To Be Argued By:
Pierre Ciric
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New York Supreme Court

APPELLATE DIVISION — FIRST DEPARTMENT

Cal. No. 2018-998

THEO CHINO and CHINO LTD,

Plaintiffs-Petitioners-Appellants,

against

THE NEW YORK DEPARTMENT OF FINANCIAL SERVICES and MARIA T. VULLO, in her official Capacity as the Superintendent of the New York Department of Financial Services,

Defendants-Respondents-Respondents.

REPLY BRIEF FOR PLAINTIFFS-PETITIONERS-APPELLANTS

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PRELIMINARY STATEMENT

Theo Chino and Chino LTD (collectively, "Appellants"), submit this brief in reply to respondents', the New York Department of Financial Services ("DFS"), Anthony J. Albanese, in his official capacity as Superintendent of DFS, and Maria T. Vullo, in her official capacity as Superintendent of DFS (collectively "Respondents"), opposition brief filed on January 9, 2019.[1]

Respondents misdirect the Court with a variety of arguments based on the alleged poor quality of Appellants' initial application for a license required under DFS's Virtual Currency Regulation, 23 New York Codes, Rules and Regulations ("NYCRR") §§ 200.1-200.22 (the "Regulation"). The quality of Appellants' application is not the issue because Appellants are not challenging DFS's determination about the application. Instead, *inter alia*, Appellants challenge Respondents' statutory power to promulgate the Regulation, as well as Respondents' various constitutional violations in doing so.

The issues before the Court are two-fold: (1) Appellants standing to challenge the Regulation under New York Civil Practice Law and Rules ("CPLR") Article 78; and (2) Appellants' Motion for Limited Discovery.

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[1] Hereinafter, Appellants' Opening Brief is referred to as "Opening Br." Hereinafter, Respondents' opposition brief is referred to as "Response Br." Hereinafter, the Record on Appeal is cited to as A. Hereinafter, the Supplemental Record on Appeal is cited to as SR.

Appellants have standing to challenge the Regulation on statutory and constitutional grounds because they have extensively and repeatedly established both below and before this Court that their business activities are subject to the Regulation and they have suffered an injury in fact. (A44-48; A62-128; A203-208; A254-259; A369-371; Opening Br. at 17-22).

The Court should reverse the decision below on the basis of the critical, legal exception to the exhaustion of administrative remedies requirement, which allows injured parties to challenge an executive agency's abuse of its statutory authority without having to go through the futile administrative completion process. Further, the Court should reverse the decision below to allow Appellants limited discovery because the Supreme Court will need the requested material and testimony to make the appropriate analysis regarding the economic nature of Bitcoin.

ARGUMENT

POINT I. Appellants Have Standing to Challenge the Regulation Under the Exceptions to the Exhaustion of Administrative Remedies Requirement

Appellants' application to DFS under the Regulation and its purported deficiencies are irrelevant to Appellants' standing to challenge Respondents' actions in abusing its statutory power. The issue is Appellants' standing, under the

exceptions to the exhaustion of administrative remedies rule, to challenge Respondents' Regulation, which was created without statutory authority and in violation of constitutional rights. (A48-58). *See also Watergate II Apts. v. Buffalo Sewer Auth.*, 46 N.Y.2d 52, 57 (1978).

Respondents conceded Appellants filed their challenge before Appellants' application was returned. (Response Br. at 16). The record clearly indicates Appellants are challenging, *inter alia*, DFS's statutory and constitutional authority to promulgate the Regulation, rather than DFS's individual determination as to Appellants' application. (A26-27; A29; A202: A209-217; A219-221; SR394: SR398).

Respondents inaccurately use DFS's legislative history and repeatedly allege Appellants failed to establish standing, by using irrelevant exemption examples from the Regulation, such as coffee shops and software disseminators. Appellants' business is neither of those things. (A255). Rather, Appellants offer a Bitcoin exchange service, that would allow customers to pay for things like a gallon of milk in Bitcoin instead of with cash or a credit card. (A255). Appellants established they were "storing, holding, and maintaining custody and control of Bitcoins" on behalf of third-parties, and converting Bitcoin to cash on behalf of third-parties. (A256). While the Regulation exemptions may apply to the third-parties, in this case the bodegas, it does not apply to Appellants themselves. The

inapplicability of the Regulation's exemptions is due to the fact Appellants did not accept Bitcoins as a merchant, under 23 NYCRR § 200.3(c)(2). Rather, Appellants held Bitcoins on behalf of a merchant and converted them into cash, making their activities subject to the license requirement. (A206; A255-256).

