CONSUMER FINANCE S01EP04

Title: A Dive into Cryptocurrency
Aired on: June 2, 2022
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Guests: Keith Barnett and Ethan Ostroff

[CHRIS WILLIS]

Hello, and welcome to the Consumer Finance Podcast. I'm Chris Willis, the co-practice leader of Troutman Pepper's Consumer Financial Services Regulatory Group and I'll be your host today. We have a great topic for you today where we are going to be talking about cryptocurrency. So, I'm going to learn something along with everybody else in the audience as well. But, before we get into talking about crypto, let me remind you to visit and subscribe to our blog, ConsumerFinancialServicesLawMonitor.com where we post material almost every day about all important happenings in the consumer financial services industry. And don't forget, that we have another podcast in addition to this one, *FCRA Focus*, which is all about things related to the Fair Credit Reporting Act. And that one is released monthly on all the popular podcast platforms. And speaking of podcast platforms, if you like our episode and like our podcast, leave us a review on the podcast platform that you get this episode from. Now, as I said, we are going to be talking about cryptocurrency today. And it really gives me the unique opportunity to show off some of the breadth of Troutman Pepper's practice. And joining me to talk about cryptocurrency are two of my partners, Keith Barnett and Ethan Ostroff. So, gentlemen, thanks for being on the podcast today.

[KEITH BARNETT]

Thanks, Chris. Great to be here.

[ETHAN OSTROFF]

Happy to join you, Chris. Thanks so much.

[CHRIS WILLIS]

I'm really looking forward to this discussion because as I said, I'm going to be learning something too because it is not an area I know that much about. And maybe you can start by helping someone who is a little bit less initiated, like me, Ethan. There's a lot of terminology in what people refer to as the world of cryptocurrency. So how would you breakdown the clutter in this area and make it sort of make sense to someone who is uninitiated?

[ETHAN OSTROFF]

You're right, Chris, and it's very easy to get confused. Digital currency is basically the blanket term used to refer to money that exists solely in a digital space. Virtual currencies and cryptocurrencies are types of digital currencies because they exist online. A virtual currency is a type of digital currency available in the virtual world typically controlled by its creators and used and accepted among the members of a specific virtual community. Here's where it sometimes gets a little confusing. All virtual currencies are digital. They only exist online. But not all digital currencies are virtual. Because they exist outside a specific virtual environment. Essentially, virtual currency is a representation of monetary value. Issued, managed and controlled by private issuers for the transaction of peer-to-peer payments. They are sometimes represented in terms of tokens and maybe unregulated legal tender such as coins or bank notes.

[CHRIS WILLIS]

Thanks, Ethan. So, what is a cryptocurrency? Now that you told us what a digital and virtual currency is, what's a cryptocurrency?

[ETHAN OSTROFF]

Sure. So, they are digital currencies because they exist online but they are also virtual currencies created with cryptographic algorithms. It's basically a digital medium of exchanged that can be sent directly, instantly and securely. The crypto, in cryptocurrency, refers to the fact that many encryption algorithms and cryptographic techniques are used to ensure security across the network and protect against counterfeiting. Many cryptocurrencies operate as block chain based decentralized systems without the need for a trusted third party such as a central bank or a credit card company. In this instance, peer-to-peer transfers are facilitated through the use of private and public keys.

[CHRIS WILLIS]

So, Ethan, one more terminology question. I keep reading about, and seeing the term stablecoin, what does that refer to?

[ETHAN OSTROFF]

Sure. So, it is a type of virtual currency. It is designed to have a stable value or price. There are many kinds and many different ways that stablecoins work. Some are stable with respect to a fiat currency, like the U.S. dollar, or are stable with respect to a commodity, like gold. Stablecoins offer some of the same benefits as other digital assets such as mobility and accessibility. But are generally intended to be less volatile because they are benchmarked.

[CHRIS WILLIS]

Thanks, Ethan for that. And so, tell me what's going on, and let our listeners know what's going on, from a federal, regulatory and administrative standpoint with respect to these currencies.

[ETHAN OSTROFF]

So, the digital asset marketplace is rapidly developing and is increasingly top of mind for lawmakers and federal regulators. You know, going back to last November we had the President's Working Group on Financial Markets along with the FDIC and OCC issue a report on stablecoins. It identified regulatory gaps, offered recommendations, and in particular, recommended that Congress enact legislation requiring that stablecoins be governed according to a comprehensive federal framework. Moving forward then to January 2022, the Federal Reserve released a report that focused on the feasibility of a retail CBDC, or Central Bank Digital Currency, to be used by the general public, as opposed to a wholesale CBDC that would be used by financial institutions for back-end settlement. And the Fed is still soliciting input on that report, I believe, through May 20th of this year. But really, we had a watershed moment in March when President Biden signed an Executive Order to establish the first comprehensive federal digital asset strategy for the United States. It's intended to promote digital asset innovation while balancing benefits and associated risks. And, one of the important things about that Order is that directs dozens of federal agencies, including the SEC, the CFTC, Treasury, the Fed, the CFPB and the FTC to study the legal and economic implications of creating a U.S. CBDC. And since we've had that Executive Order come out, we've had SEC Commissioner Gensler, speak highlighting areas related to the SEC's work. He mentioned that the SEC plans to register and regulate crypto trading and lending platforms, much like traditional regulated exchanges. He stressed his concerns regarding the potential misuse of stablecoins for illegal purposes. And, he emphasized his perspective that most crypto tokens are investment contracts under the Howey Test and his belief that it is important to the SEC that crypto tokens be registered to securities and comply with the SEC's disclosure requirements. You also had Treasury Secretary Yellen, deliver her first speech on digital assets in early April, in which she claimed that a digital dollar could become a trusted money comparable to physical cash. You also had the FDIC release a letter in April requiring all FDIC supervised institutions that intend to engage in or that are currently engaged in crypto related activities to notify its FDIC regional director, also encourage these institutions to notify their state regulator, and that letter built on the increasing attention of the banking regulators to crypto related activities of their regulated institutions. Then we had acting Comptroller of the Currency recently caution against permitting stable coin issuers to pick from a range of licensing options as some lawmakers have suggested. In other words, he's concerned about letting issuers choose between different federal and state regulatory frameworks. He also suggested that banks may need to conduct stable coin related activities in a standalone bank-chartered entity separate from other insured depository institution affiliates to properly manage crypto liquidity and blockchain specific risks.

