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Radical Experimentation Under Deregulatory Broadband Policies:  
The Rise of Shadow Common Carriers

By

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## I. INTRODUCTION

This paper expands upon my prior research devoted to correcting misconceptions and mischaracterizations of the law of common carriage that unfortunately misinform debates of important telecommunications policies such as network neutrality (Cherry, 2006, 2008a, 2008b, 2010a). This prior research shows that these misconceptions and mischaracterizations have been created by factual and analytical errors arising from analyses that *either totally ignore or improperly frame temporal dimensions of the evolution of the law of common carriage*. By contrast, analyses based on a proper framing of the temporal dimensions in the evolution of common carriage and its relationship to other bodies of law show how the U.S. policy trajectory for broadband Internet access services is a radical one (Cherry, 2008b, 2010b) that creates legal gaps not filled by antitrust or general consumer protection laws (Cherry, 2010a).

The radical nature of U.S. deregulatory broadband policy is clear when viewed in light of deregulatory policies adopted for transportation common carriers in the U.S. (Cherry, 2008b). In many ways, deregulatory telecommunications policies have followed a trajectory similar to that of deregulatory transportation policies. For this reason, in some ways experience under deregulatory policies in transportation industries is being replicated in telecommunications, such as recurring sustainability problems for universal service mechanisms, conflicting court decisions related to the effects of detariffing, and uncertainty regarding the scope of other federal and state causes of action outside of the industry-specific regulatory regime. However, there are important limitations on what can be learned from deregulatory transportation policies – unlike broadband policy – that did not eliminate the legal status of the service providers as common carriers.

Instead, we need to look at experience from other industries vital to the U.S. economy for insights as to the consequences of deregulatory policies that create *shadow* versions of regulated activities. This paper explores lessons learned from deregulatory banking policies, under which shadow banking activities have not only negatively affected certain classes of individuals but also created or exacerbated systemic risks for the financial sector. In the context of the recent financial crisis, Paul Krugman, a Nobel Laureate in economics, asserts “[w]hat ended the era of U.S. stability was the rise of ‘*shadow banking*’: institutions that carried out banking functions but operated without a safety net and with minimal regulation” (2010, emphasis added). Due in part to banking deregulation since 1980, “institutions and practices [of shadow banks] ... recreated the risks of old-fashioned banking but weren’t covered either by guarantees or by regulation. The result, by 2007, was a financial system as vulnerable to severe crisis as the system of 1930. And the crisis came” (Krugman: Punks and Plutocrats, 2010).

Recognizing that FCC classification of broadband Internet access services as Title I information services (with no Title II common carriage service component) has created *shadow common carriers* facilitates our understanding of systemic risk introduced by deregulatory telecommunications policies. Acknowledging the rise of shadow common carriers complements insights from prior analyses, applying a complexity theory perspective to examine the consequences of deregulatory telecommunications policies, that reveal a growth of systemic risks. Insights from these analyses include: the legal gap created between an industry-specific Title I regime for broadband and the general business regime of antitrust and consumer protection law (Cherry, 2010a); the unsustainability of a communications infrastructure with the desired emergent properties of widespread availability, affordability and reliability (Cherry, 2008a); and negative inter-infrastructure effects, such as the increased threat to the sustainability of the U.S. postal system (Cherry, 2006). Moreover, through federal preemption and elevation of free speech rights of broadband shadow common carriers (Cherry, 2011), deregulatory policies have also diminished the capacity of the U.S. policymaking system to further adapt its policies. In this way, deregulatory policies compound systemic risks, increasing the systemic risk that the U.S. policymaking system will be unable to respond to the systemic risks arising from the creation of shadow common carriers.

## II. THE CREATION OF SHADOW BANKING AND THE GROWTH OF SYSTEMIC RISKS

Cherry (2008c, p. 27) discussed how “[t]he recent financial crisis in the United States and its global diffusion are illustrative of the catastrophic consequences that may arise from deregulatory policies and a continuing failure of government adaptation through regulatory resilience.” The turbulence in the financial markets and the stress on the political system to respond reflect the chaos of catastrophic potential that may arise from failures of complex systems, in this case facilitated by deregulatory banking policies. Beyond its impact on the financial sector, deregulatory banking policies also contribute to more fundamental challenges of institutional governance such as the sustainability of the rule of law (Cherry 2008c). This section further examines developments in the financial sector – in particular the rise of shadow banking activities and the consequent growth in systemic risks – for insights as to likely consequences of deregulatory telecommunications policies.

### *A. How Shadow Banking Activities Have Been Created*

“Shadow activities” refers to those actions that meet the general definition of the “activity”, but fail to be recognized or regulated by public or government instructions as such. Distinctions among regulated and non-regulated entities and/or their activities are defined in legal terms.

“Shadow banking” has been used in different contexts to describe several, distinct groups of activities. These groups include off-balance sheet activities, non-bank consumer loan operations, informal community loan activities based on trust,<sup>1</sup> and fraudulent activities. The variety of activities characterized as “shadow banking” is reflective, and perhaps best understood by examination, of the differing ways in which they arise.

