The Crypto Exchange: Will Resiliency Carry the Digital Asset Sector Through 2024: Navigating the 2023 Regulatory Landscape

Speakers: Ethan Ostroff, Addison Morgan, Trey Smith

Ethan Ostroff:

Welcome to another episode of *The Crypto Exchange*, a Troutman Pepper Podcast, focusing on the world of digital assets. As long-time leaders in the intersecting worlds of law, business and government regulations, our lawyers can go beyond the buzzwords and headlines to make sense of the emerging legal and regulatory frameworks for operating in the digital asset industry.

I'm Ethan Ostroff, the host of the podcast, and a partner here at Troutman Pepper. Before we jump into today's episode, let me remind you to visit and subscribe to our blogs, consumerfinancialserviceslawmonitor.com and troutmanpepperfinancialservices.com. Don't forget to check out our other podcasts on troutman.com/podcast. We have episodes to focus on trends that drive the payments industry, consumer financial services, the Fair Credit Reporting Act and more. Make sure to subscribe to hear the latest episodes.

Today I'm joined by my colleagues, Addison Morgan, and Trey Smith for part one of our multipart 2023 digital assets and distributed ledger technology year in review series. Today, we'll be focusing on some of the notable regulatory events that occurred on the federal level, affecting the digital asset industry during 2023. Specifically, today, focusing on some activities by the Federal Reserve Board, the FDIC, the OCC, and finally talking a little bit about FinCEN.

Addison and Trey, thank you so much for joining us. We have a lot of ground to cover today, so thought we'd jump right in. I guess, at high level compared to 2022, 2023 was a little bit of a, to some extent, a tamer year. There were a lot of significant negative activities in 2022, the proverbial crypto winter. Then we saw some of these activities, or some of these things happen in 2022 certainly spill over and are still ongoing throughout 2023. But in particular, federal regulators taking certain steps and actions in an attempt to address some of the negative outcomes in 2022 in the beginning in early 2023. Want to get you guy's sort of high-level thoughts on that.

Addison Morgan:

Sure. I think that decrease consumer harm that we've seen in 2023 is really just a byproduct of the current state of the market we're in right now. Like you just alluded to, Ethan. I would say, in November of 2022, Bitcoin was trading around 15,000, and I think that's when we enter the proverbial crypto winter. I think as an everyday consumer, ironically, digital assets are unappealing in a bear market. Less volatility, less value – transaction volumes, things are not moving up and down sporadically across the market class. In that, consumers lose interest, and so there are less opportunities for consumers to be harmed.

I also think that in a bull market where things are approaching all-time highs, I think co-founders, developers, all individuals involved are in emotional states that may drive them to make decisions that they may otherwise not make. But the money is there, the volume is there. For example, a case like Terra Luna, or FTX, where we're saying one thing for the consumers, but we know, objectively, that these things are not actually happening behind closed doors. And the drive, desire, greed for money compels us to do things that we otherwise may not do. So you know, none of those variables are really present right now, although we're definitely moving to the precipice of a bull market right now.

Trey Smith:

Yes. Addison, I'd agree with that. With the crash of FTX, and the crash of Terra Luna in late 2022, we saw severe harm to the market, both in terms of the industry and to consumers as a whole. But I think in the year since then, the year plus since then, it's led to a lot of positive growth. First, we've seen that the industry is resilient. I was able to withstand fraud, outright malfeasance, and just other unregulated practices by bad actors. But those actors were primarily taking advantage of consumer ignorance and not actually denigrating any of the cryptocurrency networks themselves, at least the major ones.

But I think that the harms caused by the 2022 collapse also, so to speak, put cryptocurrencies back on regulator's maps in a meaningful way. They saw that, while the crashes didn't necessarily harm the banking industry on a wide scale, sort of like the 2008 Great Recession. They did notice that the harm or the potential for significant harm was there. So, those sorts of cataclysmic events gave rise to the opportunity for regulators to start thinking meaningfully about just how to regulate this technology and what that would look like. And has sparked them to sort of go on an information-seeking path in hopes of ultimately promulgating regulations from a place of information and from a place of being informed. We're starting to see those efforts burgeon, and hopefully materialized into some actual concrete regulation that in turn can allow the industry to expand.

