



Financial Services 2018 Year-End Report

BakerHostetler

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Introduction

Introduction

Welcome to the 2018 Year-End Report from BakerHostetler's Financial Services Industry Team. We are pleased to share our analysis of some of the key developments in the financial services industry in 2018 and our expectations for 2019. Please contact any of the team members listed at the end of this report if you have questions or would like additional information on these or other issues as they unfold in the coming months.

The significant developments from the past year we focus on in this report include the following:

- A significant victory in the Supreme Court limited the jurisdiction of federal judges to second-guess decisions made by arbitrators as to their jurisdiction to hear claims in cases where the arbitration agreement allows arbitrators to determine arbitrability.
- President Donald Trump and Congress repealed Consumer Financial Protection Bureau (CFPB) guidance promulgated during the Obama administration that provided that indirect auto lenders could face liability under the Equal Credit Opportunity Act (ECOA) for permitting and incentivizing dealer markup if such a policy led to discriminatory lending practices.
- CFPB acting Director Mick Mulvaney made his mark on the agency after taking the reins from Richard Cordray, reorienting the agency's mission and enforcement priorities, and even the agency's name.
- In the summer of 2018, the Office of the Comptroller of the Currency (OCC) announced that it would begin accepting applications for national bank charters from nondepository fintech companies engaged in the business of banking.
- In 2018, the Alternative Reference Rates Committee (ARRC) convened by the Federal Reserve Bank of New York was reconstituted in connection with the implementation of a paced transition plan for the replacement of LIBOR (London Interbank Offered Rate) as a benchmark rate. The ARRC selected the secured overnight financing rate (the SOFR) as the recommended alternative reference rate to replace LIBOR.
- The financial services industry saw steady growth in retail and energy Chapter 11 bankruptcy filings in the wake of increasing competition and declining margins.

We hope that you use our analysis and first predictions of what may be ahead for 2019 to navigate what is likely to be an unprecedented year of change.

For periodic updates throughout the year, please visit the [Financial Services Blog](#) and the blogs sponsored by other practice teams, including [The Blockchain Monitor](#), [Class Action Lawsuit Defense](#) and the [Data Privacy Monitor](#).

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Industry Developments

Supreme Court Expands Scope of Arbitrability

On Jan. 8, 2019, the U.S. Supreme Court issued a unanimous decision regarding an important procedural issue under the Federal Arbitration Act (FAA). In *Henry Schein, Inc. v. Archer & White Sales, Inc.*, No. 17-1272, it held that under the FAA, courts must enforce provisions in arbitration agreements delegating threshold questions of whether claims are subject to arbitration to the arbitrator. In so doing, the Court overruled a rule that allowed federal courts to decide themselves whether claims were subject to arbitration, regardless of contract language, if they determined the argument for arbitrability was “wholly groundless.” The Court thus eliminated one of the bases some courts have relied on to avoid the enforcement of arbitration provisions they do not like.

The *Schein* case was brought by a dental equipment distributor against other manufacturers and distributors alleging violations of federal and state antitrust law and seeking both money damages and injunctive relief. The relevant contract between the parties provided for arbitration before the American Arbitration Association (AAA) of any dispute arising under or related to the agreement, except for, among other things, actions seeking injunctive relief. Invoking the FAA, the defendant asked the district court to refer the matter to arbitration. The plaintiff, however, argued that the dispute was not subject to arbitration because its complaint sought injunctive relief, at least in part.

That triggered further arguments as to whether the court or the arbitrator should determine whether the claims were subject to arbitration. The defendant contended that the AAA rules incorporated into the contract gave the arbitrator the explicit power to resolve arbitrability questions; therefore, the arbitrator – not the court – should decide whether the dispute was arbitrable. The plaintiff countered that the argument for arbitration in this instance was “wholly groundless,” so the district court could itself resolve the threshold arbitrability question. The district court accepted the “wholly groundless” argument and denied the motion to compel arbitration. The Fifth Circuit affirmed.

In an opinion authored by Justice Brett Kavanaugh (his first majority opinion), the Court concluded that the so-called wholly groundless exception adopted by the Fifth Circuit and other lower courts was inconsistent with the FAA. The justices agreed that arbitration is a contractual process that the parties can frame in the manner they choose, including on issues of jurisdiction. When a contract allows arbitrators to decide whether a dispute can be resolved through arbitration, “a court may not override the contract.” Specifically, if a contract provides that an arbitrator may decide whether a dispute is subject to arbitration, only the arbitrator may decide the issue. In rejecting the “wholly groundless” exception, the Court noted that “we are not at liberty to rewrite the statute passed by Congress and signed by the President” and that under the FAA’s plain language, “[w]hen the parties’ contract delegates the arbitrability question to an arbitrator, the courts must respect the parties’ decision as embodied in the contract.”

The *Schein* decision’s elimination of the “wholly groundless” exception prevents claimants

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from avoiding arbitration by taking the threshold issue of arbitrability to the courts when the arbitration agreement delegates threshold arbitrability decisions to arbitrators. The ruling bolsters companies' ability to control the arbitration process for resolving disputes with customers or other businesses.

Notably, however, the Court left open the question of whether the arbitration agreement in the case in fact delegated the decision to arbitrate to the arbitrator, remanding that issue to the Fifth Circuit. In doing so, the Court reminded the Fifth Circuit that courts "should not assume that the parties agreed to arbitrate arbitrability unless there is clear and unmistakable evidence that they did so." This remand is significant because the arbitration agreement at issue did not itself contain an express delegation of arbitrability decisions to the arbitrator. Rather, it provided only that "any dispute arising under or related to this Agreement ... shall be resolved by binding arbitration in accordance with the arbitration rules of the American Arbitration Association." Those rules in turn delegate arbitrability decisions to the arbitrator; many courts have concluded that a contract's incorporation of the AAA's rules constitutes "clear and unmistakable evidence" that the parties delegated arbitrability decisions to the arbitrator. The Fifth Circuit may have an opportunity on remand to examine whether this type of implied delegation satisfies the FAA.

President Trump and Congress Repeal CFPB Guidance on Indirect Auto Lender Liability for Discriminatory Lending

The U.S. House of Representatives voted on May 8, 2018, to reject a 2013 CFPB bulletin that provided guidance regarding liability for discrimination in indirect auto lending. The same measure had passed the Senate three weeks earlier, and was then signed by the President on May 21, 2018.

The 2013 guidance was aimed at indirect auto lenders – lenders that work with auto dealers to provide loans for consumers seeking financing through the dealership where the car is purchased. Some indirect lending arrangements permit the dealer to charge the consumer an interest rate higher than that which the lender would accept, and provide compensation to the dealer tied to the amount of the markup achieved. According to the CFPB guidance, under some indirect lending arrangements, there is a "significant risk" that the incentive and discretion afforded to dealers will lead to pricing disparities based on race or other prohibited factors.

The CFPB guidance stated that the role of indirect auto lenders often involved sufficient participation in the credit decision to make the lender subject to Equal Credit Opportunity Act (ECOA) regulations barring racial and other discrimination in lending. According to the guidance, an indirect auto lender could face liability under the ECOA for permitting and incentivizing dealer markup if such a policy led to discriminatory lending practices. Then-CFPB Director Richard Cordray stated at the time that the bulletin "clarifies" the CFPB's "authority to pursue auto lenders whose policies harm consumers through unlawful discrimination."

Seeking to set aside the CFPB guidance, Congress invoked the Congressional Review Act (CRA). Part of the Republicans' 1996 "Contract with America," the CRA provides an expedited legislative process for Congress to negate recently issued agency rules by joint resolution. Following a CRA repeal, the agency is also prohibited from reissuing the rule or its equivalent unless Congress specifically

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authorizes the rule in a later enactment. The CRA route is attractive to proponents of deregulation because it involves streamlined procedures and it is not subject to filibuster in the Senate.

The actions against the CFPB bulletin mark the first time the CRA has been used to target informal agency guidance. Such use of the CRA is controversial because the act has historically been employed against formal agency rules. The CRA requires Congress to act within 60 legislative days after a rule is finalized. The CFPB guidance was issued as a bulletin in March 2013 – it did not go through formal rulemaking. In order to make the CRA applicable, Sen. Pat Toomey, R-Pa., requested and obtained a declaration from the Government Accountability Office that the guidance was a “rule” for purposes of the CRA, which reset the clock for review.

Critics of the CFPB have claimed that the auto lending guidance is an attempt to end-run the Dodd-Frank Act’s exclusion of auto dealers from CFPB jurisdiction and that the CFPB’s claims of discrimination in auto lending are based on flawed research.

Justice Kavanaugh’s Limited Class Action Jurisprudence in the DC Circuit

Justice Kavanaugh has had very few occasions to address the procedural mechanism of Rule 23. This is not surprising given that few class actions end up in the D.C. Circuit. But when he has addressed the mechanism, Judge Kavanaugh’s commentary suggests that he may be mindful of the realities and difficulties class action defendants face.

Some insight into Justice Kavanaugh’s views on class actions can be inferred from his dissenting opinion in *Cohen v. United States*, 650 F.3d 717 (D.C. Cir. 2011). In *Cohen*, the IRS had illegally collected an excise tax on long-distance phone calls. To remedy the problem, the IRS set up a “simple” refund procedure for taxpayers that would allow them to check a box on their tax returns for a standard refund amount.¹ Taxpayers who were unhappy with their refund amount under the refund rules could file a tax refund suit. Judge Kavanaugh noted that about 90 million Americans took advantage of the refund program.

A group of 10 taxpayers filed a class action under the Administrative Procedure Act (APA) alleging the IRS-created procedure was unlawful. *Id.* These taxpayers were aware of the refund rules, but did not avail themselves of the refund or file a refund suit. In his dissent, then-Judge Kavanaugh argued that a class action under the APA was improper for two reasons. First, because Congress created a specific procedure for judicial review in such cases (tax refund lawsuits), which provided an adequate alternative remedy that provided an “alternative congressionally specified judicial forum.”² Second, it was improper under the ripeness doctrine, which required plaintiffs to file refund claims with the IRS before bringing suit to challenge the 2006 refund rule.

While Justice Kavanaugh’s analysis is grounded in the APA, his commentary suggests that he took into account the practical realities of class certification and was openly skeptical of the plaintiffs’ motivations: “The reader may wonder why plaintiffs didn’t simply file the relevant forms with the IRS to get refunds, and if dissatisfied with the amounts they received or with the IRS’s refund rules, bring individual tax refund suits. After all, each plaintiff could have raised

¹ *Id.* at 719.

² *Id.* at 739.

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complaints about the refund rules in such a case, and each plaintiff's litigation would have long since concluded by now."

Justice Kavanaugh stated the answer seemed to be that plaintiffs are litigating on behalf of others, not themselves, with the "ultimate objectives [of] class certification and a court order that the U.S. Government pay *billions* of dollars in additional refunds to millions of as-yet-unnamed individuals who never sought refunds from the IRS or filed tax refund suits." "Class certification," Judge Kavanaugh concluded, "is a necessary prerequisite to the class-wide jackpot plaintiffs" – and presumably their attorneys, in the form of a fees award – "are seeking here."³

Justice Kavanaugh also presided over the panel in *Mills v. Giant of Maryland, LLC*, 508 F.3d 11 (D.C. Cir. 2007), where a proposed class brought suit against milk sellers alleging that plaintiffs consumed their product before learning of their own lactose intolerance (which caused unpleasant side effects), and that the sellers should have put warning labels on their products to inform consumers that some individuals might be intolerant of milk.⁴ Then-Judge Kavanaugh wrote that it is widely known that milk may cause certain individuals discomfort, and that "[a] bout of gas or indigestion does not justify a race to the courthouse."⁵ And, although the opinion does not address class certification, he wrote, "Were the rule otherwise, a variety of food manufacturers as well as stadiums, bars, restaurants, convenience stores, and hot dog stands throughout the country would be liable to millions of would-be plaintiffs every day."⁶

These opinions are limited, so it is difficult to forecast how Justice Kavanaugh may approach class actions. Both *Cohen* and *Mills* suggest that he is sensitive to the realities that can drive class action litigation. Finally, his dissent in *Cohen* at the very least suggests that he is willing to find that individual suits are superior to class actions in certain circumstances.

Supreme Court Rules That American Pipe Tolling Does Not Extend to Successive Class Actions

In June 2018, the U.S. Supreme Court decided *China Agritech, Inc. v. Resh*, No. 17-432, 584 U.S. __ (2018), and held that the *American Pipe* doctrine, which tolls the statute of limitations to permit members of a putative class to bring individual claims in the event class certification is denied, does not toll the statute of limitation for putative class actions. The case provides greater certainty to class action exposure for companies by preventing plaintiffs from consecutively filing, or "stacking," class actions in a bid to extend the statute of limitations.

In a unanimous decision, the Supreme Court has limited the reach of its landmark decision in *American Pipe & Constr. Co. v. Utah*, 414 U.S. 538 (1974), which tolled the statute of limitations applicable to a timely filed putative class action such that if class certification was denied, members of the failed class could timely intervene as individual plaintiffs in the "still-pending action, shorn of its class character."⁷ Following *American Pipe*, the Court extended this rule to

³ *Id.* at 737.

⁴ *Id.* at 12.

⁵ *Id.*

⁶ *Id.*

⁷ *China Agritech, Inc. v. Michael H. Resh, et al.*, Case No. 17-432, slip op. at 1 (U.S. 2018) (citing *American Pipe*, 414 U.S. at 544, 552-53).