Respondents argue they are surprised at arguments involving the exceptions to the exhaustion rule, stating these arguments were never presented beforehand. (Response Br. at 22). Yet at the same time, Respondents acknowledge Appellants' amended petition includes causes of action that the Regulation violates a separation of powers, and a violation of federal and state free speech protections, which on their face, clearly fit within the framework for exceptions to the exhaustion rule. (Response Br. at 16-27; A26; A27: A49).

On numerous occasions, Appellants raised other relevant facts supporting their arguments, which comingle with the exceptions to the exhaustion rule. (A202; A209-217; A219-221; A271; A297-298; A300-302; A310-311; A372-373; A375-376; A378, SR394, SR 398), These pleadings and motion papers are to be afforded liberal construction and plaintiffs are to be accorded "the benefit of every possible favorable inference, and determine only whether the facts as alleged fit within any cognizable legal theory." *Leon v. Martinez*, 84 N.Y.2d 83, 87-88 (1994) (*citing Monroe v. Monroe*, 50 N.Y.2d 481, 484 (1980); *Rovello v. Orofino Realty Co.*, 40 N.Y.2d 633, 634 (1976)). Based on the number of times relevant facts related to

the exceptions to the exhaustion rule were raised, and indeed acknowledged by Respondents, there clearly is a cognizable legal theory that Appellants have exceptions to the exhaustion rule.

Furthermore, while the exceptions to the exhaustion rule was directly raised for the first time during oral arguments, Appellants properly objected to Justice Carmen Victoria St. George's remarks regarding the exhaustion requirements. (A394; A398). These objections are preserved under CPLR § 5501. As long as an objection is sufficiently precise to serve as an alert to the court, the issue is considered preserved for the record. *Clarke v. NY City Tr. Auth.*, 174 A.D.2d 268, 276 (1st Dep't 1992) (*citing Kulak v. Nationwide Mut. Ins. Co.*, 40 N.Y.2d 140, 145-146 (1976)).

In light of the case law, facts in the record, and oral arguments, Respondents' arguments that exceptions to the exhaustion rule are being raised for the first time sound hollow.

The exceptions to the exhaustion rule do not require that a party be aggrieved by a final agency action, as Respondents claim, as such a requirement would defeat the point of the exception outlined by the Court of Appeals in *Watergate II Apts*. (*See* Response Br. at 23). Respondents cite *Abreu v. New York City Police Dept.*, 182 A.D.2d 414, 414 (1st Dep't 1992), for this proposition, but the facts of *Abreu* belie this argument. *Abreu* was not a case challenging an

administrative rule under CPLR Article 78, but instead involved a party attempting to mitigate damages from police closure of a business operating illegal gambling operation. *See Id*. The aggrieved party in *Abreu* did not raise exceptions to the exhaustion rule, nor was it part of the Court's analysis in its decision. *See Id.*

Among the four exceptions to the exhaustion rule argued by Appellants' is that DFS acted wholly beyond its grant of power. (Opening Br. at 12-14). Respondents go to great lengths to assert they were given broad power from the New York Legislature ("Legislature") to effect the Regulation. (Response Br. at 4-12 and 25-26). The reality is quite different.

