Financial Services 2016 Year-End Report

BakerHostetler

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Introduction

Welcome to the 2016 Year-End Report from BakerHostetler's Financial Services Industry Team. We are pleased to share our analysis of some of the key legal developments in the financial services industry in the past year and our expectations for 2017. 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:

- Cybersecurity, which cemented its position as the predominant concern for industry and for regulators.
- FinTech innovation and investment, which continued at a blistering pace as regulators and lawmakers accelerated efforts to avoid being left too far behind.
- The promise of distributed ledger technologies and blockchain technology projects, which have captured the imagination of many in industry and government and present unique legal and regulatory issues.
- The fate of the Consumer Financial Protection Bureau (CFPB) in the face of litigation and in the wake of the elections.
- The CFPB's ongoing efforts to promulgate new regulations, issue regulatory guidance, establish precedents in enforcement actions, order restitution and collect fines.
- The end of the prepaid card industry's long wait for the CFPB's final, controversial regulation, but the uncertain future of the rule in the face of potential congressional repeal or amendment and other challenges that are emerging for the industry.
- Beneficial ownership, unquestionably the anti-money laundering (AML) topic of the year, with new customer due diligence regulations finalized, the release of the Panama Papers and the largest asset seizure under the Kleptocracy Asset Recovery Rewards Act to date.
- State agency regulatory initiatives and enforcement actions in nonbank lending and state money transmitter licensing.
- Companies in the energy sector continuing to dominate in corporate bankruptcy filing.

The Report also offers insight regarding trends and emerging issues, with a watchful eye on the activities of the new administration and Congress. Few in the industry anticipated the potential scope of change we have already seen in many areas of financial services law in 2017. Even for those practicing in the highly dynamic field of FinTech, it was surprising that major legislative and regulatory initiatives over the past 20, 30 or even 40 years could be upended in a matter of weeks or months.

We hope that you use our analysis and first predictions on what may be ahead for 2017 to navigate what is likely to be an unprecedented year of change.

For periodic updates throughout what we expect to be a busy year, please visit the Financial Services Blog and the blogs sponsored by other practice teams, including the Class Action Lawsuit Defense and the Data Privacy Monitor blogs.

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Financial Services Industry Overview

The election of President Trump may prove to be a game-changer for the financial services industry, if the beginning of 2017 is any indication of what lies ahead. For FinTech companies, already accustomed to bumpy rides on roads not always on the map, operating in this less predictable world may not be quite as challenging as it is for more traditional institutions and companies. All financial services companies – large and small, new and traditional – will need to be prepared to quickly adapt to unpredictable change in the legal and regulatory landscape.

In the near term, some recently issued regulations could be eliminated.

Congress may repeal any regulations finalized within 60 days of the end of the last Congress within the first 45 days of the new administration.

One regulation targeted for repeal under this authority is the prepaid access rule published by the Consumer Financial Protection Bureau (CFPB) in October, although the desire to repeal the law is not universal, even in the industry.

Also complicating the regulatory scene is one of the new President's first executive orders, which require agencies to rescind two regulations for every new regulation proposed.

Repeal or at a minimum substantial amendment of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) is a priority of the new administration and Congress.[1] Signed into law by President Obama on July 10, 2010, the law implemented significant changes impacting almost every aspect of the financial services industry, including organizations never before subject to federal regulatory oversight. Among other things, it created the Financial Stability Oversight Counsel, designated a number of companies as "significantly important financial institutions" subject to heightened regulatory scrutiny, eliminated the Office of Thrift Supervision (OTS) and established the CFPB.

Charged with ensuring that all consumers have access to consumer financial products and services and regulating the market in which these products and services are provided, the CFPB assumed rulemaking, examination and enforcement authority related to consumer financial laws previously distributed across multiple federal agencies. In the six years since its creation, the CFPB has issued multiple new rules and guidance, examined and investigated both banks and nonbanking entities, and initiated enforcement proceedings and/or commenced civil actions in federal court, often resulting in substantial fines and restitution.[2]

None of this has been without controversy, and the Dodd-Frank Act has been challenged in the courts. After the November elections, the prospects for actual repeal improved on Feb. 3, 2017, as President Trump took the first step to make good on his campaign promise by issuing an executive order to set the stage for substantially amending, if not eliminating, Dodd-Frank.

1 Pub. L. 111–203, Title X, § 1021, July 21, 2010, 124 Stat. 1979.

2 *Id.*; see also 12 U.S.C. § 5562.

The executive order sets forth what the administration identifies as "core principles":

- Empower Americans to make independent financial decisions and informed choices in the marketplace, save for retirement and build individual wealth.
- Prevent taxpayer-funded bailouts.
- Foster economic growth and vibrant financial markets through more rigorous regulatory impact analysis that addresses systemic risk and market failures, such as moral hazard and information asymmetry.
- Enable American companies to be competitive with foreign firms in domestic and foreign markets.
- Advance American interests in international financial regulatory negotiations and meetings.
- Make regulation efficient, effective and appropriately tailored.
- Restore public accountability within federal financial regulatory agencies and rationalize the federal financial regulatory framework.[3]

Under the executive order, the Secretary of the Treasury is directed to consult with heads of the Financial Stability Oversight Council member agencies to determine which federal laws, regulations and guidance satisfy the administration's core principles, and to report back to the President within 120 days. The final report will be interesting to read, as the agency heads tasked with making recommendations will be faced with proposing how to pare back the jurisdiction of their own agencies. Moreover, not all agency heads will be replaced with appointees of the new administration by that time.

House Financial Services Committee Chairman Jeb Hensarling, a longtime proponent of repealing Dodd-Frank, will lead the fight in the House with his own legislative proposal based on a bill he introduced in the previous Congress. On the Senate side, the legislation will confront some very vocal opponents, including Sen. Elizabeth Warren, the architect of the CFPB.

A complete repeal of Dodd-Frank is unlikely, even under the most aggressive strategy.

The OTS has been abolished and is unlikely to be resurrected, and dismantling the CFPB and reassigning its responsibilities can be done, but the cost will not be negligible. Other agencies are likely to balk at relinquishing new powers gained from Dodd-Frank, and competing agency agendas may start to interfere with the process. And as the various sectors of the financial services industry weigh in with their own proposals, the debate will become more complicated. For example, one banking trade association favors the restructuring of the CFPB but not its total elimination. Another influential financial services trade association introduced another proposal that was never part of Dodd-Frank but will undoubtedly find its way into the legislative debate: It has called for the Bank Secrecy Act examinations responsibilities currently delegated to the banking agencies to be transferred to the Financial Crimes Enforcement Network, which has never had an examination capability.

3 The White House, Office of the Press Secretary, Exec. Order, Presidential Executive Order on Core Principles for Regulating the United States Financial System (Feb. 3, 2017), *available at* https://www.whitehouse.gov/the-press-office/2017/02/03/presidential-executive-order-core-principles-regulating-united-states.

Even if Dodd-Frank is amended to eliminate or significantly weaken the CFPB, there will still be other federal agencies that already share jurisdiction with the CFPB on certain issues and have independent authority to regulate in many of the areas where the CFPB has been active. For instance, the Office of the Comptroller of the Currency (OCC), the Federal Trade Commission (FTC) and the Securities and Exchange Commission (SEC) are already exercising oversight over certain aspects of FinTech. Third-party service providers, including payment processors, are a focal point for all of the banking agencies and the FTC. And the FTC is poised to pick up the slack on issues like the Fair Debt Collection Practices Act (FDCPA), as it already shares enforcement authority with the CFPB under a number of other laws. A number of state attorneys general also have voiced their readiness to fill any enforcement gap that may be left if the CFPB is eviscerated or eliminated.

What should banks and other financial services companies do during times of such uncertainty? First and foremost, they should stay abreast of developments in Washington. However, until legislation is passed and becomes law and amended regulations are promulgated, compliance with existing laws will be expected. Regulated institutions should not assume that all the promised change will come to pass, and an entity that lets down its guard may find itself in the crosshairs of the CFPB, the Financial Crimes Enforcement Network (FinCEN), the FTC, a state attorney general, or the class action plaintiffs' bar.

BakerHostetler Financial Services Industry Team

At BakerHostetler, we help our clients understand how decisions in Washington will affect their businesses. We work with clients to find the right path – whether that client is a bank or another traditional financial services provider purchasing, licensing, developing or integrating a financial technology solution, or an individual or an entity innovating to disrupt, looking for funding or seeking a more traditional partner.

Regardless of where they come from, our clients have in common the fact that their paths are less than clearly marked in this time of uncertainty. FinTech companies face even greater uncertainty, as existing laws rarely expressly address the issues on the table, and regulatory expectations often are not well enunciated and, in many cases, are still evolving. The risks associated with innovative technology usually require mitigation, given myriad legal and public policy concerns.

In the end, regardless of the technology involved, the same core legal and regulatory concerns are present: anti-money laundering and sanctions compliance, consumer protection, and, of course, cybersecurity. These concerns are in addition to the usual and more mundane issues – corporate formation and governance, fundraising, patent and trademark protection, tax and employment matters – as well as sector-specific considerations for banking, securities, insurance, healthcare, energy and other areas.

We help our clients navigate the maze of these laws and regulations to find the way forward that is the least burdensome – the one that allows innovation to flourish at the lowest cost and that best protects the value of the enterprise and its people.