Ethan Ostroff:

Super helpful insights, guys. I think that helps us sort of lead into our first topic that we wanted to cover today, which is talking a little bit about what the federal banking regulators did in 2022. The Office of the Comptroller of the Currency, Federal Deposit Insurance Corporation, and the Federal Reserve Board of Governors, and how they went about, right after the new year in 2023, trying to take steps to address what they were concerned about in the digital asset space. Thought we first might talk, Addison, about the joint statement issued by those three regulators on crypto asset risks to banking organizations. I believe that came out on January 3rd, 2023. What were your thoughts about the Feds initial safety, soundness concerns regarding the digital asset integration into the traditional financial system?

Addison Morgan:

I mean, at a high level, I mean, I think they are – the Fed's concern is definitely warranted, and we're going to speak about the liquidity risks that stemmed from or can possibly stem from the integration of the digital financial services industry into traditional banking system. But as you noted, Ethan, this first joint statement by the OCC, FDIC, and the Fed, it comes approximately three months after FTX's collapse in November of 2022. I think that one of the major catalysts of this joint statement was likely signature banks kind of involvement, and facilitating transactions on behalf of FTX. Not only FTX, central bank had a very large commercial client base that involved a number of digital asset-related entities. From crypto exchanges to custodial providers, et cetera, et cetera.

I think due to Signature Bank's closing, which was propelled primarily due to the fact that they had a very large deposit base that was based primarily on digital assets. At the beginning of the bear market, when these entities, and the market at whole is now extracting value from the market and going elsewhere. Everybody's going risk off. Signature Bank was left with basically nothing. It became very difficult for them to meet their deposit requests, and in that, they eventually become default. I think the Fed's concern is warranted. I also have somewhat of a contrarian opinion, because you have to see both sides of the coin. But I think the Fed's concerns is warranted, but due to the quick pace in which digital assets allow for permit instantaneous settlement.

I think that, although this statement came out, the Fed will, really, will have to look back at the reserve requirements for some of these national banks who are members of the Federal Reserve. Right now, that reserve requirement is zero. In a non-fractional banking system, where technically you're not required to hold any cash on hand, to meet the deposits, or deposit requests of your customers, that might have to change in an environment where everything is 24/7. I can send a payment to someone at the snap of a finger. I think that just might have to be reevaluated moving forward to mitigate some of the liquidity impacts that can come about in a system like DLT.

Ethan Ostroff:

The joint statement, if I remember correctly, it was focused on trying to maintain a clear line of separation between the digital asset world, and traditional US banking system. So from my perspective, the high-level takeaway was that, while these regulators were saying, "Hey, look, banking organizations are not prohibited or discouraged from providing any type of banking services to customers of any specific type or class." Nonetheless, these regulators were clear that they believed issuing or holding as principal crypto assets that are issued store to transfer on an open public, or decentralized network, or similar system is highly likely to be inconsistent with safe and sound banking practices. Effectively, they're saying, hands off.

Addison Morgan:

Agreed, yeah. That's exactly what they are saying. As I stated earlier, I think the catalysts for that perspective was the dissolution of Signature Bank. Signature Bank had that proprietary 24/7, real-time payment system called Signet, I believe. In which, it's basically a fiat on ramp, where your commercial clientele, they can leverage their large liquidity stores. So we're talking about hundreds of millions of dollars and convert existing fiat into cryptocurrency instantaneously.

I think you can see the Fed, the OCC, and the FDIC is concerned with that. The primary concern is just deposit inflows and outflows. In a traditional banking system, the banks are closed on weekends. And so, there might be methods by which you can still execute transactions over the weekend. But in terms of settlement, it becomes less likely, you can settle transactions in real time over the weekend, just due to the fact that those systems don't really operate. ACH doesn't operate on the weekend. Those transactions have to be settled on weekdays. I just think the Fed's primary concern is just the 24/7 nature.

