Westlaw Today
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The CFPB has entered the ring and makes clear moves to regulate nonbank digital asset activities

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NOVEMBER 22, 2022

Much of the conversation about which agency regulates digital assets centers around the roles of the Securities Exchange Commission (SEC) and the Commodity Futures Trading Commission (CFTC).

However, maybe in the spirit of never letting a good crisis go to waste, the Consumer Financial Protection Bureau (CFPB) rarely misses a moment to reinforce the scope of its supervisory purview. The CFPB's recent publication "Complaint Bulletin: An analysis of consumer complaints related to crypto-assets" (the Bulletin) is a no holds bar rebuke of digital assets through the lens of consumer complaints received by the CFPB over the past four years.

The CFPB is clearly setting the stage for it to exercise its authorities under the Consumer Financial Protection Act to regulate nonbanks engaged in digital asset activities.

The Bulletin was released during the issues/downfall/saga that is FTX (more on that below), which is a time when such critiques of the digital asset market may be most sympathetically received — especially among digital asset investors, other regulators, and especially legislators. The Bulletin details some terrifying and absolutely tragic details of consumer complaints in the digital asset world.

The Bulletin was issued on the same day the CFPB finalized updates to its procedural rules for when it exercises supervisory authority over nonbanks that it has determined are engaged in conduct that poses risks to consumers with regard to the offering of financial products or services.[1] The final updates primarily addressed when the CFPB may decide to publicly release an order that it is exercising supervisory authority over a nonbank, and when it may keep such orders confidential.

The timing of the Bulletin and finalization of these updates to the CFPB's rules for exercising supervision over nonbank financial firms is no coincidence. The CFPB is clearly setting the stage for it to exercise its authorities under the Consumer Financial Protection Act (CFPA) to regulate nonbanks engaged in digital asset activities. In doing so, it is joining other federal regulators, such as the Office of the Comptroller of the Currency (OCC), in expanding federal scrutiny of nonbank entities engaged in digital asset activities.

Ultimately, market participants may be wise to view the Bulletin as a thinly veiled warning that the CFPB believes they have the authority under the Dodd-Frank Act to regulate nonbanks who cause consumers harm.

CFPB's initial digital asset guidance

To understand the evolving role of the CFPB's oversight of nonbank digital asset activities, it is important to start at the beginning of the CFPB's involvement in regulating digital assets.

August 11, 2014 was the CFPB's first foray into digital assets through a bulletin cleverly titled "CFPB Warns Consumers About Bitcoin," in which the CFPB warned consumers about the risk associated with bitcoin.[2]

Specifically, the bulletin advises the public that "consumers are stepping into the Wild West when they engage in the market" and centers on three significant risks: (1) exchange rates are volatile and costs unclear; (2) hackers and scammers pose serious security threats; and (3) companies may not offer help or refunds for lost or stolen funds.

The August 2014 bulletin refers to the infamous Dogecoin, a digital asset that may offer more entertainment than usability, and the collapse of Mt. Gox, which marked one of the first major collapses of a crypto exchange. The CFPB also announced they would begin collecting complaints regarding digital assets.

Why did the CFPB issue this bulletin? Was it because of the Mt. Gox incident? Was it because the first Non-Fungible Token (NFT) launched in May 2014 and everyone was shocked people would pay to own jpgs?[3] No. The August 2014 bulletin occurred as a result of the Government Accountability Office's May 2014 report on virtual currencies, which recommended that the CFPB take a greater role in participating in interagency working groups concerning virtual currencies.[4]

Following the 2014 bulletins, the CFPB was silent on digital assets for five years until August 2019, when the CFPB released a handout simply titled "Virtual Valuables?" (the Handout).[5] However, to describe the Handout as being targeted at crypto currencies or other virtual assets that are associated, today, as "digital assets" may be giving too much credit to the Handout.

The Handout does use the term "digital assets" but the content provided common sense advice for a consumer's "digital footprint." "Digital assets" in the context of the Handout included valuable or significant items on consumers' electronic devices, like "funds in your PayPal account or the downloadable PDF of your tax return."

So, not exactly "crypto" related, but much of the practical advice in the Handout could apply to digital assets like bitcoin, ether, dogecoin, NFTs, etc. The advice provided for taking inventory of your digital assets, using a password, considering estate planning, and creating a plan (e.g., a will) to pass your digital assets on when you inevitably leave this world (apologies for the grim reminder).