For the traditional financial services company, this means finding the path that most appropriately corresponds to legal and regulatory obligations and expectations, permitting adequate and effective compliance and minimizing regulatory anguish.

Litigation

Litigation

Industry Developments

Violations of the Fair Debt Collection Practices Act (FDCPA), the Fair Credit Reporting Act (FCRA) and the Telephone Consumer Protection Act (TCPA) remained among the most asserted claims in consumer-initiated litigation in 2016. FDCPA claims are one of the most – if not the most – litigated.[4] In the past year, 10,402 FDCPA claims were filed, down slightly from 11,816 the year before. Among claims under these three statutes, TCPA claims grew the most. There was a 31.8 percent increase in TCPA claims in 2016 over 2015. FCRA claims grew by 4 percent.

Among putative class actions filed in 2016, 17.1 percent were FDCPA claims, 21.3 percent were TCPA claims and 9 percent were FCRA claims.

In addition to consumer-initiated litigation, 2016 saw a number of important decisions that affect the financial services sector, including *Spokeo, Inc. v. Robins*,[5] PHH Corporation v. Consumer Financial Protection Bureau[6] and Consumer Financial Protection Bureau v. CashCall, Inc.[7]

Spokeo, Inc. v. Robins

In May, the U.S. Supreme Court held, in *Spokeo, Inc. v. Robins*, that plaintiffs do not have standing to sue for statutory violations without alleging concrete and particularized harm, though intangible harm arising out of a statutory violation can nevertheless be concrete and confer standing.

Petitioner Spokeo is an alleged consumer reporting agency that operates a “people search engine,” gathering personal information about individuals for users, including employers searching for new employees. Respondent Robins discovered that his profile generated by Spokeo was inaccurate and filed a federal class action against Spokeo, alleging willful failure to comply with the FCRA requirement for consumer reporting agencies to “follow reasonable procedures to assure maximum possible accuracy of” consumer reports.[8] The Ninth Circuit reversed the district court’s dismissal of Robins’ complaint, finding Robins had adequately alleged injury in fact as required by Article III.

The Ninth Circuit’s decision was vacated and remanded by the U.S. Supreme Court because while the Ninth Circuit had addressed the “‘particularization,’ i.e., the requirement that an injury affect the plaintiff in a personal and individual way,” it had failed to address the “concreteness” of plaintiff’s alleged harm, which “requires an injury to be ‘de facto,’ that is, to actually exist.”[9]

PHH Corporation v. Consumer Financial Protection Bureau

In October, a three-judge panel from the U.S. Court of Appeals for the D.C. Circuit issued a much-anticipated decision in *PHH Corporation v. Consumer Financial Protection Bureau*, deeming the CFPB “unconstitutionally structured”[10] and overturning the bureau’s enforcement action, including

4 WebRecon LLC, *2016 Year in Review: FDCPA Down, FCRA and TCPA Up*, www.webrecon.com (Jan. 24, 2017).

5 136 S.Ct. 1540 (2016).

6 839 F.3d 1 (D.C. Cir. 2016).

7 Case No. CV 15-7522-JFW (RAOx), 2016 WL 4820635 (C.D. Cal. Aug. 31, 2016).

8 15 U.S.C. § 1681e(b).

9 136 S.Ct. at 1543, 1548.

10 839 F.3d at 8.

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a $109 million penalty against PHH, a large New Jersey-based mortgage lender. The D.C. Circuit nevertheless made clear that the CFPB will continue to operate and perform its duties.

The CFPB had fined PHH for an alleged kickback scheme whereby PHH referred customers to insurers who then purchased reinsurance from a PHH subsidiary. In seeking to vacate the enforcement order, PHH made both constitutional and statutory arguments.

PHH argued that the CFPB's status as an independent agency headed by a single director violates Article II of the U.S. Constitution. The D.C. Circuit agreed, observing that "[t]he CFPB's concentration of enormous executive power in a single, unaccountable, unchecked Director not only departs from settled historical practice, but also poses a far greater risk of arbitrary decision making and abuse of power, and a far greater threat to individual liberty, than does a multi-member independent agency."[11]

In outlining a remedy for these constitutional flaws, the D.C. Circuit rejected calls to shut down the CFPB or invalidate the entire Dodd-Frank Act. Instead, the court voided the for-cause removal provision, granting the president power to remove the CFPB director at will and to supervise and direct the director.

Additionally, the court largely sided with PHH on its three statutory arguments, agreeing that 1) Section 8 of Real Estate Settlement Procedures Act (RESPA) allows captive reinsurance arrangements where mortgage insurers pay no more than reasonable market value for reinsurance, 2) CFPB departed from the Department of Housing and Urban Development's consistent prior interpretations of RESPA, and then retroactively applied its new interpretation of RESPA against PHH, "violat[ing] bedrock principles of due process"[12] and 3) the three-year statute of limitations that has traditionally applied to agency actions enforcing Section 8 of RESPA continues to apply.

In January 2017, PHH filed a supplemental response to the CFPB's petition for rehearing and a response opposing the motion to intervene filed by Democratic attorneys general of 16 states and the District of Columbia. In February 2017, the D.C. Circuit granted the CFPB's petition for a rehearing en banc.

Consumer Financial Protection Bureau v. CashCall, Inc.

In August, the U.S. District Court for the Central District of California entered summary judgment in favor of the CFPB on its claims against payday lender CashCall Inc. arising out of allegedly unfair and deceptive loan practices. The CFPB had sued CashCall and various affiliates for violations of the Consumer Financial Protection Act of 2010 (CFPA) based on CashCall's alleged scheme to avoid state usury laws (laws governing the amount of interest that can be charged on a loan) through the use of an online lender formed under a tribal jurisdiction. On Jan. 3, 2017, the court granted an interlocutory appeal to the Ninth Circuit for disposition and/or guidance on the following four issues: 1) whether under the Consumer Financial Protection Act, an individual can be held liable for a corporation's attempts to collect unenforceable loans, where the individual lacked contemporaneous knowledge that the loans were unenforceable – and the individual's contemporaneous knowledge

11 *Id.*

12 *Id.* at 9.

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was based on legal advice that the loans were enforceable; 2) whether the CFPB's structure is unconstitutional; 3) whether a Consumer Financial Protection Act violation can be predicated on servicing and collecting loans that are void only because they are deemed to be unenforceable under state law; and 4) whether the proper test for ascertaining the "true lender" to a loan agreement looks past the contract and its parties, and instead necessitates an investigation of related transactions. The matter is currently stayed, pending resolution of the appeal.

Representative Matters

FirstMerit derivative shareholder litigation

On Jan. 26, 2016, Huntington Bancshares announced that it would acquire FirstMerit Corporation in a merger valued at approximately $3.4 billion in stock and cash. Within weeks of the announcement, five FirstMerit shareholders filed separate lawsuits against FirstMerit, its board of directors and Huntington in state and federal court alleging breaches of fiduciary duty and violations of federal securities law. Among other relief, the lawsuits sought a preliminary injunction that would have prevented FirstMerit's shareholders from voting on the proposed merger. The Cleveland BakerHostetler team represented FirstMerit in connection with these lawsuits. FirstMerit, along with the other defendants, successfully moved to stay the state court actions pending resolution of the federal cases, which were consolidated into a single action. FirstMerit and the other defendants then moved to dismiss the consolidated federal action and opposed the plaintiffs' motion for a preliminary injunction. With those motions pending, the parties reached a preliminary settlement agreement to resolve the case and allow the shareholder vote to go forward in exchange for certain additional disclosures concerning the merger. As a result, the shareholder vote took place and the merger closed on schedule.

BakerHostetler has successfully defended Fair Credit Reporting Act (FCRA) class actions across the country.

FCRA class action

In the past year, we have won two motions to dismiss FCRA class actions in which plaintiffs alleged that defendants procured consumer reports without sufficient authorization; obtained voluntary dismissal of two putative FCRA class actions before responsive pleadings were due, without settlement; and obtained dismissal of an FCRA class action through a novel use of a Rule 68 offer of judgment that placed the adequacy of the class representative in jeopardy. In addition, we have represented a large retailer and its credit-issuing financial institution in various individual actions brought by consumers under the FCRA throughout the country, often resolving the matters as voluntary dismissals without settlement or for nominal settlement amounts. Despite the Supreme Court's ruling in *Spokeo*, we expect that the upward trend in FCRA class actions will continue into 2017 as the plaintiffs' bar continues to take advantage of vagueness in the statute, the potential for devastating statutory damages and the courts' struggle to find a cohesive standard for establishing standing.

Other selected matters

- Successfully represented multiple financial institutions in class actions and individual consumer-initiated actions involving allegations of violations of the Telephone Consumer Protection Act (TCPA) and consumer privacy laws.

Litigation

- Representing a federally insured financial institution in five parallel putative nationwide class actions in connection with the institution's deposit-advance program. After successfully transferring and consolidating the lawsuits, our team successfully obtained a dismissal of 17 of the 18 counts in the consolidated complaint, including federal Electronic Fund Transfer Act and usury claims, as well as a variety of state-law claims.
- Represented several financial institutions and service providers, from some of the largest U.S. banks to local credit unions, in connection with proactive compliance and reactive security incident response services. We handled a wide range of incidents, such as malware infections, vendor errors, complex network intrusions, denial-of-service attacks and incidents resulting from employee carelessness, as well as intentional acts by malicious employees. We also helped financial institutions with Gramm-Leach-Bliley Act (GLBA) and other regulatory compliance issues. These engagements often involved successful interactions with state and federal financial regulatory authorities.