Ethan Ostroff:

Okay. Then, so quickly after that, I mean, same month, just a few weeks later, the Fed comes out with its statement on Section 913 of the Federal Reserve Act, this policy statement. Where it's redirecting its attention from national banks, who are chartered and regulated by the OCC to state member banks. That statement revealed the adoption of a rebuttable presumption by the Fed that activities, a State Member bank may engage and are limited to only those activities that a national bank may engage in his principle. There's some carve out that we don't need to go into. But generally speaking, that was sort of the perspective, so they sort of doubled down to the state member banks. Is that who this statement was directed to? Is just simply closing that hole. or what did the policy statement establish with respect to digital asset related activities?

Addison Morgan:

Yeah. The statement is directed specifically to state member banks. A state member bank is a bank that has received his charter from some state agency, but has been approved to become a member of the Federal Reserve System. The state member bank has access to a master account with the Fed, can leverage Fed wire, ACH, et cetera. So yes, I mean, like you stated Ethan, Fed has adopted a rebuttable presumption, basically discloses the Fed's expectation that statement member banks examine OCC guidance and regulation to determine whether a given activity is permissible for national banks. The OCC supervises and regulates national banks and national banks are just those banks who received their charters from the OCC, as opposed to main charter at the state level.

Ethan Ostroff:

What should we be thinking about in the context of this rebuttable presumption mean? What does it really mean? For example, from the perspective of like, digital asset activities, are they exempted from this rebuttable presumption or they fall within it? How does that work?

Addison Morgan:

No. I mean, I think the Fed has characterized it as a rebuttable presumption. But in the policy statement, if you read it, the Fed clearly states that they have not identified any authority permitting national banks to hold most crypto assets, including Bitcoin and Ether. They also state, issuing tokens on an open public, and/or decentralized network is highly likely to be inconsistent with safe and sound banking practices. So, seemingly, it appears that state member banks basically have an insurmountable presumption to meet because the Fed has already indicated that there are no OCC regulations that permit national banks to hold digital assets as principal.

Basically, to engage in practice, that Signature Bank was engaging in, actually holding digital assets on its balance sheets. So that its commercial clientele can engage in these 24/7 365 transactions. But, you know that the core about earlier, and so it does note at the end of the policy statement, that while state member banks cannot engage in holding digital assets as principle, they can engage in kind of digital asset custodial practices. I think that carve out was placed there, because if you think about it, custodial services really don't implicate the same liquidity risks that acting as a real time payment transfer intermediary does. So, it's a nice carve out for the state member banks there, but it's just something to do to the lack of liquidity risks associated with that practice.

Ethan Ostroff:

Okay. Then, I guess, Trey, just a month later, the Fed, the OCC, and the FDIC come out with another joint statement right on liquidity risks to banking organizations, resulting from crypto asset market vulnerability. To me, this was sort of incomplete alignment with the policy statement, and highlighting the concern that a bank with a high concentration of demand deposits. Largely consisting of digital assets may be susceptible to heightened liquidity risks, as Addison and I have been talking about. So, do you have any thoughts about that and what we should be thinking about in the context of that liquidity statement?

Trey Smith:

You see, this statement largely tracking the risks, and that kind of led to the downfall of the crypto industry in 2022. They identified as practices that would be susceptible to risk as fraud, misrepresentations, legal uncertainty, risks around depositor funds, volatility, poor risk management, and so on, and so forth. I think, largely, it does come down to a question of risk management, whether a bank engages in collateralizing loans that are denominated in dollars with cryptocurrency. I mean, that's going to, to some degree, be inherently risky as an activity just because the asset class is new, and the valuations are subject to fluctuation.