With the release of the May 2022 enforcement memorandum, the CFPB positioned itself to become a meaningful regulator in the digital asset world.

The CFPB was quiet, again, until November 2021 when the newly appointed CFPB Director Rohit Chopra mapped out three digital asset related policy initiatives for the CFPB moving forward:

(1) requesting comment on, and examining, the role of Big Tech in digital payment networks,

(2) monitoring the broader consumer adoption of cryptocurrencies, including monitoring for compliance with federal consumer financial protection laws; and

(3) engaging with other members of the Financial Stability Oversight Council to determine whether to initiate designation proceedings for certain nonbank crypto-related activities.

Early 2022: The CFPB sets the stage

The CFPB appears to be executing on Director Chopra's vision for the CFPB in the digital asset space. The difference in the digital asset market from 2017 to 2022 cannot be understated. The market had developed at a rapid pace, with much of the infrastructure and market players that you would typically see in existing securities and commodities markets being present by 2022. There were liquidity providers, brokers, dealers, exchanges and advisors.

On the other hand, some things never changed. The market had seen multiple booms and busts (e.g., NFTs had really taken off and were now beginning to crash), thousands of non-sensical tokens existed, the CFTC and SEC continued to try to find their digital asset swim lane, prudential bank regulators continued to weigh whether these financial technology companies engaged in digital asset activities should be issued novel or traditional banking charters, and financial technology companies continued to establish partnerships with banks and other financial institutions marketing digital assets products and services to consumers.

On April 25, 2022, the CFPB announced its intention to begin invoking its "dormant" statutory authority to examine nonbanks under Title X of the Dodd-Frank Act.[6]

In a proposed rule establishing procedures to implement certain provisions within Title X of the Dodd-Frank Act, the CFPB cited a broad catch-all provision of Title X that purports to permit the agency to examine:

(1) nonbank entities (e.g. mortgage and private loan companies),

(2) "larger participants" in other nonbank markets for consumer financial products and services, and

(3) nonbanks whose activities the CFPB has reasonable cause to determine pose risks to consumers.[7]

The implications here should not be missed or underappreciated. Liquidity providers, brokers, dealers, exchanges, advisors and many other market participants that transact in digital assets could fall into any of these three categories, depending on the size and scope of their activities.

The CFPB stated this authority gives them the ability when they have reasonable cause to examine nonbanks and use traditional enforcement methods to stop nonbanks from engaging in conduct that poses risks to consumers. The reasonable cause element may be based solely on complaints the CFPB collects.[8] By putting out the Bulletin, the CFPB has made clear it is preparing to actively exercise its once dormant Title X authority over nonbanks.

Less than a month after the April 25 bulletin, on May 17, 2022, the CFPB issued an enforcement memorandum in response to confusion among consumers over which, if any of the new financial technology companies (referred to in the Bulletin as Fintechs) were safe for consumers' money.[9]

Specifically, the CFPB was addressing those Fintechs which made deceptive representations related to the Federal Deposit Insurance Corporation (FDIC) or deposit insurance protections for consumers, which misled consumers into believing they were insured by the FDIC.

Many of these Fintechs, the CFPB claimed, lured consumers into purchasing digital assets, by materially misrepresenting their FDIC insured status. Material misrepresentations are a "deceptive" practice in violation of the Consumer Financial Protection Act (CFPA). The CFPB was starting to see their role and how it fit within the developing regulatory space regarding digital assets.

With the release of the May 2022 enforcement memorandum, the CFPB positioned itself to become a meaningful regulator in the digital asset world. The CFPB was now claiming authority to regulate nonbanks, and was using its authorities under Regulation DD (requires uniform disclosures for consumer deposit accounts), Regulation E (protects consumers engaging in electronic fund and remittance transfers), and the CFPA's unfair, deceptive or abusive acts or practices (UDAAP) authorities to issue enforcement orders against misrepresentations made by nonbank Fintechs.

Today: The CFPB begins to act

And then the collapse of FTX Trading, Ltd. (FTX) and its subsidiary Alameda Research LLC (Alameda) happened. This article will simply refer to the events surrounding FTX and Alameda as the "FTX saga" because the events are still playing out as this article goes to press.

