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CLE RELAY

CLE RELAY SESSION 3

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Hot Topics in Fintech and Crypto



Agenda

- Issues and Trends Impacting Fintech and Crypto Assets
- The Evolving Battle Over SEC Regulation & Enforcement
- Judicial Skepticism of Administrative Action
- Navigating Regulatory Oversight

Issues and Trends Impacting Crypto Assets

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Issues and Trends Impacting Crypto Assets

- **Increasing Adoption by Traditional Finance (TradFi)**
 - ETF approval
 - Increasing engagement by institutional investors
- **Acceptance and Regulatory Clarity Abroad**
 - European Union's MiCA regulation to take effect
 - Monetary Authority of Singapore introduces regulations
 - UAE's DIFC enacts Digital Assets Law
- **Legislative and regulatory uncertainty in the United States**
 - SAB 121
 - FIT21

How Bitcoin Made a Believer Out of BlackRock

CEO Larry Fink's U-turn illustrates Wall Street's growing desire to capitalize on a market long considered the Wild West of finance

Mastercard Launches P2P Cryptocurrency Transfer Service for 14 Countries in Latin America

Communication | Author: EqualOcean News | Yesterday 07:52 PM (GMT+8)

The Rise of Crypto in the UAE: A Hub for Innovation

by Liz Mills – May 8, 2024 in Crypto in Action

A wild new era for crypto politics

By ZACHARY WARMBRODT | 06/03/2024 08:00 AM EDT

The Evolving Battle Over SEC Regulation & Enforcement

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SEC's Regulation By Enforcement

Progression of SEC enforcement actions:

2017: Initial Coin Offerings (“ICOs”)

2022: Crypto lending and “Earn” programs

2023: Trading platforms & staking as a service

2024: Decentralized finance (“DeFi”) and crypto wallets

“The Commission has spoken directly to crypto market participants in enforcement actions”

Testimony of Chair Gensler before House Committee on Financial Services; April 18, 2023

“More than 100 Commission orders, settled actions, and court decisions also have made clear when the offer and sale of a token is a security, including our actions against Telegram, LBRY, and Kik.”

Remarks by Chair Gensler before the Piper Sandler Global Exchange & Fintech Conference; June 8, 2023

Divergent Outcomes in Federal District Courts

“[W]hether a particular transaction in a crypto-asset amounts to an investment contract does not necessarily turn on whether an investor bought tokens directly from an issuer or, instead, in a secondary market transaction.”

-Judge Failla, *SEC v. Coinbase, Inc.*

“[T]he Court declines to draw a distinction between these coins based on their manner of sale, such that coins sold directly to institutional investors are considered securities and those sold through secondary market transactions to retail investors are not.”

-Judge Rakoff, *SEC v. Terraform Labs Pte. Ltd.*

“Whereas ... [i]nstitutional [b]uyers reasonably expected that [the defendant crypto-asset company] would use the capital it received from its sales to improve the [crypto-asset] ecosystem and thereby increase the price of [the crypto-asset],” those who purchased their coins through secondary transactions had no reasonable basis to expect the same.”

-Judge Torres, *SEC v. Ripple Labs, Inc.*

SEC Enforcement Actions to Watch

- Pending cases against trading platforms
 - *SEC v. Coinbase* (S.D.N.Y.)
 - *SEC v. Binance* (D. D.C.)
 - *SEC v. Kraken* (N.D.C.A.)
- On the horizon
 - SEC v. Uniswap
 - SEC v. Consensys

Press Release

SEC Charges Coinbase for Operating as an Unregistered Securities Exchange, Broker, and Clearing Agency

Boards, Policy & Regulation | Technology | Regulatory Oversight | Securities Enforcement | Government

SEC warns Uniswap Labs of potential enforcement action

By Reuters

April 11, 2024 1:50 AM EDT · Updated 2 months ago



SEC Trading Platform Cases

The SEC alleges that:

- 1) purchases and sales of many crypto assets on secondary markets are securities transactions and therefore Coinbase, Kraken, and Binance operate as:
 - **unregistered brokers**, including by soliciting potential investors, handling customer funds and assets, and charging transaction-based fees;
 - **unregistered exchanges**, including by providing a market place that, among other things, brings together orders of multiple buyers and sellers of crypto assets and matches and executes those orders; and
 - **unregistered clearing agencies**, including by holding its customers' assets in Coinbase-controlled wallets and settling its customers' transactions by debiting and crediting the relevant accounts.
- 2) Staking services are unregistered securities offerings
- 3) Coinbase wallet operated as an unregistered broker

SEC v. Coinbase, Inc., No. 1-23-cv-04738 (S.D.N.Y.)