Some shadow banking activities were created to avoid regulatory rules, either legally or illegally. Legal activities include off-balance sheet activities created to avoid capital requirements (Bank for International Settlements, 1986; Wall and Peterson, 1996), as well as money market funds as a method to bypass Regulation Q that had regulated interest rates of

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<sup>1</sup> Although not relevant to this paper, prior to modern banking and continuing in parallel in many modern economies, “handshake” money lending through community activities has also been described as a form of shadow banking. Examples include grey market loan-making in China (See article <http://www.todayonline.com/Commentary/EDC110405-0000312/Chinas-shadow-financial-world> updated April 5, 2011) and the use of gold dowries in India (Power, 2003).

savings accounts.<sup>2</sup> Illegal activities include myriad forms of fraudulent, off-book activities (Singh and Laurila, 1999; Morris and Pronto, 2000).

Other shadow banking activities have been created as a matter of law through deregulatory policies that either dismantled prior regulatory limitations on activities or prohibited regulation of new activities enabled by innovation. An example of dismantling prior regulation is the Garn-St. Germain Depository Institutions Act of 1982 that deregulated savings and loans associations and allowed banks to provide adjustable-rate mortgage loans. Another example is the Gramm-Leach-Bliley Act of 1999, otherwise known as the Financial Services Modernization Act of 1999, that repealed part of the Glass-Steagall Act of 1933 and allowed commercial banks, investment banks, securities firms, and insurance companies to consolidate. Repeal of these regulatory rules combined with technological innovations in computers and mathematical algorithms gave rise to new complex, financial instruments. An example of prohibiting regulation of new activities is the Commodity Futures Modernization Act of 2000 that essentially exempted these new financial instruments, such as derivatives and swaps, from oversight by agencies that regulated more conventional financial assets. This Act also continued existing 1992 preemption of any state laws that would treat over-the-counter derivatives as gambling or otherwise illegal.

Finally, some shadow banking activities have grown from unintended consequences of deregulatory policies. For example, the Depository Institutions Deregulation and Monetary Control Act of 1980 allowed institutions to charge any interest rates they choose, and removed regulatory limits on savings account interest rates by repealing Regulation Q. With this deregulation, banks were forced to pay market interest rates to compete for larger deposits and to discontinue loss-leader perks such as no-fee checking accounts. The decline in financial savings of households combined with the increased costs of checking accounts led to a substantial reduction in deposit account ownership (Caskey, 1995). In response, there was a boom in check-cashing outlets and pawnshops that engage in fringe, or shadow, banking for the segment of consumers without bank accounts (Caskey, 1995).

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<sup>2</sup> Regulation Q (12 U.S.C. 371a) was part of the Banking Act of 1933, which has been repealed.

### *B. The Growth of Systemic Risks from Shadow Banking*

Policy innovations arose from the banking panics of the 1930's to address the systemic risk of bank runs (Acharya, Cooley, Richardson, and Walter, 2011, pp. 5-6). One of these innovations is the Banking Act of 1933, which created the Federal Deposit Insurance Corporation to provide credible government insurance for individual bank deposits and effectively dealt with the problem of retail bank runs. The 1933 Act also created the Glass-Steagall provisions, which separated investment banks from commercial banks in an effort to insulate depositors' savings from being used to finance high-risk investments in financial markets. Another innovation is considered to be the framework created by the Securities Act of 1933 and the Securities Exchange Act of 1934. These Acts were intended to ensure that investors receive material information concerning securities offered for public sale and to redress market misbehavior; they also required public financial information be verified by independent auditors using standardized accounting rules. Collectively, all these Acts enabled a national financial system with the emergent properties of stability and liquidity.

The rise of systemic risks – both new from innovation and recurring from deregulatory policies – has changed the emergent properties of the financial systems in the U.S. and internationally. Over the past three decades, financial markets have become more dynamic and unstable (Hacker and Pierson, 2010, p. 68). As early as the 1980s, problems posed by complex, off-balance sheet activities have been recognized. Hyde (1986) states “Perhaps most alarming to industry watchers are some of the newer forms of off-balance sheet (or what some are calling ‘shadow banking’) activities. Swaps, for example, because of their complexity, must be carefully coordinated to avoid threatening liquidity. Most of the other shadow-banking activities also have inherent problems” (p. 4).<sup>3</sup> More recently, Hacker and Pierson (2010) assert that “[t]echnological innovation made possible the development of new financial instruments and facilitated spectacular experiments with securitization” (p. 68), and that “the development of complex new financial products ... increased the risk to the system as a whole” (p. 67)

Acharya et al (2011) describe the tremendous growth in systemic risk arising from failures of financial institutions created by deregulatory policies — that have dismantled prior rules that had been imposed to promote financial stability — and technological innovations in the

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<sup>3</sup> The text of this quote appears on p. 4 of the article available on the LexisNexis database.

financial sector.<sup>4</sup> “There is in essence a negative externality on the system because the systemic cost of a financial institution’s collapse — which can lead to failures of others, the freezing of capital markets, or both — is not fully internalized by that institution” (Acharya et al, 2011, p. 15). With regard to the financial crisis of 2007-2009, they assert, “The market failure here was that regulation should have been focused on such externalities so as to curb the risks to the financial sector and the economy at large. However, prudential regulation of the financial sector has focused not on systemic risk but rather on the individual institution’s risk profile. This design is seriously flawed” (Acharya et al, 2011, p. 15).