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also toll statutes of limitation for individual suits brought by putative class members after denial of class certification.⁸

In the wake of *American Pipe* and its progeny, the federal circuit courts split on the question of whether such tolling extends to successive class actions filed beyond the applicable statute of limitations period.⁹ While a majority of circuits had adopted an “anti-stacking rule,” pursuant to which *American Pipe* tolling did not apply to successive class actions, the Ninth and Sixth Circuits had permitted such stacking – a move that threatened to allow the plaintiffs’ bar to evade the statute of limitations by endlessly refile putative class actions in the hope of finding a judge willing to certify them. In *Resh*, decided on June 11, 2018, the Court unanimously adopted the anti-stacking approach and held that *American Pipe* tolling did not extend to successive class actions.

Resh was the third of three successive putative class action cases “brought on behalf of purchasers of [] China Agritech’s common stock,” all of whom alleged “materially identical” violations of the Securities Exchange Act of 1934.¹⁰ A two-year statute of limitations, and a five-year statute of repose, applied to the claims.¹¹ The first related putative class action suit (the First Action) was filed in February 2011 and was timely.¹² Class certification was denied in the First Action, and notice was sent to putative class members informing them that they must act to protect their rights to relief by either joining the First Action as a plaintiff or filing their own action individually.¹³

The second related putative class action (the Second Action) was filed in October 2012, still within the statute of limitations.¹⁴ The district court denied class certification on different grounds.¹⁵ Given that the Second Action was filed within the statute of limitations period, “putative class members who promptly initiated individual suits in the wake of the class-action denial would not have encountered [any] statute of limitations bar” to their individual claims or intervention into the existing lawsuit.¹⁶

Thereafter, Michael Resh, an individual who did not seek lead plaintiff status in either the First or Second Actions, filed a third related putative class action suit (the Resh Action) in June 2014 – after the statute of limitations had run. The district court dismissed the Resh Action, finding that the *American Pipe* line of cases “did not toll the time to initiate class claims.”¹⁷ The Ninth Circuit reversed, finding that “[p]ermitt[ing] future class action named plaintiffs, who were unnamed class members in previously uncertified classes, to avail themselves of *American Pipe*

8 *Id.* (citing *Crown, Cork & Seal Co. v. Parker*, 462 U.S. 345, 350, 353-54 (1983)).

9 *Id.* at 4-5.

10 *Id.* at 2.

11 *Id.* at 2-3.

12 *Id.* at 3.

13 *Id.*

14 *Id.*

15 *Id.* at 4.

16 *Id.*

17 *Id.*

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tolling ... would advance the policy objectives that led the Supreme Court to permit tolling in the first place.”¹⁸ (internal quotation marks and citations omitted). In particular, the Ninth Circuit reasoned that such tolling “would cause no unfair surprise to defendants and would promote economy of litigation by reducing incentives for filing protective class suits during the pendency of an initial certification motion.”¹⁹

Finding this reasoning unpersuasive, the Supreme Court held that “*American Pipe* does not permit the maintenance of a follow-on class action past expiration of the statute of limitations.”²⁰

At the center of the Court’s ruling was its reaffirmance of the policy underlying Rule 23, which is the promotion of judicial economy by avoiding “needless multiplicity of actions.”²¹ The Court reasoned that tolling the limitations period for individual claims serves the interest of “economy of litigation” because class certification is determinative of whether the claims “will proceed as a class” and, accordingly, whether there is even a need to assert an individual claim in the first place.²² But for class actions, “efficiency favors early assertion of competing class representative claims” to facilitate prompt adjudication of whether “the class mechanism is [even] a viable option”²³

The Court explained that “[t]he time to file individual actions once a class action ends is finite, extended only by the time the class suit was pending; the time for filing successive class suits, if tolling were allowed could be limitless. ... Endless tolling of statute of limitations is not a result envisioned by *American Pipe*.”²⁴ Indeed, *American Pipe*’s equitable-tolling exception is rooted in the formal doctrine of equitable tolling, which is not available to plaintiffs who slept on their rights. And a “would-be class representative who commences suit after expiration of the limitation period ... can hardly qualify as diligent.”²⁵

The Court summarized its ruling as being grounded in the purpose of Rule 23:

The watchwords of *American Pipe* are efficiency and economy of litigation, a principal purpose of Rule 23 as well. Extending *American Pipe* tolling to successive class actions does not serve that purpose. The contrary rule, allowing no tolling for out-of-time class actions, will propel putative class representatives to file suit well within the limitation period and seek certification promptly.²⁶

Eleventh Circuit Sides With Wells Fargo on Post-Class Certification Motion to Compel Arbitration

Wells Fargo achieved a significant victory on May 10, 2018, in decade-old litigation over

18 *Id.*

19 *Id.*

20 *Id.* at 2.

21 *See id.* at 6 (citations and internal quotations marks omitted).

22 *Id.*

23 *Id.* at 7.

24 *Id.* at 10-11.

25 *Id.* at 9.

26 *Id.* at 15.

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allegedly unlawful overdraft fees when the Eleventh Circuit held that Wells Fargo had not waived its right to compel arbitration as to the unnamed plaintiffs in the recently certified classes.

In *Gutierrez v. Wells Fargo Bank, NA*, No. 16-16820 (11th Cir., May 10, 2018), the Eleventh Circuit vacated the district court's order denying Wells Fargo's motion to compel arbitration of the unnamed plaintiffs' claims and remanded for further proceedings. In the vacated order, the district court held that Wells Fargo waived its right to compel arbitration by acting "inconsistently with its arbitration rights during its pre-certification litigation efforts" and that the plaintiffs would suffer "significant prejudice" if Wells Fargo were allowed to invoke arbitration after nearly 10 years of litigation.

Disagreeing with the district court, the Eleventh Circuit held that "it cannot be said that Wells Fargo's failure to seek arbitration with the unnamed class members prior to class certification manifested inconsistency with its arbitration rights, considering that it would have been impossible in practice to compel arbitration against speculative plaintiffs and jurisdictionally impossible for the district court to rule on those motions before the class was certified."

The Eleventh Circuit also found it significant that Wells Fargo provided "fair notice at a relatively early stage of litigation" that it wished to preserve its right to compel arbitration as to unnamed plaintiffs in the event the classes were certified. Notably, before the classes were certified, the Eleventh Circuit affirmed an order holding that Wells Fargo waived its right to compel arbitration as to the *named* plaintiffs.

At the outset of the litigation, Wells Fargo elected not to compel arbitration of the named plaintiffs' claims, later explaining that it believed the arbitration agreement's prohibition on classwide arbitration would be unenforceable under applicable state law. Two years later, the Supreme Court held in *AT&T Mobility LLC v. Concepcion* that state laws purporting to void prohibitions on class arbitration are pre-empted by the Federal Arbitration Act, prompting Wells Fargo to reconsider whether to seek arbitration.

Although Wells Fargo moved to compel arbitration immediately after the Supreme Court issued its opinion in *Concepcion*, the Eleventh Circuit held it had already waived its right to compel arbitration as to the named plaintiffs. The Eleventh Circuit's ruling largely negates the practical effect of this earlier holding.

Representative Matters

- Represented financial institutions in a putative class action lawsuit brought by counties seeking to recover recording fees in connection with mortgage assignments.
- Represented a financial institution in a multistate putative class action filed on behalf of commercial checking account holders in connection with a novel claim under the Uniform Commercial Code.
- Represented a financial institution in a putative nationwide class action challenging the administration of customer accounts.
- Represented financial institutions in multiple putative national class actions throughout the country regarding various consumer product and transaction fees.

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- Represented a financial institution in a vendor dispute alleging breach of contract and fraud claims.
- Acted as a U.S. court-appointed examiner in connection with an investigation of a potential fraudulent scheme regarding state-owned foreign banks.

Emerging Issues and Trends

Supreme Court to Rule on Scope of Fair Debt Collection Practices Act

Currently before the U.S. Supreme Court is whether entities conducting nonjudicial foreclosure proceedings are subject to the requirements of the Fair Debt Collection Practices Act, 15 U.S.C. §§ 1692 *et seq.* (FDCPA). Whether entities conducting nonjudicial foreclosure proceedings are subject to the requirements of the FDCPA has divided the courts for many years. The Supreme Court's ruling on this issue could finally provide the mortgage industry and lower courts with guidance as to the proper steps to follow in nonjudicial foreclosure proceedings.

By way of background, the FDCPA generally only applies to entities or persons that fall under its definition of "debt collector." Under the FDCPA, a debt collector is any person engaged in any business "the principal purpose of which is the collection of any debts, or who regularly collects or attempts to collect ... debts owed or due or asserted to be owed or due another." Thus, to qualify as a debt collector, a person must be collecting a debt. The FDCPA generally defines debt as a consumer's obligation to pay money. At the heart of the issue regarding whether entities engaged in nonjudicial foreclosure proceedings is the FDCPA's definition of the terms "debt" and "debt collector." Specifically, whether nonjudicial foreclosures are attempts at collecting a debt.

The Supreme Court granted certiorari to review the decision of the Court of Appeals for the Tenth Circuit in *Obduskey v. McCarthy*. In *Obduskey*, the Tenth Circuit ruled that entities engaged solely in nonjudicial foreclosure proceedings are not debt collectors under the FDCPA and, therefore, not subject to the requirements of the FDCPA. The Tenth Circuit reasoned that the definition of debt in the FDCPA is synonymous with money. It further reasoned that nonjudicial foreclosures are attempts to enforce security interests and not attempts to collect money from a debtor. The Tenth Circuit reached this conclusion by noting that the general rule in nonjudicial foreclosures, such as the Colorado nonjudicial trustee foreclosure law at issue in the case, is that the sale does not preserve to the trustee a right to collect any deficiency in the loan amount against the debtor personally. Therefore, according to the Tenth Circuit, because nonjudicial foreclosures allow the trustee to recover money or proceeds only from the sale of the property and not the debtor personally, it is not an attempt to collect a debt subject to the requirements of the FDCPA.

The Tenth Circuit aligned itself with the Ninth Circuit's decision in *Vien-Phuong Thi Ho v. ReconTrust Co., NA*. In *Ho*, the Ninth Circuit held that a trustee engaged in nonjudicial foreclosure proceedings under California law was not a debt collector subject to the requirements of the FDCPA. There, the Ninth Circuit also found that because the "object of a nonjudicial foreclosure is to retake and resell the security, not to collect money from the borrower," actions under California's nonjudicial foreclosure law were not attempts to collect a debt.

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Underlying the rulings of the Tenth and Ninth Circuits are policy considerations regarding the traditional state power to regulate real property and foreclosures. Both the Tenth and Ninth Circuits in *Obduskey* and *Ho* found that interpreting the FDCPA to apply to nonjudicial foreclosures would create “sustained friction between the [FDCPA] and the state [nonjudicial foreclosure] scheme.” Absent a clear and manifest intent by Congress to regulate this traditional area of state regulation, the Tenth and Ninth Circuits were reluctant to apply an interpretation of the FDCPA that would have wide-ranging implications by supplanting the traditional state regulation of foreclosures.

On the other hand, the Fourth and Sixth Circuit Courts of Appeals have ruled that nonjudicial foreclosure proceedings fall under the scope of the FDCPA as attempts to collect a debt. For example, in *Glazer v. Chase Home Finance LLC*, the Sixth Circuit found that mortgage foreclosure is an attempt to collect a debt because it reasoned that “every mortgage foreclosure, judicial or otherwise, is undertaken for the very purpose of obtaining payment on the underlying debt, either by persuasion ... or compulsion” Therefore, the Sixth Circuit ruled that mortgage foreclosure actions, whether judicial or otherwise, fall within the purview of the FDCPA as attempts to collect a debt.

The Sixth Circuit aligned itself with the Fourth Circuit’s decision in *Wilson v. Draper & Goldberg, P.L.L.C.* In *Wilson*, the Fourth Circuit reasoned that the enforcement of a security interest in foreclosure was just one method of collecting the underlying debt and, therefore, it fell under the scope of the FDCPA. In particular, the Fourth Circuit was concerned that interpreting the FDCPA as not applying to nonjudicial foreclosure actions “would create an enormous loophole in the [FDCPA]” by “immunizing any debt from coverage if that debt happened to be secured by a real property interest” and foreclosure was the chosen method of collection of the underlying debt. Notably, neither the Sixth Circuit nor the Fourth Circuit discussed the potential conflict between state law and the FDCPA arising from their interpretation that entities engaged in nonjudicial foreclosure actions are required to also comply with the FDCPA.

As observed by the Tenth and Ninth Circuits, the potential conflict between the FDCPA’s requirements and state nonjudicial foreclosure law creates a significant tension between state and federal law. For example, generally the FDCPA prohibits debt collectors from communicating with third parties about the debt absent consent by the debtor. However, state nonjudicial foreclosure law may require the public filing of liens and trustee notices of sale. Further, under certain circumstances, the FDCPA prohibits communications with the debtor. Yet many state nonjudicial foreclosure laws have strict requirements for notices that must be sent to the debtor before foreclosure may proceed and do not provide an exception to sending these notices if, for example, the debtor is represented by an attorney. These were the kinds of conflicts the Ninth Circuit observed that meant that “a trustee could not comply with California law without violating the FDCPA” – effectively preventing California’s nonjudicial foreclosure system from functioning.

The Supreme Court’s review of the Tenth Circuit’s decision in *Obduskey* is expected to finally provide lower courts with guidance as to the scope of the FDCPA in the area of mortgage foreclosure law. Importantly, the Supreme Court’s ruling could have a wide-ranging effect on the countless foreclosure actions that are instituted throughout the various states that have established a system for nonjudicial foreclosures.