Emerging Issues and Trends

With respect to *Spokeo*, lower courts have begun to apply the Supreme Court's language, and we will learn more about its effect on FCRA and other statutory damages-based claims in 2017. No definitive result has been reached among the circuits. We will continue to monitor the development of standing issues in the wake of *Spokeo* as more circuit courts weigh in.

With *PHH*, in light of the D.C. Circuit's recent decision to rehear the panel decision *en banc*, the continued viability of the CFPB's single-director structure remains in question, as is the panel's conclusion that the CFPB lacked the power to retroactively apply new interpretations of settled law to enforcement actions. Given the significance of these issues, it is likely the D.C. Circuit will rule later this year.

Finally, the CashCall decision casts doubt on lenders' ability to avoid usury laws simply by causing loan contracts to be entered in states with higher, or nonexistent, usury caps. This case has implications for online lenders' reliance on choice-of-law provisions in their own loan contracts when setting maximum interest rates.

Lending

Lending

Industry Developments

Regulatory agencies overseeing lending activity of banks and nonbanks were busy in 2016, addressing issues plaguing the sector and working toward increased transparency, due diligence and disclosure in the industry.

The CFPB was particularly active in 2016, proposing amendments to the Truth in Lending Act, providing direction to credit card lenders, advocating for student loan reform and continuing its attack on predatory mortgage-lending practices. The CFPB imposed its will by issuing guidance, fines and sanctions while partnering with the Department of Justice to continue investigating discriminatory redlining practices.

In its "Semi-Annual Risk Perspective for Spring 2016," the Office of the Comptroller of the Currency (OCC) issued a warning to commercial real estate lenders to tighten their lending standards. Citing financial trends in the commercial real estate market similar to those seen before the recession of 2007, the OCC alerted lenders that, along with the Federal Reserve and the Federal Deposit Insurance Corporation, it will begin to monitor lenders' risk management processes more closely.

The increased scrutiny will focus on lenders' management and board oversight, portfolio management, access to pertinent information, market analysis and credit risk review functions.

The agencies also will examine whether the lenders' credit underwriting standards have loosened and how often lenders agreed to such things as longer terms, interest-only periods, limited guarantor requirements, less restrictive covenants, and incomplete or inadequate stress-testing. Outside of the commercial real estate context, the OCC took notice of online and marketplace lending, and it encouraged responsible innovation and the need for controlled oversight.

Representative Matters

- Represented BankUnited, N.A., in connection with a $42 million loan to a hotel developer in midtown Manhattan. In addition to the nuances of a financing transaction, this transaction involved structuring concerns related to the collapse of an existing ground lease encumbering the property, as the borrower had recently acquired the fee interest in the real property.
- Represented longtime client Meilman Family Real Estate, LLC, in connection with a $50 million loan from Transamerica Life Insurance Company. The loan encumbers our client's properties located at 413-419 West 14th Street, 421-435 West 14th Street and 436 West 15th Street in the Meatpacking District of New York City. As a condition precedent to obtaining the financing, our representation includes the extensive negotiation of certain amendments to ground leases that presently encumber these properties.

Emerging Issues and Trends

The real estate sector continued to grow along with the rest of the domestic economy as a whole during 2016. For the past couple of years, many industry insiders indicated uncertainty when asked if the current business cycle – which has now persisted more than seven years – would come to an end. The recovery following the financial turmoil of 2008 and 2009 is already well beyond a typical three-and-a-half-year cycle. That said, nothing about the current cycle is

Lending

"standard," and macroeconomic indicators show that the economy is growing at a mature and sustainable 2 percent per year rate. Further, unemployment of less than 5 percent should provide continued consumer strength, bolstering growth. Low oil prices serve to essentially increase consumers' disposable income. Persistent economic growth and consumer strength should flow through to the real estate market, with continued strong demand across asset types fueling robust demand for real estate debt.

Despite continued economic growth, 2016 saw commercial banks become more conservative than they were in 2015.

One of the major drivers is the implementation of retention requirements under the Dodd-Frank rules that became effective Dec. 24, 2016. Under these retention rules, commercial mortgage-backed securities (CMBS) must retain 5 percent of the credit risk over a five-year period. CMBS lenders have responded to this requirement by becoming more selective and cautious. The relatively strong real estate market should not curtail CMBS lending substantially heading into 2017, but look for continued sluggishness as lenders move forward under the changed regulatory scheme.

Anticipate cautious life insurance and mortgage Real Estate Investment Trust lenders as well. Growth should continue given the strong demand for debt financing, but these lenders may remain selective, resulting in manageable growth during the coming year.

Continuing the trend, institutional lenders will continue to be careful when it comes to construction lending. This may not be a negative given the mature nature of the current cycle. Limited access to construction funding may curtail the intense overbuilding many regions experienced in the lead-up to the financial crisis, allowing for an increased period of manageable growth for the real estate industry as a whole.

Given the institutional lending environment, expect continued opportunities for preferred equity, mezzanine and other non-institutional lenders to fill the void left by decreased bank and CMBS lending. In light of the continued demand for financing, these subordinate lenders can be fairly selective regarding the transactions they fund.

Other factors may affect lenders in the coming months. The Federal Reserve will likely increase rates; however, conservative increases have been anticipated for some time and have already been priced into the market. If the Fed decides to make a move, as long as it refrains from more-aggressive-than-expected rate increases, there should be no real shock to real estate debt markets. Also, there is some uncertainty as to the effect President Trump will have on regulations affecting institutional lenders. Deregulation may cause an uptick in institutional lending.

Throughout 2017, we expect real estate lending will continue to grow, although at a manageable and guarded pace, and nonbank lenders should continue to pick up the slack caused by a decrease in loans made by CMBS and other institutional lenders.

Regulatory, Compliance and Licensing

Regulatory, Compliance and Licensing

Industry Developments

Both federal and state regulators have been active in the in a number of areas including anti-money laundering compliance, cybersecurity, state licensing and consumer lending. The CFPB was particularly active in the areas of auto loans, mortgages, credit cards and student loans. Over the past year it was also very visible in dealing with debt collection activities of depository institutions and nonbank entities.

Bank Secrecy Act and AML Compliance

Bank Secrecy Act and anti-money-laundering compliance continue to be the most significant compliance issues for the banking industry, money transmitters and many other financial services companies. At an industry conference in November, a former top enforcement staffer at the Office of the Comptroller of the Currency said that 95 percent of national banks were subject to some level of formal or informal enforcement action as a result of BSA/AML compliance shortcomings. The fallout inevitably means more staff, greater investments in the compliance infrastructure, delays in approvals of proposed mergers or acquisitions, in some cases "look backs" and other remediation, and an occasional fine.

Beneficial ownership has been a flashpoint in AML compliance circles for years. A 2015 series of investigative articles run by The New York Times underscored the lack of transparency in the use of shell corporations to hold real estate properties.[13]

For years, efforts have been made to require the collection of more information at the time of corporate formation. Federal legislative proposals have been introduced, state initiatives undertaken. FinCEN and the bank regulators similarly have been focused on ensuring that financial institutions collect such information during the customer due diligence process.

Shortly after the Panama Papers were released in early April, the US Department of the Treasury announced a three point strategy to increase financial transparency. In addition to the issuance of final beneficial ownership regulations, Treasury proposed Beneficial Ownership legislation, and proposed IRS regulations to require foreign-owned, single-member limited liability companies (LLCs) to obtain employee identification numbers.[14]

The beneficial ownership regulations become effective in May 2018.[15]

As the industry is working toward compliance with the new regulation more "derisking" is likely, and undoubtedly the closure of long standing accounts.

Enforcement highlights

On April 25, 2016, the CFPB entered into a consent order with Pressler & Pressler LLP, Sheldon H. Pressler and Gerard J. Felt in connection with the law firm's debt collection practices.[16] In the consent order, the CFPB alleged that the attorneys spent between 30 seconds and a few minutes reviewing documents before filing, made false or empty allegations about consumer debts, filed

13 The New York Times, *Towers of Secrecy: Piercing the Shell Companies, available at* https://www.nytimes.com/news-event/shell-company-towers-of-secrecy-real-estate.

14 U.S. Department of the Treasury, Press Release, *Treasury Announces Key Regulations and Legislation to Counter Money Laundering and Corruption, Combat Tax Evasion* (May 5, 2016), *available at* https://www.treasury.gov/press-center/press-releases/Pages/jl0451.aspx.

15 81 Fed. Reg. 29398, May 11, 2016, *available at* https://www.gpo.gov/fdsys/pkg/FR-2016-05-11/pdf/2016-10567.pdf.

16 *In the Matter of:* Pressler & Pressler, LLP, Sheldon H. Pressler, and Gerard J. Felt, CFPB Consent Order, 2016-CFPB-009 (April 25, 2016).

lawsuits based on unreliable or false information, and harassed consumers with unsubstantiated court filings. The law firm agreed to cease all filings of lawsuits with unsubstantiated claims, ensure accurate court filings and pay civil penalties of $1 million.