If you have loans being collateralized with cryptocurrency, there is going to be some risk that if there's a price decrease that the loans would be under collateralized. On that side of issuing stablecoins and digital assets, I mean, we have seen frameworks where that can be a less risky activity. For example, in New York, regulations there allow issuers to issue stablecoin, so long as they are backed by appropriate US government reserves. I think it really just comes down to a risk management perspective. Banking is inherently a risky activity. Some activities are more risky than others, but it's going to be down to the individual banks, and hopefully with some additional guidance from the applicable regulators to sort of minimize that risk, and ensure that some guardrails are in place to prevent the worst-case scenarios from happening.

Ethan Ostroff:

Were there any specific risk management practices that federal banking regulators suggested that banks implement to mitigate these liquidity risks?

Trey Smith:

Their statement focus more so on the risks of liquidity based on the cryptocurrency practices that were in place. So it was more backward-looking and more focused on the sort of practices that could result in risks into banks. But I think that going forward, they've implemented some – they've discussed, or they typically discussed their novel program to supervise banks who are engaged in certain practices. I think that's sort of an information gathering exercise that's intended to sort of start collecting information on what kind of guard rails would be appropriate.

Ethan Ostroff:

It was interesting, I thought there was a flurry of activity in early 2023 like we've been talking about. The pause into the summertime, when we get this announcement that you mentioned about the creation of the Feds novel activity supervision program. Essentially, a supervisory risk assessment tool of the Fed, geared toward monitoring several activities engaged in by banks that are subject to the Fed's supervision. So, maybe you can explain a little bit to our listeners the functions of this program, if the adoption of this program by the Fed signals anything to the market.

Trey Smith:

Yes. You have the Fed's novel activity supervision program, you mentioned. The purpose behind that program was to make sure that these risks that we've been talking about, that are associated with innovative technology are appropriately being sort of managed and addressed. Those risks are specifically activities that relate to crypto assets: custody, collateralized lending, trading, sort of the activities we've been discussing to date. But the idea there is sort of that the Fed can supervise these activities within its normal bank supervision processes, in a way that will allow them to, like I mentioned earlier, sort of, ultimately develop that informed regulation in terms of kind of what does that – what does the creation of that program mean?

I don't think it necessarily amounts to a tacit approval of these activities. I do think it indicates that the Fed is interested in learning more about them. At the end of the day, this is unchartered waters in a large sense, decentralized ledger technologies, and these cryptocurrencies. The effect of implementing them on any sort of wide scale is still unknown. I think on one hand, the Fed is interested in innovating and innovation more generally, and exploring the potential of allowing banks to offer digital asset related services. But I think, perhaps more importantly, their own sort of truth-seeking excursion of their own to just kind of learn more about what exactly, what sort of practices these banks are engaged in, what it looks like, and the broader risks that engaging in those activities create.

Ethan Ostroff:

Perhaps in implicit acknowledgement that the Fed has been asleep at the proverbial wheel for a decade, or decade and a half, where banks subject to their supervision have been progressively dipping their proverbial toes further, further into the digital asset waters. And perhaps, the Fed was caught flat footed with some of the failures and collapses at the end of 2022. I mean, would you agree with that?

Trey Smith:

I would certainly agree with that. A lot of what happened in late 2022 was the result of a regulatory vacuum. And in the absence of clear guidance, various actors sort of took advantage and push the limits. Without that supervision, and without that clear guidance, whether knowingly or unknowingly, risks were taken and losses were incurred. So now, the regulators are certainly playing catch up, and trying to figure out just exactly how the technology works and what the risks factors are.

Ethan Ostroff:

Sure. Sure. Interestingly, that same day that we got the announcement about the creation of the Fed's novel activities supervision program. Addison, we also got an expansion by the Fed, honest discussion of the permissible state member bank activities that was originally talked about in that policy statement we discussed previously. And issued a supervisory non-objection process for state member bank seeking to engage in certain activities involving dollar tokens, or what we might call the dollar token statement. Could you talk a little bit to our listeners about this guidance document, and what we think the Fed was trying to clarify for state member banks?