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Supreme Court to Review FCC Deference in TCPA Cases

On Nov. 13, 2018, the U.S. Supreme Court granted certiorari in *Carlton & Harris Chiropractic, Inc. v. PDR Network, LLC*, after the Fourth Circuit vacated a lower court ruling regarding what constitutes an “unsolicited advertisement” under the Telephone Consumer Protection Act (TCPA).²⁷

The Supreme Court is set to review whether the Hobbs Act requires district courts to accept the legal interpretations of the TCPA made by the Federal Communication Commission (FCC). This ruling may bring uniformity to the amount of judicial deference that federal courts afford to the FCC’s TCPA rules in civil litigation.

District Court Ruling

In *PDR Network*, a chiropractic office brought a putative class action against the publisher of a widely used compendium of prescription drug information, alleging the publisher violated the TCPA by sending a fax to the chiropractic office inviting its manager to reserve a free copy of the book.²⁸ The publisher moved to dismiss, arguing the fax was not an unsolicited advertisement because the book was free and not for purchase. The chiropractor office disagreed and cited a 2006 FCC rule that provides, in pertinent part, “facsimile messages that promote goods or services even at no cost ... are unsolicited advertisements under the TCPA’s definition.”

Applying a *Chevron* analysis, the district court ruled that the Hobbs Act did not compel deference to the FCC’s rule where the statute was unambiguous. In addition to finding that the TCPA’s definition of unsolicited advertisement was clear and easy to apply, the district court held that the TCPA prohibits only advertisements with a “commercial aim.” For these reasons, the district court granted the chiropractic office’s motion to dismiss.

Fourth Circuit’s Decision

On appeal, the Fourth Circuit vacated the district court ruling and held that (1) the Hobbs Act deprived the district court of jurisdiction to consider the validity of and apply *Chevron* deference to the 2006 FCC rule and (2) faxes that offer goods and services – even if free – are “advertisements” under the TCPA.

Hobbs Act

The Hobbs Act “provides a mechanism for judicial review of certain administrative orders.” Importantly, the Hobbs Act contains a “jurisdiction-channeling” provision vesting the federal appellate courts with “exclusive jurisdiction” to “enjoin, set aside, suspend (in whole or in part), or to determine the validity of” the orders to which the act applies, including the FCC’s TCPA rules. As courts of limited jurisdiction, federal district courts do not have the authority to reach issues where, as here, Congress has specifically stripped them of jurisdiction.

Citing decisions from the Sixth, Eighth and Eleventh Circuits, the Fourth Circuit ruled that “[w]hen *Chevron* meets Hobbs, consideration of the merits must yield to jurisdictional

²⁷ No. 17-1705, 2018 WL 3127423, at *1 (2018).

²⁸ 883 F.3d 459, 469 (4th Cir. 2018).

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constraints.”²⁹ In finding that the district court “erred when it eschewed the Hobbs Act’s command in favor of a *Chevron* analysis to decide whether to adopt the 2006 FCC Rule,” the Fourth Circuit held that the jurisdictional command of the Hobbs Act requires the district courts to apply FCC interpretations of the TCPA.

2006 FCC Rule

In rejecting the district court’s interpretation of the 2006 FCC rule, the Fourth Circuit held that the publisher’s fax offering a free good was an advertisement under the plain meaning of the rule. Notably, the Fourth Circuit determined that although the publisher does not charge for its book, “giving away products in the hope of future financial gain is a commonplace marketing tactic” and it is “certainly plausible that the amount of money [the publisher] receives turns on how many copies of the [book] it distributes.”

The Supreme Court did not grant certiorari on this issue. Specifically, the publisher asked the Supreme Court to consider the following: “must faxes that ‘promote goods and service even at no cost’ have a commercial nexus to a firm’s business to qualify as an ‘advertisement’ under the TCPA, or does a plain reading of the FCC’s 2006 order create a per se rule that such faxes are automatically ‘advertisements’?”

Implications

The Supreme Court’s ruling may harmonize the current landscape where only some district courts observe the FCC’s interpretations of the TCPA. Moreover, the ruling could have ramifications for the FCC’s much-anticipated ruling on what constitutes an automatic telephone dialing system (ATDS) under the TCPA.

While it did not grant certiorari as to the Fourth Circuit’s interpretation of the 2006 FCC rule, if the Supreme Court were to affirm the Fourth Circuit’s decision, that would leave in place a per se rule that a fax promoting free goods or services is an unsolicited advertisement under the TCPA. A reversal, however, would likely curb the Hobbs Act’s jurisdictional-channeling provision and provide more autonomy to district courts looking to apply a *Chevron* analysis to ambiguous statutory language.

Given that the TCPA provides for a private right of action and statutory damages, until the Supreme Court rules, companies should take a conservative approach to the FCC’s interpretations of the TCPA. This includes, among other things, monitoring vendors and independently assessing whether their communications trigger TCPA concerns.

²⁹ See, e.g., *Mais v. Gulf Coast Collection Bureau, Inc.*, 768 F.3d 1110, 1121 (11th Cir. 2014) (holding that under the Hobbs Act, the district court lacked the power to review the validity of the FCC’s 2008 interpretation of “prior express consent”).



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Industry Developments

CFPB/BCFP Update

For the CFPB, under acting Director Mick Mulvaney, 2018 was a year of significant change. Mulvaney declared the end of the CFPB's regulation by enforcement. In doing so, he placed a temporary hold on all regulatory and enforcement actions to review them, culminating in a dramatic reduction of enforcement activity. Although the CFPB settled a small number of enforcement actions brought under former Director Cordray, it did not file its first enforcement action under Mulvaney until September.

Mulvaney also reorganized the CFPB while confronting legal challenges to both the CFPB's structure and his appointment as acting director. Even the CFPB's name was subject to change, as Mulvaney attempted to rename it as the Bureau of Consumer Financial Protection, or BCFP. Additionally, the bureau solicited from the public and covered entities "requests for information" on various topics to determine whether the CFPB was best fulfilling its mission, signaling possible changes in the future. Lastly, Kathy Kraninger began her role as director of the CFPB in early December following a contentious Senate confirmation.

CFPB's Structure

On Jan. 31, 2018, the en banc D.C. Circuit held, 7-3, that the CFPB's structure was constitutional, overturning the D.C. Circuit's October 2016 panel decision.³⁰ The en banc D.C. Circuit did, however, reinstate the RESPA-related portions of the D.C. Circuit's panel decision, namely (i) certain captive mortgage reinsurance arrangements are permissive, and (ii) RESPA's three-year statute of limitations applies to any RESPA claims brought by the CFPB. On June 7, 2018, Mulvaney dismissed the charges against PHH and terminated the matter.

Mulvaney also survived a challenge from Leandra English, the deputy director appointed by outgoing Director Richard Cordray. A federal court denied English's attempts to obtain a temporary restraining order and a preliminary injunction preventing President Trump from appointing any acting director other than her.³¹ Before a three-judge panel of the D.C. Circuit could rule on English's appeal, she resigned from the CFPB and withdrew the lawsuit.³²

CFPB Overhaul

Early on in his tenure, Mulvaney declared through a staff announcement, an op-ed piece and a speech to the Mortgage Bankers Association that the CFPB would be ending regulation by enforcement. More recently, Mulvaney's policy included an end to supervisory examinations of the Military Lending Act (MLA).³³

30 *PHH Corp. v. CFPB*, 881 F.3d 75 (D.C. Cir. 2018).

31 *See, e.g., English v. Trump*, No. 17-2534 (TJK), 279 F. Supp. 3d 307, 312 (D.D.C. July 13, 2018).

32 *English v. Trump*, No. 18-5007, 2018 WL 3526296 (D.C. Cir. July 13, 2018).

33 *See, e.g., Mick Mulvaney, The CFPB Has Pushed Its Last Envelope*, Wall St. J. (Jan. 23, 2018, 7:40 p.m.), <https://www.wsj.com/articles/the-cfpb-has-pushed-its-last-envelope-1516743561>.

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Mulvaney also made several moves to restructure the CFPB, including folding the Office of Students and Young Consumers into the Office of Financial Education.³⁴ In July 2018, he also created the Office of Innovation to establish policies to facilitate innovation, engage with entrepreneurs and regulators, and review outdated or unnecessary regulations.³⁵

Enforcement Activity

Automobile Loans

The CFPB continues to examine auto loan servicing activities, focusing on whether servicers have engaged in unfair, deceptive, or abusive acts or practices. Recent examinations have identified such acts or practices related to billing statements and wrongful repossessions.³⁶

In April 2018, the CFPB, in conjunction with the OCC, assessed a \$1 billion penalty against Wells Fargo Bank N.A. for violating the Consumer Financial Protection Act through its mandatory insurance program for auto loans and how it charged certain borrowers for mortgage interest rate-lock extensions.³⁷

Credit Cards

CFPB examinations of credit card account management operations focused on advertising and marketing, account origination, account servicing, payments and periodic statements, dispute resolution, and the marketing, sale, and servicing of add-on products. The CFPB identified entities that failed to periodically re-evaluate credit card accounts for APR reductions as required by Regulation Z when the APR for such accounts was previously increased.³⁸

For example, the CFPB entered into a consent order with Citibank N.A. requiring Citibank to pay \$335 million in restitution to consumers impacted by the bank's failure to periodically re-evaluate APR increases for approximately 1.75 million credit card accounts. The CFPB also found that Citibank failed to institute reasonable written policies and procedures to ensure APR re-evaluations occurred. Notably, the enforcement action was instituted after Citibank self-identified several deficiencies and errors in its rate re-evaluation methodologies, all of which were uncovered when Citibank initiated a compliance review program across its credit card business. The bureau cited this self-disclosure as one of the reasons it did not assess civil money penalties against Citibank.³⁹

34 See, e.g., Glenn Thrush & Stacy Cowley, *Mulvaney Downgrades Student Loan Unit in Consumer Bureau Shuffle*, N.Y. Times (May 9, 2018), <https://www.nytimes.com/2018/05/09/us/student-loans-consumer-financial-protection-bureau-cfpb.html>.

35 *Bureau of Consumer Financial Protection Announces Director for the Office of Innovation*, Consumer Financial Protection Bureau (July 18, 2018), <https://www.consumerfinance.gov/about-us/newsroom/bureau-consumer-financial-protection-announces-director-office-innovation/>.

36 CFPB, *Supervisory Highlights*, Issue No. 17, at p. 3 (Sept. 6, 2018), https://s3.amazonaws.com/files.consumerfinance.gov/f/documents/bcfp_supervisory-highlights_issue-17_2018-09.pdf (hereinafter, "*Supervisory Highlights*").

37 *Bureau of Consumer Financial Protection Announces Settlement With Wells Fargo for Auto-Loan Administration and Mortgage Practices*, CONSUMER FINANCIAL PROTECTION BUREAU (Apr. 20, 2018), <https://www.consumerfinance.gov/about-us/newsroom/bureau-consumer-financial-protection-announces-settlement-wells-fargo-auto-loan-administration-and-mortgage-practices/>.

38 *Supervisory Highlights* at p. 5.

39 *Bureau of Consumer Financial Protection Settles With Citibank, N.A.*, CONSUMER FINANCIAL PROTECTION BUREAU (June 29, 2018), <https://www.consumerfinance.gov/about-us/newsroom/bureau-consumer-financial-protection-settles-citibank-na/>.

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Debt Collection

Recent examinations of larger participants in the debt collection market identified violations of the FDCPA, including failures to obtain and mail debt verification before engaging in further collection activities. In response, participants were expected to revise their debt validation policies and procedures to ensure that they obtain appropriate debt verification when requested, and that they mail the verification to consumers prior to additional collection activities.⁴⁰

In June 2018, the CFPB announced a \$5 million settlement with Security Group Inc. and its subsidiaries over improper in-person and telephonic collection attempts on installment loans and retail sales installment contracts. The bureau also found the entities violated the Fair Credit Reporting Act (FCRA) by regularly furnishing inaccurate and incomplete information about consumers to credit reporting agencies.⁴¹

Mortgage Servicing

In 2018, the CFPB focused on mortgage servicers' loss mitigation processes, particularly how servicers handle trial modifications where consumers are paying as agreed. Recent mortgage servicing examinations uncovered unfair acts or practices relating to the conversion of trial modifications to permanent status and initiation of foreclosures after consumers accepted loss-mitigation offers. These examinations also identified issues with entities charging consumers amounts not authorized by modification agreements or by mortgage notes.⁴²

Payday Lending

CFPB examinations of payday lenders revealed unfair and deceptive practices as well as violations of Regulation E. Examiners observed deceptive collection letters, wherein entities represented that they "will, or may have no choice but to, repossess consumers' vehicles if the consumers fail to make payments or contact the entities." These representations were made despite the fact that such entities did not repossess vehicles nor have business relationships with repossession companies. The CFPB also identified instances where entities were initiating electronic funds transfers using debit card numbers or ACH credentials without valid authorization, as required by Regulation E. Instead, such entities were using consumer account information previously provided for other purposes.⁴³

In July 2018, the CFPB entered into a consent order with Triton Management Group Inc., a payday lender found to have violated Dodd-Frank, the Consumer Financial Protection Act and TILA by failing to properly disclose finance charges associated with auto title loans. The bureau also found that Triton used advertisements that failed to disclose the APR and other TILA-required information. The order entered a judgment of \$1,522,298 against Triton.⁴⁴

40 *Supervisory Highlights* at p. 6.

41 *Bureau of Consumer Financial Protection Settles With Security Group, Inc.*, CONSUMER FINANCIAL PROTECTION BUREAU (June 13, 2018), <https://www.consumerfinance.gov/about-us/newsroom/bureau-consumer-financial-protection-settles-security-group-inc/>.

42 *Supervisory Highlights* at p. 5.

43 *Supervisory Highlights* at p. 10.