Judge Failla's Decision on Coinbase's motion for judgment on the pleadings:

- **Trading platform:** SEC adequately alleged exchange, broker dealer, and clearing agency claims
 - Secondary market trades can be investment contracts with no express contract
 - “Common enterprise” exists because profit for all purchasers is dependent on “the post-launch development and expansion of the token’s *ecosystem*.”
- **Staking service:** SEC adequately alleged an unregistered offer and sale of securities
 - “Coinbase was able to offer Staking Program participants enhanced liquidity and quicker reward payments compared to staking on their own.”
- **Wallet:** SEC *failed* to allege that Coinbase Wallet acts as an unregistered broker
 - “Coinbase has no control over a user’s crypto-assets or transactions via Wallet, which product simply provides the technical infrastructure for users to arrange transactions on other DEXs”

SEC on the Defensive

- ***Coinbase Inc. v. SEC* (3d Cir. Dec. 15, 2023)**
 - Seeks an order compelling the SEC to engage in rulemaking
- ***Beba LLC and DeFi Education Fund v. SEC* (W.D. Tex. Mar. 25, 2024)**
 - Seeks a declaration that Beba’s “airdrop” was not a securities offering and its tokens are not securities
- ***Crypto Freedom Alliance of Texas v. SEC* (N.D. Tex. Apr. 23, 2024)**
 - Challenges SEC final rule expanding interpretation of “dealer” to potentially encompass DeFi
- ***Consensys Software Inc. v. Gary Gensler et al.* (N.D. Tex. Apr. 25, 2024)**
 - Challenges SEC jurisdiction over ETH, after Consensys received a Wells Notice.
- ***SEC v. Digital Licensing Inc.* (“Debt Box”) (D. Utah May 28, 2024)**
 - SEC sanctioned for “gross abuse of power” for misrepresenting facts to obtain a TRO, and ordered to pay defendants \$1.8 million.

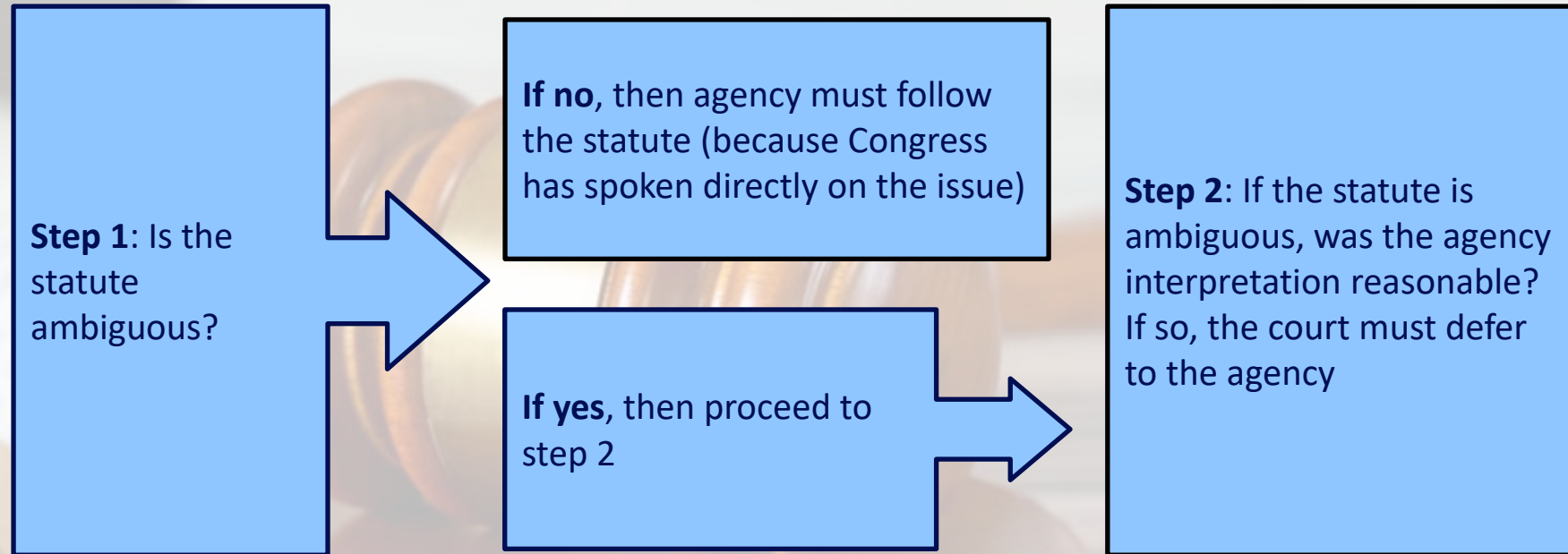
Judicial Skepticism of Administrative Action

