non-protectionist regulation interests, such as protecting local health and safety, that will burden interstate commerce. If the statute treats domestic and out-of-state commerce equally in order to achieve some legitimate local purpose, incidental effects on interstate commerce will be tolerated unless those effects exceed the putative local benefits.

These rules constitute in part an adjunct to the federal system for situations in which the right of exit alone may not preserve the benefits of interjurisdictional competition (Epstein 1992: 160). For example, the dormant commerce requirements modulate the multistate coordination problem inherent in building interstate facilities such as a railroad, or in operating interstate business ventures such as those of a major insurer. If each state can impose restrictions on the portions of the venture within its territory, then each state can act as a "hold-out," seeking to extract from the interstate enterprise the profits from the entire venture (see Cohen 1991: 351). Alternatively, the aggregate cost of inconsistent state demands may well exceed the total value of the interstate enterprise. However, the dormant commerce clause forestalls such dissipating regulation by its nearly per se rule prohibiting open discrimination against out-of-state commerce, and by prohibiting even facially nondiscriminatory regulation that is overly burdensome to interstate commerce.

The similarity of the Internet to previous interstate "instruments of commerce" such as railroads or trucks is striking. Given that the Internet is not simply a means of communication, but a conduit for transporting digitized information goods such as software, data, music, graphics, and videos, there may be a variety of instances where state regulation of network traffic constitutes an impermissible burden on commerce similar to burdensome regulation of tractor-trailer mudflaps, or of the length of railway trains. For example, several states have considered enacting provisions designed to prohibit access to on-line pornography; some such provisions would make the Internet service provider (ISP) liable if such images were transmitted on her system. However, as discussed at some length above, it is unrealistic to believe that the ISP can screen or block such images. ISPs facing this type unavoidable liability may simply choose to shut down, a result that suggests that such measures are ripe for challenge as an impermissible burden on interstate commerce. Thus, there is a likelihood that state regulation of the Internet will raise the same kind of "hold-out" or coordination problems previously addressed by the dormant commerce clause cases.

However, in the case of the Internet, such state regulatory peccadillos will strike far closer to core liberties than those previously experienced. People familiar with the Internet know that one of the network's great benefits is that the average citizen can participate for a relatively small investment. In the past, communicating or catering to a national constituency required heavy capital outlays; the Internet makes nationwide communication and commerce accessible to citizens for as little as a few hundred dollars (Krol & Ferguson 1995: 23).

But the prospect of multijurisdictional liability may raise the price of participation beyond the average citizen's reach. Much of the network's democratizing influence may be lost if the threat of unseen, lurking multijurisdictional liability deters all but the most heavily capitalized entrepreneurs from pursuing all but the most highly profitable ventures. The average user simply cannot afford the cost of defending multiple suits in multiple jurisdictions, or of complying with the regulatory requirements of every jurisdiction she might electronically touch. Thus, the need for dormant commerce nullification of state overreaching is greater on the Internet than any previous scenario.

Exporting Law

The language of the "instruments of commerce" cases relies implicitly on the "vertical" federal relationship created when the states ceded to the central government authority to regulate interstate commerce in order to avoid certain external costs of interjurisdictional competition. A complementary line of Supreme Court cases recognizes a role for the dormant commerce clause in modulating "horizontal" federal relationships. Whereas the "instrument of commerce" case prohibit states from impeding the ability of businesses to "vote with their feet," these complementary cases hold that the dormant commerce clause operates to prohibit states from exporting their law "products" into the local markets of sister states.

For example, in *Edgar v. MITE Corp.*,[4] the Supreme Court analyzed the ability of a state to dictate corporate merger guidelines to wholly out-of-state corporations. The Court looked at this question through a dormant commerce lens, holding that a statute allowing one state to interdict a tender offer to not only its own residents, but to shareholders in other states, offended the dormant Commerce Clause. The opinion suggested that this was not simply because the state had intruded on power reserved to Congress, but because of the intrusion upon the sovereignty of sister states.

Similarly, in *Healy v. The Beer Institute*,[5] the Court struck down a Connecticut statute that required beer merchants to certify that they offered their products for the same price in states neighboring Connecticut as they did in Connecticut itself. The effect of the statute was to impermissibly regulate beer pricing outside the borders of the state; the Court held that state regulation of activity wholly outside

[4]457 U.S. 624 (1982).
[5]491 U.S. 324 (1989).

the borders of a state offends the commerce clause, whether or not the activity has some effect within the state. The court emphasized that "the Commerce Clause dictates that no State may force an out-of-state merchant to seek regulatory approval in one State before undertaking a transaction in another."