44 *Bureau of Consumer Financial Protection Settles With Triton Management Group*, CONSUMER FINANCIAL PROTECTION BUREAU (July 19, 2018), <https://www.consumerfinance.gov/about-us/newsroom/bureau-consumer-financial-protection-settles-triton-management-group/>.

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Three months later, in October 2018, the CFPB settled with Cash Express LLC, a company offering payday loans, title loans and check-cashing services, for, among other things, (i) threatening in collection letters that it would take legal action against consumers, even though the debts were past the date for suing on legal claims; (ii) misrepresenting that it might report negative credit information to consumer reporting agencies, when the company did not actually report such information; and (iii) abusively withholding funds during check-cashing transactions to satisfy outstanding amounts on prior loans, without disclosing this practice on the front end.⁴⁵

Small-Business Lending

As noted by the CFPB, in 2016 and 2017, it began assessing ECOA compliance in institutions' small-business lending product lines, focusing on the risks of an ECOA violation in underwriting, pricing and redlining. To date, the CFPB has observed effective management of the risks of an ECOA violation, including evidence of boards of directors and management maintaining active oversight of compliance management systems. With regard to self-monitoring, institutions implemented small-business lending monitoring programs, conducted semiannual ECOA risk assessments, and established committees to review pricing-exception practices and volume. The only noted adverse findings related to the collection of limited data on small-business lending decisions, which the CFPB noted could impede an institution's ability to monitor and test for the risk of ECOA violations.⁴⁶

OCC Accepts Fintech Charters

In the summer of 2018, the OCC announced that it would begin accepting applications for national bank charters from nondepository financial technology (fintech) companies engaged in the business of banking.⁴⁷

Generally, the national bank charter framework authorizes banks to conduct business on a nationwide basis under uniform standards and various oversight,⁴⁸ and the OCC's decision will apply this framework to qualifying fintech companies. "The decision to consider applications for special purpose national bank charters from innovative companies helps provide more choices to consumers and businesses, and creates greater opportunity for companies that want to provide banking services in America. Companies that provide banking services in innovative ways deserve the opportunity to pursue that business on a national scale as a federally chartered, regulated bank," stated Comptroller of the Currency Joseph M. Otting.⁴⁹

Under the new rule, applicants will be evaluated throughout a four-phase process. The application process considers several categories, and will specifically assesses whether the

45 *Bureau of Consumer Financial Protection Settles With Cash Express*, CONSUMER FINANCIAL PROTECTION BUREAU (Oct. 24, 2018), <https://www.consumerfinance.gov/about-us/newsroom/bureau-consumer-financial-protection-settles-cash-express/>.

46 *Supervisory Highlights* at p. 12.

47 *OCC Begins Accepting National Bank Charter Applications From Financial Technology Companies*, Office of the Comptroller of the Currency (July 31, 2018), <https://www.occ.gov/news-issuances/news-releases/2018/nr-occ-2018-74.html>.

48 *Exploring Special Purpose National Bank Charters for Fintech Companies*, Office of the Comptroller of the Currency, <https://www.occ.gov/topics/responsible-innovation/comments/special-purpose-national-bank-charters-for-fintech.pdf>.

49 *OCC Begins Accepting National Bank Charter Applications From Financial Technology Companies*, Office of the Comptroller of the Currency (July 31, 2018), <https://www.occ.gov/news-issuances/news-releases/2018/nr-occ-2018-74.html>.

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proposed bank will have a reasonable chance of success, be operated in a safe manner, provide fair access to financial services, promote fair treatment of customers, ensure compliance with laws and regulations, and foster healthy competition.⁵⁰ Moreover, qualifying companies that receive a national bank charter will be subject to the same laws, rules, regulations and federal supervision that apply to existing national banks.⁵¹ In addition, such qualifying companies will be required to submit a detailed contingency plan that addresses potential threats and other strategies to avoid failure.⁵²

While the OCC views its decision as one “to promote economic opportunity and support innovation that can improve financial services to consumers, businesses, and communities,”⁵³ the plan has faced mixed reviews. Since the announcement, at least two lawsuits have been filed against the OCC challenging the OCC’s authority to issue these charters, including an action by the Conference of State Bank Supervisors.⁵⁴ Although the OCC is fighting these allegations, the lawsuits will likely delay implementation for fintech companies seeking national bank charters.

Financial Choice Act

Growing skepticism of the ability of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Dodd-Frank Act) to prevent another financial crisis spurred the U.S. House of Representatives to pass the Financial Creating Hope and Opportunity for Investors, Consumers and Entrepreneurs Act of 2017 (the Financial Choice Act), on June 8, 2017.⁵⁵ The bill (HR 10) was passed by the House without a single Democrat vote and sought to make significant changes to the regulatory reforms and related agencies and practices set forth by the Dodd-Frank Act, including restructuring of the CFPB, eliminating the Financial Stability Oversight Council’s ability to designate nonbank financial companies as systemically important financial institutions, repealing Dodd-Frank’s Orderly Liquidation Authority, and reducing burdens on banking institutions based on capital levels irrespective of asset size.⁵⁶ One of the hallmark provisions of the Financial Choice Act is the “off-ramp” provision that allows banking organizations to exempt themselves from regulatory requirements, such as exemptions from stress tests, as long as they maintain a minimum leverage ratio (equity-capital) of at least 10 percent.⁵⁷

50 *Comptroller’s Licensing Manual: Considering Charter Applications From Financial Technology Companies*, Office of the Comptroller of the Currency, <https://www.occ.gov/publications/publications-by-type/licensing-manuals/pub-considering-charter-apps-from-fin-tech-co.pdf>.

51 *OCC Begins Accepting National Bank Charter Applications From Financial Technology Companies*, Office of the Comptroller of the Currency (July 31, 2018), <https://www.occ.gov/news-issuances/news-releases/2018/nr-occ-2018-74.html>.

52 *Id.*

53 *Id.*

54 *See, e.g., Conference of State Bank Supervisors v. Office of the Comptroller of the Currency*, No. 1:18-cv-02449 (D.D.C. filed Oct. 25, 2018); *Vullo v. Office of the Comptroller of the Currency*, 1:18-cv-8377 (S.D.N.Y. filed Sept. 14, 2018); *OCC Moves to Dismiss State Regulators’ Second Lawsuit Opposing Fintech Charter*, *The National Law Review* (Jan. 9, 2019), <https://www.natlawreview.com/article/occ-moves-to-dismiss-state-regulators-second-lawsuit-opposing-fintech-charter>; *CSBS Sues OCC Over Fintech Charter*, CSBS (Oct. 25, 2018), <https://www.csbs.org/csbs-sues-occ-over-fintech-charter>; Spiezo, Caroline, *NY Suit Against OCC Could Delay Regulatory Clarity for Fintech Companies*, *New York Law Journal* (Sept. 17, 2018), <https://www.law.com/newyorklawjournal/2018/09/17/091718Fintech/>.

55 *H.R. 10 – Financial CHOICE Act of 2017*, Congress.gov, <https://www.congress.gov/bill/115th-congress/house-bill/10>.

56 Rachel Witkowski, Andrew Ackerman, *What’s in the Financial Choice Act*, *WALL ST. J.* (June 8, 2017, 4:50 p.m.), <https://www.wsj.com/articles/whats-in-the-financial-choice-act-1496955001>.

57 *The Financial CHOICE Act Executive Summary*, American Bankers Association, [https://www.aba.com/Advocacy/LetterstoCongress/Documents/ABAExecutiveSummaryofTheFinancialCHOICEAct\(HR%2010\).pdf](https://www.aba.com/Advocacy/LetterstoCongress/Documents/ABAExecutiveSummaryofTheFinancialCHOICEAct(HR%2010).pdf).

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Without the support of Senate Democrats, the Financial Choice Act stalled in the Senate after being referred to the Senate Committee on Banking, Housing and Urban Affairs in June 2017. In March 2018, however, the Senate passed the bipartisan-backed Economic Growth, Regulatory Relief and Consumer Protection Act (S 2155).⁵⁸ On May 22, 2018, the regulatory reform bill was passed by the House without amendment to the Senate version and was subsequently signed into law by the President on May 24, 2018.⁵⁹ While S 2155 is far from a repeal of the Dodd-Frank Act and not quite as broad from a reform perspective as the Financial Choice Act, it does provide community and regional banks, as well as nonbank financial institutions, with relief from certain requirements that have been perceived by many as overburdensome.⁶⁰ In addition to increasing the asset threshold at which enhanced prudential standards apply from \$50 billion to \$250 billion, S 2155 also exempts banks with less than \$10 billion in total consolidated assets from the Volcker Rule and eases certain naming restrictions under the Volcker Rule, reduces reporting and supervision requirements applicable to community banks, and eases certain securities law requirements.⁶¹

Legal Cannabis Banking Update

Since the legalization of medical marijuana by California in 1996, 33 states and the District of Columbia have legalized medical marijuana.⁶² Following Washington's and Colorado's lead in 2012, a total of nine states and the District of Columbia have further legalized the drug for recreational use.⁶³ While states continue to legalize marijuana, whether for medical or recreational use, it remains illegal under federal law. Despite the uncertainty caused by the inconsistencies between state and federal laws, the U.S. market for marijuana has seen a steady growth over the past several years. The combined sales of medical and recreational marijuana totaled \$6.56 billion in 2016⁶⁴ and rose to approximately \$7.9 billion in 2017.⁶⁵ Although the legal waters surrounding marijuana were further muddled in 2018 by the Department of Justice's (DOJ's) rescission of the 2013 and 2014 Cole Memos, which provided marijuana-related businesses (MRBs) and the financial institutions providing services to MRBs with guidance as to compliance and oversight, sales continued to grow to between \$7.4 million and \$9.3 billion by the end of the year.⁶⁶ The DOJ's rescission, however, did not affect guidance from the Financial Crimes Enforcement Network (FinCEN) published in 2014 providing additional compliance and regulatory advice to financial institutions serving MRBs, which explicitly relied on the Cole Memos.

58 *S.2155 – Economic Growth, Regulatory Relief, and Consumer Protection Act*, Congress.Gov, <https://www.congress.gov/bill/115th-congress/house-bill/10>.

59 *Id.*

60 Norbert Michel, Ph.D., *A Comparison of Two Financial Regulatory Reform Approaches*, The Heritage Foundation (Jan. 2, 2018), <https://www.heritage.org/sites/default/files/2018-01/BG3275.pdf>; Alan Rappoport, Emily Flitter, *Congress Approves First Big Dodd-Frank Rollback*, N.Y. Times (May 22, 2018), <https://www.nytimes.com/2018/05/22/business/congress-passes-dodd-frank-rollback-for-smaller-banks.html>.

61 CRS Report R45073, *Economic Growth, Regulatory Relief, and Consumer Protection Act (P.L. 115-174) and Selected Policy Issues*, by David Perkins et al., <http://www.crs.gov/Reports/R45073>.

62 *Governing the States and Localities, State Marijuana Laws in 2018 Map*, <http://www.governing.com/gov-data/safety-justice/state-marijuana-laws-map-medical-recreational.html>.

63 *Id.*

64 New Frontier Data, *The Cannabis Industry Annual Report: 2017 Legal Marijuana Outlook*, https://newfrontierdata.com/wp-content/uploads/2015/11/CIAR_Webinar_FINAL.pdf.

65 Andrew DePietro, *Here's How Much Money States Are Raking in From Legal Marijuana Sales*, Forbes (May 4, 2018, 3:13 p.m.), <https://www.forbes.com/sites/andrewdepietro/2018/05/04/how-much-money-states-make-cannabis-sales/#3e63347f1811>.

66 Ed Keating, *2019 Marijuana Industry Predictions and Trends*, Cannabiz Media (Dec. 19, 2018), <https://cannabiz.media/2019-marijuana-industry-predictions-and-trends/>.

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The extensive growth in marijuana sales over the past several years has encouraged the development of a relatively new industry: cannabis banking. Although financial institutions have generally been reluctant to provide their services to MRBs due to the unclear legal landscape surrounding the industry, the 2018 FinCEN Marijuana Banking Updates confirmed that the number of financial institutions supporting MRBs has steadily risen from 318 in October 2016⁶⁷ to 486 in September 2018 – nearly a 35 percent increase.⁶⁸ Yet, because so few banks offer services to MRBs, most of these businesses operate solely on a cash basis – a risky model for any business. In 2018, a variety of banking alternatives were utilized to combat this issue, one being the use of blockchain technology to create a purely cashless banking system that provides businesses with access to process payments from customers and remit payments to vendors, employees and other affiliates.⁶⁹ States that have legalized marijuana are also exploring approaches that could provide MRBs with banking solutions, including the creation of state-chartered banking systems completely separate from the federal banking system. A California bill attempting to create such a system was killed in the California Assembly in August,⁷⁰ but a new bill was recently prefiled for the California Senate's 2019 Session.⁷¹ Ohio Revised Code § 3796.031 authorizes the Ohio Department of Commerce to adopt rules that establish a cashless, closed-loop payment processing system through which entities, patients and caregivers would have access to financial institutions for marijuana-related transactions.⁷² However, the Ohio director of commerce has yet to adopt any rules or regulations under the Ohio Administrative Code establishing such a system. With the U.S. House of Representatives' transition to a Democrat-dominated chamber in January 2019, only time will tell whether the year will bring more definite regulations for the cannabis banking industry.

Representative Matters

In 2018, BakerHostetler's Regulatory, Compliance and Licensing team continued to provide counsel and guidance to financial institutes at the state and federal levels. A few notable engagements are provided below:

- Counseled a Spanish bank looking to expand its online footprint in the United States on anti-money laundering issues such as customer due diligence and know your customer, as well as on applicable state law.
- Counseled a national consumer lender on state licensing issues with regard to a consumer lending product by conducting a 50-state survey. Additionally, the firm assisted the lender in obtaining the necessary licenses.