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The Doctrines

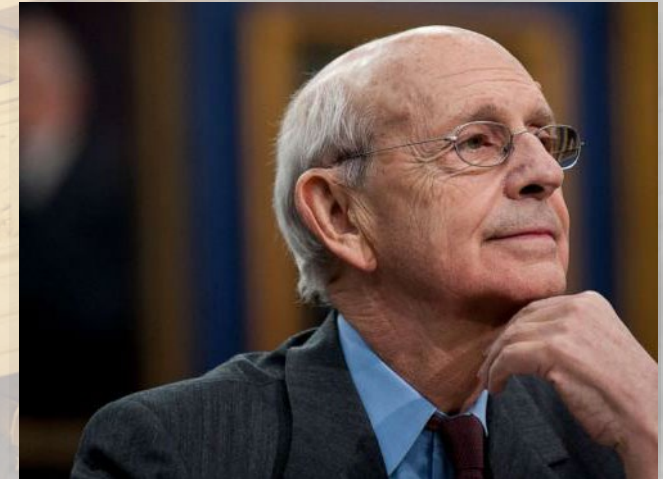
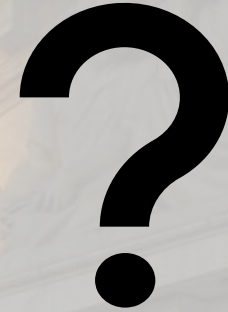
1. Chevron Deference
2. Major Questions Doctrine
3. Nondelegation Doctrine

Chevron Deference



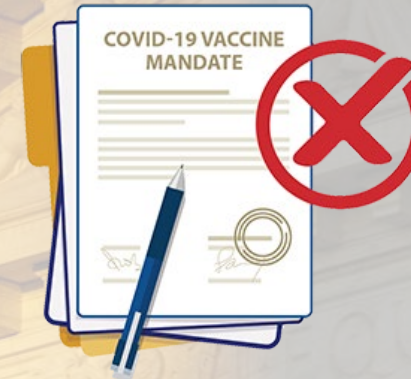
Major Questions Doctrine

- Until recently, it was a relatively obscure theory about how courts should interpret challenges to agency authority.
 - It can be traced to a 1986 law review article published by then-Judge Stephen Breyer.
 - The doctrine gained prominence against a regulatory background where agencies were addressing profound issues in society with little guidance from Congress.



Major Questions Doctrine, cont'd

- The Major Questions Doctrine was recognized in shadow docket decisions including the eviction moratorium per curiam and the OSHA large-employer vaccine mandate per curiam.
- *West Virginia v. EPA*, 142 S. Ct. 2587 (2022), formalized the doctrine as a judicially created method of statutory interpretation.
- If an agency seeks to decide an issue of major national significance, its action must be supported by clear congressional authorization.



Nondelegation Doctrine

- Congress cannot pass off its legislative authority to unelected regulators.
- Justice Gorsuch’s concurring opinion in *West Virginia v. EPA* (joined by Justice Alito) links the Major Questions Doctrine to the Nondelegation Doctrine.
 - “When Congress seems slow to solve problems, it may be only natural that those in the Executive Branch might seek to take matters into their own hands.” “But the Constitution does not authorize agencies to use pen-and-phone regulations as substitutes for laws passed by the people’s representatives.”