The FTX saga is, in some ways, similar to what happened with Mt. Gox, Voyager Digital, and Celsius Network — digital assets disappear, a consumer's funds are lost, and the exchange claims bankruptcy.

However, the scale of the FTX saga is far, far greater than any past events. Immediately prior to its collapse, FTX held less than $1 billion in liquid assets against $9 billion in liabilities.[10]

Somewhere between $1 billion and $2 billion of FTX's customers' money is currently "missing," and this could be due to general credit risk associated with customer money deposited at FTX, but even if this is the case there appears to be fraud and mishandling of customer funds.[11] Some losses may be due to theft by hackers who stole Ether and maybe other digital assets held by FTX.[12]

How did FTX's downfall start? Very briefly, on November 2, 2022, reporter Ian Allison published an article that approximately $5.8 billion of the $14.6 billion in assets on Alameda's balance sheet were FTX's own exchange token, FTT.[13]

If that statement does not amaze you, understand this: One of the authors here could create Barrett-coin. Could even put it on a blockchain, and deposit one-million Barrett-coins into my account. However, if I convince one of the other authors to give me $1.25 for one Barrett-coin, no sane person would claim I (Barrett) am now a millionaire.

FTX did just that, but claimed they had almost $6 billion. Go big or go home?

From there, things began to deteriorate quickly. On November 9, 2022, Alameda's website went offline and they stopped trading.[14] At the same time, the SEC and CFTC reportedly began investigating whether FTX was mishandling customer funds through Alameda.[15] Binance (a competitor) offered to purchase FTX, but after looking at the balance sheet they backed out of plans to purchase FTX.[16] On November 11, 2022, FTX filed bankruptcy.[17]

Now, back to the CFPB. On November 10, 2022, just before FTX filed bankruptcy, the CFPB issued the Bulletin providing an analysis of digital asset complaints. No direct tie, or even mention of FTX or Alameda is in the nearly 50 page Bulletin, but the timing is unmistakable. The CFPB is watching what's happening. The CFPB **also** released its final changes to its nonbank supervision procedural rule.

The CFPB states in the Bulletin that they published this information because of the recent growth in complaints. The CFPB gives a statistic that the "majority of the more than 8,300 complaints" related to digital assets occurred during the time frame of October 2018 through September 2022. The greatest number of complaints apparently come from California. Interestingly, the volume of complaints increased when the price of bitcoin increased. The Bulletin actually only covers complaint data during the four year time period between October 2018 and September 2022, which leaves out two years and could skew any of the CFPB's conclusions.

November 2022 Bulletin: the data

With the CFPB's collection of complaints, they allege that "taken together, issues commonly identified in these complaints strongly suggest that consumers are at risk when seeking to acquire or transact with crypto-assets." Although the statement may appear obvious, some context should also be considered. Specifically, this statement is based on 8,300 complaints during a four year period during which there were 99,049 complaints related to mortgages; 112,049 complaints related to checking or savings accounts; 130,199 complaints related to credit cards or prepaid cards; 232,064 complaints related to debt collection, and 1,250,304 complaints related to credit reporting, credit repair services, or other personal consumer reports.[18] In this context, the CFPB could be viewed as using a very small set of data to justify its actions, but these markets are of all sizes and given the large retail presence in the digital assets space, some role for the CFPB should be expected.

The CFPB is joining other federal banking regulators in purporting to expand federal oversight over nonbanks engaged in financial services.

According to the Bulletin, the top complaint they receive on digital assets is fraud related and the number appears to be growing. The other complaint categories in order of volume received were: transaction issues, money was not available when promised, other service problem, wrong amount charged or received, confusing or missing disclosures, and unexpected or other fees. The CFPB calls out the very timely matter of consumer complaints concerning frozen accounts, platform bankruptcies, and the losses consumers ultimately have because of those unfortunate events. Mainstream platforms that have either frozen accounts or declared bankruptcy include: Mt. Gox, Voyager Digital, Celsius, CoinFLEX, Babel Finance, FTX, and more recently BlockFi.

According to the Bulletin, certain vulnerable populations are also at heightened risk for scams and abuse, such as younger populations, servicemembers, older consumers and Black and Latinx communities.