67 Financial Crimes Enforcement Network, *Marijuana Banking Update*, (data ending Mar. 31, 2018), https://www.fincen.gov/sites/default/files/shared/277157%20EA%202nd%20Q%20MJ%20Stats_Public.pdf.

68 Financial Crimes Enforcement Network, *Marijuana Banking Update* (data ending Sept. 30, 2018), https://www.fincen.gov/sites/default/files/shared/Marijuana_Banking_Update_September_2018.pdf.

69 CannabisNewsWire, *Cash-Heavy Cannabis Industry Looking for Alternative Fintech Banking Solutions*, PR Newswire (Apr. 17, 2018, 8:30 a.m.), <https://www.prnewswire.com/news-releases/cash-heavy-cannabis-industry-looking-for-alternative-fintech-banking-solutions-679979523.html>.

70 Nick Kovacevich, *California Kills Cannabis Banking Plan*, Forbes (Aug. 21, 2018, 2:47 p.m.), <https://www.forbes.com/sites/nickkovacevich/2018/08/21/california-kills-a-cannabis-banking-plan/#693f849e10a6>.

71 CA SB51, *Financial Institutions: Cannabis*, <https://legiscan.com/CA/text/SB51/2019>.

72 O.R.C. § 3796.031(A).

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- Represented a startup debt settlement company in the analysis of state law licensing and compliance matters.
- Represented a national corporate credit union in analysis and compliance-related matters regarding services to MRBs.
- Represented a national sports association in analysis and compliance matters relating to issuance of promotional and loyalty gift cards.
- Represented a mobile home company in analysis, compliance and licensing regarding consumer finance issues for the purchase of a mobile home.

Emerging Issues and Trends

Continued Impact of Mobile Apps in the Fintech Space

The reliance on mobile devices has disrupted almost every area of business, and fintech is no exception. According to a report by Juniper Research, there will be more than 2 billion users of mobile banking apps by 2020.⁷³ In the fintech space, mobile apps allow for payment processing, personal loans, automated investing, operations with cryptocurrency and much more. Fintech companies are marketing the mobile apps as a way to stay “flexible” while keeping everything in real time. Additionally, besides making the customer’s life easier, the mobile apps have created a space for companies to lower their costs and gain direct access to customer information. This allows the top fintech companies to attract more customers through the appeal of lower rates. Throughout 2019, we will continue to see fintech companies incorporate mobile apps into their business models in order to remain competitive in the growing world of mobile technology.

State Attorneys General and State Regulatory Agencies Filling the Regulatory Void Left by the CFPB

Given the CFPB’s new philosophy, state attorneys general and state regulators are poised to fill the void created by the bureau. In fact, Section 1042 of Dodd-Frank grants state attorneys general and state regulators the authority to initiate civil actions to enforce provisions of the Consumer Financial Protection Act as well as regulations that prohibit unfair, deceptive, or abusive acts or practices.⁷⁴

In 2019, we anticipate that state regulators and state attorneys general will continue to invoke its authority to regulate state and federal consumer financial services providers in order to fill the enforcement void created by the CFPB. For example, some states may continue to expand state authority, as Maryland did with the Maryland Financial Consumer Protection Act of 2018, which expands enforcement authority, increases civil penalties, creates a student loans

⁷³ *Digital Banking Users to Reach 2 Billion This Year, Representing Nearly 40% of Global Adult Population*, JUNIPER RESEARCH, <https://www.juniperresearch.com/press/press-releases/digital-banking-users-to-reach-2-billion> (last visited Jan. 13, 2019).

⁷⁴ 12 U.S.C. § 5552.

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ombudsman and directs the Commission of Financial Regulation to regulate fintechs.⁷⁵ Further, state attorneys general will likely continue to speak out against the CFPB, as was the case when more than 30 state attorneys general expressed concern at the CFPB's announcement that it would no longer ensure that lenders comply with the MLA.⁷⁶

As states continue to exercise their authority under respective state and federal laws, lenders and other financial services providers licensed in some or all 51 jurisdictions must continue to stay up to date on state law.

75 Maryland Financial Consumer Financial Protection Act (H.B. 1634), effective Oct. 1, 2018.

76 Letter of 32 State Attorneys General to Acting Director Mick Mulvaney, dated Oct. 23, 2018, <https://ago.vermont.gov/wp-content/uploads/2018/10/MLA-letter-to-CFPB.pdf> (last visited Jan. 15, 2019).



Lending

Lending

Industry Developments

LIBOR Replacement

Over the past year, the ARRC convened by the Federal Reserve Bank of New York was reconstituted with an expanded membership to ensure successful implementation of a paced transition plan for the replacement of LIBOR (London Interbank Offered Rate) as a benchmark rate. As part of this mandate, the ARRC issued various guidelines on fallback contract language for floating rate notes. These guidelines suggest key items including defining trigger events for benchmark rate replacement, a successor rate “waterfall” and a spread adjustment waterfall. For floating rate notes, the ARRC proposes clearly defining events that start the transition from LIBOR. Following a trigger, documents should then include a clear waterfall for determining what benchmark rate replaces LIBOR and then what spread adjustment should be applied to that rate.

The ARRC selected the secured overnight financing rate (the SOFR) as the recommended alternative reference rate to replace LIBOR. Unlike LIBOR, SOFR does not include credit risk in its calculation. ARRC suggests allowing maximum flexibility in crafting spread adjustment language to account for this and several other differences between LIBOR and SOFR or any other successor benchmark rate.

Welcome Changes to High-Volatility Commercial Real Estate Finance Restrictions

The Federal Reserve and the OCC implemented high-volatility commercial real estate (HVCRE) regulations from the Dodd-Frank Act in January 2015. These regulations placed greater burdens on lenders and developers in an attempt to curtail certain high-risk loans. Among other restrictions, lenders were required to keep higher reserves for loans secured by HVCRE, and developers needed to invest 15 percent minimum equity in certain projects.

While meant to curb risky real estate lending and development, the regulations broadly defined HVCRE. This subjected many relatively stable loans to HVCRE compliance. A chilling of capital markets and a freeze-out of smaller developers who could not meet the minimum equity requirements ensued.

On May 24, 2018, President Trump signed into law the Economic Growth, Regulatory Relief, and Consumer Protection Act (EGRRCPA), which, in part, amended HVCRE regulations. This welcomed amendment narrowed and substantially clarified the definition of HVCRE. Moreover, EGRRCPA expressly carves out properties that attain substantial completion or generate sufficient cash flow to support the debt service and expenses of the real property from the definition of HVCRE. These changes allow lenders to reclassify loans as non-HVCRE once borrowers hit these milestones.

Other major changes include (i) the exemption of all loans made before Jan. 1, 2015, from HVCRE status and (ii) a clarification that appraised property value (rather than borrower’s cost) can be utilized to compute whether a borrower’s capital contribution meets the 15 percent threshold.

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These changes fix many of the issues lenders and developers had with the 2015 regulations and reduce some of the burdens and costs associated with HVCRE loans. These changes could spur an increase in construction lending as well as other loans that were considered HVCRE.

Representative Matters

In 2018, we represented Centennial Bank, Fifth Third Bank, KeyBank, MB Financial Bank and other institutional lenders in a variety of club loans, middle-market commercial loans, construction loans and real estate financings. By way of example, our 2018 transactions included:

- Representing Centennial Bank in a \$132 million construction loan for a development in Westchester County, New York.
- Representing Centennial Bank in a \$65 million predevelopment loan for a development site in Brooklyn, New York.
- Representing Fifth Third Bank in a \$33 million loan to refinance a shopping center in Summit County, Ohio.
- Representing Bank Leumi in a \$47.5 million construction loan for a project in Brooklyn, New York.
- Representing KeyBank in a \$20 million bond redemption and mortgage loan for a school site in Queens, New York.

Emerging Issues and Trends

In November 2018, the IRS issued proposed regulations that materially change the way stock and assets of controlled foreign corporations (CFCs) can be used to support debt of U.S. affiliates. In the commercial lending market, this has the potential to impact long-standing approaches to obtaining guarantees and collateral from CFCs. In some cases, this may lower a company's cost of borrowing and permit a borrower to provide additional collateral support, particularly in asset-backed/borrowing-base loan structures.

Lenders have generally accepted that to minimize adverse tax consequences for U.S. borrowers, they would often avoid requiring direct guarantees or collateral from foreign affiliates of U.S. borrowers. Instead, lenders have often required a pledge of up to 65 percent of the voting capital stock (and 100 percent of the nonvoting capital stock) of CFCs to secure loans.

However, as a result of proposed regulations the IRS issued in November 2018, the adverse tax consequences that could result from guarantees and collateral support from CFCs owned by U.S. corporations have been mitigated, which could make obtaining guarantees and collateral support from CFCs more attractive to lenders and, in some instances, corporate borrowers. Lenders could have access to greater direct credit support from CFCs without adverse consequences for borrowers.

Lending

This is because the regulations turn off the application of the tax provision that effectively caused a deemed distribution from the CFC of a U.S. corporation. The relief applies where an actual distribution of earnings from the CFC would be exempt from U.S. tax under provisions enacted as part of the Tax Cuts and Jobs Act of 2017 (Section 245A).

Thus, lenders and U.S. corporations that are borrowers may wish to include guarantees and assets from CFCs, under some circumstances, where such credit support by foreign affiliates can lead to more flexible covenants, lower pricing or an increased borrowing base availability to a borrower. However, lenders and borrowers should proceed cautiously. For example, U.S. LLCs and LPs are still subject to deemed dividend rules, and consequently the adverse tax consequences would continue to apply to these types of entities. In addition, credit support fees paid to a CFC by a U.S. affiliate can attract adverse withholding and other tax consequences. Borrowers will also want to carefully consider their own tax strategies and the cost-benefit analysis involved in bringing non-U.S. entities into their loan arrangements.

The regulations will be effective when finalized. However, taxpayers may elect to apply the rules for taxable years of foreign affiliates beginning after Dec. 31, 2017.



Restructuring

Restructuring

Industry Developments

2018 was a strong economic year in the United States, with strong GDP growth, reductions in the unemployment rate, and strong-performing equities markets. Given the strong economy, we were not surprised to see a reduction in restructuring activity. In fact, filings in the U.S. bankruptcy courts have decreased by 2 percent since 2017.⁷⁷ The decline in filings is less steep than in 2017, but still represents a general downward trend in bankruptcy filings over the past decade. Commercial Chapter 11 bankruptcy filings in calendar year 2018 decreased by 5 percent from 2017, although filings by companies with more than \$100 million in liabilities kept even with 2017's pace. Consumer filings represented about 95 percent of bankruptcy filings in 2018. Total filings in the Bankruptcy Appellate Panels decreased significantly, down by 10 percent from the number of filings in 2017.

One trend from 2017 that has continued is the uptick in prepackaged or prenegotiated large Chapter 11 cases. For the past two years, a majority of billion-dollar Chapter 11 cases have been prepackaged or prenegotiated cases.⁷⁸ About a quarter of Chapter 11 cases in 2018 sought sales, and about a third of cases utilized Debtor-in-possession (DIP) financing. By industry, retail businesses continued to dominate bankruptcy headlines in 2018, but healthcare and media/technology filings also increased in 2018. Each is discussed below.

Retail

Demand for offline retail centers continued to fall through 2018. The year marked record highs in brick-and-mortar retail store closures, creating challenges for landlords of retail-related real estate. Some of the significant retail bankruptcy filings from 2018 include Chapter 11 filings by Sears, Claire's, Nine West Holdings, The Walking Company, Brookstone, Mattress Firm, Remington Outdoor Company Inc., Southeastern Grocers and David's Bridal. After filing for Chapter 11 in 2017, in 2018 Toys R Us liquidated its U.S. business after restructuring attempts failed. The Bon-Ton Stores Inc. was also sold and liquidated, then reemerged as an online retailer.

Healthcare

Healthcare bankruptcy filings increased by 55 percent in 2018. More than a third of 2018's healthcare Chapter 11 filings were by skilled nursing and long-term care hospitals.

Media/Technology

The media and technology industries have also faced challenges, stemming in part from the rise of internet, digital and on-demand streaming platforms that are crowding out ad-based platforms. Technology filings increased by 130 percent from 2017. The largest Chapter 11 filing of 2018 was by iHeartMedia, the largest radio broadcaster in the United States. LBI Media, the country's largest privately owned Spanish-language media company, filed for Chapter 11

⁷⁷ Federal Judicial Caseload Statistics 2018, United States Courts, Administrative Office of the United States Courts.

⁷⁸ Reorg, *Reorg First Day 2018 Year in Review: Retail Filers Seek to Restructure \$20B of Debt in Chapter 11; Healthcare Filings Increase 55%, Tech Filings up 130%, SDNY Filings Down 32%*, at https://app.reorg.com/v3/#/items/intel/1937?item_id=66235, Jan. 10, 2019.

Restructuring

in November 2018. Tech startups also struggled in 2018, including a number of filings by companies such as 3D printer maker PrintrBot and FreeLinc Technologies, a research and development company focused on adopting near-field magnetic induction as a new wireless standard.

Energy

While Chapter 11 filings in the energy sector have fallen steeply since their peak in 2016, oil and gas filings remained steady from 2017 at about 20 filings per half of the year. Three of the 10 largest Chapter 11 filings in 2018 were by companies in the energy industry. Notable 2018 Chapter 11 filings in the energy and mining sectors included EV Energy Partners, Rex Energy, Westmoreland Coal, Mission Coal and FirstEnergy Corp.

Representative Matters

In 2018, the firm continued to represent and assist secured creditors in liquidations, debt restructuring and workouts, asset sales, insolvency and receivership proceedings, and more.

