US FINTECH SPECIAL FEATURE

Regulating the future

What happens when a complex legal and regulatory system tries to address fast-paced innovation? **Todd Beauchamp, Stephen Wink, Yvette Valdez, Alan Avery, Loyal Horsley** and **Deric Behar** of **Latham & Watkins** discuss the challenges facing US regulators

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The US has always been at the forefront of technological innovation but recent drastic advances have truly revolutionised certain sectors of the average American's life. Financial services have been and continue to be reshaped by technology. Fintech aims to introduce new products, services and efficiencies – or to disintermediate traditional access points – to the way people bank, transfer money, borrow and invest. But where entrepreneurs see opportunity, regulators often see risk.

Financial services is one of the more heavily regulated industries, in the US and globally and regulation has not kept pace with the changes imposed by fintech. The US financial regulatory system is complex and a bit unwieldy: there are multiple regulators at the federal level and then each state may have applicable laws or regulations. The US regulatory system is well-suited to dealing with discrete sectors and well-defined market participants but not quite able to manage when the sector walls break down and market participants take on wholly new personas.

Over the last year we have seen retailers enter the banking and credit space, social media platforms innovate new methods of cross-border payments and banks doing everything in their power to fend off the assaults on their bailiwicks with their own offerings, or by entering strategic partnerships with the innovators.

Markets are quickly evolving but federal regulators seem stuck, viewing innovation through the well-worn lens of years past. Some state regulators have been more forward-thinking in their approaches to fintech regulation but the innovator's challenge compounds when contending with laws that differ from state to state. Forward-thinking federal regulators do not have it easy either, as they face political and legal challenges from sceptical politicians, state authorities and partisan advocacy groups.

Federal regulators have all recognised the need to refine their approach to regulating new technology and new products and services, balancing the desire to encourage innovation with the need to protect American consumers. Some of the most innovative and high-profile fintech developments of the past few years have involved blockchain

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ledgers, cryptocurrencies, security tokens, utility tokens and stablecoins (collectively, cryptoassets).

So far, federal regulators have moved to address certain specific questions or issues, while leaving many other questions unanswered and the industry unclear on legal and regulatory requirements or expectations. FinCEN, which imposes the US's primary anti-money laundering and counter-terrorism finance law and its implementing regulations, introduced guidance in 2013 to ensure that virtual currency activity was captured under the Bank Secrecy Act. The SEC, guided by 1946 Supreme Court precedent, has treated most tokens sold in initial coin offerings (ICOs) as securities and regulates the space via non-binding guidance, enforcement action and no-action letters.

The SEC has become increasingly active in enforcing federal securities laws in the cryptoasset space, leading 20 enforcement actions in 2018. The Office of the Comptroller of the Currency (OCC), SEC, Commodity Futures Trading Commission (CFTC), and Consumer Financial Protection Bureau (CFPB) have all created offices of innovation to attempt to engage with and understand the fintech industry in their respective regulatory purviews.

Compound regulatory uncertainty with enforcement activity that has not abated, and the threat to American innovation becomes apparent. There is less risk-taking by the undercapitalised, capital outflow to regulation-friendly jurisdictions and increased market dominance by the established players that have the deep pockets to easily mobilise talent and systems, absorb defence costs and pivot development to alternate geographies as needed.

Yet innovation flourishes…

Despite the risks and regulatory uncertainty, fintech innovation in the US continues to flourish. At midyear 2019, there are over 40 venture capital-backed fintech unicorns – privately held start-ups valued at over $1 billion – in the US worth over $150 billion in aggregate. In 2019, US investment in fintech reached new highs in deal volume and funding, while the number of investors participating in fintech funding rounds has doubled since 2014.