To be clear, the Bulletin is not just a warning to consumers. As noted above, one of the prongs that the CFPB must satisfy to make a determination to exercise its supervisory authority over a nonbank entity under the CFPA is that the nonbank is engaging in activity that poses risks to consumers. The compilation of customer complaints and conclusion that consumers are at risk when engaging in digital asset activities is the CFPB making the argument that just about any digital asset activity offered by a nonbank will satisfy that test.

In doing so, the CFPB is joining other federal banking regulators in purporting to expand federal oversight over nonbanks engaged in financial services. For example, the Acting Comptroller of the Currency recently announced an enhanced focus on bank-nonbank partnerships being undertaken by the OCC, and the OCC, Federal Deposit Insurance Company and Federal Reserve are also working on updates to interagency supervisory guidance regarding nonbank partnerships.

With the news events swirling around FTX, it is likely that this matter receives a great deal of attention from the CFPB in the coming months.

Takeaways for certain market players

"Big Tech" companies like Facebook, YouTube, and Instagram should take careful note of the CFPB's Bulletin and other actions to-date. The CFPB already made it clear that Big Tech's involvement in the payments space was an area of interest (having sent requests for information to many of them in late 2021).[19]

The industry should get used to the idea of the CFPB being a regulatory player in the digital asset world alongside the SEC, CFTC, state banking authorities and prudential banking authorities.

In context of Big Tech, the Bulletin states that most consumer complaints regarding digital assets originate through advertisements on social media platforms. Remember, the CFPB is now claiming and warning it will exercise authority over nonbanks where it has reasonable cause to determine consumers are at risk. And, reasonable cause can be based on complaints received by the CFPB.

Big Tech is also a frequent target of CFPB Director Rohit Chopra. When Director Chopra was at the Federal Trade Commission ("FTC"), he issued dissenting statements against the FTC's $5 billion fine against Facebook for violations of consumer privacy matters[20] and Zoom's settlement setting up a $43,280 fine per violation over allegations they misled customers about certain privacy protections.[21]

Big Tech is not the only market players who may wish to pause and reevaluate regulatory risks on the horizon. Traditional finance companies are not out of the scope of the CFPB's ire. The CFPB provides analysis in its Bulletin related to digital assets offered through consumer credit products such as credit, debit, and prepaid cards that offer rewards in digital assets and through digital asset person-to-person payments. Complaints allege that consumers' digital asset rewards cards are frequently declined, consumers never received their digital asset rewards, or that they cannot close the credit card because they need to reach out to a third-party bank.

Next steps for consumers and investors

Despite the mounting complaints concerning digital assets, many will continue to view digital assets as a sensible investment **so long as** investors conduct sufficient due diligence– just like you should with any investment. The CFPB's complaints from consumers predominantly center on bad actors in a very loosely regulated space. Imagine if the people stopped trading equities because of Bernie Madoff. The underlying assets are frequently viable, but an improved level of scrutiny should be applied to the market participants that interact with consumers and otherwise facilitate transactions in the digital assets market for or on behalf of consumers.

Next steps for institutions marketing and selling digital assets

Step one is making sure your complaint management program is working to track and resolve complaints received from consumers and regulators in a timely and compliant manner. Poor complaint management is low hanging fruit for regulators and one the CFPB has plenty of actual and real time data on.

The second step is looking internally at your organization's is customer service function. This review should consider how responsive your customer service team at managing is the everyday issues that occur with digital assets, how clear terms and conditions, as well as other disclosures, are in regards to explaining to customers what they have agreed to. The Bulletin's insistence on poor customer service as a cause for different types of fraud and scams that impact consumers of digital assets cannot be ignored.

The third step is joining the conversation around appropriate regulation. Institutions need to coordinate with trade groups and peers to lobby for safe and efficient regulation that protects consumers and ensures the continued marketability of digital assets. Institutions in the digital assets space should welcome smart and workable regulation, it provides legitimacy and helps protect the market from bad actors that would be deterred by regulatory oversight.

Conclusion

The industry should get used to the idea of the CFPB being a regulatory player in the digital asset world alongside the SEC, CFTC, state banking authorities and prudential banking authorities. The Bulletin and updates to its authorities over nonbanks is the CFPB clearly stating that it is prepared to use the CFPA to exercise supervision over the activities of nonbanks in the digital asset space.

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Notes

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This article was first published on Westlaw Today on November 22, 2022.