In September 2016, the CFPB entered into another consent order against online lender Flurish, Inc., on grounds that the entity failed to provide consumers with the benefits promised.[17] The CFPB alleged that Flurish misled consumers into thinking that it would build consumers' credit as well as the true cost of the loan and the actual annual percentage rate. It also alleged that the entity did not report consumers' credit information to credit bureaus despite advertising itself as a means to build credit.[18] Under the order, Flurish was ordered to pay $1.83 million in redress to victims as well as a $1.8 million civil money penalty.[19] Also, Flurish was ordered to end practices the CFPB found to be deceptive, end misleading advertisements and ensure accurate pricing.[20]

On Oct. 11, 2016, the CFPB entered into a consent order with Navy Federal Credit Union (NFCU) for alleged violations in connection with the entity's debt collection practices.[21] Specifically, the CFPB alleged that NFCU 1) threatened to take legal action when the entity did not intend to do so, 2) threatened to contact service members' military commanders about the debts, 3) misled consumers into thinking it repaired credit when it did not, 4) engaged in the practice of freezing consumers' electronic account access and disabled certain services upon delinquency, and 5) trained employees to obtain a consumer's commanding officer's contact information as alternative contact information. Under the order, NFCU was directed to pay a civil money penalty of $5.5 million, cease and desist from making deceptive representations in any debt collection communication to a consumer, cease and desist from engaging in unfair acts regarding electronic account access, and reserve $23 million for eligible consumers.

On Dec. 16, 2016, the CFPB entered into a consent order with Moneytree, Inc., for alleged violations regarding deceptive online advertisements and collection letters. According to the CFPB, the payday loan and check-cashing company made unauthorized electronic transfers from consumers' bank accounts. Under the order, the company agreed to cease all illegal practices, issue $225,000 in consumer refunds and pay a civil penalty of $250,000.

Rulemaking highlights

The CFPB's prolific rulemaking authority continued throughout 2016.

One of the more sweeping lending-related rules to emerge in 2016 was the CFPB's proposed ban on mandatory class action waivers in arbitration agreements (Arbitration Rule).

On May 5, 2016, the CFPB issued a Notice of Proposed Rulemaking seeking comments regarding a proposed rule to prohibit covered entities from including call action waivers from "pre-dispute arbitration agreements" in consumer contracts. Under the proposed rule, covered consumer

17 *In the Matter of: Flurish, Inc., d/b/a LendUp*, File No. 2016-CFPB0-0023 (Sept. 27, 2016), *available at* http://files.consumerfinance.gov/f/documents/092016_cfpb_LendUpConsentOrder.pdf.

18 *See id.* at pgs. 4-8.

19 *See id.* at pgs. 14-17.

20 *See id.* at pgs. 12-13.

21 *In the Matter of: Navy Federal Credit Union*, CFPB Consent Order, 2016-CFPB-0024 (Oct. 11, 2016).

contracts could not prohibit consumers from joining or filing class action lawsuits. Moreover, covered institutions would be required to submit arbitration information to the CFPB. If adopted, the rule would apply to a wide variety of banking depository and credit products offered by certain auto lenders, loan servicers, credit unions and debt collectors, among others.

The Arbitration Rule has both proponents and critics. Those in favor of the rule argue that it will ensure consumers have their day in court, deter companies from engaging in conduct that will invoke consumer-initiated lawsuits and increase transparency. Those against the rule argue that arbitration is more efficient than class actions, that it will increase costs that will be shifted to consumers, and that only the consumer attorneys stand to benefit. According to the CFPB's Fall Rulemaking Agenda, it is considering the comments on the proposed rule and anticipates that it will issue a final rule in the first quarter of 2017.

Debt collection remains a high priority of the CFPB and the largest single source of consumer complaints. Following an Advance Notice of Proposed Rulemaking issued in 2013, the CFPB issued materials in July 2016 in advance of a panel under the Small Business Regulatory Enforcement Fairness Act (SBREFA) to consult with small businesses that may be affected by policy proposals under consideration. This process is limited to entities considered "debt collectors" under the FDCPA; however, the CFPB intends to issue another SBREFA proceeding in which it focuses on companies that collect their own debts. The CFPB will continue to analyze results and has committed to engage in pre-rule activities through February 2017.

In July 2016, the CFPB issued a Notice of Proposed Rulemaking for payday, vehicle title and high-cost installment loans. The proposed rule would apply to two categories of short-term loans. The first group of loans would have terms of 45 days or less. The second group would apply to loans with a term greater than 45 days if they 1) have an all-in annual percentage rate greater than 36 percent and 2) are repaid directly from the consumer's account or income, either of which is secured by the consumer's vehicle. Under the proposed rule, lenders must confirm that the consumer has the ability to repay the loan. The comment period expired in October, and the CFPB has yet to issue a date for the final rule.

Following up on the CFPB's TILA-RESPA Integrated Disclosure Rule (TRID), which went into effect on Oct. 3, 2015, the CFPB issued a proposed rule in July 2016 amending TRID to clarify certain provisions of Regulation C and to make technical corrections.

FDIC

Through regulatory enforcement, the Federal Deposit Insurance Corporation (FDIC) continued to focus on the compliance management systems of the supervised banks.[22]

State agencies

With the CFPB's future in question, state regulatory agencies remain important. The CFPB has a memo of understanding with state attorneys general to coordinate efforts and share information. Additionally, the CFPB works with state regulatory agencies, such as departments of commerce. We anticipate an increase in state agencies working jointly with federal agencies, such as the CFPB. Given the uncertainty of the CFPB's future, state agencies' role in regulation may become more important.

22 *In the Matter of: Independent Bank Memphis, Tennessee*, FDIC-15-0242b.

Regulatory, Compliance and Licensing

State money transmitter licensing developments

At the beginning of 2016, 47 states required entities to obtain licenses if they engaged in transmitting money or value from one person to another or from one location to another. In 2016, New Mexico and South Carolina enacted money transmitter licensing statutes, with New Mexico requiring licenses by Jan. 1, 2017, and South Carolina by midyear. The extent to which these two states require virtual currencies–related businesses to obtain licenses remains to be seen.

The New York Department of Financial Services has now issued five approvals for the operation of virtual currency–related businesses in New York. Three have received licenses under the new virtual currency regulation. Two others received trust charters. The DFS also has denied four applications. Additional applications for licenses have been filed by companies whose operations were not grandfathered.

North Carolina amended and is updating its money transmitter statute, including language specifically addressing virtual currency–related businesses. Several other states, including Illinois, provided regulatory clarification on how their laws apply.

The California legislature abandoned efforts to pass virtual currency legislation, and the fate of such legislation in 2017 remains uncertain. New Hampshire, Vermont, North Dakota, Washington and Arizona have pending proposals that would address everything from the use of bitcoin to buy marijuana to recognizing the legitimacy of smart contracts and blockchain records.

The Uniform Law Commission Committee on Virtual Currencies is finalizing a model uniform code for virtual currency that will then be circulated to the states. Each state must individually consider the legislation and whether to adopt it in whole or in part.

Representative Matters

BakerHostetler remains poised to assist financial institutions with regulatory, licensing and compliance matters. Through 2016, Baker counseled non-depository institutions regarding mortgage, consumer lending and other issues, including state lending and licensing issues. As companies continue to expand services and product offerings, a need has emerged in which companies not primarily engaged in lending seek to expand their service offerings to consumers. Our firm continues to conduct nationwide surveys regarding various state lending and licensing laws on behalf of clients in industries, including but not limited to mortgage lending, auto lending, consumer lending, student lending and virtual currencies.

Student lending

We assessed and revamped an online, for-profit college's enrollment and marketing materials. The college, which offers several types of higher education, secondary education and career programs, required an overhaul of its Truth in Lending Act (TILA) compliance program. As part of the project, we drafted enrollment agreements, revised marketing materials, compiled a TILA practices and procedures manual, and conducted 50-state surveys of late fees, nonsufficient fund fees and finance charge limits. At the end of the engagement, the team audited the college's enrollment process to ensure that required forms were obtained and disclosures were made at the appropriate times.

Regulatory, Compliance and Licensing

Through state regulator contacts, our BakerHostetler team acquired additional information concerning annual percentage rate and finance charge calculation and compliance issues. The regulators also provided key enforcement information, allowing the BakerHostetler team to deliver proactive and practical advice to the client.

State money transmitter survey

In addition to participating in meetings of the Uniform Law Commission working group drafting the Virtual Currency Model Code, our attorneys are continually surveying state money transmitter regulators to determine which states require what licenses for different types of virtual currency–related activities. We also work with a variety of financial services and FinTech companies in analyzing the business model, assessing whether or to what extent money transmission licenses are required, seeking regulatory opinions, and assisting them in obtaining money transmission licenses. In addition, we advise on general regulatory matters and represent clients in enforcement actions arising under the state laws. In addition to participating in meetings of the ULC working group, our attorneys continue to survey state money transmitter regulators to determine which states require what licenses for different types of virtual currency–related activities.

Consumer lending nationwide survey

We advised a private benefits provider regarding a proposed business model in which it would connect clients with student loan refinancers and consumer loan lenders. The team created a master analysis detailing each state's licensing and registration requirements and created user-friendly charts outlining the requirements for each of the proposed products and platforms. As a result, the private benefits provider was able to craft a product that satisfied the objectives of its business team while remaining compliant with various state laws.