More specifically, Acharya et al describe “several types of systemic risk that can be generated from the failure of a financial institution, especially during a financial crisis” (2011, p. 16). One type is counterparty risk, whereby “[i]f a financial institution is highly interconnected to many other financial institutions, then its failure can have a ripple effect throughout the system” (Acharya et al, 2011, p. 16). Examples include derivatives and credit default swaps. This negative externality creates incentive to become too big to fail, pushing institutions to the model of large complex financial institutions (Acharya et al, 2011, p. 18). Furthermore, different types of institutions with different regulation and guarantee levels, and mispriced guarantees and excessive risk taking for any one type can wreak havoc on the whole financial sector (Acharya et al, 2011, p. 18).

Another type of systemic risk is “spillover risk that arises as one institution’s trouble triggers liquidity spirals, leading to depressed asset prices and a hostile funding environment, pulling others down and thus leading to further price drops and funding illiquidity” (Acharya et al, 2011, p. 17, footnote omitted). This recently occurred with the subprime collateralized debt obligations.

A third type of systemic risk consists of bank-like runs in the shadow banking system. A recent example is the run on investment banks and money market funds after Lehman Brothers failed due to uncertainty and lack of information about the health of these institutions. (Acharya et al, 2011, pp. 27-28)

Determining appropriate policy responses to the growth in systemic risks is hotly debated. A short-term response in the U.S. consisted of emergency bailout legislation exceeding

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<sup>4</sup> Similarly, Krugman (2009, p. 163) asserts “politicians and government officials should have realized that we were re-creating the kind of financial vulnerability that made the Great Depression possible.”

\$700 billion intended to constrain the devastation to the financial system and the economy of the subprime mortgage crisis and the failure of Lehman Brothers. With regard to long-term reform, the Dodd-Frank Wall Street Reform and Consumer Protection Act was enacted and signed by Pres. Obama in 2010. Some argue that the Dodd-Frank Act is not strong enough to adequately protect consumers or to sufficiently cut the size of big and interconnected financial entities (Morgenson, 2010). There is vigorous discussion as to what further regulatory reforms may be necessary to address the various forms of systemic risk. Although beyond the scope of this paper to address in detail, recommended reforms include the need to reimpose regulatory measures similar to those that had been repealed or rendered inapplicable under deregulatory policies. For example, to prevent bank runs on investment banks, Acharya et al (2011, pp. 27-28) advocate establishing mechanisms to guarantee liabilities and imposing restrictions on the scope of activities in a manner similar to Glass-Steagall.

### *C. Evolution of Regulation to Protect Consumers of Shadow Banking Services*

In addition to exacerbating systemic risk, shadow banking activities have negatively affected certain classes of individuals. As previously discussed, the growth of check-cashing outlets and pawnshops for consumers without bank accounts was an unintended consequence of the Depository Institutions Deregulation and Monetary Control Act of 1980. Many states have responded to the proliferation of these non-bank consumer services through regulation of this shadow banking system.

For example, in the 1980's, the Consumers Union, a public interest law firm, pushed for bills to be introduced in multiple states to force provision of low cost "lifeline banking" services (cheap bank services for poor people). Several states have since enacted "Lifeline or Basic Banking" regulations, which forced banks to provide some no-frills bank services for low cost, such as free cashing of government checks (Elerding, 1985, pp. 147-155). New Jersey was the first to do so in 1991 with the New Jersey Consumer Checking Act, N.J.S.A. 17:16N-1. Another example is the regulation of payday loan activities. By 2000, payday loans are legal and regulated in 37 states, and effectively or explicitly banned in 13 states (Drysdale and Keestaal, 2000).

Most recently, the federal government has established the federal *Bureau of Consumer Financial Protection* in the Dodd-Frank Wall Street Reform and Consumer Protection Act of



2010. The Bureau will become active in July 2011, introducing a new source of potential federal regulation over the consumer financial services industry.

### **III. THE CREATION OF SHADOW COMMON CARRIAGE AND THE GROWTH OF SYSTEMIC RISKS**

As with banking, over time “shadow common carriers” have been created in different contexts based on legal distinctions among regulated and non-regulated entities and/or their activities. In the U.S., common carriage regulation under federal law applies only to those services classified as telecommunications services under Title II of the Communications Act of 1934. In recent years, in light of technological innovations in communications and the pursuit of deregulatory policies, the FCC has classified a number of services as *not* being Title II services, at both the retail and wholesale levels, even though such services are provided in competition with and are substitutes for Title II services. In many cases, the FCC has classified such services as information services under Title I of the Communications Act of 1934, for which the FCC’s jurisdiction is narrowly limited.<sup>5</sup> Moreover, in determining that such services are Title I and not Title II services, the FCC has preempted the States from imposing requirements that are inconsistent with its ruling; as a result, the FCC’s ruling effectively applies to both interstate and intrastate activities.<sup>6</sup>

In this regard, the most significant ruling by the FCC has been its classification of broadband Internet access services as information services under Title I, even though narrowband access to the Internet remains a telecommunications service under Title II. With regard to Internet Protocol (IP) enabled services, including Voice over Internet Protocol (VOIP), the FCC’s classification scheme is mixed and not fully resolved.<sup>7</sup> Thus far, the FCC has failed to resolve classification of IP-enabled services as a general matter, but has only ruled as to the

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<sup>5</sup> The FCC’s jurisdiction over Title I services is not direct but restricted to “ancillary jurisdiction”, that is, jurisdiction that is derived from and ancillary to its jurisdiction derived from other portions of the Communications Act of 1934.