Global Restructuring

Represented multiple automotive manufacturers in the complex global restructuring of Takata Corp., an international manufacturer of automotive parts. The restructuring involved asset sales in North and South America, Europe, China and Japan; product liability concerns; and multiple insolvency proceedings. The multiyear negotiations and insolvency proceedings culminated in spring 2018 in the \$1.6 billion sale of Takata's assets to Key Safety Systems, now Joyson Safety Systems.

Examiner Work

White collar partner John J. Carney acted as an examiner appointed by the Bankruptcy Court to investigate the connection of billionaire Nirav Modi's U.S. entities to the largest bank fraud in India's history, allegedly perpetrated by Modi. After India's criminal authorities seized Modi's Indian companies, his U.S. companies – Firestar Diamond Inc., A. Jaffe and Fantasy Inc. – filed for Chapter 11 bankruptcy protection in the U.S. Bankruptcy Court for the Southern District of New York. The firm assembled a team of bankruptcy and white collar attorneys to probe the circumstances of the fraud and the involvement of Modi's U.S. entities therein. After deposing more than 45 witnesses and reviewing millions of documents and financial records, the team ultimately found evidence to establish the critical links tying Modi and the U.S. entities to the Indian fraud. The examiner's investigation concluded with the team's submission to the court of a nearly 200-page report containing investigative findings, which has been well-received by the court, the U.S. and Indian government agencies, and private parties.

Emerging Issues and Trends

As always, a major driver of the level of restructuring activity is likely to be overall economic activity. Real GDP increased at an annual rate of 3.4 percent heading into the fourth quarter of 2018. The increase in real GDP reflects an increase in consumer spending, inventory

Restructuring

investment, government spending and business investment.⁷⁹ Meanwhile, delinquency rates for commercial and residential real estate loans continued to decrease, hitting record lows at 3.01 percent for residential loans and 0.69 percent for commercial loans as of the third quarter of 2018.⁸⁰ The Federal Reserve raised its benchmark rate to 2.5 percent in the fourth quarter of 2018, which marks the fourth interest hike of the year and the highest rates have been since the financial crisis a decade ago. All of that said, looking forward, market analysts expect the retail, healthcare, advertiser-supported media and energy industries to face pressure in 2019. In addition, while there is a strong economy today, some experts are predicting an economic downturn by early 2020 based on monetary and trade policies combined with a potential stock market correction.

In 2018 legal developments, restructuring practitioners saw the Supreme Court reach a decision with potentially hefty economic consequences arising post-confirmation litigation from the *Centaur LLC et al. Chapter 11 cases. Merit Management Group, LP*, 138 S. Ct. 883 (2018). In an appeal from the Seventh Circuit, the Supreme Court narrowly construed a “safe harbor” provision in the Bankruptcy Code that had been previously held to prevent avoidance of transactions where funds moved through a financial institution. The Supreme Court held that the only transfer relevant to the safe harbor was the actual transfer to be avoided, and not any of the component parts of the transfer. In other words, a transfer would not fall under the safe harbor just because a covered financial institution acted as a conduit for the funds. It is yet unclear what practical impact the *Merit Management* decision will have, but there is the potential for an increase in clawback litigation for such transactions.

Furthermore, restructuring practitioners should keep an eye on a case pending in the Supreme Court this year, *Mission Product Holdings, Inc. v. Tempnology LLC, nka Old Cold LLC*, Case No. 17-1657. The Supreme Court granted certiorari to resolve a circuit split over whether a trademark licensee’s rights survive a debtor-licensor’s rejection of the underlying trademark license pursuant to Section 365 of the Bankruptcy Code. The First Circuit in *Mission Products* had held that when the debtor-licensor of certain chemical-free cooling clothing products rejected its license agreement with the licensee to develop and market those products, the licensee lost all rights under the agreement, including trademark rights, not expressly protected by Section 365(n). In *Sunbeam Products, Inc. v. Chicago Manufacturing, LLC*, 686 F.3d 372 (7th Cir. 2012), the Seventh Circuit reached the opposite conclusion, explaining that “what § 365(g) does by classifying rejection as breach is establish that in bankruptcy, as outside of it, the other party’s rights remain in place.”⁸¹ This decision may have significant impact on intellectual property rights in the event of insolvency.

79 U.S. Bureau of Economic Analysis, Gross Domestic Product, 3rd Quarter 2018 (third estimate); Corporate Profits 3rd quarter 2018 (revised estimate), Dec. 21, 2018, at <https://www.bea.gov/news/2018/gross-domestic-product-3rd-quarter-2018-third-estimate-corporate-profits-3rd-quarter-2018> (visited Jan. 9, 2019).

80 Federal Reserve Board, Charge-Off and Delinquency Rates on Loans and Leases at Commercial Banks, at <https://www.federalreserve.gov/releases/chargeoff/delallsa.htm> (visited Jan. 9, 2019).

81 *Id.* at 376-377.



Financial Technology (Fintech)

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Industry Developments

OCC Fintech Charter

In an action highly anticipated by the fintech industry, on July 31, 2018, the OCC announced that it would begin accepting applications for “national bank charters from nondepository fintech companies engaged in the business of banking.”⁸² The OCC’s so-called Fintech Charter provides a path for fintech companies, such as online lenders and cryptocurrency exchanges, to become chartered national banks. In an OCC press release, Comptroller of the Currency Joseph M. Otting said the Fintech Charter will “make the federal banking system stronger by promoting economic growth and opportunity, modernization and innovation, and competition.”

Less than two months after the OCC announcement, the state of New York sued the federal government, seeking to void the Fintech Charter on grounds related to consumer risk and constitutionality. The complaint alleges that in implementing the Fintech Charter, the OCC exceeded its authority under the National Bank Act and usurped powers reserved to the states in violation of the 10th Amendment of the U.S. Constitution.⁸³ A subject of much debate within the traditional financial services and emerging fintech industries, the real impact of the Fintech Charter remains to be seen and will likely become more clear over the course of 2019.

Rejection of Bitcoin Exchange Traded Funds

On July 26, 2018, the U.S. Securities and Exchange Commission (SEC) issued an order disapproving a proposed rule change sought by Bats BZX Exchange Inc. (BZX) that would have allowed BZX to list and trade shares of the Winklevoss Bitcoin Trust (WBT).⁸⁴ Had the rule change been approved, the WBT would have held bitcoins as its sole asset, shares of WBT would have been issued and redeemed in exchange for bitcoin, and WBT shares would have been available only to certain “authorized participants.” The WBT would have sought to have its shares track the price of bitcoin by calculating the net value of its bitcoin holdings every 15 seconds based on the price of bitcoin on the Gemini Exchange, a cryptocurrency exchange that is also owned by the Winklevoss twins.

Cameron and Tyler Winklevoss first sought SEC approval for the WBT more than five years ago, in July 2013. The brothers have amended the WBT registration statement nine times, with the recent disapproval order being the latest in a long string of rejections by the SEC. The SEC explained its rationale for this most recent disapproval order in a 92-page document. In brief, the SEC concluded that BZX was unable to show that it could design rules to prevent fraud and manipulation and to protect investors related to the WBT shares.

In the order, the SEC rejected the argument that the bitcoin market was inherently resistant to manipulation. In doing so, the SEC cited, among other things, the “51% vulnerability”; the concentration of bitcoin ownership; the prevalence of cyberattacks on bitcoin exchanges; and recent studies finding evidence of bitcoin price manipulation involving Tether, a cryptocurrency

82 <https://www.occ.gov/news-issuances/news-releases/2018/nr-occ-2018-74.html>.

83 <https://www.reuters.com/article/us-usa-treasury-fintech-lawsuit/new-york-sues-u-s-to-stop-fintech-bank-charters-idUSKCN1LU210>; *Vullo v. Office of the Comptroller of the Currency et al.*, U.S. district court, Southern District of New York, No. 18-08377.

84 https://www.sec.gov/rules/other/2018/34-83723.pdf?mod=article_inlinev.

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claimed to be backed 1:1 by U.S. dollars that is used as a store of value for cryptocurrency market participants. According to the SEC, because the bitcoin market is not resistant to manipulation, BZX would have had to enter into appropriate surveillance-sharing agreements with “significant” regulated bitcoin markets in order to sufficiently deter fraud and price manipulation and protect investors. The SEC found that adequate surveillance-sharing agreements were not in place.

Despite ongoing attempts by several market actors, approval of Bitcoin ETFs appears unlikely in the near future, based on recent comments from SEC Chairman Jay Clayton, who cited continued concerns over a lack of adequate investor protections, including difficulties mitigating risks related to cryptocurrencies being stolen or manipulated on exchanges.⁸⁵

Initial Coin Offerings

On July 25, 2017, the SEC issued its 21(a) report concluding that, according to the U.S. Supreme Court decision in *SEC v. W.J. Howey Co.*, the DAO token qualified as a security under the federal securities laws, and thus its offering had to either be registered with the SEC or subject to a valid exemption from registration.⁸⁶ On Dec. 11, 2017, the SEC affirmed this position in a cease-and-desist order served on Munchee Inc. that prompted Munchee to refund approximately \$15 million of funds raised in a so-called initial coin offering event, or ICO.⁸⁷ On Feb. 6, 2018, in official remarks to a U.S. Senate committee, Clayton reaffirmed that ICOs “have largely been” sales of unregistered securities.⁸⁸ In testimony before a U.S. House of Representatives subcommittee made on April 26, 2018, Clayton commented again on ICOs, stating that “[t]here are none that I’ve seen that are not securities.”⁸⁹

In a June 6, 2018, interview with CNBC, Clayton clarified that bitcoin is not a security.⁹⁰ Similarly, in public remarks made on June 14, 2018, SEC Director William Hinman stated that “current offers and sales of Ether are not securities transactions.”⁹¹ In the same remarks, Hinman emphasized the importance of the Howey test and warned, “[S]imply labeling a digital asset a ‘utility token’ does not turn the asset into something that is not a security.” In an apparent effort to provide further clarity, on Oct. 18, 2018, the SEC announced the creation of the Strategic Hub for Innovation and Financial Technology (FinHub), a centralized resource on the SEC’s fintech initiatives, including those relating to blockchain.⁹² In November, Hinman announced the SEC intends to release “plain English” guidance to assist ICO issuers in determining whether the SEC will consider ICO tokens to be a security.⁹³ The guidance is expected in early 2019.

85 <https://www.bloomberg.com/news/articles/2018-11-27/bitcoin-etfs-roadblocked-by-lack-of-safeguards-sec-s-chief-says?srnd=cryptocurrencies>.

86 <https://www.sec.gov/litigation/investreport/34-81207.pdf>.

87 <https://www.sec.gov/litigation/admin/2017/33-10445.pdf>.

88 <https://www.banking.senate.gov/imo/media/doc/Clayton%20Testimony%20202-6-18.pdf>.

89 <https://docs.house.gov/meetings/AP/AP23/20180426/108233/HHRG-115-AP23-Wstate-ClaytonJ-20180426.pdf>.

90 <https://www.cnbc.com/2018/06/06/sec-chairman-clayton-says-agency-wont-change-definition-of-a-security.html>.

91 <https://www.sec.gov/news/speech/speech-hinman-061418>.

92 <https://www.sec.gov/news/press-release/2018-240>.

93 <https://www.coindesk.com/sec-official-says-plain-english-guidance-on-icos-is-coming>.

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Despite the above warnings and guidance, the ICO market boomed in the first half of 2018, with almost \$14 billion raised through ICOs.⁹⁴ The SEC responded by issuing subpoenas to as many as 80 companies and individuals involved in ICO events,⁹⁵ announcing plans to examine up to 100 hedge funds dealing with cryptocurrencies,⁹⁶ and working with regulators in Canada and in U.S. states to launch a coordinated series of international enforcement actions dubbed “Operation Cryptosweep.”⁹⁷ Some of the more notable actions taken by the SEC include those against Centra Tech,⁹⁸ AriseBank⁹⁹ and Titanium Blockchain Infrastructure Services Inc.¹⁰⁰ In the case of AriseBank, in December the SEC obtained an order from a federal court in Texas requiring the former CEO and COO of AriseBank to pay \$2.7 million to settle registration and anti-fraud violations.¹⁰¹ According to the North American Securities Administrators Association, as of Aug. 28 there were more than 200 ICOs and cryptocurrency-related investment products under active investigation.¹⁰²

Based on a report issued in September 2018, the ICO boom appears to have subsided in the latter half of the year. According to the report, nearly half of all ICOs since 2017 failed to raise any funds, and the month of August 2018 showed the lowest rates of return on startup ICOs since May 2017, with such efforts raising only \$326 million compared with the \$3 billion-per-month average observed during the first three months of 2018.¹⁰³ Another report issued in September stated that 70 percent of tokens issued in ICOs have seen their value fall below the token value at the time of the ICO. The report also stated that of the tokens that completed an ICO in 2017-2018, more than one-third, having raised more than \$2.3 billion, have not yet listed their tokens on any exchange.¹⁰⁴

According to a study from Boston College, approximately 56 percent of crypto startups were no longer in business after just four months.¹⁰⁵ The study tracked more than 4,000 ICOs in the first half of 2018 by monitoring their Twitter accounts, and found that more than half of these accounts were inactive within 120 days from the time their ICO was announced. Another survey of tokens with more than \$50 million in market cap found that more than 80 percent of these tokens are scams, and more than 10 percent were abandoned and never made it onto an exchange.¹⁰⁶

94 <https://www.coindesk.com/ico-tracker/>.

95 <https://www.nytimes.com/2018/02/28/technology/initial-coin-offerings-sec.html>.

96 <https://www.wsj.com/articles/crypto-focused-hedge-funds-on-secs-radar-1521757104>.