In 2011, three years after the 2008 financial crisis, Governor Cuomo, to protect New Yorkers from misdeeds of the financial industry, announced legislation creating DFS. Andrew Cuomo, Governor, New York State, Annual Message State of New York: New York at a Crossroads, a Transformation Plan for a New York at 22 (Jan. 5, 2011) (available at https://www.governor.ny.gov/sites/governor.ny.gov/files/archive/assets/documents/SOS2011.pdf).[2] Specifically, Governor Cuomo stated, "a primary mission of this new agency will be to stand up for consumers, protect them against predatory lending and unlawful foreclosure practices, and provide access to good, honest and

[2] Previously cited at A175.

capable financial services at competitive rates." *Id.*

The Governor's focus was the financial institutions and their activities, which drove the system to the edge of the cliff in 2008. *Id.* Governor Cuomo stated:

> "The newly formed department will merge the Insurance Department, Banking Department and the Consumer Protection Board, and will be capable of regulating modern financial services organizations. A primary mission of this new agency will be to stand up for consumers, protect them against predatory lending and unlawful foreclosure practices, and provide access to good, honest and capable financial services at competitive rates."
>
> *Id*.

Nowhere in Governor Cuomo's outline for DFS was there a reference to virtual currencies or modifying the statutory definition of the financial products covered by this legislation *Id.*

By the time the legislation creating DFS was signed, Bitcoin had already been invented in 2008. Andreas M. Antonopoulos, MASTERING BITCOIN: UNLOCKING DIGITAL CRYPTOCURRENCIES (2014).[3] But the Legislature only gave DFS the authority to "supervise the business of, and the persons providing, financial products and services" in New York. Financial Services Law ("FSL") §

[3] Previously cited at A29.

201(a). The Legislature never extended the new department's authority to regulate virtual currencies. (A209; A216-217; A221).

The lack of authority for DFS to regulate virtual currencies is also illustrated by the Legislature's creation and vote on New York Assembly Bill A08783 and Governor Cuomo signing the bill into law on December 21, 2018. 2018 N.Y. ALS 456, 2018 N.Y. Laws 456, 2018 N.Y. Ch. 456, 2017 N.Y. AB 8783. New York Assembly Bill A08783 titled "An act to establish the digital currency task force; and proving the repeal of such provisions upon expiration thereof" is the Legislature's foray into investigating the uses of virtual currencies in the state. The enactment of New York Assembly Bill A08783 clearly indicates DFS does not have the broad power to regulate virtual currencies as it vociferously has claimed, and strengthens Appellants' position that Respondents overstepped their grant of power and underlying purpose. *See Greater N.Y. Taxi Assn. v. N.Y.C. Taxi & Limousine Commn.*, 25 N.Y.3d 600, 608 (2015) (*See also* Opening Br. at 13-14).

While the Court has discretion to determine if a party may be relieved of the requirement to exhaust administrative remedies before proceeding with an action, Appellants outlined that they qualify for all four exceptions to the exhaustion rule. (Response Br. at 25-26 *c.f.* Opening Br. at 12-17). Indeed, should the Court require more evidence to properly determine Appellants' exceptions, as part of the Court's discretion, the record could be further developed upon remand to the Court below.

Matter of People Care Inc. v. City of N.Y. Human Resources Admin., 89 A.D.3d 515, 516 (1st Dep't 2011).

Additionally, Respondents repeatedly allege Appellants have no injury in fact. It is Respondents' stance that no injury can be incurred without Appellants following the Regulation in some manner, either by completion of a DFS application or explaining how an exception to the Regulation would or would not apply to Appellants. (Response Br. at 26-31). Respondents, and the Court below, have misapprehended how an injury in fact is to be determined in this instance.

A party does not have to prove harm with extreme specificity to suffer an injury in fact. *Police Benevolent Assn. of N.Y. State Troopers, Inc. v. Div. of N.Y. State Police*, 29 A.D.3d 68, 70 (3rd Dep't 2006); *N.Y. Propane Gas Assn. v. N.Y. State Dept. of State*, 17 A.D.3d 915, 916 (3rd Dep't 2005). As previously outlined, Appellants' injuries are not merely the financial ones demonstrated in tax filings they voluntarily provided, but also enunciated in the required ongoing expenses mandated by the Regulation. (Opening Br. at 19-21). To follow Respondents' logic that an injury can only be established after complying with an agency regulation, would create a catch-22 for all challengers of administrative regulations and essentially void all the exceptions to the exhaustion rule.

Therefore, this Court should reverse the Supreme Court's decision, and hold that Appellants meet the exemptions to the exhaustion rule and suffered an injury in fact, thus have standing to bring their action.