<sup>6</sup> Under the U.S. Constitution, the federal government has jurisdiction over interstate commerce and the States have jurisdiction over intrastate commerce. However, through exercise of preemption powers, there are contexts in which the federal government can preempt States’ regulatory powers over intrastate activities.

<sup>7</sup> In 2004, the FCC initiated a rulemaking to examine issues relating to IP-enabled services, including its statutory classification as a telecommunications or information service, which is still pending (In the Matter of IP-Enabled Services, 2004).

classification of services provided by some specific providers. For example, AT&T's phone-to-phone IP service has been classified as a Title II service (In the Matter of Petition for Declaratory Ruling of AT&T, 2004), whereas pulver.com's VOIP service has been classified as a Title I service (In the Matter of Petition for Declaratory Ruling of pulver.com, 2004); the distinction in classifications is based on differing technical configurations used to provide the services, with AT&T's service being offered over the public switched telephone network (PSTN) and pulver.com's service being offered through a broadband connection obtained from yet another provider. Most recently, the FCC declined to classify mobile data service providers as common carriers under the Communications Act of 1934, although under its Title III authority it did require such facilities-based providers of commercial mobile data services to offer data roaming arrangements to other such providers on commercially reasonable terms and conditions.<sup>8</sup>

The coexistence of competing services in which some are legally classified as common carriers and others are not has created competition between common carriers and "shadow common carriers". For those shadow common carriers classified as Title I services, the baseline obligations are legally undefined and their development by the FCC is narrowly constrained jurisdictionally. The network neutrality debate represents the struggle to define the basic obligations of those shadow common carriers that provide services through access to the Internet and classified as Title I. As to the attempts to define obligations of the various types of shadow common carriers, the policy debate over network neutrality has received the most attention by the media, both nationally and internationally. But it is important to recognize that similar debates are occurring with regard to the obligations of other types of shadow common carriers, such as those providing VOIP.

This section incorporates and integrates analyses in prior research to describe the rise of shadow common carriage and to explain why it is a radical policy development. It begins by reviewing the original meaning of common carriage as legally enforceable relational norms under the common law, which have been retained through various modifications under statutory law. It then reviews how broadband Internet access services were eventually classified as Title I services, which was a radical departure from prior policy.

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<sup>8</sup> Title III of the Communications Act of 1934 provides FCC jurisdiction over radio communication. Title III has been previously amended to provide the FCC jurisdiction over mobile communications, under which commercial mobile service providers are treated as common carriers but exempt from some provisions of Title II related to rate regulation.

This section then discusses how efforts to establish baseline obligations of shadow common carriers are really attempts to reconstruct norms already embedded in common carriage. However, the political fight over Title II classification – political pressure to avoid legal classification as Title II – creates artificially constructed distinctions between common carriers and shadow common carriers for political purposes that obfuscates sorely needed recognition of the critical relational norms that should govern provision of the various services. Unfortunately, fixation on the statutory classification scheme has diverted policymakers’ focus from consideration of the systemic risks and macro-effects likely to ensue from the creation of shadow common carriers. Several examples, which are more thoroughly discussed in prior research, are then provided.

#### *A. Common Carriage Imposes Legally Enforceable, Relational Norms Under Tort Law*

A critical component of my research has been devoted to correcting misconceptions and mischaracterizations of the law of common carriage that unfortunately misinform debates of important telecommunications policies. These misconceptions and mischaracterizations arise from errors in analyses that *either totally ignore or improperly frame temporal dimensions of the evolution of the law of common carriage*. Yet a historically accurate, temporal analysis<sup>9</sup> of the evolution of common carriage and related bodies of law is critical for understanding how deregulatory policies have created shadow common carriers, both reintroducing and producing systemic risks.

Many misconceptions and mischaracterizations of common carriage arise from a failure to understand its legal origins. Unfortunately, many social science scholars and even lawyers misattribute the origins of common carriage regulation in the United States to statutory law, and for communications in particular to the Communications Act of 1934 — both assertions are factually wrong and form the basis for flawed analyses. These assertions ignore the common law

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<sup>9</sup> Pierson (2004) examines the importance of *time* in conducting analyses in political contexts. He asserts that analyses underlying recommendations for policy change require “theoretical understandings of the different ways in which ‘history matters’” (Pierson, 2004, p. 6) “Yet an exploration of these temporal dimensions of social processes is precisely the weakest link in social science’s historical [development].... Many of the key concepts needed to underpin analyses of temporal processes, such as path dependence, critical junctures, sequencing, events, duration, timing, and unintended consequences, have received only very fragmented and limited discussion” (Pierson, 2004, pp. 5-7). Pierson discusses the tendency in recent years for research to distort social events or processes by ripping them from their temporal context – such as distortions endemic to neoclassical economics – and examines how to more appropriately conduct analyses involving long term processes.

origins of common carriage, as well as the foundational legal norms under tort law that have been preserved in subsequent statutory laws of common carriage.