Addison Morgan:

Sure. Like you noted, Ethan, this is essentially a triple down on the policy statement we discussed earlier. In here, in this dollar token statement, the Fed is really, really just expounding on what state member banks decide what activities they can engage in, that involve stablecoins. As we noted earlier, under the policy statement, state member banks can engage in any activity that a national bank can engage in. One of the primary points of this dollar token statement is to reiterate that back in 2021, OCC released the interpretive letter 1174. In that letter, the OCC recognize that national banks may use stablecoins to perform bank permissible functions such as payment activities.

So, in this dollar token statement, the Fed is saying just that. Because national banks can engage in stablecoin-related activities, so can state member banks. However, there's a caveat, because to engage in these stablecoin-related activities, a state member bank must perform certain tasks first. So providing notice to its lead supervisory point of contact at the Fed, of the bank's intention to engage in the stablecoin-related activity, describe the stablecoin-related activity, the bank intends to engage in. Then, the bank must also demonstrate that it has established appropriate risk management practices, like Trey was discussing earlier, for the proposed stablecoin-related activity.

Ethan Ostroff:

So effectively, six months or so, after issuing its earlier statement about state member banks, when the activities they are and are not permitted to take. They finally sort of acknowledged, wait, we understand that there are entities in the space who are engaged in stablecoin-related activity. Effectively, they're saying, "We're not saying you can't do it, but you got to tell us about it. You got to disclose a whole bunch stuff here. Tell us here, tell other people and you got to make sure we're okay with this, so that we don't get caught flat footed not understanding that all the scope of the activities you're performing." Is that effectively what we have here?

Addison Morgan:

I think that's right, Ethan. Like you noted earlier, the Fed may have been asleep at the wheel, because this interpretive statement or interpretive letter by the OCC, it was published in 2021, well before kind of cataclysmic events that occurred in the digital asset industry towards the latter half of 2022. That document has always been at the Fed's disposal. But I think, certain things had to transpire. Consumer harm had to be inflicted before the Fed really looking at the space with a magnifying glass, and trying to determine how they can foster innovation and technological evolution. But also maintain the safety and soundness principles that have always been prevalent in the banking system.

Ethan Ostroff:

Got you. So then, Addison, we get about a month and a half or so later, end of September, the Fed releases its final digital asset related publication of the year. And was examining a functionality of DLT that is likely going to play an important role in the years to come. Specifically, tokenization. Could you talk at high level a little bit for our listeners, just how is tokenization described by the Fed, some thoughts about how tokenization might enhance the digital asset industry? Then, what if anything is the Fed's primary concern with tokenization from a financial stability standpoint?

Addison Morgan:

Sure. We can begin with just discussing tokenization at the high level. I think that in order to understand tokenization and its potential benefits, I think we need to discuss fungibility as a concept. So, we all are aware of the various digital assets that exist in the ecosystem today, so Bitcoin, Ethereum, basically any ERC 20 token, but those are fungible tokens. If I want to send Ethan a Bitcoin, Ethan knows that one bitcoin equals one Bitcoin, right? They're fungible, these are interchangeable assets. On the other end of the spectrum, we also have non-fungible technology or non-fungible tokens. NFTs. Which had become a fad as of late.

I was talking to my sister the other day, she was like, why are NFT's so important? They're just like JPEG profile pics. I think, for a lot of people, that is the kind of fundamental perspective on that technology. I mean, it's really just there to display that you own something out. But in a sense, that is the technology. So non-fungible technology, especially on DLT-based system, it is a data structure or a form of data that cannot be replicated. So, in that. it is unique. If we think about other kind of things in our lives, that also provide some sort of unique ownership, whether it be a core title, whether it be a real estate title, whether it be your bank account, et cetera, et cetera. You can bring value off chain, bring it on chain, and have it represented by this unique digital structure of data that cannot be replicated.