97 <http://www.nasaa.org/45121/state-and-provincial-securities-regulators-conduct-coordinated-international-crypto-crackdown-2/>.

98 <https://www.sec.gov/news/press-release/2018-53>.

99 <https://www.sec.gov/news/press-release/2018-8>; <https://www.justice.gov/usao-ndtx/pr/cryptocurrency-ceo-indicted-after-defrauding-investors-4-million>.

100 <https://www.sec.gov/news/press-release/2018-94>.

101 <https://www.sec.gov/news/press-release/2018-280>.

102 <http://www.nasaa.org/45901/nasaa-updates-coordinated-crypto-crackdown/>.

103 <https://www.bloomberg.com/news/articles/2018-09-10/crypto-ico-funding-dropped-in-august-to-lowest-in-16-months?srnd=cryptocurrencies>.

104 <https://diar.co/volume-2-issue-38/>.

105 <https://www.unlock-bc.com/news/2018-07-11/digital-tulips-returns-to-investors-in-initial-coin-offerings>.

106 https://research.bloomberg.com/pub/res/d28giW28tf6G7T_Wr77aU0gDgFQ.

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While some foreign jurisdictions have allowed ICOs to continue unregulated or have even adopted new ICO-friendly laws and regulations, others have followed the SEC's lead in seeking to enforce their securities laws. One jurisdiction of note is Malta, which in late 2018 had three new laws take effect: (i) The Malta Digital Innovation Authority Act, (ii) The Innovative Technological Arrangement and Service Act, and (iii) The Virtual Financial Asset Act. The Malta Digital Innovation Authority Act establishes an agency that will regulate the blockchain industry, protect consumers and financial markets, and promote transparency. The Innovative Technological Arrangement and Service Act establishes a regime for the registration and certification of technology service providers and lays the groundwork for future technology developments. The Virtual Financial Asset Act establishes a "financial instruments test," which provides guidance on whether a cryptocurrency or token issued in an ICO constitutes a security. Any asset that does not squarely pass the test will be deemed a "virtual financial asset" regulated by the new law.¹⁰⁷

Another noteworthy example is Hong Kong, which was once friendly to ICOs but in 2018 took several actions against such offerings, including sending warning letters to exchanges listing ICO tokens,¹⁰⁸ taking action against ICO issuers¹⁰⁹ and issuing cautionary statements to the public.¹¹⁰ In January 2018, the SEC suspended trading of a Hong Kong blockchain company's stock based on unusual and unexplained market activity,¹¹¹ and in July 2018 the SEC obtained a final judgment against two individuals involved in the activity.¹¹² Despite successes such as this, it appears that U.S. and foreign governments alike have had difficulties keeping pace with ICOs and token-related securities law violations as they proliferate in a largely borderless economy and amid an inconsistent and constantly changing international regulatory landscape.

SEC Enforcement Actions: Fraud

Fraud actions involving cryptocurrency have been widespread. In a recent decision of note, a New York federal court held that a foreign company and its two foreign founders were subject to personal jurisdiction in a lawsuit brought by the SEC. In *SEC v. PlexCorps*, the SEC alleged that the defendants, two Canadian residents, violated the securities laws and misappropriated more than \$15 million from investors through false and misleading statements regarding the PlexCoin ICO.¹¹³ The defendants, who developed and launched the PlexCoin ICO in Canada, moved to dismiss the action for lack of personal and subject matter jurisdiction, arguing that while many U.S. investors bought into the company's offering of digital currency, the Canadian business attempted to exclude U.S. persons from the ICO.

In denying the defendants' motion, the court considered a significant amount of evidence marshaled by the SEC and ultimately found that the SEC established that the defendants

107 https://www.forbes.com/sites/rogeraitken/2018/10/29/crypto-investors-flocking-to-blockchain-island-malta-in-droves/?fbclid=IwAR3xTynR_iQWPXKbBJFHIQI7B0mQfz45yGy5fEKtrYRatgweYhYEvCSI5E#383ffbca5ff9.

108 <https://www.sfc.hk/edistributionWeb/gateway/EN/news-and-announcements/news/doc?refNo=18PR13>.

109 <https://www.scmp.com/business/banking-finance/article/2137918/hong-kongs-regulator-halts-initial-coin-offering-orders>.

110 https://www.sfc.hk/web/EN/files/ER/PDF/Speeches/Julia_20180413.pdf.

111 <https://www.sec.gov/litigation/suspensions/2018/34-82452.pdf>.

112 https://www.sec.gov/litigation/litreleases/2018/lr24190.htm?utm_source=dldr.it&utm_medium=linkedin.

113 Complaint, *SEC v. PlexCorps*, No. 17-CV-7007, ECF 1 (E.D.N.Y. Dec. 1, 2017).

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conducted significant dealings in the United States.¹¹⁴ In September 2018, the SEC submitted a letter to the PlexCoin court seeking sanctions and a default judgment against PlexCorps' founders for ignoring court orders concerning accounting and repatriation of digital assets and evidence discovery. The SEC believes a large portion of the funds raised in the ICO are still being held in cryptocurrency wallets controlled by the PlexCorps founders.¹¹⁵

On Aug. 14, 2018, the SEC announced that it had obtained permanent officer-and-director and penny stock bars against the founder of a company who perpetrated a fraudulent ICO.¹¹⁶ In September, Crypto Asset Management LP, a hedge fund, agreed to pay a \$200,000 penalty to settle charges that it operated as an unregistered investment company. The fund raised more than \$3.6 million over a four-month period in 2017, while falsely marketing that it had filed a registration statement with the SEC and that it was the "first regulated crypto asset fund in the United States."¹¹⁷ On Oct. 9, 2018, the SEC filed a subpoena enforcement action in California against an investment trust that failed to respond to an investigative subpoena issued by the staff. The investigation focused on a claim by a penny stock, Cherubim, that it had allegedly executed a \$100 million financing commitment to launch an ICO.¹¹⁸

In another action reported on Oct. 11, 2018, the SEC obtained a court order preventing an ICO that falsely claimed it was approved by the SEC and that a related cryptocurrency fund was "licensed and regulated" by the agency.¹¹⁹ In a similar action, the SEC announced the suspension of trading in the securities of a U.S.-based retail company, alleging the company made false claims that it had partnered with an SEC-qualified custodian for cryptocurrency transactions and was conducting a token offering registered under SEC regulations.¹²⁰ On Nov. 29, 2018, the SEC announced that it had accepted settlements and entered consent orders against Floyd Mayweather Jr. and Khaled Khaled (also known as D.J. Khaled) related to charges of promoting securities issued in ICOs without fully disclosing that they were being compensated by the entities offering the ICO tokens.¹²¹

There were numerous other fraud actions in the U.S. and abroad in 2018. Examples include a lawsuit filed by South Korean prosecutors against a U.S. cryptocurrency mining firm alleging a multimillion-dollar fraud,¹²² class action lawsuits alleging a Ponzi scheme against a bitcoin investment platform,¹²³ Commodity Futures Trading Commission (CFTC) actions against a cryptocurrency firm alleging fraud and asset misappropriation,¹²⁴ DOJ action against a fake ID

114 Memorandum & Order, *SEC v. PlexCorps*, No. 17-CV-7007, ECF 84 (E.D.N.Y. Aug. 9, 2018).

115 <https://www.coindesk.com/sec-seeks-court-sanction-against-plexcoin-ico-founders>.

116 <https://www.sec.gov/news/press-release/2018-152>.

117 <https://www.sec.gov/news/press-release/2018-186>.

118 <https://www.sec.gov/litigation/litreleases/2018/lr24308.htm>.

119 <https://www.sec.gov/news/press-release/2018-232>.

120 <https://www.sec.gov/news/press-release/2018-242#W83xoALj9-U.linkedin>.

121 <https://www.sec.gov/litigation/admin/2018/33-10579.pdf>; <https://www.sec.gov/litigation/admin/2018/33-10578.pdf>.

122 <https://www.coindesk.com/prosecutors-file-charges-alleged-250-million-crypto-mining-fraud/>.

123 <https://www.coindesk.com/us-court-freezes-bitconnect-assets-as-lawsuits-mount/>.

124 <https://www.cftc.gov/PressRoom/PressReleases/pr7678-18>; <https://www.cftc.gov/PressRoom/PressReleases/pr7675-18>.

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operation that seized \$4.7 million in bitcoin,¹²⁵ and a multi-agency cross-border action alleging a \$36 million fraud scheme involving bitcoin that extradited a British citizen from Morocco to the U.S.¹²⁶

SEC Enforcement Actions: Unregistered Securities

In 2018, the SEC also initiated several ICO-related actions that did not involve fraud. In September, TokenLot LLC and its owners agreed to pay more than \$500,000 in penalties to settle charges that they acted as unregistered broker-dealers in the sale and trading of securities. TokenLot LLC, a self-described ICO Superstore where investors could purchase digital tokens and engage in secondary trading, handled more than 200 different digital tokens for more than 6,000 retail investors from July 2017 until February 2018.¹²⁷ Also in September, the SEC and CFTC charged 1pool Ltd. (aka 1Broker) and its CEO with offenses related to its actions to solicit U.S. investors to purchase swaps and commodity transactions, allow investors to open trading accounts by providing only a username and email address, and require customers to fund their accounts using bitcoin. According to the complaint, 1Broker's actions violated federal securities laws requiring broker-dealer registration and customer identity verification.¹²⁸

In November, the SEC settled charges against the founder of EtherDelt, a digital token trading platform for blockchain-based tokens commonly issued in ICOs, for operating an unregistered national securities exchange.¹²⁹ On Nov. 16, 2018, the SEC announced that it had settled charges against two companies – Carriereq Inc., doing business as Airfox, and Paragon Coin Inc. – for securities registration violations arising out of previously conducted ICOs. The SEC published the cease-and-desist orders, which imposed \$250,000 penalties, required the companies to register the tokens under the Exchange Act by filing Form 10 and required the companies to implement an online claims process allowing token purchasers to recover amounts paid for the tokens.¹³⁰ In another settlement, CoinAlpha Advisors LLC settled registration violation charges when it agreed to return \$600,000 raised from 22 investors from several U.S. states. The SEC alleged that CoinAlpha engaged in a general solicitation of unregistered securities and failed to take reasonable steps to ensure only accredited investors purchased interests in its fund.¹³¹

CFTC Enforcement Actions

One of the most notable CFTC actions of 2018 involves the foreign cryptocurrency exchange Bitfinex and Tether, an affiliated company that issues a cryptocurrency that the company claims is backed 1:1 by U.S. dollar reserves. On Dec. 6, 2017, the CFTC sent subpoenas to Bitfinex and Tether.¹³² Although the subject of the subpoenas is unknown, some have speculated that

125 <https://www.justice.gov/usao-ndoh/pr/toledo-man-charged-producing-and-selling-false-identification-documents>.

126 <https://www.justice.gov/usao-sdny/pr/british-citizen-extradited-morocco-defrauding-investors-more-36-million>.

127 <https://www.sec.gov/news/press-release/2018-185>.

128 <https://www.sec.gov/news/press-release/2018-218>.

129 <https://www.sec.gov/news/press-release/2018-258>.

130 <https://www.sec.gov/news/press-release/2018-264>.

131 <https://www.sec.gov/litigation/admin/2018/33-10582.pdf>.

132 <https://www.bloomberg.com/news/articles/2018-01-30/crypto-exchange-bitfinex-tether-said-to-get-subpoenaed-by-cftc>.

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they relate to a possible bitcoin price manipulation scheme, and foreign news sources claim to have linked Bitfinex to a potential money laundering scheme.¹³³

Bitfinex has denied any wrongdoing, and in June 2018 Tether announced that a U.S. law firm confirmed that Tether's bank deposits had U.S. dollars sufficient to back every unit of Tether cryptocurrency in circulation.¹³⁴ An analysis by Bloomberg appears to support a similar conclusion.¹³⁵ However, suspicions of price manipulation have continued amid Tether's issuance of \$250 million worth of new Tether cryptocurrency units on May 20,¹³⁶ as well as the departure of a senior Bitfinex executive¹³⁷ and allegations of price manipulation in an analysis published on June 25 by two professors at the University of Texas at Austin.¹³⁸

A separate investigation into alleged price manipulation was launched in May 2018 by the CFTC and the DOJ. According to Bloomberg News, the DOJ "opened a criminal probe into whether traders are manipulating the price of Bitcoin and other digital currencies."¹³⁹ As part of the investigation, the CFTC has issued subpoenas to Bitstamp, Coinbase, itBit and Kraken, which are the four cryptocurrency exchanges that the CME Group uses to calculate the price of its bitcoin futures products.¹⁴⁰ This investigation is ongoing.

In October 2018, the CFTC announced that a federal district court had ordered a New York-based corporation and its CEO to pay more than \$2.5 million in civil penalties and restitution in what the CFTC called its first-ever anti-fraud enforcement action involving bitcoin. The CFTC brought the action in response to a Ponzi scheme in which the defendants generated false statements showing gains from bitcoin trading to solicit more than \$600,000 from at least 80 investors between 2014 and 2016.¹⁴¹ In November, the CFTC ordered an individual to pay more than \$1.1 million in restitution to his former employer, a Chicago-based proprietary trading firm, and its individual customers, arising out of a fraud scheme based on trading bitcoin and litecoin.¹⁴²

Representative Matters

Federal Policy

Advised a major blockchain industry and fintech client on federal policy and strategies for engagement with U.S. regulators and lawmakers.

133 <https://www.financemagnates.com/cryptocurrency/news/bitfinex-mixed-colombian-cocaine-polish-media-reports/>.

134 <https://www.bloomberg.com/news/articles/2018-06-20/tether-hired-former-fbi-director-s-law-firm-to-vet-finances>.