Most recently, in *BMW of North America v. Gore*,[6] the Supreme Court overturned a punitive damage award assessed against an automobile manufacturer that failed to disclose re-painting of new cars damaged in transit from factory. This nationwide practice by the manufacturer violated the consumer fraud provisions of the state of Alabama, where the punitive damages were awarded. However, the defendant showed that its practice complied with the requirements of at least 25 states. The Supreme Court opinion emphasized the impact that punitive damages awards in one state might have on the substantive policies of sister states. The Court stressed that a state cannot impose economic sanctions on violators of its laws in order to induce those entities to alter their lawful conduct in other states.

Regulation and Competition

The function of this constitutional principle seems clear as a matter of competitive federalism: states may not attempt to externalize the costs of their domestic regulatory schemes on other states, or "export" their domestic regulations into another jurisdiction (Posner 1992: 638–9). The most blatant attempt to do this appears in *Healy*, where Connecticut's certification program was admittedly designed to deter Connecticut residents from driving to neighboring states to purchase beer at lower prices than those available in Connecticut—in other words, Connecticut hoped to deter its residents from "voting with their feet" against the state's regulatory scheme. Only by inducing beer distributors to artificially inflate their prices in neighboring states could Connecticut hope to deter such exit. But by forcing a price increase in neighboring states, Connecticut would effectively export the costs of its domestic regulation to its neighbors, potentially frustrating their own domestic regulatory schemes. *Edgar* and *BMW* arose from similar attempts to export the costs of domestic regulation of, respectively, securities or products disclosures. The dormant commerce doctrine articulated in these cases functions as a buffer against such externalization of regulatory costs.

This principle has important ramifications for on-line commerce. Take, for example, the activities of the Securities Bureau in the state

[6]116 S.Ct. 1589 (1996).

of New Jersey. These state regulators have taken a highly pro-active stance toward supervising on-line investment solicitations, and with good reason: a variety of fraudulent investment schemes have appeared both on the Internet and on proprietary systems such as America OnLine (McGeehan 1996: 1A). However, at least some of these regulators have adopted the rather extreme position that any electronic communication which may be received in New Jersey, and which meets the local statutory definition of a "security" is subject to New Jersey securities law, including local requirements of registration and disclosure (Silverman 1995: 10). A former chief of the Bureau has opined that on-line offerings by registered brokers in other jurisdictions, even when legitimate and accompanied by full disclosure, violate New Jersey law if the broker is not registered in New Jersey (Sherman 1995: A3). This position looks suspiciously similar to that of Illinois in *Edgar v. MITE*: a state demanding that out-of-state businesses comply with its domestic securities law, even if the business has fully complied with the securities law of its own state. Indeed, under the New Jersey rationale, online activity is subject to New Jersey regulation whether or not it has any effect in the state. To trigger regulation, the offer need only be electronically accessible from New Jersey, whether or not anyone from New Jersey actually invests. In effect, under this policy, New Jersey is attempting to dictate to the entire nation—if not the world—what the standards for investment offerings shall be.

As a practical matter, this position is untenable. Because of the geographic indeterminacy of the Internet, online businesses and content providers simply cannot tell with any degree of assurance the geographic location from which access to data has been requested, and there is no practical way to screen out contacts from particular jurisdictions. The end result is that on-line businesses have no way of knowing whether their communications, advertisements, transactions, and even shipments of digital goods comply with the regulatory regime of wherever the goods or information may end up, because there is no reliable way to ascertain where the data *will* end up. If online businesses are subjected to the regulation of every potential jurisdiction, Internet commerce will face an almost insurmountable burden in attempting to predict what requirements might be imposed upon it.

This is not to argue that ignorance of the law is an excuse. Given the finite number of U.S. jurisdictions that might have contact with an Internet site, there are only a finite number of applicable state regulations. Businesses could gather information on all the potential regulations—this would be burdensome, but not impossible. The question would then be what strategy a business should adopt, knowing the possible rules, but being uncertain which might apply. Two strategies might be expected to emerge, depending on the pattern of regulation. In instances where the regulation of the 50 states was consistent but merely differed in magnitude, the "lowest common denominator" would have to prevail—if, for example, various states required increasing levels of disclosure about a product or transaction, an online business could opt to offer the highest level of disclosure required. By complying, as the case might be, with either the most demanding or restrictive regulatory regime, a business might satisfy the lesser included requirements of all the other jurisdictions as well.