In a sense, tokenization will just unlock a lot of value in illiquid markets that are being impaired by friction right now. That's basically what the Fed talked about, just bringing these "reference assets" that currently are not represented in a digital world, bringing them on chain. And in that, creating or filling voids of liquidity that otherwise would exist elsewhere. So, how may this kind of philosophy or concept of tokenization enhance the digital asset industry? I don't think it will enhance the digital asset industry, but I think it will serve as an antidote to some of the deficiencies currently in the traditional banking system, or traditional financial system at large.

Whether that be transaction friction. We talked about this earlier, if you want to send an ACH transaction, the banks are closed on the weekends, and so those transactions will not be on Saturday and Sundays.

So if you have a deal, you're trying to get done some sort of contract you're trying to finalize, no consideration can be facilitated on Saturday and Sunday. I think that tokenization amongst a variety of other things just solve that problem. The Fed's primary concern here, and one of my concerns as well, is that when you start to bring off chain assets, like gold, for example, you start to bring those things or bring data representations of those things on chain. There could be risks of runs on the issuers who are issuing kind of these tokenized assets. If I'm issuing tokenized gold to my customer base, which requires me, presumably so requires me to actually hold physical gold on my balance sheet to meet the redemption requests of these customers.

Well, if I'm open on the weekends for whatever reason, the market makers drive the price of that token down tremendously. And I can't meet the redemption requests of my consumers because the company itself is closed on the weekend, not the underlying system that is facilitating the transactions of the tokenized gold token. But the company that's responsible for redemptions, it's closed on the weekend. The company might show up Monday and see that, its prices in the drain. If this company also holds the tokenize gold token on their balance sheet, well, that asset has been eviscerated, or has any value due to the massive sell off that occurred over the weekend.

So, just like Silvergate Bank, that company might find it very hard to meet those redemption requests on the upcoming Monday. So the Fed is just really concerned, here we go again with the 24/7 nature of transaction and instantaneous nature of settlement in the DLT space, and how that may impact companies that are even involved with tokenization. I think that that is a very important consideration, and one that I don't believe the industry has really wrapped his hands around this idea of over and under collateralization. I think, Trey was discussing this point earlier, but that was the Fed's kind of primary concern when it comes to tokenization. But although, they didn't know, tokenization will likely be beneficial with respect to the traditional financial system moving forward.

Ethan Ostroff:

I appreciate that, Addison. I mean, I think tokenization is a huge topic in the traditional financial system right now, and how this is going to work with bringing real world assets on chain, and all of the potential risks and benefits of that. It seems like that is going to be a clear focus and of interest to both federal regulators and the industry, writ large in the near term. The final thing I think we wanted to touch on today was to talk about the Financial Crimes Enforcement Networks or FinCEN's Notice of Proposed Rulemaking regarding convertible virtual currency mixing.

This came out in the middle of October, and would require domestic financial institutions to conduct additional record keeping and reporting activities to monitor transactions that are reasonably suspected to involve convertible virtual currency mixing. So thought we might just talk a little bit about – maybe Addison, you could start us off. What is it about this Notice of Proposed Rulemaking that's unprecedented? How was CVC mixing defined by FinCEN? Maybe talk a little bit about how an actual CVC mixture functions in practice?

Addison Morgan:

Sure. So to answer your first question, this NPRM is unprecedented, because this is the first time ever that FinCEN has leveraged its authority under the Patriot Act. This authority allows FinCEN to designate class of transactions that are of a primary money laundering concern. Here, they have decided to designate basically any transaction involving CVC mixing as a transaction class that FinCEN has a primary money laundering concern. It's fascinating. But yes, that is why this NPRM is unprecedented.

Ethan Ostroff:

How does FinCEN define CVC mixing? Is there a difference between their way of defining it and how a CVC mixture functions in practice?