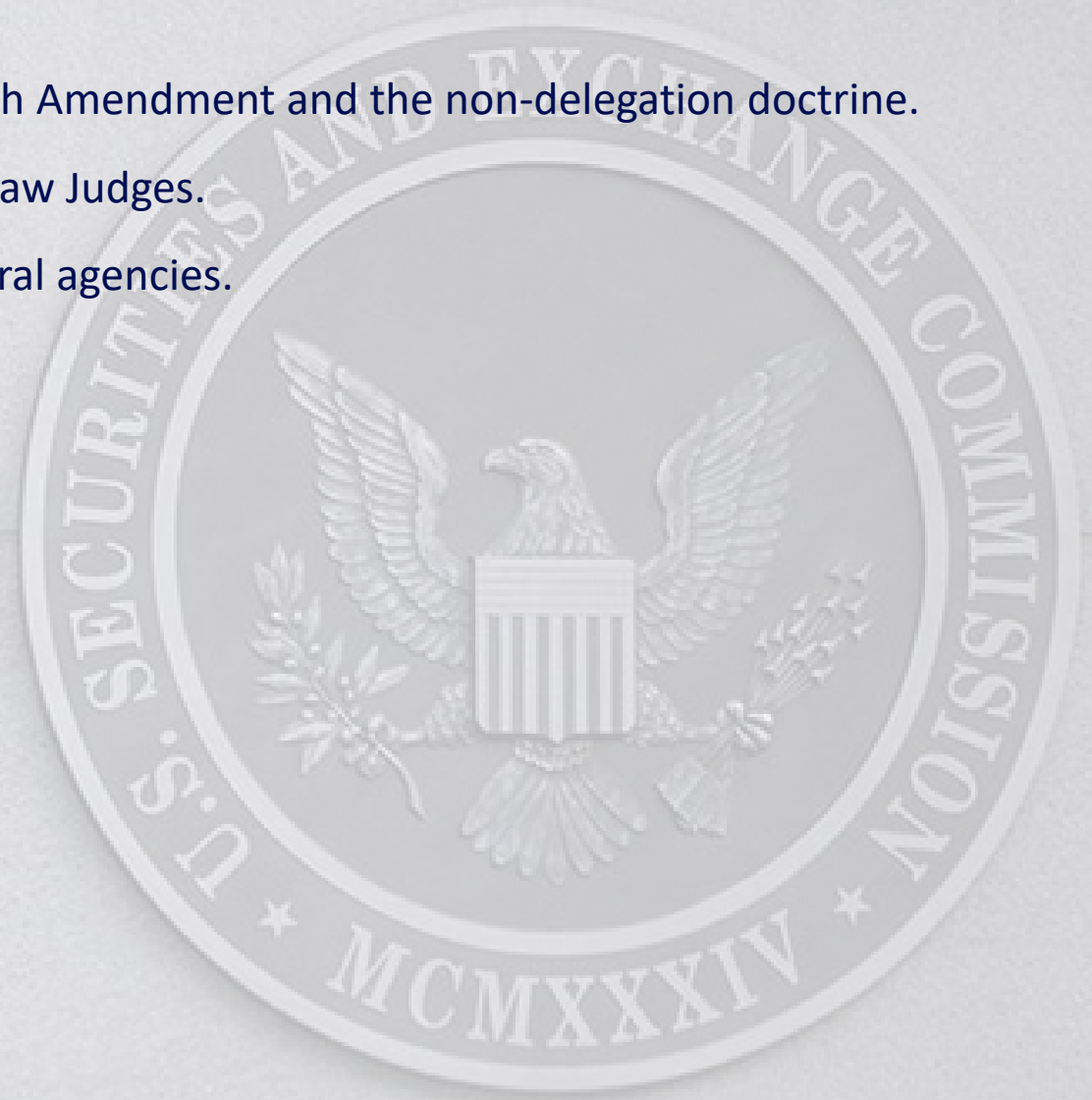
Loper Bright Enterprises v. Raimondo

- 40 years ago, in *Chevron v. Natural Resources Defense Council*, the Court held that courts should defer to a federal agency's interpretation of an ambiguous statute as long as that interpretation is reasonable.
- Loper will decide whether *Chevron* remains good law.
- The case was brought by a group of commercial fishing companies that challenged a rule issued by the National Marine Fisheries Service requiring the fishing industry to pay for the costs of observers who monitor compliance with fishery management plans.



SEC v. Jarkesy

- Challenge to SEC's in-house enforcement power under the Seventh Amendment and the non-delegation doctrine.
- Challenges for-cause removal protections for SEC Administrative Law Judges.
- Potential to significantly cut back on the regulatory power of federal agencies.



CFPB v. Cmty. Fin. Serv. Ass'n of Am.

- Whether CFPB's funding authority violates the Appropriations Clause and the structural separation of powers.
 - Instead of receiving money allocated to it each year by Congress, CFPB received funding from the Federal Reserve System
 - Amount was based on CFPB request
- Trade associations representing payday-lending industry sued CFPB, to stop Payday Lending Rule from taking effect.
- The Fifth Circuit struck down the Rule based on the CFPB's unique funding scheme.
 - Fifth Circuit held CFPB operates outside the normal congressional appropriations process.