Lawmakers in the US have reacted aggressively to fintech developments where they see heightened privacy, cybersecurity and trading risks, and even national security concerns. However, they also want to foster innovation and expansion. For example, the newly-formed House Task Force on Financial Technology, created to examine the current legal framework for fintech, held its inaugural hearing in June 2019 to focus on what it sees as the SEC's piecemeal regulatory regime; the SEC, for its part, denied that its approach was piecemeal or unclear. The House also created a Task Force on Artificial Intelligence, which will focus on the issues raised by the growing use of artificial intelligence in financial services. In an attempt to provide more statutory certainty to the growing cryptoasset industry, the House is also considering several bills, such as the Token Taxonomy Act and the Blockchain Regulatory Certainty Act, which would clarify the regulatory posture of certain products and services.

To the extent that regulatory uncertainty and political pressure stymies fintech in the US, or legislatures and regulators collaborate to craft a coherent and supportive framework, 2019 may prove to be a watershed year for the future of American innovation.

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Where do we stand?

Latham & Watkins takes a deep dive into US trends to unpick the patchwork efforts to regulate tokens, blockchains and cryptocurrencies and the businesses that deal in them

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In the US, the attempts to regulate the growing cryptocurrency and token industries have perplexed regulators and legislators at federal and state levels. In the past year or so, lawmakers have made a concerted effort to better understand the potential risks and rewards in this space.

With stablecoin projects burgeoning in the US and cryptocurrencies rebounding strongly in 2019, market regulators and both federal and state legislatures have made some progress in attempting to provide legal clarity regarding the status of digital assets and cryptocurrencies (collectively, tokens) and the platforms on which they trade.

In spring 2019, the Securities and Exchange Commission (SEC) released its *Framework for 'Investment Contract' Analysis of Digital Assets* (Framework), which it intends to serve as a guide in determining whether a token is a security. The Framework focuses on the third prong of the Howey test: whether an investor reasonably expects to derive profits from the efforts of others and what constitutes sufficient decentralisation to avoid meeting that criteria. Issuers and sellers must consider whether managerial efforts continue to be important to the value of the token and whether the token's value correlates to the value of the goods or services for which it can be exchanged.

The Framework notes that: 'price appreciation resulting solely from external market forces … impacting the supply and demand for an underlying asset generally is not considered 'profit' under the Howey test.' Thus, a token would not necessarily be deemed a security if its price rose incidentally 'to obtaining the right to use it for its intended functionality'.

The SEC has lately been dogged in its pursuit of non-compliance in the token space. Most recently, it sued Kik Interactive for its 2017 ICO of one trillion Kin Tokens. The SEC alleges the ICO violated Section 5 of the Securities Act (requiring registration and appropriate disclosures and safeguards). Kik has pledged to challenge the SEC's categorisation of Kin Tokens as securities. Industry players are hopeful that judicial scrutiny of the SEC's analysis will provide some clarity for future ICOs.

The Commodity Futures Trading Commission (CFTC) has general anti-fraud and manipulation enforcement authority over virtual currencies (either directly, as commodities in interstate commerce or as futures, options or derivatives, if the virtual currency has been packaged as such). Since 2015, the CFTC has been very active in bringing enforcement actions relating to fraud and manipulation in the spot markets or general non-compliance with regulatory requirements related to the virtual currency instrument.

Federal legislation on tokens and blockchain

Two bills addressing the regulatory uncertainty surrounding tokens have been introduced in the House: the Token Taxonomy Act of 2019 (HR 2144) (TTA) and the Digital Taxonomy Act of 2019 (HR 2154) (DTA). If enacted, the TTA would amend the definition of a 'security' in the Securities Act of 1933 (Securities Act), the Securities Exchange Act of 1934 (Exchange Act), the Investment Advisers Act of 1940 (Advisers Act) and the Investment Company Act of 1940 (Company Act). The DTA, on the other hand, would simply appropriate $25 million per year (from 2020 to 2024) to the Federal Trade Commission (FTC) to prevent unfair and deceptive practices in digital token transactions and mandate the FTC to provide an annual report to Congress outlining its actions related to digital tokens, along with any recommendations for additional legislation. The DTA and TTA are complementary and neither would amend the Commodity Exchange Act.