Addison Morgan:

Sure. FinCEN defines CVC mixing as the facilitation of CVC. CVC just stands for convertible virtual currency, so just another kind of proprietary definition of cryptocurrency in general. But it defines it as, CVC transactions in a manner that obfuscates the source, destination, or amount involved in one or more transactions. I think that's a solid definition, but it's probably best to just discuss very briefly, just the functionality, and what users, particularly the illicit actors, what they're trying to accomplish by using a cryptocurrency mixer. So, a DLT-based system is just an amplified accounting system, really no different than a bank's ledger, how the bank is monitoring your debits and credits. The same thing that a blockchain does.

But the difference between the two is that the blockchain transactions, once those transactions are finalized, there's a record in the form of a cryptid data that lives on that ledger, basically into perpetuity. So, when someone tries to, like I said, when illicit actor tries to or uses cryptocurrency mixer, what they're trying to do is sever the link between their digital wallet. So if I'm individual A, I'm sending Ethan $1,000 in USDC to Ethan's digital wallet. Once that transaction is finalized, there will be a store of encrypted data that contains three variables. The first variable; A, Addison sent 1000 USDC from his digital wallet, which is an address to Ethan's digital wallet. It will also contain the value of that transaction. Then lastly, it will show that Ethan was the recipient of that $1,000 in USDC.

What the users of the CVC mixes are trying to do, they're trying to sever that link between Addison and Ethan. In practice, a CVC mixer, usually, the illicit actor will send the 1000 USDC to a wallet address, and so this is the CVC mixer. So that will send it to like an omnibus account. So this account just contains a variety of – well, it contains USDC in this hypothetical. And it contains other people's USDC that has also been deposited in this very large omnibus account.

If Ethan wants to receive that 1000 USDC, Ethan will be provided deposit code or a withdrawal code, where now Ethan just uploads this withdrawal code to the omnibus account, and he will now receive the 1000 USDC. On the blockchain explorer, it was important because on the blockchain explorer, it'll just show that, hey, Addison sent 1000 USDC to this random smart contract that's not Ethan. On the back end, on Ethan's blockchain explorer, it will just show that Ethan withdrew 1000 USDC from this random smart contract address. So, in that, the link is now severed.

You can imagine why FinCEN would be concerned about this, because, if the links are severed, it becomes that much more difficult to determine who is doing what, where it's going where, and really, where's the illicit activity. As you know, Ethan, what OFAC and FinCEN ultimately had to do last year was just start blacklisting the smart contract addresses themselves. Instead of blacklisting particular users, or particular digital wallet addresses belonging to users, we'll just blacklist a smart contract. Anybody who has been involved in transactions involving this smart contract, your digital asset wallet is blacklisted, in a sense.

Ethan Ostroff:

Right. A significant impediment to FinCEN addressing and implementing anti-laundering, anti-money laundering, and preventing for countering terrorist financing. A huge issue not just for federal regulators, but a particular interest as we've seen over the past year of both parties in Congress. This idea that there has to be something done differently, to assist in the prevention of money laundering and terrorist financing. That seems to be at least from some people's perspective, seems to be a gap in the digital asset industry. Do you agree with that?

Addison Morgan:

I agree. I think DLT-based systems, it comes with a lot of gifts. But from a regulatory standpoint, it also comes equipped with a lot of curses, so to speak. I think this is one of the primary curses. There are reasons in which you may want to utilize a crypto mixer in a compliant way. Like I know some of the arguments that were made in a Tornado Cash case was that, certain individuals or were tried to send money anonymously to Ukraine. So they had altruistic motives, but just didn't want anyone knowing that they were helping out, and providing aid to Ukraine.

But on the flip side, there are a multitude of reasons where you could utilize a crypto mixer for illegal purposes. OFAC is So, always kind of mentioning the Lazarus group in their public releases with respect to crypto mixers, because that group is known for engaging in activities on the dark web, with respect to drug trafficking in a wide range of other incidents or other activities. And so, yes, I agree. I'm not sure how this will play out when it's all said and done. But I anticipate that FinCEN and OFAC will continue just to blacklist the crypto mixers themselves, as opposed to trying to pinpoint which particular actors are doing what, when, where, and how.