Tort law is first and foremost a law of responsibilities and redress. It identifies what we will call “loci of responsibility.” These loci consist of spheres of interaction that come with, and are defined (in part) by relational duties: obligations that are owed by one person to others when interacting with those others in certain contexts and in certain ways. Beneficiaries of this special class of duties enjoy a concomitant privilege or power; they are entitled to seek legal redress if injured by the breach of one of these duties. (Goldberg and Zipursky, 2005, p. 368)

The duties imposed under tort law are *relational norms* that “enjoin persons from acting toward certain other persons in certain ways” (Goldberg and Zipursky, 2010, p. 45). Moreover, “Torts are legal wrongs for which courts provide victims a *right of civil recourse* — a right to sue for a remedy” (Goldberg and Zipursky, 2010, p. 71, emphasis added).

Under the common law, the duties of common carriers are *tort obligations* to serve upon reasonable request without unreasonable discrimination at just and reasonable prices and performed with adequate care (Cherry, 2006, p. 962). Common carrier obligations are legally enforceable, relational norms. Importantly, common carriers bear these obligations merely based on the existence of their economic relationship with customers, *independent of any requirement or finding of monopoly or market power*. Moreover, these duties require common carriers not to interfere with customers’ interests, “notwithstanding the liberty restriction inherent in such a duty imposition” (Goldman and Zipursky, 2010, pp. 21-22, footnote omitted).

To argue that common carriage obligations should be imposed only upon a finding of monopoly or market failure, both ignores and misunderstands the long-recognized “[r]elational directives ... [to] enjoin [common carriers] to treat or to refrain from treating *other persons* in a particular way” (Zipursky, 1998, p. 59, emphasis in original).<sup>10</sup> As a general matter, the law and economics perspective fails to capture the notion of “right” (Zipursky, 1998, p. 82) or to

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<sup>10</sup> As Cherry (1999, 2008a) explains, public utilities historically received certain privileges pursuant to a contractual relationship with government in exchange for which they bore certain obligations. These privileges included protection from market entry, usually through monopoly franchises. It is at this juncture that the existence of monopoly became relevant to the regulatory obligations imposed on public utilities, some of which were also common carriers. Unfortunately, the dual classification of telephone companies, now telecommunications carriers, as both common carriers and public utilities has led to factually inaccurate and inappropriate association between common carriage obligations and monopoly or market power.

understand that “[t]ort law is not just a system for the selective imposition of liability in ways that will maximize wealth or other social welfare goals”(Zipursky, 1998, p. 4).

As explicitly stated in the Cullom Report (1886, pp. 175-180),<sup>11</sup> the federal statutory regime of common carriage developed not because common carriage obligations were not needed, but because (1) the common law remedies relying on judicial litigation by customers were considered inadequate; (2) States lacked jurisdiction over interstate commerce; and (3) reliance on competition was deemed insufficient to protect customers from unreasonable discriminatory practices in interstate commerce. Congress thus enacted the Interstate Commerce Act of 1887, codifying the relational norms of common carriage but altering the means of their enforcement, which included the establishment of and oversight by a federal regulatory agency and requiring the filing of tariffs containing a schedule of rates, term and conditions of service. The ICA was later amended in 1910 to apply to telegraph and telephone companies, and provided the basis for the statutory framework of Title II of the Communications Act of 1934 when federal jurisdiction over telegraph and telephone companies was transferred to the newly created FCC.

#### *B. The Initial Application of Common Carriage with respect to Information Services*

Beginning in the 1960’s, the FCC struggled with the regulatory treatment of computer networks over communications networks. Through a series of proceedings, known as the *Computer Inquiry* proceedings, the FCC developed a classification scheme based on a dichotomy between basic services and enhanced services (Cannon, 2003). Basic service was defined as the offering of “a pure transmission capability over a communications path that is virtually transparent in terms of its interaction with customer supplied information” (Cannon, 2003, p. 183, footnote omitted). Enhanced services, although “offered over common carrier transmission facilities ... employ computer processing applications that act on the format, content, code, protocol or similar aspects of the subscriber’s transmitted information” (Cannon, 2003, pp. 185-186, footnote omitted).

Under this dichotomy, the FCC determined that enhanced services provided via narrowband telecommunications had a separable telecommunications service component,

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<sup>11</sup> The U.S. Senate Report of the Senate Select Committee on Interstate Commerce, established to address the “railroad problem”, is usually referred to as the Cullom Report, named after Senator Cullom who chaired the Committee.

defined as basic service (Cannon, 2003). In these proceedings, the Commission imposed Title II common carriage obligations on the telecommunications service component (basic service) to address potential anticompetitive conduct by telecommunications carriers with regard to competitors in an ancillary market — consisting of unaffiliated enhanced service providers (ESPs) — for whom access to the carrier’s underlying telecommunications facilities was deemed essential. In this way, there was a convergence of concerns with discriminatory and anticompetitive conduct, to which application of common carrier obligations by Commission rule was deemed a solution; however, the application of common carriage relational norms on telecommunications carriers in serving unaffiliated ESP’s arose from a different economic relationship than that between carriers and (enduser) customers under the common law. Thus, for the provision of enhanced services via narrowband telecommunications, both the enduser customer and unaffiliated ESPs obtained the telecommunications service component through a common carriage relationship with the underlying common carrier.

After enactment of the Telecommunications Act of 1996, this framework was subsequently applied to carriers’ provision of DSL (broadband) services — although, under the 1996 Act, the relevant terminology is information service rather than enhanced service.<sup>12</sup> In 1998, the FCC classified DSL service as a Title II common carriage service available to endusers, and the telecommunications component was available on a common carriage basis to unaffiliated Internet access service providers (ISPs) per FCC rule to prevent anticompetitive conduct by the carrier (In re Deployment of Wireline Services, paras. 36-37).