Other selected matters

- Advised clients and trade associations throughout the year on compliance management systems and implementation of the systems and new federal public data reporting requirements.
- Developed a compliance management system for a solar power company that provides leasing and financing options to consumers for the purpose of obtaining solar energy panels.
- Counseled time-share companies regarding TRID compliance and state licensure issues.
- Trained and counseled non-depository lenders regarding federal mortgage rules and servicing requirements.

Emerging Issues and Trends

We anticipate that the CFPB will remain focused on debt collection practices, which comes as no surprise given the number of complaints it receives on the topic.

A takeaway from the past year is that debt collectors must be careful in communicating with consumers to ensure that the message conveyed is accurate and not intended to intimidate or mislead consumers. Additionally, before filing an action to collect debt, the entity filing the action must obtain relevant documentation to confirm the debt, sufficiently review the account-level documentation and ensure affidavits are executed by attorneys with personal knowledge.

Mortgage lenders are gearing up for greater data collection requirements, which will go into effect Jan. 1, 2018. The CFPB issued modifications to Regulation C for the Home Mortgage Disclosure Act (HMDA), which greatly impacts the mortgage origination process. The rule revises the way in which lenders collect data related but not limited to the following: loan application processes, credit scores, loan costs, debt-to-income ratios, loan-to-value ratios and reasons for denial, in addition to expanded demographic information. The rate and manner in which the data is collected and reported will be critical because that data may be used to substantiate fair lending claims, both private and public.

The CFPB and the Federal Trade Commission (FTC) share enforcement responsibility of the FDCPA. The agencies coordinate efforts to monitor the debt collection industry and to protect consumers from unfair, deceptive and abusive debt collection practices. We anticipate that we will continue to see joint enforcement actions initiated by both agencies. We will also continue to monitor the CFPB's efforts to maintain its regulatory and enforcement authority especially as it is related to federal statutes such as RESPA. The CFPB's enforcement actions suggest the need for lenders to understand the compliance practices of their marketing partners.

Lastly, we anticipate that final rules will be issued regarding arbitration, debt collection and TRID. We will follow developments, as any final rule in the arbitration and debt collection areas will likely bring even more change to the lending industry.

Restructuring

Restructuring

Industry Developments

Bankruptcy filings continued their overall decline in 2016. According to the Administrative Office of the U.S. Courts, filings were down almost 7 percent from 2015 for the 12-month period ending June 30, 2016. The decrease was entirely due to the ongoing reduction in consumer filings. Business filings were up slightly, driven by the energy, retail and restaurant industries.

Energy

Energy companies continued to dominate new corporate bankruptcy filings. In less than two years, more than 213 oil and gas companies with approximately $85 billion in debt have sought bankruptcy protection.[23] Many of these filings have come after extensive negotiations with creditors yielded mixed results, and attempts to obtain new financing or restructure existing debt outside of bankruptcy failed. Certain companies were able to avoid filing for bankruptcy by restructuring their debt out of court. Filings and out-of-court debt restructurings are expected to continue in 2017, but possibly at a less significant pace.[24] High-yield energy sector bond spreads have decreased from the all-time high but are still high enough to price in significant risk of default. Looking forward, if the price of oil stabilizes for a long enough period at an attractive price point, we expect there will be market consolidation.

Retail

The retail sector, in particular chains with a large brick-and-mortar presence, continues to face pressure from numerous sources, including increasing online sales, changing consumer preferences, high fixed costs, aggressive expansion, fluctuations in the purchasing power of the dollar and international cost cycle issues that affect profit margins. In 2016, several well-known brands sought bankruptcy protection, including Sports Authority, American Apparel, Wet Seal, Aéropostale and Hancock Fabrics. Many other retailers, such as JCPenney, are struggling and even contracting. Additionally, those retailers that have emerged from bankruptcy in some form often fail to correct the issues that necessitated the first bankruptcy filing and wind up filing for bankruptcy a second or even third time. Although the recent election will have some short-term impact on retail, the underlying challenges will remain the same and many retail chains will remain vulnerable.

Restaurants

While less widely reported, there have been a significant number of restaurant insolvencies. The restaurant industry is an important contributor to the United States economy and accounts for roughly 4 percent of GDP.[25] Within the past 12 months, restaurant companies representing chains such as Fox & Hound, Quaker Steak & Lube, Bailey's Old Country Buffet, Cosi, Don Pablo's and Logan's Roadhouse have filed for bankruptcy protection.[26] Other restaurants and restaurant companies have managed to avoid bankruptcy through cutbacks and location closings. Standard & Poor's distress ratio assigned a disturbing fourth-place ranking for restaurant bonds.[27]

23 David Hunn, *Woe in the oilfield: 213 companies have now declared bankruptcy*, *available at* http://fuelfix.com/blog/2016/10/25/213-oil-companies-have-declared-bankruptcy-how-hard-it-is-to-be-an-oilfield-service-company/.

24 David Hunn, *135 oil companies are on the edge of bankruptcy. So why is that good news?*, *available at* http://fuelfix.com/blog/2016/09/12/135-oil-companies-are-on-the-edge-of-bankruptcy-so-why-is-that-good-news/.

25 http://www.restaurant.org/Industry-Impact/Employing-America/Economic-Engine.

26 Wolf Richter, *Restaurant Industry, Leading Indicator of US Economy Sours, Bankruptcies Pile up*, *available at* http://wolfstreet.com/2016/10/02/restaurant-industry-bankruptcies-restaurant-performance-index-rpi/.

27 Richard Berman, *Analysis/Opinion*, *available at* http://www.washingtontimes.com/news/2016/oct/10/minimum-wage-hikes-putting-restaurants-out-of-busi/.

Restructuring

Restaurants are particularly sensitive to fluctuations, in part because of typically high fixed costs, changing consumer tastes and the nonessential nature of their product.[28] They often operate on slim margins and fail even during economic booms. Nevertheless, the number of recent restaurant bankruptcies is higher than it has been in several years and may signal a decrease in consumer spending confidence.

Representative Matters

Energy

Our industry-leading energy restructuring practitioners have represented debtors, purchasers, secured creditors and other constituents in large, complex energy bankruptcy and insolvency matters throughout the United States involving offshore and shale producers, oilfield servicing companies, and renewable energy companies. Representative engagements include representation of the debtor in *In re American Eagle Energy Corp.* in Colorado and *In re Black Elk Energy Offshore Operations, LLC* in the Western District of Texas, and representation of an international financial institution in connection with the Dune Petroleum Chapter 11 cases pending in Delaware. We also represented a large Midwestern regional bank in the resolution of more than $65 million in distressed loans, including syndicated loans, to oilfield services companies and producers in the Midwest and West, achieving favorable resolutions through consensual sales or restructurings.

Restructuring of hedge fund

We represented a '40 Act investment adviser with $1.2 billion in assets under management in connection with the structuring of a sale to a hedge fund through a Chapter 11 proceeding.

Hospitality portfolio

We assisted the secured creditor of a portfolio of hotel assets based in Ohio by securing the early dismissal of two potentially adverse Chapter 11 proceedings and to liquidate the portfolio of assets in proceedings throughout Ohio.

Investment bank

We represent a large investment banking firm in connection with bankruptcy litigation involving a $4 million tail-fee claim arising out of an oil and gas bankruptcy filed in Texas.

Emerging Issues and Trends

It is unclear in what direction President Trump's administration will go regarding a number of issues impacting the economy. As of the end of January 2017, the stock market overall had risen, with both the Dow and the NASDAQ hitting record highs. Conversely, the bond market was battered, and more than a trillion dollars was lost over a two-day period because of spikes in bond yields. The future of Dodd-Frank and the CFPB remains uncertain; depending on what position the new administration takes, banks may loosen their underwriting standards and increase lending. On the other hand, if the bond markets continue to be adversely impacted, borrowing costs may increase.

28 Wolf Richter, *Restaurant Industry, Leading Indicator of US Economy Sours, Bankruptcies Pile up*, *available at* http://wolfstreet.com/2016/10/02/restaurant-industry-bankruptcies-restaurant-performance-index-rpi/.

Restructuring

We are keeping a watchful eye on three sectors. First, commercial real estate: Morningstar recently reported that a tremendous amount of 10-year CMBS loans are coming due over the next 12 months and are facing real estate prices that have not recovered from the peak of the market (2006-07). Second, the healthcare industry is facing increasing challenges in 2017 prompted by changing Medicare reimbursement rules and volatility related to the Affordable Care Act. Third, insolvencies in the oil and gas and renewable energy segments have grown throughout 2016 and are expected to continue into 2017.

Financial Technology (FinTech)

Financial Technology (FinTech)

Industry Developments

As 2017 began, the most prominent words in financial services were FinTech and cybersecurity. Although FinTech has been around seemingly forever, the focus currently on this space is unprecedented. And past experience seems less useful than ever for predicting the future of traditional financial institutions.

This is due in large part to the disruptive fervor of innovators, investor excitement and the rate at which innovative financial products and services are being offered outside of traditional channels – all of which seemed to reach new heights in 2016. This disintermediation has endangered long-standing relationships, and millennials simply are not engaging with more traditional providers.