CFPB v. Cmty. Fin. Serv. Ass'n of Am. (cont'd)

- Supreme Court reversed the Fifth Circuit, holding that the CFPB's funding mechanism is consistent with the Appropriations Clause.
 - Appropriations Clause is “simply a law that authorizes expenditures from a specified source of public money for designated purposes.”
 - CFPB's funding mechanism was a valid appropriation “made by Law.”

Garland v. Cargill

- Is a semi-automatic rifle with a bump stock a “machine gun” under federal law? Does an agency have the authority to decide?
 - ATF initially maintained that bump stocks were not machine guns.
 - In 2018, ATF reversed that position.
- The Fifth Circuit struck down ATF’s regulation:
 - “A plain reading of the statutory language, paired with close consideration of the mechanics of a semi-automatic firearm, reveals that a bump stock is excluded from the technical definition of ‘machinegun’ set forth in the Gun Control Act and National Firearms Act.”
 - “[I]f the statute is ambiguous, Congress must cure that ambiguity, not the federal courts.”



Navigating Regulatory Oversight

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Overview: What's New?

- NYDFS
 - Virtual Currency guidance on [Customer Service Requirements](#) (May 30, 2024)
 - Updated [cybersecurity](#) regulations (November 2023)
- FinCEN's [Beneficial Ownership](#) Reporting Rule (Effective January 2024)
- CFPB rules and guidance
 - Open Banking Rule (October 2023)
 - Digital payment/wallet apps (including crypto) (November 2023)
 - AI-assisted customer service (June 2023)
- California [Digital Financial Assets Law](#) (October 2023)
- Third Party Management

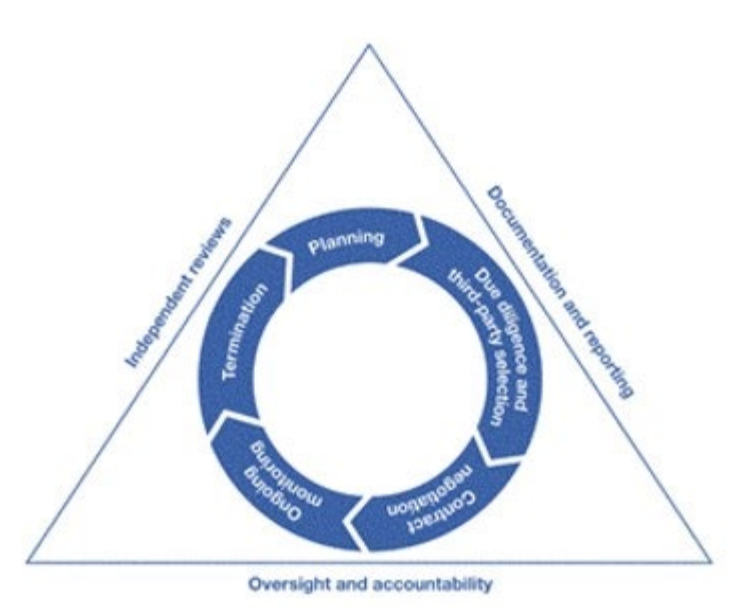
Deep Dive: Focus on Partnerships

- Why are Bank-Fintech partnerships such a **hot issue** for regulators right now?
- What are the signs that we should **expect something different** now from regulators when it comes to Bank-Fintech partnerships?
- There is a **tension** for banks and their partners in implementing their financial crime policies and meeting consumer protection expectations.



Has something changed in the requirements for documenting Bank-Fintech partnerships?

- Reinforcement of existing guidance
- Regulator concern that banks are not implementing requirements
- [Third-Party Relationships: Interagency Guidance on Risk Management](#), June 6, 2023 (Federal Reserve, OCC, FDIC)
 - Rescinds OCC Bulletin 2013-29 and FAQs OCC Bulletin 2020-10; Board 2013 guidance (SR Letter 13-19); FDIC guidance (FIL-44-2008)
 - New guidance is multi-agency to “promote consistency in supervisory approach” and leans more heavily towards the OCC’s prescriptive and detailed approach
 - More focused on “new or novel structures and features”
- NYDFS Industry guidance
 - [Guidance on Assessment of the Character and Fitness of Directors, Senior Officers, and Managers](#) (January 22, 2024)
 - [Cybersecurity Requirements for Financial Services Companies](#) (Updated Nov 2023)
 - [Guidance Regarding Listing of Virtual Currencies](#) (Nov 2023)