Ethan Ostroff:

Got you. Trey, maybe we could talk a little bit to close out today's episode, specifically about the reporting and record keeping requirements of the NPRM. What are the entities that are subject to it? Which records does the NPRM or would it require those entities to collect? Some of that information might be helpful to our listeners.

Trey Smith:

Sure. The proposed rule is going to apply to covered financial institutions as the term is defined under the Bank Secrecy Act. First, that is going to include banks, broker dealers, money service businesses, et cetera, et cetera. But it specifically applies to covered financial institutions, which receive or have passed through transactions in convertible virtual currency. Specifically, that the institution knows, suspects, or has reason to suspect involves CVC mixing either within or outside the United States.

In terms of the information that the proposed rule is going to require the covered entities to collect is going to largely break down into two categories of information. They're going to want information about both the transaction and the customer engaging in the transaction. On the transaction side, they want to know some of the things that Addison just described. From the blockchain, they want to know the amount of CVC that was transferred, the dollar equivalent, they want to know what type of CVC was used, which mixer. They want to know the wallet addresses, the date of the transaction. Interestingly, they also want to know the IP addresses that are associated with the transaction, likely for law enforcement purposes to have a sort of IP unique address that's associated with a given computer.

Then on the customer information side, they're going to want the customer's name, their date of birth, their address, their email address, and just in hopes of melding the two, and giving law enforcement a place to start where some of these transactions are showing up to facilitate those sorts of illicit transactions. I think the ultimate goal is not just law enforcement, though. I think what FinCEN is really trying to do here is to remove and deter mixers as an avenue towards terrorism financing, drug financing, et cetera, by increasing the transparency, and sort of just communicating to illicit actors that this is not going to be as viable of a way to engage in illicit activities, whether I think it'll be effective or not. That's, of course. going to be up for debate. Cryptocurrency wallets are inherently anonymous, but you do have that on ramp, off ramp on the banking side. Potentially, it will achieve those goals. That's sort of what the act is aiming to collect, and who they're trying to regulate here in passing this rule.

Ethan Ostroff:

Guys, under the NPRM if I'm remembering correctly, covered finance institutions will be required to collect, maintain, and report this information to FinCEN within 30 calendar days of initial detection. I believe the comment period ended in January of 2024, and so we're sort of waiting with bated breath to see what FinCEN does next, and what a final rule might look like.

I guess, to finish out this discussion of this notice of proposed rulemaking from FinCEN. Trey, could you talk just a little bit about exemptions from the reporting and record keeping requirements as described in that NPRM?

Trey Smith:

Yes. The proposed rule, it defines convertible virtual currency mixing in a way that exempts covered institutions that use certain internal protocols to execute transactions. Banks, broker dealers, my service businesses, that would otherwise constitute CVC mixing. But the caveat is that, those entities can only take advantage of that exemption if they otherwise preserve at least some records of those transactions when using the protocol. That exemption is pretty much just designed to avoid applying the rule to transactions for existing digital assets service providers, who do have these sorts of protocols that would otherwise fall within the proposed rules are already sort of retaining records, and conducting their business in a way that adequately allows law enforcement, or some other regulator, or authority to access that information if they need be. It's a small exemption, and it frees you, it frees the institution from having to make the disclosures. It doesn't necessarily change a whole bunch from an information collection standpoint to a degree.

Ethan Ostroff:

Got you. That's great insight. Trey, thank you for that. I want to thank you both for joining us today. As a reminder to our listeners, this is part one of our multipart series. During our next episode, we'll be talking about the activities in 2023 by the CFPB and the FTC, so look forward to that discussion, guys. Thank you to our audience for listening to today's episode. Don't forget to visit our blogs, consumerfinancialserviceslawmonitor.com and troutmanpepperfinancialservices.com, and subscribe so you can get the latest updates. Please make sure to also subscribe to this podcast via Apple Podcasts, Google Play, Stitcher, or whatever platform you might use. We look forward to the next time.