LAW360

Portfolio Media. Inc. | 111 West 19th Street, 5th Floor | New York, NY 10011 | www.law360.com
Phone: +1 646 783 7100 | Fax: +1 646 783 7161 | customerservice@law360.com

Fintech Litigation To Watch In 2020

By **Philip Rosenstein**

Law360 (January 1, 2020, 12:04 PM EST) -- In 2019, the U.S. Securities and Exchange commission brought a pair of closely watched actions against Kik Interactive Inc. and Telegram Group Inc. for unregistered offerings of digital tokens, setting the stage for an intriguing 2020. Two other big names in fintech, Bitfinex and Tether, faced questions about potential market manipulation.

State regulators have also challenged the U.S. Office of the Comptroller of the Currency's creation a new type of federal bank charter geared toward fintech companies, which could jumpstart technology companies' entry into financial services. The Second Circuit is set to weigh in on the federal authority to oversee fintech.

Here, Law360 takes a look at the some of the big fintech cases to look out for in the coming year.

The SEC Takes on the Big Dogs

In 2019, the SEC launched its most high-profile enforcement actions against initial coin offerings, or ICOs, since it began addressing whether transactions involving digital currencies are covered by federal securities laws a few years ago.

"The cases the SEC pursued initially were often against the outright frauds or folks who didn't have money to fight back and they manufactured a few administrative precedents that they could then invoke to support cases against some of the bigger fish," Benjamin Sauter, a litigator with Kobre & Kim LLP, told Law360.

The agency launched an action against Canadian messaging company Kik in early June over a $100 million offering of its kin tokens in 2017. It also sued another messaging company, Telegram, in October, halting its $1.7 billion offering of its gram tokens. Both cases were brought in the U.S. District Court for the Southern District of New York.

The SEC alleges the companies violated the Securities Act of 1933 by failing to register their token offerings, which it says are securities as defined in the law.

The central issue the court is expected to address in the Kik case is the application of the Howey test to ICOs. That test, stemming from a 1946 U.S. Supreme Court case of the same name, broadly interprets the term "investment contract" under the Securities Act of 1933 as an agreement in which a person invests money in a common enterprise, expecting profits based on the efforts of others.

“Having someone outside the commission like a federal judge, looking at the facts and circumstances as they're presented and getting a court to apply Howey and its progeny will give clarification, which is what people have been asking for since at least 2017,” Rebecca Rettig, a partner and litigator focused on fintech at FisherBroyles LLP, told Law360.

The SEC released guidance in 2017 that took the form of a report on a German group known as the DAO, which stands for decentralized autonomous organization, that used blockchain technology to raise about $150 million in 2016. Although the SEC said it would not take any enforcement action against the group, it said the DAO's tokens — which were sold online to U.S. investors — legally qualified as securities and urged entrepreneurs and investors to act with caution.

The agency only reached legal conclusions about the DAO's tokens, and said it would evaluate coin offerings from other companies based on the "facts and circumstances" of each case.

Rettig said it remains unclear whether the Kik case will be resolved in 2020 and offer any further clarity on how the SEC treats ICOs. It will depend on the court’s schedule and how motivated the parties are, she said. After failing to secure discovery from high-ranking SEC officials in November, Kik and the SEC will meet again Jan. 14 to discuss an end date for the discovery process.

Focusing on the nature and sale of the gram tokens, attorneys say the Telegram case presents more nuanced questions than the Kik case about securities law and how it applies to the budding digital currency space.

In October, the SEC obtained a temporary restraining order in New York federal court to block Telegram and its wholly owned subsidiary TON Issuer Inc. from delivering approximately 2.9 billion gram tokens to investors that were planned for distribution no later than Oct. 31, at which time the tokens could then have been sold into U.S. markets.

Telegram subsequently agreed not to offer, sell or deliver any tokens until the conclusion of a hearing, scheduled for Feb. 18 and 19, on the SEC's request for a preliminary injunction to indefinitely block the delivery of tokens to their 171 private purchasers from around the world.