Regulators' view: *Fact or Fiction?*

- Fintechs are lacking experience in highly-regulated financial services
- Banks are subordinating their role in partnerships to their Fintech partners
- Banks rely too much on partners or middleware providers
- Contracts are not customized to particular partnerships and products
- Banks and partners do not have adequate resources dedicated to compliance
- Partners are not exercising appropriate and regular oversight of each other
- Partnerships have not been subject to appropriate risk assessments
- Regulators are skeptical about use of technology to provide financial services



Financial Crime Requirements

- **Anti-Money Laundering and Combating the Financing of Terrorism**
 - Bank Secrecy Act, 31 U.S.C. § 5311, et seq. and implementing regulations, 31 C.F.R. Chapter X
 - Suspicious Activity Reporting
- **Anti-fraud compliance**
 - Safety and soundness
 - Operational risk mitigation
- **Consumer protection statutes**
 - Unfair, Deceptive, or Abusive Acts or Practices (“UDAAP”), 12 U.S.C. § 5531 (“Dodd-Frank Act”).
- **Data security and privacy requirements**
 - Gramm-Leach-Bliley Act (“GLBA”) Safeguards Rule
- **Regulators**
 - Consumer Financial Protection Bureau (CFPB)
 - Federal Trade Commission (FTC)
 - State attorneys general, financial regulators
 - Prudential regulators (OCC, FDIC, Fed)



When/How Can These Requirements Conflict?

- Information collection
 - Customer identification/KYC
 - Customer due diligence, enhanced diligence, source of funds
- Account access
 - Refusing new customer or account
 - Suspending access
 - Closing account
- Funds access
 - Freezing or withholding customer funds
 - Government freezes and seizures
- Consumer complaints and dispute investigation and resolution



Why is this a Bank-Fintech partnership issue?

- There may be dissonance between the party that faces the consumer and the party that sets or controls policies and procedures
- Operational **responsibility** can be outsourced, but **liability** generally cannot be
- Supervisory oversight will focus on the **allocation of responsibilities** and **operational handoffs** between partners
- Regulators are intensely focused on the regulated entity's **management** of third parties
- These considerations should be part of partnership **negotiations and planning**



[Client Alert: Bank-Fintech Partnerships Update: Banking Agencies Finalize Key Risk Management Guidance | Jenner & Block LLP](#)

Consumer complaint channels have expanded ... and grown more public

- **Traditional customer service** – bank and fintech
- **Social media** – posts, tweets, etc. by consumers
- **Regulators**
 - CFPB complaints database
 - FTC complaints database
 - State AGs and consumer protection agencies
- **Better Business Bureau**
- **Media reports**



Best Practice Takeaways for Bank-Fintech Partners

- Prepare for supervision and **information requests** related to third-party relationships and services
 - Non-bank Fintech partners are subject to oversight
 - Bank Service Company Act – Banks are required to notify regulators of Technology Service Providers. 12 U.S.C. § 1867(c)
 - CFPB has jurisdiction over “service providers.” 12 U.S.C. § 5481(26)
 - FDIC has enforcement authority over “institution-affiliated parties.” 12 U.S.C. § 1813(3)(u)
- **Clarify roles and responsibilities** in partnership documents
 - E.g. Reliance agreements for customer identification
- **Integrate** anti-fraud and anti-money laundering compliance functions appropriately
 - Risk Assessment and mitigation planning should cover both



Best Practice Takeaways (Continued)

- **Train** both AML and Fraud teams on consumer protections laws
- **Calibrate** anti-money laundering risk mitigation measures with consumer protection requirements
- Ensure reasonably explicit policies and procedures for **funds access**
- Treat **customer complaints** about funds access as an early warning system for policy/procedure/operation review and improvement
- Assess the **consumer experience** of policies through the user interface



Best practices checklist

- ✓ Maintain and update contract files (periodically review contracts)
- ✓ Identify and document relationship owner(s), including for compliance
- ✓ Collect and analyze cross-partnership metrics related to compliance
- ✓ Create strong records of management and oversight of third-party relationships
- ✓ Ensure agreed-upon program policies and procedures
- ✓ Transparent documentation of customer account decision-making
- ✓ Streamline complaints channels and handling Identify issues in timely manner, document notification, remediation
- ✓ Identify and document risk appetite and profile for partnerships
- ✓ Ensure/track training and communication re program for bank employees and partners



Questions?

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