Banks and other traditional financial services companies and providers have taken seriously these apparent shifts underway in what, where and how customers are obtaining financial services and products. They are taking proactive steps whether the focus is on marketplace lending, blockchain or distributed ledger technologies, a virtual currency–based cross-border transfer system, or the need to improve back-office efficiencies. Continuing a trend of the past several years, they have set up venture capital funds, created incubators and increased participation in consortia. In 2016, smaller organizations with fewer resources stepped up efforts to partner with FinTech companies.

The regulatory outreach

Regulators and lawmakers have not been oblivious to these developments, and we have observed them engaging in ways they never have before. Every relevant agency convened some type of open forum at which it heard presentations from FinTech companies. For example:

- The OCC convened a one-day "Forum on Supporting Responsible Innovation in the Federal Banking System" in June 2016.[29] The Federal Reserve Board's annual financial innovation roundtable in December focused on online lending.[30] In addition, individual Federal Reserve banks sponsored programs during the year that focused on marketplace lending, payments and more.
- The SEC hosted a daylong forum to discuss automated investment advisers (robo-advisers), online marketplace lending, crowdfunding and blockchain technology.[31] The Commodities Futures Trading Commission (CFTC) used an early 2016 open Technology Advisory Committee meeting to hear industry representatives address regulated automated trading, swap data standardization and harmonization, and blockchain technology.
- The FTC – which has been addressing FinTech, including bitcoin and blockchain, from an enforcement perspective for several years – held two forums on marketplace lending in 2016.[32] Its third annual FinTech Forum, scheduled for March, will focus on artificial intelligence and blockchain technology.[33]

29 https://www.occ.gov/news-issuances/news-releases/2016/nr-occ-2016-55a.pdf.

30 https://www.federalreserve.gov/newsevents/speech/brainard20161202a.htm.

31 https://www.sec.gov/spotlight/fintech.

32 FTC Press Release, FTC Announces Agenda for June 9 FinTech Forum on Marketplace Lending (May 26, 2016), *available at* https://www.ftc.gov/news-events/press-releases/2016/05/ftc-announces-agenda-june-9-fintech-forum-marketplace-lending and FTC Press Release, FTC to Host FinTech Forum on Crowdfunding and Peer-to-Peer Payments on Oct. 26 (Aug. 3, 2016), *available at* https://www.ftc.gov/news-events/press-releases/2016/08/ftc-host-fintech-forum-crowdfunding-peer-peer-payments-oct-26.

33 FinTech Forum: Artificial Intelligence and Blockchain, *available at* https://www.ftc.gov/news-events/events-calendar/2017/03/fintech-forum-blockchain-artificial-intelligence.

Financial Technology (FinTech)

- The FDIC's Community Bank Advisory Committee meeting in June 2016 was the setting for discussions on FinTech and the perspective of millennials on banking.[34]

Some regulators have been even more proactive in their outreach efforts. The OCC created an Office of Innovation and has indicated a willingness to grant limited-purpose bank charters to FinTech companies (under the right circumstances). The CFTC approved a regulation to make its regulations governing record-keeping and storage obligations "technology neutral" to ensure that they do "not stand in the way" of financial technology like blockchain.

FinTech investment

It will be no surprise that when the final numbers are tallied for 2016, the drive to develop new enterprise-wide operating systems or the killer consumer app will have fueled a record level of venture capital investment in FinTech. Also, on a geographic basis, FinTech spending in 2016 will undoubtedly have been the most broadly distributed ever. Money is being spent not just in Silicon Valley or Boston, or even just in the United States and United Kingdom; the spending spree is global. And it's not just the sexy blockchain/distributed ledger technologies, marketplace lending and new payments systems that are benefiting.

More than 8,000 FinTech companies now offer everything from back-office solutions for financial institutions to mobile P2P micropayments.

These changes have also fueled a boom in regulatory technology (RegTech) – tools to help organizations manage the intricacies of ever-expanding and complicated compliance requirements.

Bitcoin, blockchain technology and distributed ledgers

Possibly the most exciting ongoing developments in FinTech are occurring in the space commonly referred to – although not entirely correctly – as "blockchain technology." The conversation that started a few years ago with "bitcoin" and rapidly expanded to "cryptocurrencies" before being pushed aside for everything "blockchain," has now evolved into "blockchain technology" and "distributed ledger technologies," or DLT.

However, bitcoin has not disappeared.

With the price of bitcoin again surging over $1,000, there is renewed interest in this first use case of blockchain technology – as a currency and for value transfer.

We are seeing an increase in start-ups focusing on bitcoin exchange platforms and value transfer systems. Bitcoin ATMs are on the verge of becoming ubiquitous in many cities and on college campuses around the country. A growing number of central governments are exploring how to digitize sovereign currencies. Other cryptocurrencies like Ether (Ethereum) continue to gain traction and new ones are making their debut, each one professing to be a better form than the last. Zcash was the star debutant in 2016, offering holders "privacy and selected transparency."

34 FDIC Press Release, FDIC Announces Advisory Committee on Community Banking Meeting (July 18, 2016), *available at* https://www.fdic.gov/news/news/press/2016/pr16058.html.

Financial Technology (FinTech)

We have selected several events in 2016 that highlight the legal and regulatory challenges the technology presents.

The DAO ranks first

"The DAO" was voted the most influential development in blockchain technology in 2016 in a survey conducted by an industry-leading publication, *CoinDesk*. For the uninitiated, surreal may best describe The DAO and the events surrounding its seemingly successful crowdfunding efforts in mid-2016.

The DAO presents an ideal case study for learning, among other things, about:

- The disruptive potential of cryptocurrencies and distributed ledger technology – both for the securities industry and for other sectors of the economy.
- The use of cryptocurrencies as a means for raising capital.
- The future use of smart contracts to raise and deploy venture capital.
- How decentralized organizations may create new standards for corporate governance.
- Why the law will inevitably lag the technology.

Bitfinex

Bitfinex, a leading currency exchange, experienced a one-two punch in 2016. First, it entered into a consent order with the CFTC; then, within weeks, $70 million of bitcoin was stolen from customer accounts.

Certain cryptocurrency activities regulated by the CFTC

The CFTC's consent order with Bitfinex was arguably the most important enforcement action in the blockchain community in 2016, setting the stage for potentially resolving a key issue for the community in 2017. The CFTC fined Bitfinex $75,000 in connection with its operations of an online platform for exchanging and trading cryptocurrencies. The order said Bitfinex permitted ineligible participants to trade bitcoins on a leveraged margined or financed basis. Because it held the cryptocurrencies in an omnibus settlement wallet it owned and controlled and to which it "held the private keys necessary to access the wallet," it had engaged in illegal, off-exchange commodity transactions and failed to register as a futures commission merchant.[35]

A petition was filed soon after the order was issued, asking the CFTC to clarify certain issues raised involving transfer of ownership, but seemingly not resolved, in the Bitfinex order.[36]

Hack

Bitfinex developed a creative response to the hack that prevented it from going into bankruptcy. It distributed to its customers one token for every dollar of value lost in the hack. The ultimate value of the token was contingent on the recovery of the stolen cryptocurrencies, which could be tracked on the blockchain. The company planned to redeem them or exchange them for shares

35 Pete Rizzo, Petition Pushes CFTC to Clarify Rules on Blockchain 'Delivery', (July 20, 2016), *available at* http://www.coindesk.com/petition-cftc-clarify-blockchain-rules-delivery/; *In the Matter of BFXNA, Inc. d/b/a/ Bitfinix, CFTC Docket No. 16-19, available at* http://www.cftc.gov/idc/groups/public/@lrenforcementactions/documents/legalpleading/enfbfxnaorder060216.pdf.

36 Pete Rizzo, Petition Pushes CFTC to Clarify Rules on Blockchain 'Delivery', (July 20, 2016), *available at* http://www.coindesk.com/petition-cftc-clarify-blockchain-rules-delivery/.

of its parent company's stock. The company quickly redeemed a small portion of the tokens and moved aggressively to encourage token holders to convert them to the parent company's stock.[37]

John Doe summons

Borrowing on its efforts to trace tax evasion through foreign bank accounts, in November the IRS served a John Doe summons on Coinbase, the largest U.S.-based virtual currency exchange, seeking to find U.S. taxpayers who may have used virtual currencies to evade taxes.[38] The summons seeks records identifying U.S. customers over a three-year period and documents related to their transactions over the same period as well as an extensive list of other documentation. An account holder filed in December to block the summons, claiming concerns about the U.S. government's ability to keep such records secure. The exchange has asked to join the case. The IRS has requested more time as it is considering filing to enforce the subpoena or taking other action.

Bitcoin as money: Is it or isn't it?

One judge in New York said yes. Another in Florida said no. Who is right? This answer can be important when determining which laws and regulations apply.

While the Florida trial court judge said bitcoin "has a long way to go before it is the equivalent of money," the decision's precedential value is probably very limited, and it is not binding on the state regulator responsible for interpreting the statute at issue. The Florida attorney general has appealed the decision of the Florida trial court judge. Efforts are underway in the state legislature to amend the statute.

A United States District Court held that bitcoins are funds under 12 U.S.C. § 1960 and that the defendant could be prosecuted for operating an unlicensed money transmitting business. This ruling is consistent with an earlier one in New York.

Key regulatory highlights

In addition to the regulators' outreach efforts, we have identified the following as some of the more important developments in 2016. In many cases, these developments will not be the last word on the matter as they progress in 2017.