The SEC alleges that the sale of the grams violated the Securities Act of 1933 because the tokens are securities that were never registered — a characterization that Telegram has steadfastly denied. The company claims the grams were never publicly offered and instead were sold to sophisticated purchasers who can use them as a commodity once the TON Blockchain launches.

Rettig said the questions raised in the Telegram case not only home in on whether the gram token sale was an unregistered securities offering, “but also address issues around fundraising in the fintech space.”

“This goes to how to properly use SAFTs [simple agreement for future tokens] or other fundraising mechanisms,” she said. “It could really add additional guidance that we haven't gotten in the form of a clear enforcement order or something along those lines, that specifically addresses these issues.”

A SAFT is a type of presale agreement that companies launching digital tokens use to fundraise. Companies usually target accredited investors and sell purchase agreements that include a promise to deliver tokens at a later date.

Gary DeWaal, special counsel at Katten Muchin Rosenman LLP, said that the Telegram case raises “a much more subtle legal issue” than the Kik case.

Telegram has argued that the SEC's theory that grams constitute securities was "fundamentally flawed" because the company has not and does not intend to offer grams to the public through an ICO. Instead, it sold them through private agreements in an offering with valid exemptions to registration, according to the company.

"The grams themselves, as distinct from the purchase contracts, will merely be a currency or commodity (like gold, silver or sugar) — not a 'security' — once the TON Blockchain launches," Telegram said.

The parties have until Jan. 13 to file preliminary briefs for motions for summary judgment, to challenge the existing temporary restraining order or to strike affirmative defenses. In the meantime, discovery is ongoing.

Attorneys are cautious about suggesting these cases will yield clear legal bright lines as early as next year.

“I don't think that we will have anywhere near 100% certainty on how to operate in the space in 2020,” Rettig said. “But I think that we can continue to build over time and use the guidance and the enforcement orders that we've been getting from the SEC, and then these new judicial opinions that we're going to be getting” to effectively counsel fintech clients on token sales moving forward.

The cases are U.S. Securities and Exchange Commission v. Telegram Group Inc. et al., case number 1:19-cv-09439, and SEC v. Kik Interactive Inc., case number 1:19-cv-05244, both in the U.S. District Court for the Southern District of New York.

States Look to Slow Federal Encroachment Into Fintech Oversight

The ever-developing fintech field has brought big tech into finance with the likes of Apple Pay and the proposed Facebook-backed Libra digital currency. To facilitate adherence to the many state laws governing nonfederally chartered banks, the Office of the Comptroller of the Currency in 2018 said it would begin accepting applications for special-purpose national bank charters from financial technology companies that don’t take deposits.

The New York Department of Financial Services and the Conference of State Bank Supervisors swiftly challenged the OCC’s authority to create what is known as the fintech charter. With the CSBS case thrown out in D.C. district court, the DFS case in the Southern District of New York is being closely watched as it appears set to determine whether the charter is legally valid.

“The [fintech charter case] is important litigation, because many of the companies that could be interested in the charter are blue chip fintech companies that have major client bases and major operations, and the entrance of those types of companies into the banking system is a noteworthy development in and of itself,” Michael Nonaka, co-chair of the financial services group at Covington & Burling LLP, told Law360.

After New York secured a win at the district court level, the OCC said in a Dec. 19 filing that it was appealing the case to the Second Circuit.

DFS' lawsuit alleges that the OCC overstepped its statutory authority when it decided to start offering fintech charters and takes aim at the OCC's special-purpose chartering regulation, arguing that it improperly expands the agency's chartering powers to include nondepository financial institutions and is now being used by the OCC to bootstrap the fintech charter into existence.

U.S. District Judge Victor Marrero in the Southern District of New York was largely sympathetic to this point of view in his May ruling, when he held that the National Bank Act "unambiguously requires that ... only depository institutions are eligible to receive national bank charters from OCC."

The OCC has maintained that it disagrees with Judge Marrero's decision and has acknowledged that it could have a dampening effect on industry interest in applying for the fintech charter.