POINT II. Discovery is Justified if The Court Finds Appellants Have Standing

While Appellants and Respondents agree on the legal standard necessary to grant a limited discovery request in Article 78 proceedings, Appellants contest Respondents' factual assumptions as to whether the discovery request is "material and necessary" and justified by "ample need." (Opening Br. at 22-23; Response Br. 33). Respondents erroneously argue their process was completely transparent and that all relevant materials DFS utilized in the promulgation of the Regulation was made publicly available. (A138; A271; A274-286).

Appellants specifically seek materials explaining the contradiction between DFS's justification of the Regulation and the public record produced by Respondents during hearings they conducted. (A310). During hearings held by DFS on the topic of virtual currency on January 28 and January 29, 2014 in New York City (the "Hearings"), the only relevant testimony as to the economic nature of virtual currencies established that Bitcoin was not a financial product, but rather that it had all the characteristics of a commodity. (A304-305). The hearings provided no guidance or support as to how Respondents based their economic

definition of Bitcoin in order to establish it as a "financial product or service." (A304-305). As such, Respondents must have operated internally, by either obtaining additional information or somehow erroneously concluding the economic nature of Bitcoin would fit the statutory definition of a "financial product or service." It is these internal records Appellants seek. (A307-313).

The limited records under the control of Respondents pertaining to these internal discussions will reveal what data they relied on to determine the economic nature of Bitcoin and draw their conclusions they could regulate it before enacting the Regulation. Either those records do not exist, meaning Respondents promulgated a Regulation beyond DFS's regulatory authority, and certainly in an arbitrary and capricious fashion, or the records do exist and Respondents have an obligation to make those records public.

Despite Respondents' claim, Appellants have shown the materials publically available are clearly insufficient and do not provide a rational basis for the Regulation. (A309-A313). The public at large, and the technology industry in particular, are owed transparency as to how Respondents made a determination that triggered one of the most devastating virtual currency regulations in the country and in the word.

Additionally, Appellants, through their carefully tailored discovery request, are only seeking those materials under DFS's custody that have not been made

public. For example, DFS claimed there is "extensive research and analysis" in its statement of needs and benefits supporting the Regulation. (A304-306). Jim Harper, while servicing as Global Policy Counsel at the Bitcoin Foundation, requested this information along with other information under the New York Freedom of Information Law, but to date DFS has never provided this "extensive research and analysis." (A305-306).

Further, Appellants seek information from Benjamin Lawsky, who was the DFS Superintendent at the time of the proposal and subsequent promulgation of the Regulation. (A312). Mr. Lawsky has exclusive personal knowledge not shared with the public or Appellants about the basis of Respondents' determination of the economic attributes and nature of Bitcoin. (A311). He is the most knowledgeable person as to how the ultimate decision on this issue was made. (A312). Non-party witnesses are allowed under New York's liberal discovery policy, especially when they possess material and necessary information. *Matter of Kapon v. Koch*, 23 N.Y.3d 32, 38 (2014).

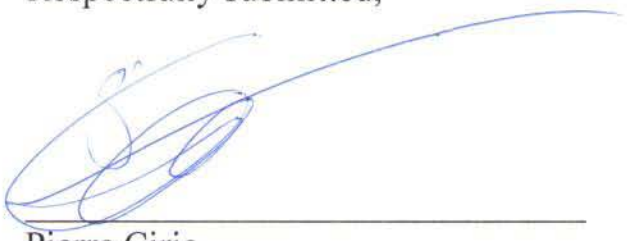
CONCLUSION

The Court needs to reverse the decision below to preserve the critical exception to the exhaustion of administrative remedies requirement allowing injured parties to challenge an agency's abuse of its statutory authority to regulate innovative industries. Therefore, for all of the reasons detailed herein and in

Appellants' brief, the Supreme Court's decision, order and judgment should be reversed both as to the cross-motion to dismiss and cross-motion for limited discovery, and remanded to the Supreme Court for further proceedings.

Dated: January 18, 2019
New York, New York

Respectfully submitted,



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