Playing in regulatory sandboxes

To address criticisms that regulation is a key barrier to FinTech innovation, at least six countries have announced formal initiatives to create regulatory sandbox projects that offer start-ups and other young companies a safe place in which they can test innovative products and services in an environment that involves a "lighter" regulatory touch. The best-known initiatives are in the United Kingdom, Australia, Singapore, Hong Kong, Thailand, Indonesia and Malaysia. Other initiatives are in Abu Dhabi, which has set up a new Regulatory Laboratory, and in Ontario, where the Securities Commission has established LaunchPad for securities-related projects.

37 Bitfinix The Official Blog, Bitfinex Announces Sizable *Token-for-Equity Exchange by Customers*, Oct. 13, 2016 *available at* http://blog.bitfinex.com/announcements/bitfinex-announces-sizable-token-equity-exchange-customers/.

38 The United States Department of Justice Press Release, *Court Authorizes Service of John Doe Summons Seeking the Identities of U.S. Taxpayers Who Have Used Virtual Currency*, (Nov. 30, 2016), *available at* https://www.justice.gov/opa/pr/court-authorizes-service-john-doe-summons-seeking-identities-us-taxpayers-who-have-used.

Financial Technology (FinTech)

State laws on cybersecurity, AML and OFAC

The New York Department of Financial Services finalized a regulation in 2016 that imposed new AML and OFAC requirements on not only banks but also money transmitters and other financial services businesses licensed in the state.[39] In early 2017, the DFS similarly finalized a new regulation imposing significant requirements on cybersecurity efforts of banks, money transmitters and other financial services companies regulated by the DFS.[40] Virtual currency businesses are already subject to substantially similar cybersecurity requirements.

The FinTech bank charter

In October, the OCC announced a Responsible Innovation Framework that included the creation of a new Office of Innovation to work with banks and nonbanks.[41] In December, the comptroller unveiled plans to begin accepting applications from FinTech companies for special-purpose bank charters.[42]

Federal Reserve initiatives and working paper

Federal Reserve System initiatives include the Faster Payments Task Force, which involves a number of FinTech companies.[43] Well known for its quality research, the Fed released a study that included the results of an insightful 2015 consumer survey on mobile banking and mobile payments worthy of a read by anyone providing services via mobile apps.[44] Federal Reserve staff in December also released a working paper discussing distributed ledger technology in payments, clearing and settlement to "stimulate discussion and critical comment."[45]

SEC staffs up

The agency has formed the Distributed Ledger Technology Working Group with approximately 75 persons across the agency building expertise, identifying risk areas and coordinating efforts among the SEC's various divisions and offices as well as assisting law enforcement and other regulators and liaising with industry.

FINRA seeks comment on DLT report

Early in 2017, the Financial Industry Regulatory Authority (FINRA) released a report on distributed ledger technology as "an initial contribution to an ongoing dialogue with market participants about the use of DLT in the securities industry."[46]

39 New York Department of Financial Services Press Release, *New York's Landmark Anti-Terrorism Transaction Monitoring And Filtering Program Regulation Takes Effect*, (Jan. 5, 2017), *available at* http://www.dfs.ny.gov/about/press/pr1701051.htm.

40 New York Department of Financial Services Press Release, *Governor Cuomo Announces First-In-The-Nation Cybersecurity Regulation Protecting Consumers And Financial Institutions From Cyber-Attacks To Take Effect March 1*, (Feb. 17, 2017), *available at* http://www.dfs.ny.gov/about/press/pr1702161.htm.

41 OCC Press Release, OCC Issues Responsible Innovation Framework, Seeks Comment (Oct. 26, 2016) *available at* https://www.occ.gov/news-issuances/news-releases/2016/nr-occ-2016-135.html.

42 OCC Press Release, OCC To Consider Fintech Charter Applications, Seeks Comment (Dec. 2, 2016), *available at* https://occ.gov/news-issuances/news-releases/2016/nr-occ-2016-152.htm.

43 Federal Reserve Banks, *Faster Payments*, *available at* https://fedpaymentsimprovement.org/faster-payments/.

44 Board of Governors of the Federal Reserve System, Consumers and Mobile Financial Services (March 2016), *available at* https://www.federalreserve.gov/econresdata/consumers-and-mobile-financial-services-report-201603.pdf.

45 Finance and Economic Discussion Series Division of Research & Statistics and Monetary Affairs, Federal Reserve Board Washington, D.C., *Distributed Ledger Technology in Payments, Clearing and Settlement*, 2016-095, *available at* https://www.federalreserve.gov/econresdata/feds/2016/files/2016095pap.pdf.

46 FINRA Report, *Distributed Ledger Technology: Implications of Blockchain for the Securities Industry*, (Jan. 2017), *available at* http://www.finra.org/sites/default/files/FINRA_Blockchain_Report.pdf.

Financial Technology (FinTech)

FDIC beefs up examination guidelines

The FDIC issued "Examination Guidance for Third-Party Lending," which supplements guidance on the subject issued in late 2015 to cover marketplace lending activities.[47]

CFPB

The CFPB published its first report on the results of its outreach to FinTech innovators through its Project Catalyst, established in 2012.[48]

CFPB no-action letters

Intended to promote consumer-friendly innovation, the CFPB will provide a kind of "no-action" letter to entities applying for a determination that the CFPB staff will not recommend enforcement or supervisory action with respect to the particular aspects of a new product and under specific statutes and regulations.[49] While the concept is welcome, the practical aspects render the process costly, time-consuming and of limited value because of the relatively narrow range of laws that the CFPB will include within the scope of this review.

CFPB enforcement targets payment platform and online lender

In 2016, the CFPB issued two enforcement actions targeting FinTech companies – an online lender[50] and a payments platform.[51] Both orders seemed intended to communicate to a broader FinTech audience certain CFPB expectations.

CFPB prepaid access regulation and enforcement action

The CFPB also finalized long-pending regulations for open-loop prepaid access. It also has announced a substantial enforcement action against a prepaid card program manager and processor for problems that occurred when switching processing platforms.

Representative Matters

- **Payments generally.** During 2016, BakerHostetler attorneys worked with clients across the FinTech spectrum, advising on state money transmitter licensing issues, FinCEN money service business registration, anti-money laundering and sanctions compliance, privacy and data security, Regulation E and other disclosures, and consumer protection issues, including unfair and deceptive acts and practices and escheatment. Our work included drafting and negotiating licensing agreements, advising on transactional matters, structuring private equity investments, mergers and acquisitions, corporate reorganizations and dissolutions, preparing patent applications, and filing for trademarks. We also represented clients in enforcement actions under state money transmission licensing laws and in contract disputes and litigation.

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47 FDIC Examination Guidance for Third-Party Lending (July 29, 2016), *available at* https://fdic.gov/news/news/financial/2016/fil16050a.pdf.

48 CFPB, Project Catalyst Report: Promoting Consumer Friendly Innovation (October 2016), *available at* https://s3.amazonaws.com/files.consumerfinance.gov/f/documents/102016_cfpb_Project_Catalyst_Report.pdf.

49 CFPB Press Release, *CFPB Finalizes Policy to Facilitate Consumer-Friendly Innovation* (Feb. 18, 2016), *available at* http://www.consumerfinance.gov/about-us/newsroom/cfpb-finalizes-policy-to-facilitate-consumer-friendly-innovation/.

50 CFPB Press Release, *CFPB Orders Lend Up to Pay $3.63 Million for Failing to Deliver Promised Benefits* (Sept. 27, 2016), *available at* http://www.consumerfinance.gov/about-us/newsroom/lendup-enforcement-action/.

51 http://www.consumerfinance.gov/policy-compliance/enforcement/actions/dwolla/.

- **Prepaid access.** We assisted prepaid card program managers in addressing state money transmission licensing issues, enhancing AML compliance programs, analyzing the CFPB's new prepaid access regulation as it impacts existing program documentation, and assessing escheatment exposure. We work with both open- and closed-loop programs, plastic and virtual, to review and revise terms and conditions, privacy policies, data security programs and more. We reviewed unique business models, including virtual wallets and online exchanges. Our attorneys lectured at the Gift Card Network University and participated in multiple webinars and podcasts discussing developing issues.
- **Third-party payment processors.** The firm represented large and small payment processors in contract, litigation, and regulatory and compliance matters including mergers and acquisitions, contract negotiations, network, card and NACHA rules, and various contractual disputes. We represented clients in resolving state licensing issues and negotiating settlements of federal and state enforcement actions. Our lawyers presented regularly at the WesPay Third-Party Sender Roundtable meetings.
- **Virtual currencies.** We represented multiple bitcoin exchanges on a wide range of regulatory and compliance matters, assisting them in assessing money transmitter licensing obligations, establishing and enhancing anti-money laundering and OFAC compliance programs, and developing policies and procedures necessary to comply with the New York Department of Financial Services' new virtual currency licensing regulations, including consumer compliance, cybersecurity and anti-money laundering compliance. We worked with clients seeking money transmitter licenses and, in an effort to save multiple clients the cost of individually seeking opinions of state regulators, we surveyed the states to determine whether a money transmitter license is required to sell bitcoin out of inventory. We advised on the launch of a gold-backed virtual currency system and the creation of cryptocurrencies backed by sovereign currency. We drafted agreements for the sale and licensing of bitcoin ATMs and addressed legal issues involved in the operation of a bitcoin ATM. We prepared several clients for successful IRS Title 31 (BSA/AML) Examinations, helped them analyze their data for suspicious activity monitoring purposes and assisted in drafting suspicious activity reports involving multiple new data points. On behalf of a data recovery firm, we sought an opinion from FinCEN regarding whether it was required to register as a money services business in connection with the use of bitcoin in ransomware cases. Our lawyers taught at the Anti-Money Laundering Compliance Bootcamp for Virtual Currency Businesses.
- **Blockchain and distributed ledger technology.** BakerHostetler lawyers represented clients exploring and deploying blockchain and other distributed ledger technologies in multiple use cases, including payment processing and cross-border payments. We have analyzed legal issues associated with smart contracts, provided regulatory advice, drafted patent applications and assisted in patent prosecution.
- We represented Fortune 500 companies developing and selling FinTech products and services. In one case, we advised a publicly traded company on regulatory issues associated with the rollout of technology to facilitate the purchase of prepaid airtime and data internationally. This project included coordinating counsel in more than 20 countries as we considered telecommunications, privacy/data security, money transmission licensing and anti-money laundering compliance requirements in the United States and abroad.