Nonaka said he thinks that in 2020, certain trends like the growth in fintech-bank partnerships will continue largely unaffected by the fintech charter litigation.

“Bank-fintech partnership growth is more attributable to the fact that there are common interests in combining the technology, scale and costs of funds that both sides have as advantages and offering products and services in an augmented way,” he said. “So I think that will continue independent of what happens with the charter.”

Leslie Spencer, a partner at Ropes & Gray LLP, told Law360 that given the nature of the question being asked, the fintech charter could end up before the Supreme Court, although it could be a “drawn out process” before that point.

The case “fundamentally addresses the states’ rights to regulate banking,” making it more likely to end up at the high court, she said.

As for how the OCC expects the litigation to play out, Comptroller Joseph Otting said at the end of October at a fintech conference that he is confident the courts will eventually confirm the agency’s power to institute the charter.

The case is Lacewell v. Office of the Comptroller of the Currency et al., case number 1:18-cv-08377, in the U.S. District Court for the Southern District of New York.

Bitfinex and Tether Taken to Court

Bitfinex, a major cryptocurrency exchange, and Tether, a company with which Bitfinex shares ownership and issues the tether stablecoin, have been embroiled in litigation brought by state prosecutors and individual investors in 2019.

The companies are facing claims from New York State Attorney General Letitia James that they lied to New York investors after authorities uncovered that Tether loaned Bitfinex up to $900 million to cover losses after a Panamanian bank holding Bitfinex cash had its funds frozen.

Stablecoins such as tether are advertised as cryptocurrencies backed 1-to-1 by fiat currency, which should keep the value of the token much more stable than most other cryptocurrencies, which experience wild swings in price. James questioned Tether’s claim that it had dollars in the bank to back every tether token once the nature and size of the loan between Tether and Bitfinex was disclosed.

Individual cryptocurrency investors have brought a pair of suits against Bitfinex and Tether in federal court alleging the companies engaged in a broad scheme to manipulate the price of Bitcoin by issuing unbacked tether. The suits highlight the findings of a pair of academic reports concluding that Tether and Bitfinex coordinated to manipulate the price of Bitcoin, as well as some of what James' office uncovered.

A 97-page complaint filed in Washington federal court Nov. 22, which asserts commodities, antitrust and racketeering claims, is similar to one filed in New York federal court Oct. 6.

The October suit also accused the companies of lying about tether tokens being backed 1-to-1 by U.S. dollars and of issuing unbacked tethers as a way of manipulating the Bitcoin market. That suit is seeking a massive $1.4 trillion if damages are tripled as required by the Racketeer Influenced and Corrupt Organizations Act and antitrust statutes.

Kobre & Kim's Sauter noted that the complaints are "obviously very detailed and there's been work put into it. [But], I don't know, just on the face of it, that there's actually a manipulation claim alleged."

Sauter said he wouldn't be surprised if motions to dismiss the manipulation cases are filed in 2020.

He said that even if Tether and Bitfinex knew that issuing tether in the way they did would impact the price of Bitcoin, "it doesn't necessarily mean they're going to meet the legal elements for manipulation because you actually need to show that that created an artificial price."

With Jim Walden of Walden Macht & Haran LLP on their side in the New York action, Bitfinex and Tether will certainly continue to vehemently contest the manipulation claims.

"There are hundreds of thousands of people, millions of people, that rely on the crypto ecosystem, and to take such a heavy-handed shot at all of their investments based on this kind of evidence seems to me to be highly problematic," Walden previously told Law360.

The cases are David Leibowitz et al. v. iFinex Inc. et al., case number 1:19-cv-09236-KPF, in the U.S. District Court for the Southern District of New York and Young et al. v. iFinex Inc. et al., case number 2:19-cv-01902, in the U.S. District Court for the Western District of Washington..

--Additional reporting by Jon Hill, Dean Seal and Nathan Hale. Editing by Abbie Sarfo.

All Content © 2003-2020, Portfolio Media, Inc.