### *C. The Subsequent Inapplicability of Common Carriage with respect to Information Services*

Beginning with cable modem access in its *Cable Modem Declaratory Ruling* in 2002<sup>13</sup> and then following with DSL access in its *Wireline Broadband Order* in 2005,<sup>14</sup> the FCC reversed course and classified broadband Internet access service as an information service under Title I without a separable telecommunications component under Title II. In so doing, *the FCC placed broadband access service on a different legal trajectory by eliminating provision of the underlying*

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<sup>12</sup> The FCC interpreted “information service” under the Telecommunications Act of 1996 to include what the FCC had classified as “enhanced service” prior to the 1996 Act.

<sup>13</sup> The FCC’s ruling in Inquiry Concerning High-Speed Access to the Internet Over Cable and Other Facilities (2002) is often referred to as the *Cable Modem Declaratory Ruling*.

<sup>14</sup> The FCC’s report and order In the Matter of Appropriate Framework for Broadband Access to the Internet over Wireline Facilities (2005) is often referred to as the *Wireline Broadband Order*.

*telecommunications on a common carriage basis to both enduser customers and ISPs.* With regard to endusers, the entity providing the underlying telecommunications is no longer subject to the longstanding legally enforceable norms of common law common carriage, later codified in the Communications Act of 1934. To the extent that the FCC had extended these norms to unaffiliated ISPs under the *Computer Inquiry* cases, it also now permits the providers to violate those norms to competitors. This non-common carriage trajectory continues under the FCC's recent order establishing network neutrality rules (In the Matter of Preserving the Open Internet Broadband Industry Practices, 2010); and, to the extent that obligations are imposed in this order, their sustainability upon judicial review is highly uncertain.

The FCC's elimination of common carriage access to telecommunications for both enduser customers and unaffiliated ISPs has created *shadow common carriers*. The entities (telecommunications carriers and cable companies) providing the underlying telecommunications by which information services are conveyed are performing what had previously been legally classified as common carriage functions but now with minimal regulation. They do not bear responsibility for violating the longstanding relational norms of common carriers.

#### *D. Loss of Common Carriage and Effects on Emergent Properties and Individual Rights*

The significance of eliminating these relational norms of common carriage to telecommunications provided over broadband networks, and thereby creating shadow common carriers, has been obscured by discourse within the network neutrality debate (Cherry 2006). In this regard, some parties assert that neither common carriage nor network neutrality rules are necessary for the provision of broadband Internet access services because competition is sufficient to protect against abuses of discrimination and that any remaining problems should be addressed under antitrust law.<sup>15</sup> These assertions, made without any reference to the historical evolution of common carriage, are fundamentally flawed.

First, these assertions ignore how the relational norms underlying common carriage obligations functioned as an early form of consumer protection to enduser customers (Cherry, 2008a, 2010a). The professed ability to simply rely on competition squarely contradicts the

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<sup>15</sup> For example, on April 12, 2010, twenty-two economists filed a letter with the FCC making such assertions in the rulemaking proceeding on network neutrality rules (Eisenach, 2010).

findings of Congress in the Cullom Report that, even with common carriage obligations, the common law remedies were inadequate and competition was insufficient to protect consumers. As a result, enforcement of these legal norms necessitated creation of the statutory framework of common carriage in the Interstate Commerce Act of 1887, which was later incorporated in the Communications Act of 1934.

Second, these assertions ignore how public utility obligations functioned as an early form of social welfare regulation to ensure availability of an essential service throughout a community (Cherry 2003, pp. 768-771), often through grant of a monopoly franchise.<sup>16</sup> It is the coexistence of these common carriage and public utility obligations – augmented under federal and state statutory regimes – that have provided the legal foundation for generating the desired emergent properties of widely available, affordable and reliable transportation and telecommunications infrastructures” (Cherry, 2008a, p. 950).

Third, a fundamental error embedded in such claims is a failure to appreciate that the industry-specific legal regimes of common carriage and public utilities largely *predate* the legal regime for general businesses consisting of antitrust and consumer protection laws.

Recognition of this temporal sequence is critical, as the statutory general business regime evolved as an adjunct to the industry-specific statutory regimes. As a result, in numerous cases and circumstances the general business regime has been preempted or superseded by the industry-specific regimes, and, for such situations, further evolution of the general business regime thereby addressed issues *not* covered by the traditional industry-specific regimes... [U]nder deregulatory policies ... it is unclear whether the general business regime will adequately address the situations or circumstances that had previously been addressed by the traditional industry-specific regimes. (Cherry, 2010a, p. 13, emphasis in original).

Consequently, deregulatory policies may create “legal gaps” between the general business and deregulatorily adjusted industry-specific regimes.