- **Online savings.** An example of our efforts on behalf of start-up FinTech companies creating products or services aimed at millennials is our representation of a company that developed an online platform to encourage saving toward specific goals such as the purchase of a house or car. Recognizing the cost constraints of early-stage companies, we analyzed the business model and funds flow to determine if it would need to register as an MSB and whether it would need to seek money transmitter licenses. We worked with the company to develop a strategy that did not require licensing or registration. We developed terms and conditions for the product and terms of use for the website, worked with the company to patent certain technology, obtained key trademark protection, and reviewed agreements with partners and service providers. We also coordinated meetings with CFPB staff, as part of Operation Catalyst, to provide a briefing on the product.

Emerging Issues and Trends

The new administration

The inevitable question is whether the Trump administration will encourage and possibly accelerate regulatory engagement with the FinTech community. While at least one Federal Reserve Bank president has suggested that regulation is in the best interest of FinTech firms,[52] early signs seem to support broader regulatory engagement to help firms, but with a relatively light regulatory touch.

For example, the acting chairman of the CFTC, who is designated to become the permanent chairman, has promised to make FinTech a priority and cultivate a "regulatory culture of forward thinking." Advocating a "do no harm" approach, he has indicated support for digital ledger technology and acknowledged the potential of smart contracts. He also has chastised the U.S. for falling behind initiatives in other countries to proactively support FinTech innovation.[53]

If the new administration were inclined to pull back on FinTech initiatives, the result would be singularly disadvantageous to the United States: job losses, loss of tax revenue and a loss of some of our best and brightest innovators are only a few of the potential negative consequences.

FinTech development is like a genie – it is out of the bottle, and it is not going to be put back in.

It is truly global, and if the U.S. takes a different path, many other countries stand ready to extend a welcome to these companies. As one U.S.-based entrepreneur said, "I would rather work in Northern California than anywhere else in the world, but I will move if I have to."

52 In a February 2017, the president of the Philadelphia Federal Reserve Bank addressed speech the role of regulation in creating the trust necessary to ensure a strong and sound financial system and ultimately a strong and sound economy. He suggested that "[f]intech firms need that trust the same as any other bank or financial institution" and suggested FinTech companies should embrace regulation as they need regulation for their own protection. https://www.philadelphiafed.org/publications/speeches/harker/2017/02-06-17-gic-payment-systems-in-the-internet-age.

53 CFTC Report, Keynote Address of CFTC Commissioner J. Christopher Giancarlo Before SEFCON VII, (Jan. 18, 2017) *available at* http://www.cftc.gov/PressRoom/SpeechesTestimony/opagiancarlo-19.

Looking Ahead in 2017

Looking Ahead in 2017

- **Cybersecurity.** The immediacy of concerns around cybersecurity and regulatory efforts to shore up regulation and supervision in this area make this our top issue for 2017, outranking even the efforts to repeal or eviscerate Dodd-Frank and eliminate or emasculate the CFPB. With the NYDFS regulations now final and federal regulators seriously examining the efforts of their charges, we expect more enforcement actions and fines for those falling short.
- **The new administration, Dodd-Frank and FinTech.** On Feb. 3, 2017, the new administration issued an executive order directing the Treasury secretary to undertake a thorough review of the Dodd-Frank Act to determine which parts of the legislation may be amended or repealed. Legislative initiatives are already underway. Against this backdrop, inevitable questions remain as to whether the administration will encourage and possibly accelerate engagement with the FinTech community. Early signs support further engagement. However, if the new administration decides to apply a heavier touch to regulating FinTech companies, the result would be singularly disadvantageous to the U.S.; job losses, loss of tax revenue and loss of some of our best and brightest innovators are only a few of the potential negative consequences.
- **CFPB.** In *PHH*, the D.C. Circuit Court ruled that RESPA's three-year statute of limitations applies to CFPB enforcement actions. Going forward, past or pending enforcement actions that apply longer statutes of limitations could be vulnerable on due process or statutory interpretation grounds. It is possible that the CFPB may look to bring enforcement actions under statutes with longer statutory enforcement actions.

  In early 2017, President Trump executed an executive order requiring agencies to revoke two regulations for every new regulation issued. Since executing the order, the Trump administration has confirmed that it does not apply to independent agencies such as the CFPB.[54] Accordingly, it looks like we can expect the CFPB to continue with its plan to issue final rules regarding arbitration, the TILA-RESPA Integrated Disclosure Rule and high-cost installment loans.
- **Consumer litigation.** For the eighth year in a row, the number of Telephone Consumer Protection Act litigants continues to grow. The strict liability statute continues to be a favorite among both individual plaintiffs and class action plaintiffs. As lower courts begin to address the issue of damages in the wake of *Spokeo*, it will be interesting to see how courts apply the Supreme Court's ruling to statutes like the TCPA, which do not require actual damages.
- **Lending trends.** In 2016, commercial lenders became even more conservative than they were in the previous year, due in part to the Dodd-Frank retention requirements. Despite a robust real estate market and the new administration's deregulation goal, for the time being, commercial lenders must continue to comply with the current regulatory scheme. In 2017, we anticipate real estate lending to grow at a moderate pace, with nonbank lenders picking up some of the slack caused by a decrease in loans made by other institutional lenders.

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54 White House Press Office, Memorandum: Interim Guidance Implementing Section 2 of the Executive Order of Jan. 30, 2017, titled "Reducing Regulation and Controlling Regulatory Costs" (Feb. 2, 2017), *available at* https://www.whitehouse.gov/the-press-office/2017/02/02/interim-guidance-implementing-section-2-executive-order-january-30-2017.

Looking Ahead in 2017

- **Restructuring.** Commercial real estate, healthcare and energy are three sectors to watch. Each industry is facing a potential change that could have a significant impact. In commercial real estate, 10-year loans are coming due and are facing real estate prices that we have not seen since the market peak of 2006-07. The healthcare industry faces two possible disrupters that could have a significant impact on the bottom line: revised Medicare reimbursement rules and a possible repeal of or significant amendment to the Affordable Care Act. Lastly, in the energy sector, the last year saw increased insolvencies in the oil and gas and renewable energy segments, which are expected to continue over the next year.
- **Prepaid access.** If the CFPB's new prepaid rule is not repealed, the big question is whether it will be modified before its Oct. 1 effective date. For those who have not started to review program documentation for compliance, time is growing short. At the same time this review is conducted, prepaid programs should consider the implications of the recent CFPB action against a prepaid card program manager and its processor for existing relationships. And prepaid access programs should keep an eye on changes in the Bank Secrecy Act and/or FinCEN regulations for more extensive customer due diligence regulations. Law enforcement is also more focused than ever on the product, with evolving criminal abuse and expanded use of card readers at the scene of a crime. For prepaid programs – both open and closed – 2017 will be a good time to review anti-money laundering compliance efforts.
- **Anti-money laundering compliance and the Bank Secrecy Act.** Significant efforts to seek some relief from the ever-growing list of BSA/AML regulations and regulatory expectations in the new Congress are expected. The recent proposal of the Clearing House Association will be influential in this process, although U.S. policy and lawmakers are likely to run into international opposition if they are too aggressive in relaxing standards. In the meantime, the New York Department of Financial Services will start to enforce its new regulation, keeping pressure on federal regulators who historically are less than appreciative if another regulator finds issues in institutions they are responsible for examining. Bringing financial institutions into compliance with the new beneficial ownership rule by May 2018 will consume significant staff resources in many financial institutions and will further aggravate de-risking concerns.
- **Distributed ledger technologies (DLT) and blockchain.**

The number of use cases deploying blockchain and other distributed ledger technologies will explode in many sectors of the economy, well beyond financial services, and greater legal and regulatory attention is inevitable.

  Education will be critical to avoid hastily made decisions on regulating DLTs.
- **Virtual currencies.** Newer, more anonymous versions will cause law enforcement, regulators and others considerable consternation until they understand them better. Virtual currency ATMs will become ubiquitous in many cities as the use of bitcoin and other currencies grows to support the burgeoning DLT use cases. More states will consider amending their money transmitter statutes or look closely at the new Uniform Virtual Currency Model Code expected to be approved later this year.

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