A different result would be expected where state regulations were inconsistent—if, for example, some jurisdictions required disclosure of certain facts about a product or service, but other jurisdictions forbade such disclosure. In such instances, being unable to predict which jurisdictions' regulation might apply, and being unable to comply with all the potential requirements, on-line businesses might choose to comply with the rule of the majority of jurisdictions, and hope that no transactions occurred where compliance was lacking. But unless the possibility of such transactions were very small, or the penalties for non-compliance were substantially outweighed by the profit to be had from taking the risk, it seems more likely that rational businesses would simply cease to transact business online (Epstein 1992: 160).

The Interstate Laboratory Online

Under the traditional commerce analysis, either of these results is likely to place a serious burden on interstate commerce; depending on the local benefits to be gained by the regulations, the burden may or may not be undue. At least in the situation where online businesses are conflicted out of the market, the detriment to commerce would appear so severe that it is difficult to imagine what local benefits would be sufficient to compensate. This may not always be true in the "lowest common denominator" situation. In the example given of product disclosure, excessive disclosure dictated by the most demanding jurisdiction may be costly, but one can imagine that consumers might benefit enough to outweigh the costs.

However, from the perspective of competitive federalism, the situation is far more grave than the traditional balancing test might suggest. If the "lowest common denominator" prevails among on-line services, then the "laboratory of the states" is disabled. No state wishing to experiment with a lesser level of regulation will be able to do so. Similarly it goes almost without saying that the "laboratory" is disabled in the situation where on-line services are driven out of business by conflicting requirements. Either result arises out of the inability in an on-line environment to geographically circumscribe contacts. In essence, if businesses are subjected to a state's regulation merely on the basis of online contacts, then the businesses cannot "exit" or "vote with their feet" to escape the burdensome regulation of a particular jurisdiction—the regulation follows them wherever they go.

This constitutes an enormous problem for horizontal federalism. A particular state cannot be permitted to dictate to the entire country the regulatory standards for any activity. It is one thing if a particular state wishes to regulate all the businesses within its borders out of existence—the result simply constitutes a terrible failure (or, depending on the state's goal, perhaps a spectacular success) of that state's regulatory experiment within its own laboratory. Excessive in-state regulation may be checked either by disgruntled voters or by a mass exodus of affected firms. But it is another matter entirely if it regulates out of existence businesses that its sister states are attempting to foster within their borders. Sister state constituencies have no opportunity to be heard at the ballot box, and firms cannot "vote with their feet" if there is nowhere beyond the reach of the objectionable regulation to flee.

If national uniformity is to be imposed on a regulatory matter then it is the prerogative of the federal government to do so, and not the prerogative of a particular state. In some instances the Internet will facilitate externalization of domestic regulatory costs—perhaps a state could decide to attract businesses by permitting very lax Internet advertising standards bordering on deception. One would expect that costs of any deception that would result from the lax regulation would accrue primarily outside the permissive jurisdiction, effectively forcing out-of-state residents to pay for the permissive state's system. Yet such a situation does not justify extraterritorial application of other states' more stringent regulations to reach the shady advertisers. To the extent that some Internet activity may facilitate externalization of regulatory costs, then the competitive federal model will function poorly in those areas. But this means that federal regulation, not extraterritorial state regulation, is required—precisely the reason that, under the federal constitution, regulation of commerce was placed in the hands of a central authority. At least at the federal level, the competitive interests of other states have the opportunity for representation, which will not be the case at the "horizontal" level of a sister state's regulatory scheme.

Conclusion

State regulators may of course complain that the constitutional constraints I have outlined, and which have now been adopted by at least one federal court, will prevent them from protecting their citizenry against the very real threats of fraud and vice on the Internet. The answer to such an objection is that although the state may not regulate the citizenry of other states, it is perfectly free to regulate its own citizenry: Minnesota is welcome to penalize Minnesotans who engage in on-line gambling, and New Jersey is welcome to require its residents to file disclosures certifying that they have thoroughly investigated any on-line opportunity in which they decide to invest.

Demand-side regulation is naturally less convenient for the state regulators, but the federal system considered here was not designed with the convenience of regulators in mind. It is rather designed to maximize individual liberties by forcing local governments into a competitive market for regulation. If citizens value stringent protection from on-line fraud and vice, and one state or another offers such protection, then that state may expect an influx of citizens seeking the safety of that regime. If, on the other hand, citizens find such regulation overly burdensome, then that judgment will similarly be manifested either by voice or exit, and the regime should go the way of previous failed experiments from the laboratory of the states.

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