135 <https://www.bloomberg.com/amp/news/articles/2018-12-18/crypto-mystery-clues-suggest-tether-has-the-billions-it-promised>.

136 <https://cointelegraph.com/news/tether-mints-250-mln-of-new-usdt-tokens-rekindles-controversy>.

137 <https://www.reuters.com/article/us-cryptocurrencies-bitfinex/bitfinex-chief-strategy-officer-departs-idUSKBN1J12IN>.

138 https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3195066.

139 <https://www.bloomberg.com.cdn.ampproject.org/c/s/www.bloomberg.com/amp/news/articles/2018-05-24/bitcoin-manipulation-is-said-to-be-focus-of-u-s-criminal-probe>.

140 <https://coingape.com/us-regulator-subpoenas-to-bitcoin-exchanges-bitcoin-manipulation/>.

141 <https://www.cftc.gov/PressRoom/PressReleases/7831-18>.

142 <https://www.cftc.gov/PressRoom/PressReleases/7839-18>.

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ICO Remediation

Represented a blockchain industry client in responding to multiple SEC subpoenas and investigations related to a previously conducted ICO event.

Cryptocurrency Exchange

Engaged by a major U.S. cryptocurrency exchange to represent the client before the Internal Revenue Service in a tax controversy matter.

Emerging Issues and Trends

Cryptocurrency Payment Processors and Exchanges

In 2018, cryptocurrency payment processors appeared to make gains integrating cryptocurrencies into merchant payment systems. Square, a mobile payments firm, announced that its revenue from bitcoin sales reached \$37 million in the second quarter of 2018¹⁴³ and that it generated \$43 million in bitcoin revenue in the third quarter.¹⁴⁴ In June, Square was granted a virtual currency license from the New York Department of Financial Services (DFS).¹⁴⁵ In July, BitPay, one of the world's largest providers of merchant cryptocurrency payment processing services, also received a virtual currency license from the New York DFS.¹⁴⁶

In November 2018, the New York DFS approved Coinsource Inc.'s application for a virtual currency license. Coinsource operates 40 Bitcoin teller machine (BTM) kiosks in New York, allowing customers to buy and sell bitcoin for cash.¹⁴⁷ According to Coin ATM Radar, the BTM industry is growing fast, with an average of 4.9 new BTMs installed each day and a total of 4,167 BTMs available across the globe, with 56 percent located in the U.S.¹⁴⁸

On Sept. 18, 2018, the New York attorney general's office released its Virtual Markets Integrity Initiative Report.¹⁴⁹ The report addressed 10 major virtual currency trading platforms. Key takeaways include the following:

- Many of the trading platforms that participated in the report lack safeguards to effectively prevent conflicts between customer and insider interests. Items of particular concern include employee trading practices and the manner in which platform operators trade on their own venues.
- Only a minority of platforms have formal market manipulation policies and restrict, let alone monitor, automated algorithmic trading. There is no mechanism for analyzing suspicious trading strategies across platforms.

143 <https://www.coindesk.com/square-sees-profits-from-bitcoin-sales-double-in-q2>.

144 <https://cointelegraph.com/news/squares-bitcoin-revenue-increases-by-6-million-in-q3-profits-top-500-000>.

145 <https://www.dfs.ny.gov/about/press/pr1806181.htm>.

146 <https://www.dfs.ny.gov/about/press/pr1807161.htm>.

147 <https://www.dfs.ny.gov/about/press/pr1811011.htm>.

148 <https://cointelegraph.com/news/almost-5-new-cryptocurrency-atms-installed-worldwide-each-day-data-shows>; <https://coinatmradar.com/charts/gauge/>.

149 https://ag.ny.gov/sites/default/files/vmii_report.pdf?mod=article_inline.

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- Consumer funds are at risk because of data security vulnerabilities and an absence of industry standards for insurance and auditing virtual assets.
- The report concludes with a list of questions customers should ask before participating on virtual currency trading platforms.

Three platforms declined to participate in the report, claiming that they did not operate in New York. However, the attorney general found otherwise and referred those entities to the New York State DFS.

In October 2018, cryptocurrency exchange Gemini announced that it had secured insurance coverage for cryptocurrency assets held in its custody through a global consortium of industry-leading insurers.¹⁵⁰ Also in October, a new cryptocurrency exchange platform backed by leading institutional trading firms was announced. Named ErisX, the exchange intends to let investors trade bitcoin, ether, bitcoin cash, litecoin and cryptocurrency futures.¹⁵¹ In addition to exchanges and payment processors, cryptocurrency hedge funds also appear to have grown in 2018. According to Bloomberg, hedge funds have now replaced high-net-worth individuals as the biggest participants in high-value cryptocurrency transactions conducted through private sales.¹⁵²

Stablecoins

On Sept. 10, 2018, the New York DFS announced that it authorized both Paxos Trust Company LLC and Gemini Trust Company LLC to offer price-stable cryptocurrencies pegged to the U.S. dollar, commonly known as “stablecoins.”¹⁵³ According to a DFS press release, the approvals of these new financial products came after rigorous review and will be subject to ongoing examinations to ensure compliance with BSA/AML and OFAC regulations, adherence to cybersecurity standards, prevention of market manipulation, maintenance of proper information reporting and consumer protection, and assurances that the stablecoins are fully exchangeable for the U.S. dollar.

Paxos Standard is built on the Ethereum blockchain and is backed by U.S. dollar deposits held in segregated accounts at multiple FDIC-insured U.S. banks, with the account balances verified by independent audit firms. All Paxos Standard tokens in circulation will be backed by U.S. dollars, and upon redemption for dollars, the Paxos Standard tokens will be immediately destroyed. The Gemini Dollar also runs on the Ethereum blockchain, with each Ethereum-based token backed by a U.S. dollar. The dollars backing the Gemini Coin will be held at a major U.S. bank in an FDIC-insured account, with monthly audits to be performed on the account by a public accounting firm.

Another notable stablecoin that launched in 2019 is the “USD Coin” (USDC), which was introduced by the Boston-based startup Circle, a Goldman Sachs-backed venture. Like the Paxos and Gemini stablecoins, USDC runs on Ethereum, is pegged to the U.S. dollar and is backed by U.S. dollar

150 <https://www.businesswire.com/news/home/20181003005283/en/>.

151 https://www.bloomberg.com/news/articles/2018-10-03/eris-exchange-to-create-crypto-market-backed-by-drw-virtu?utm_source=google&utm_medium=bd&cmpid=google.

152 <https://www.bloomberg.com/news/articles/2018-10-01/institutional-investors-are-using-back-door-for-crypto-purchases?srnd=cryptocurrencies>.

153 <https://www.dfs.ny.gov/about/press/pr1809101.htm>.

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reserves. According to reports, the dollar reserves backing USDC will be verified by a major U.S. audit firm.¹⁵⁴ USDC currently trades on Coinbase, a major U.S. cryptocurrency exchange.¹⁵⁵

Initiatives by Traditional Financial Services Firms

While many commercial banking institutions continue to avoid servicing cryptocurrency businesses due to concerns over anti-money laundering compliance and other risk factors, some smaller banks appear to be strategically engaging cryptocurrency clients. According to a 2018 Coindesk article, Metropolitan Commercial Bank (MCB) has referred to cryptocurrency businesses as “pioneers” and has clients that include cryptocurrency exchanges as well as other hedge funds and cryptocurrency investors. The article states that MCB experienced a 300 percent increase in its first-quarter 2018 noninterest income, in large part due to fees earned from its crypto initiatives.¹⁵⁶

The U.S. bank that arguably has benefited the most from banking cryptocurrency clients is Silvergate Bank of San Diego. SEC filings from 2018 reveal that Silvergate Bank, which reportedly provides banking services to almost 500 customers in the cryptocurrency industry, is preparing to go public.¹⁵⁷ Another notable announcement came from the Swiss online bank Swissquote, which reportedly experienced a 44 percent increase in profits in the first half of 2018 as a result of its new service offering of bitcoin trading accounts for its clients.¹⁵⁸

Larger institutional financial services firms have focused more on innovative financial products related to cryptocurrencies and the value proposition of implementing blockchain to streamline backend payment and clearing/settlement systems. For example, Goldman Sachs, which already helps its clients deal in bitcoin futures, is reportedly setting up a cryptocurrency trading desk.¹⁵⁹

Another major U.S. financial services company issued an optimistic report in 2018 that described cryptocurrencies as a “new institutional investment class” and is reportedly planning to offer bitcoin swap trading.¹⁶⁰

Separately, another bank announced it had beta-tested a digital safety deposit box, which seeks to provide cryptocurrency storage and multi-signature services for cryptocurrency exchanges and investment funds.¹⁶¹ A third bank was awarded a U.S. patent for a cryptocurrency storage facility targeted at enabling enterprise-level institutions to store cryptocurrencies on behalf of their customers, including private key storage.¹⁶² Additionally,

154 <https://www.bloomberg.com/news/articles/2018-09-26/circle-joins-ranks-of-stable-crypto-coins-with-dollar-token?srnd=cryptocurrencies>.

155 <https://blog.coinbase.com/coinbase-and-circle-announce-the-launch-of-usdc-a-digital-dollar-2cd6548d237>.

156 <https://www.coindesk.com/metropolitan-bank-crypto-bitcoin-clients-millions>.

157 <https://xconomy.com/san-diego/2018/11/20/silvergate-bank-files-for-ipo-to-grow-cryptocurrency-services/>.

158 <https://cointelegraph.com/news/major-swiss-online-bank-posts-soaring-profits-after-offering-clients-crypto-investing>.

159 <https://www.bloomberg.com/news/articles/2018-06-20/goldman-sachs-mulling-crypto-trades-beyond-futures-solomon-says?srnd=cryptocurrencies>; <https://www.cnbc.com/2018/09/06/goldman-sachs-cfo-calls-reports-of-shutting-down-crypto-desk-fake-news.html>.

160 <https://cointelegraph.com/news/morgan-stanley-report-shows-strong-institutional-investment-for-bitcoin/amp>.

161 <https://www.businesswire.com/news/home/20181108005224/en/VersaBank-Subsidiary-VersaVault-Initiates-Commercialization-Stage-Digital>.

162 <https://www.coindesk.com/bank-of-america-wins-patent-describing-crypto-storage-method>.

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among many other blockchain patents filed by financial services firms, two major U.S. credit card companies published patent applications that seek patents for blockchain-based solutions to improve payment processing systems.¹⁶³

Cryptocurrency Market Analysis

Near the end of 2018, several studies were published reporting data and analysis on the cryptocurrency market. A report from the Blockchain Transparency Institute analyzed high-volume bitcoin “trading pairs” on various cryptocurrency exchanges and found “clear evidence of wash trading” on 22 of 25 exchanges analyzed.¹⁶⁴ A bitcoin trading pair is an exchange of bitcoin for another type of cryptocurrency (or vice versa), and wash trading is a form of market manipulation where an investor simultaneously buys and sells the same financial instrument to create artificial market activity. The report claims to have identified four different “bot strategies” used to artificially inflate bitcoin trading pair volumes via wash trading on cryptocurrency exchanges. According to the report, more than 80 percent of the top bitcoin trading pairs volume reported by CoinMarketCap is wash-traded, with most of the trading pairs having actual volume under 1 percent of their reported volume.

Another report analyzed website traffic on the most frequently used cryptocurrency exchanges and found that many cryptocurrency exchanges with low website traffic report high transaction volumes.¹⁶⁵ According to the report, this indicates that some cryptocurrency exchanges may be artificially inflating the dollar value of transactions processed on their platforms. Cryptocurrency market manipulation is also the topic of a recently published research paper co-authored by professors from four different universities that provides a detailed examination of “pump and dump” schemes in the cryptocurrency markets. The report’s findings suggest that such schemes are “widespread and often quite profitable.”¹⁶⁶

Another apparent trend, reported by Diar, found that institutional bitcoin trading appears to be shifting away from traditional exchanges in favor of over-the-counter markets.¹⁶⁷ Finally, in December 2018 the University of Cambridge released its Second Global Cryptoasset Benchmarking Study, which “gathers survey data from more than 180 cryptoasset companies and individuals, covering 47 countries across five world regions” and provides analysis focused on mining, exchange, storage and payments.¹⁶⁸ In one notable finding, the study reports that in the first three quarters of 2018, the number of ID-verified cryptocurrency users almost doubled, increasing from 18 million to 35 million.

163 <https://www.coindesk.com/mastercard-wins-patent-for-speeding-up-crypto-payments>; <https://www.coindesk.com/american-express-thinks-blockchains-could-help-prove-payments>.

164 <https://www.blockchaintransparency.org/>.

165 <https://www.theblockcrypto.com/2018/12/13/analysis-of-cryptocurrency-exchange-traffic-could-results-hint-at-faked-volume/>.

166 https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3303365.

167 <https://diar.co/volume-2-issue-49/>.

168 <https://www.jbs.cam.ac.uk/faculty-%20research/centres/alternative-finance/publications/2nd-global-cryptoasset-benchmarking-%20study/#.XDfADFBKiUn>.



Conclusion and Contact Us

Conclusion

As illustrated by this review, 2018 marked significant changes in the financial services industry. Developments included a change of leadership and direction at the top of the CFPB; new and innovative financial services offerings, including legal cannabis banking; fintech charters; and important developments in the case law affecting financial services class actions and consumer protection statutes such as the TCPA, the FDCPA and the FCRA. We continue to monitor the financial services landscape. Stay tuned to our team's Financial Services Blog and sign up for our periodic Client Alerts for practical information and advice about succeeding in this volatile environment. Feel free to reach out to us for help with issues that affect your business and your clients.

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