The TTA defines the term 'digital token' and then excludes it from the definition of 'security' in the Securities Act (with corresponding amendments to the Exchange Act, Advisers Act and Company Act). The TTA defines 'digital unit' ('a representation of economic, proprietary, or access rights that is stored in a computer readable format') and states that a digital token is a digital unit that meets certain criteria.

Specifically, a digital unit is created through a decentralised, mathematically verified process, recorded on a distributed ledger and tradeable peer-to-peer. The definition of a digital token expressly excludes digital units that represent 'a financial interest in a company or partnership, including an ownership interest or revenue share'. Overall, it appears that the TTA would exclude Bitcoin and Ether (which the SEC has already indicated are not securities) and many utility tokens from the definition of security.

To further facilitate the issuance and trading of digital units, the TTA creates an exemption from registration for transactions involving the offer and sale of digital units, as long as the person offering, promoting or selling the digital unit 'has a reasonable and good faith belief' that the digital units were digital tokens. The second prong of the exemption, however, states that if the SEC notifies such person that the digital unit is, in fact, a security, the issuer/promoter/seller must publish a notice that the digital unit is a security, cease all sales and return all proceeds (minus reasonable expenses) within 90 days of receiving the notice. This provides the SEC with a veto, and may undercut the utility of the exemption. In reality, if an issuer must always be on the lookout for the SEC's notice, after which it must return all proceeds from the sale of purported digital tokens, it is likely to find another method of raising capital.

The market is likely to continue to rely on the same sort of facts-and-circumstance analysis that is applied today, which puts many tokens, excluding some payment tokens and stablecoins, at greater risk of being deemed securities by the SEC. As a result, though the TTA is a welcome step, its utility may be limited unless additional limits are placed on the SEC's veto power.

The TTA also includes an amendment to the Securities Act that pre-empts state laws relating to the offer and sale of digital tokens. As it stands in mid-2019, state laws may capture and regulate digital tokens under their securities or money transmitter laws. The TTA does allow the states to retain their investigatory and enforcement powers in this space.

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Without express guidance from the SEC or legislative changes to the applicable laws, regulated market intermediaries are reticent to trade security tokens (tokens that specifically accede to being securities). The Exchange Act requires that a market intermediary demonstrate adequate custody of customers' securities; how that translates to digital units is unclear. The TTA would require the SEC to amend the Exchange Act to indicate that satisfactory control by a securities intermediary is demonstrated by using public key cryptography to protect a digital unit and by following commercially reasonable cybersecurity practices that enable the regulated market intermediary to 'solely be able to sign on behalf of such digital unit.' While this amendment would answer the custody question at a high level, it does not address all of the satisfactory control location questions an intermediary may have related to security tokens.

State legislatures and the rise of self-regulation

At the state level, various legislatures have also made attempts to clarify the laws and regulation governing tokens. In February 2019, Wyoming passed a bill granting virtual currencies 'super-negotiability' status, similar to fiat currency, under Article 9 of the US Uniform Commercial Code. This means that tokens, like cash, can now be exchanged in that state free and clear of encumbrances (liens, security interests, etc.).

A similar bill has recently been introduced in Missouri, which would 'require the state and political subdivisions thereof to accept virtual currency as legal tender'. Colorado and Montana have also recently passed bills exempting the exchange of utility tokens from state security laws if the primary purpose of the token has a consumptive, rather than speculative or investment, purpose. Rhode Island has a similar bill under consideration, which would 'exempt a developer or seller of an open blockchain token from the provisions of the Rhode Island Uniform Securities Act'.

Many other states have bills at various stages of progression through their legislatures. New York's legislature, for example, is considering a bill 'allowing signatures, records and contracts secured through blockchain technology to be considered in an electronic form and to be an electronic record and signature'. The bill would also: 'allow smart contracts to exist in commerce'. Utah is considering a Blockchain Technology Act, which: 'exempts a person who facilitates the creation, exchange, or sale of certain blockchain technology-related products from [the state's] Money Transmitter Act [and] creates a legislative task force to study the potential applications of blockchain technology to government services.'