In the retail market, the elimination of common carriage obligations by the Commission’s

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<sup>16</sup> Some confuse common carriers with public utilities. They are not synonymous, although some entities – such as telecommunications carriers – are both common carriers and public utilities. The common law of public utilities developed in the nineteenth century based on a relationship between government and certain entities under which some governmental privilege, such as access to public rights-of-way or eminent domain power, was granted to the entity (Cherry 2008a, p. 962). The grant of such privilege was considered a franchise, under which certain obligations were specified in a written agreement or at a minimum imputed under the common law. These obligations include relational norms similar to those of common carriers, an affirmative duty to extend facilities to provide service, and a barrier to discontinuance of service. Some franchises also protected the public utility from competitive entry.



classification of broadband Internet access services as Title I information services has left enduser customers without civil recourse for violation of the underlying relational norms. The FCC's adoption of network neutrality rules in December 2010 is an attempt to provide some protection to customers, but their sustainability upon appeal is doubtful – as the rules are still based on Title I jurisdiction, which the D.C. Circuit Court of Appeals found insufficient to support an earlier FCC order prohibiting certain network management practices (*Comcast v. FCC*, 2010) – and the House of Congress has already passed a resolution pursuant to the Congressional Review Act to repeal the rules. In the wholesale market, given the uncertain validity of the essential facilities doctrine under antitrust law under *Verizon v. Trinko* (2004, pp. 410-411), the elimination of the common carriage provision of the underlying telecommunications to unaffiliated ISPs has also jeopardized the availability of a legal remedy to such ISPs. As for a nationwide network, reliance solely on the general business regime is inadequate to develop and sustain the desired emergent properties of widely available, affordable, and reliable broadband infrastructures (Cherry, 2008a, pp. 956-967).

#### *E. The Growth of Systemic Risks from Shadow Common Carriage*

Ahistorical analyses bearing the flaws described in the previous section serve to misframe inquiry. They do not acknowledge – and encourage policymakers to divert much-needed focus from – the systemic risks to the communications infrastructure, as well as other infrastructures with which it interconnects, created by deregulatory telecom policies. As with the banking industry, we need to review experience over time under differing legal structures for telecommunications services in order to appreciate what norms or rules are needed to address and prevent systemic risks, and to understand how deregulatory telecommunications and broadband policies create shadow activities that reintroduce or create systemic risk.

Framing inquiry from a historical perspective reveals several forms of systemic risk introduced by deregulatory policies, which have thus far been insufficiently addressed and in most cases not even recognized by policymakers. As previously discussed, some arise from the disruption of the interrelationships among industry-specific and general business legal regimes. As explained in depth in Cherry (2010a), for Title II services, enactment of new and (re)interpretation of existing savings clauses creates uncertainty as to what causes of action can be brought under the Communications Act of 1934 on the one hand and under the antitrust and

consumer protection laws on the other. Moreover, for Title I services, an entirely new interface must be constructed with the antitrust and consumer protection laws. The adverse consequences are not confined to a few unfortunate customers or ISP's, but potentially impact the entire nation by impeding the development and sustainability of an overall broadband infrastructure with desired emergent properties of widespread availability, affordability and reliability.

Deregulatory policies are also creating or exacerbating problematic, inter-infrastructure effects. First, the FCC has created intramodal asymmetric regulation between telecommunications carriers' narrowband and broadband networks. The differential economic effects of "such asymmetry may ultimately lead to the unavailability of *any* common carriage-provided service, whether narrowband or broadband" (Cherry, 2006, p. 498, emphasis in original, footnote omitted), thereby negatively affecting customers of both narrowband and broadband services.

Second, deregulatory policies may lead to devastating, unintended consequences for the U.S. Postal Service (USPS). Increasing electronic substitution of communications over the Internet for First-Class Mail is undermining the financial viability of the USPS. The USPS is a common carrier system, and "[t]o address the financial unsustainability of the USPS' current business model, the President's Commission on the United States Postal System recommends that the USPS become more Internet-dependent through both coordination of internal operations and provision of valued-added services to customers" (Cherry, 2008a, p. 968, footnote omitted). Will increasing the USPS system's reliance on a non-common carriage broadband infrastructure lead to deterioration of the geographic availability of the postal system, and even to the de facto erosion of common carriage provided by the postal system? Policymakers have not focused on the inter-infrastructure effects between the broadband and postal systems as non-common carriage and common carriage systems, respectively.

Third, telecommunications infrastructure interconnects with other critical infrastructures, such as transportation and electricity. Outages, failures, and performance characteristics in one infrastructure can dramatically and adversely affect performance in the others, as demonstrated by telecommunications network outages affecting airports and the electricity Northeast Blackout of 2003 bringing down the cellular network. Potential adverse consequences may be exacerbated for transportation and electricity networks as they increasingly interconnect with broadband networks, because "packet-switched networks are less secure and reliable than traditional

wireline, circuit-switched networks, and the Internet is extremely fragile to targeted attacks” (Cherry, 2008a, p. 969, footnotes omitted). To the extent that deregulatory policy hastens substitution of broadband for narrowband networks, higher risk and lower network reliability are externalized to these other infrastructures.

#### *F. Compounding of Systemic Risks From Less Adaptable Policymaking System*

Deregulatory policies creating shadow common carriers have also created mechanisms of entrenchment that lessen adaptability of the U.S. policymaking system. One such mechanism is federal preemption. For example, the FCC’s classification of broadband Internet access services as Title I information services preempts the States from imposing requirements that are inconsistent with this ruling. In addition, the States’ have limited ability to act even while the overall classification of IP-enabled services under federal law remains unresolved.<sup>17</sup> Consequently, the FCC has blocked experimentation by the States to compensate for or adjust to this change in federal policy. As explained in Cherry (2007), such preemption undermines the adaptability of federalism as a policymaking algorithm. Federalism is a patching algorithm that has inherent advantages by providing forces for both policy innovation and stability – the States are jurisdictional patches that drive policy innovation through experimentation to which the federal government can provide stability by addressing spillover effects among the States. Federal preemption removes state experimentation, locking in any further policy change to more cumbersome federal processes that are less responsive to changing circumstances.

Deregulatory policies have also affected the constitutional rights of communications providers under the free speech clause of the U.S. Constitution in manner that is likely to enhance successful constitutional challenges to block federal experimentation with network neutrality policies. The level of free speech protection of a communications service provider under the U.S. Constitution is important for determining the permissible scope of government

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<sup>17</sup> In 2003, the Minnesota Public Utilities Commission (MPUC) had ordered Vonage to comply with Minnesota regulations applicable to telephone service with regard to its offering of VOIP service. In response to the MPUC order, Vonage filed a petition with the FCC requesting it to preempt the MPUC order. The FCC subsequently issued an order preempting state regulation of VOIP service – irrespective of whether Vonage’s service should be characterized as telecommunications service or information service – because it was impossible or impractical to separate the intrastate components of VOIP service from the interstate components (In the Matter of Vonage Holdings Corporation, 2004). The U.S. Eighth Circuit Court of Appeals upheld the FCC’s order of preemption in *Minnesota Public Utilities Commission v. Federal Communications Commission* (2007).

regulation over that provider.<sup>18</sup> The classification of broadband Internet access services as Title I services may alter, and likely heighten, the free speech rights of broadband providers compared to what they would have been had they been classified as common carriers.<sup>19</sup> As a result, broadband providers' constitutional challenges under the free speech clause against the FCC's new network neutrality rules may have been effectively strengthened (Cherry 2011), complicating the FCC's ability to fill the legal gap between obligations of common carriers and Title I providers.

There are also combinatorial effects from deregulatory policies and subsequent legal developments that may impede future federal policymaking related to broadband shadow common carriers by limiting the scope of constitutionally permissible Congressional legislation. For example, in *Citizens United v. Federal Election Commission* (2010), the U.S. Supreme Court overruled a century of precedent related to campaign financing laws in holding that corporations must be treated identically to natural persons under the First Amendment free speech clause with regard to political speech. Cherry (2011) explains how *Citizens United*, by elevating the constitutional free speech rights of corporations, may diminish the federal government's ability to protect consumer interests with regard to network neutrality principles. "Overall, the combinatorial or interactive effect of *Citizens United v. Federal Election Commission* and the maintenance of the FCC's current classification of broadband Internet access services is to effectively elevate the free speech rights of corporations to wield their economically derived wealth above both the economic and free speech rights of individuals" (Cherry, 2011, p. 5 of manuscript).

Thus, deregulatory policies have also created systemic risks for the U.S. policymaking system itself, diminishing its capacity to further adapt its policies in response to changing circumstances. Federal preemption blocks state policy experimentation; and elevation of free speech rights enables shadow common carriers to bring constitutional challenges that may limit the scope of federal policy experimentation. In this way, deregulatory policies compound systemic risks, increasing the systemic risk that the U.S. policymaking system will be unable to respond to the systemic risks arising from the creation of shadow common carriers.

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<sup>18</sup> As interpreted by the courts, the free speech rights of providers of various communications technology platforms, from highest to lowest are: press, cable TV, broadcasting, and common carrier.

<sup>19</sup> As to the FCC's adoption of network neutrality rules, the Report and Order and the dissenting statement of Commissioner McDowell assert competing arguments related to First Amendment constitutional challenges likely to be raised upon appeal (In the Matter of Preserving the Open Internet, 2010).

#### **IV. CONCLUSION**

Misconceptions and mischaracterizations of the law of common carriage have unfortunately misinformed debates of important telecommunications policies such as network neutrality. These misconceptions and mischaracterizations have been created by factual and analytical errors arising from analyses that either totally ignore or improperly frame temporal dimensions of the evolution of the law of common carriage. A historically accurate, temporal analysis of the evolution of common carriage reveals the radical nature of U.S. deregulatory policies that have created shadow common carriers.

In particular, the classification of broadband Internet access services as Title I information services (with no Title II common carriage service component) – as well as the unresolved classification of IP-enabled services – has created shadow common carriers for broadband and growth in systemic risks. This classification not only eliminates applicability of the centuries-old relational norms of common carriage, but also reflects a failure to appreciate the legal foundation of common carriage and public utility obligations that have enabled the development of U.S. telecommunications infrastructure with the desired emergent properties of widespread availability, affordability and reliability. This classification also requires construction of a new interface between Title I broadband information services and the general business regime of antitrust and consumer protection laws. Moreover, this classification exacerbates potential, negative inter-infrastructure effects for the U.S. Postal Service and other critical infrastructures such as transportation and electricity.

Deregulatory policies creating shadow common carriers also lessen adaptability of the U.S. policymaking system itself. Through federal preemption and elevation of free speech rights of broadband shadow common carriers, both state and federal policy experimentation are blocked or significantly impeded. In this way, deregulatory policies compound systemic risks by increasing the systemic risk that the U.S. policymaking system will be unable to respond to the systemic risks arising from the creation of shadow common carriers.

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