The regulation of cryptocurrency continues to evolve, not only at the legislative level but the industry level as well. Industry has begun to act in places where regulation is lacking. In February 2019, CFTC commissioner Brian Quintenz stated that participants in the cryptocurrency industry should create a self-regulatory structure, advising that token platforms should: 'come together to form some type of self-regulatory structure where they can discuss, agree to, implement, and hopefully examine or audit'. To that end, various token industry organisations have attempted to establish self-regulatory organisations (SROs) and have published self-regulatory guidelines and standards.

For example, the Gemini Trust Company, which is licensed and regulated by the New York State Department of Financial Services (NYSDFS) as a token exchange and custodian, promotes itself as a compliance-centric company: it has been proactive in creating a code of conduct for its users that takes into account federal and state laws. Gemini, along with other industry players, has also created the Virtual Commodity Association Working Group (VCA), an SRO for US virtual currency exchanges and custodians, which intends to work together with the CFTC to provide additional oversight of (and presumably enforcement power over) virtual currency markets.

Companies engaged in this industry (either through tokens or other digital assets) throughout the world have created, or have attempted to create, SROs for their home jurisdiction to provide additional guidance and help steer regulation for the industry. Many such SRO structures, however, are industry-driven and very few are, at this time, backed by governmental mandate. Robust and unified self-regulation in the token space still remains largely aspirational since an established self-regulatory framework is not feasible until applicable legislatures and regulatory agencies align on a coherent (or at least not conflicting) governance regimes with consistent definitions, operating procedures and enforcement mandates.

The potential of the OCC's fintech charter

The federal financial regulators took a fairly long time to enter the fintech fray, which left state regulators as the dominant voices in this space. The Consumer Financial Protection Bureau (CFPB) launched Project Catalyst in 2012 in an attempt to engage with the fintech community but its impact was relatively limited. In July 2018, the CFPB created an Office of Innovation, which absorbed Project Catalyst. While the CFPB has issued some no-action letters, which have allowed fintech companies to use new technology or data in their provision of consumer products and services, it has not created fintech-specific rules or regulations or updated current rules and regulations to reflect fintech innovation in the consumer finance space.

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On the other hand, the Office of the Comptroller of the Currency (OCC) – the chartering authority and primary regulator of national banks in the US – opened its Office of Innovation in 2014. The OCC has since announced that it is accepting applications for special purpose national bank (SPNB) charters from non-depository fintech companies. It also provided a supplement to its Licensing Manual to address charter applications by fintech companies (the Licensing Supplement). These moves by the OCC, coming after nearly two years of debate and resistance by state regulators and community banks, build on a white paper released in December 2016 (the White Paper: 'Exploring Special Purpose National Bank Charters for Fintech Companies'), the March 2017 draft supplement to the OCC Licensing Manual ('Evaluating Charter Applications From Financial Technology Companies') and comments submitted by the public in response to both.

Though the OCC has been open to accepting SPNB charter applications for about a year, it has yet to issue a single charter. In the Policy Statement, the OCC stated that the SPNB charter would: 'level the playing field with regulated institutions and help ensure [fintech companies] operate in a safe and sound manner'. The OCC further explained that fintech companies that receive an SPNB charter would be subject to the same high standards of safety and soundness that all national banks must meet.

According to the OCC, a fintech company with an SPNB charter will be supervised like similarly situated national banks and would have to meet similar capital, liquidity, risk management, financial inclusion and contingency planning requirements. These requirements, taken together with the extensive application process laid out by the OCC and the heightened supervision that an SPNB will initially face, may, as a practical matter, be at odds with the OCC's stated intent of supporting innovation since very few fintech companies are likely to be able to comply with such requirements before actually launching a product that requires multi-state licensing or some relationship with a regulated entity (either a bank or non-bank financial institution).

In addition, the relationship between a SPNB and the Federal Reserve remains unclear. By statute, all national banks must be members of the Federal Reserve. However, the Board of Governors of the Federal Reserve has not provided any guidance on the treatment of SPNBs. Membership of the Federal Reserve offers many benefits, including access to the Discount Window and to the FedWire payment network. The uncertainty as to the treatment of SPNBs simply underlines the confusing landscape fintech companies considering the SPNB charter face.

A battle between federal and state regulators

Federal regulators moved slowly to address fintech; but the states have been aggressive in their regulation. Now, the states are aggressively defending their dominance in the fintech space. In 2017 (after the OCC's 2016 White Paper's release), the Conference of State Bank Supervisors (CSBS) and New York State Department of Financial Services (NYSDFS) then-Superintendent Maria Vullo each separately sued the OCC and then-Acting Comptroller Keith Noreika in the US District Court of the District of Columbia and the US District Court of the Southern District of New York respectively, alleging that granting the proposed charter was outside the scope of the OCC's statutory authority and would harm the US financial system. Both suits were dismissed, primarily on the ground that the claims were premature because the OCC had not taken any official action on the chartering process.

The OCC's decision to then move forward and begin accepting applications for SPNB charters provided another opening for state-led litigation. The NYSDFS filed a second suit reiterating its initial claims in September 2018 and the CSBS filed a new suit the following month. The OCC moved to dismiss both, arguing that the claims were still premature because the OCC had not yet received — let alone approved — any SPNB charter applications.

In a May 2019 order, US District Court Judge Victor Marrero rejected the OCC's motion to dismiss the NYSDFS' new lawsuit and by doing so, may have put the charter in limbo for the foreseeable future. Judge Marrero found that the OCC indicated a 'clear expectation of issuing SPNB charters' and that the NYSDFS has sufficiently alleged 'at least some demand for, and interest in, such charters'. Accordingly, the NYSDFS demonstrated that there is now a 'substantial risk that the harm will occur'. Specifically, this means that: (1) New York citizens will lose the 'critical financial protections' that the dual banking system and state regulatory oversight affords; and (2) that the NYSDFS will be deprived of future revenue in connection with assessments it levies upon New York State-licensed institutions.

The District Court order is certainly a significant setback for the OCC and for supporters of the fintech charter

The case remained unresolved in mid-2019. The OCC and NYSDFS have been conferring on language for a proposed final order. The OCC's actions appear to be designed to expedite its ability to appeal the decision to the US Second Circuit Court of Appeals. Whether the Second Circuit will come to a different conclusion from the Southern District is unclear. But the OCC could make a broader-based argument before the Circuit Court and the scope of the appeal could be shaped by the proposed order the OCC is working on with the NYSDFS.

The District Court order is certainly a significant setback for the OCC and for supporters of the fintech charter. The OCC already faced a challenge in terms of the practical utility of the charter, as fintech companies grapple with important questions and issues when evaluating whether the charter would provide a viable long-term regulatory approach. While a few companies have publicly announced their charter applications or their desire to begin the chartering process, none have actually completed the arduous and time-consuming process. In addition, several fintech companies recently announced their intention to pursue a full national bank charter, forgoing the SPNB charter altogether. Adding litigation risk to the long list of factors a company must weigh in determining whether to pursue the SPNB charter is likely to render the charter non-viable for the immediate future.

While the OCC's intention in providing the SPNB charter is, ostensibly, to support and encourage innovation that can improve and expand access to financial services, the significant – and in some cases uncertain – regulatory requirements and open hostility from state regulators may impede that vision. The high initial expectations and ongoing burden associated with the SPNB charter, coupled with the open questions and litigation uncertainty, are likely to mean that the pool of potential candidates for an SPNB charter will be limited to a discrete number of well-resourced and sophisticated groups with sufficiently experienced personnel. Of these, some will probably already have regulatory compliance structures in place and fail to see a compelling benefit in transitioning to an SPNB charter, regardless of the litigation risk. Others may walk away for fear of jeopardising their established relationships with state regulators.

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