[KEITH BARNETT]

So, the way I can respond to this question, Chris, is actually start talking about the types of clients that I have represented in this space. Because I think that helps inform the discussion. I represent cryptocurrency exchanges, I represent companies that are establishing and issuing their own cryptocurrencies, and I've represented companies that engage in crypto mining. With respect to these types of representations, the federal agency that I deal with the most, in connection with who is active, is FinCEN. That's the Financial Enforcement Crimes Network. I also deal with the state banking and financial services regulators. The issues that we deal with are threefold. One, each of these types of companies that deal with crypto, in one form or another want to know whether they are a money transmitter under federal law that needs to register with FinCEN. Then the second issue, is the same issue as the first issue, with a slight difference. These companies want to know whether they are a money transmitter under state law that needs a license for the states in which they do business. You know, we look for the answers and exemptions there. But there is a third issue that permeates all of this. And, that is the Office of Foreign Assets Control, otherwise known as OFAC. So, while most people pay attention at least in a legal sense to the Securities and Exchange Commission, you know, hey is cryptocurrency a security? Or they will pay attention to the CFTC, the Commodity Futures Trading Commission and ask whether a cryptocurrency is a commodity. One thing that permeates through all of this, irrespective of the other agencies is OFAC. OFAC regulations apply irrespective of whether a company is a money transmitter, regulated by the SEC, regulated by the CFTC, FDIC or any of the other alphabet soup. And so, the issue there is, why is that? What is the importance of OFAC? The importance is as follows: the federal and state governments have stated that cryptocurrencies are potential vehicles for illicit behavior with respect to money laundering and terrorist financing. OFAC regulates that with respect to the movement of money. And so, OFAC is saying to cryptocurrency companies, whether you're mining, establishing, or an exchange, what are you doing to identify the people who are buying, selling and trading crypto on your platform? And some of you may recall that during the earlier days of cryptocurrencies, Bitcoin in particular, there was a lot of news out there that people were using Bitcoin to conduct criminal activities, or at least to finance criminal activities. And, OFAC definitely paid attention to that as did the other federal regulators. And in October of last year, OFAC published a bulletin whereby it offered sanctions compliance guidance for the cryptocurrency industry. And so, what does that guidance mean for our crypto clients? Well, for the crypto exchanges, it's further affirmation that you need to know who your customer is. You need to obtain information about the people, or the companies, that sign up to buy, sell or trade any type of currency, be it fiat or crypto, and check the users against the OFAC list of Specially Designated Nationals. So, what does all of that mean? It means that if someone is using your platform to buy, sell, otherwise exchange some form of cryptocurrency, you've got to get their information. What's their name, what's their address, phone number, social security number, government issued ID, and you cross check that with OFACs Specially Designated Nationals List to make sure that they are not sanctioned. And, what do I mean by that? Well, as we all know, the Biden administration with the recent war in Ukraine, has sanctioned, as the news headlines are saying it, Russian oligarchs, right? And so, these Russian oligarchs actually appear on this Specially Designated Nationals List. That means that if you are a crypto exchange, and one or more of these oligarchs tries to engage in activities on your exchange, you need to know who they are. Their name, address, phone number, whatever information you can and block them from exchanging or engaging in any type of cryptocurrency trade on your exchange. So that's how significant OFAC is. One of the other things that OFAC does, or recommends, is companies to incorporate geo location tools and IP address blocking controls. So, what does that mean? Let's get back to the example of the crypto exchange. Someone is trying to sign up on the exchange and they provide, maybe like a fake name, you know fake ID, with like a legitimate person. OFAC recommends that companies have IP address blocking tools, so you could know who is actually trying to get on the exchange and buy, sell, trade, do whatever, with cryptocurrencies and block them if they are in a country that OFAC considers to be high risk for terrorism or money laundering. And so, back to my original point, irrespective of all the things that we heard Ethan say about all, what all the different agencies are doing, ultimately, everything will boil down to OFAC regulations. One more thing that I want to say before I turn it back over to you Chris, the question that has been posed to me by clients after the Russian sanctions, was, okay, well, what do I do if I'm actually holding a virtual wallet with cryptocurrencies for someone who is on this OFAC list and then, but they got on the list only after I took them in as a client? Well, OFAC, in those circumstances, requires you to block the person from being able to access their cryptocurrency. You're just supposed to pretty much hold on to it and report that to FinCEN. And so, there are a lot of issues here to cover, there are a lot of federal agencies to cover but I really wanted to talk about OFAC because it is something that I see pop up all of the time and it's sometimes an overlooked issue, and, but with that, I will turn it back to you Chris, for your next questions.

[CHRIS WILLIS]

Yeah thanks. That was an incredibly thorough response from the both of you, Ethan and Keith, about the roles of the various different federal agencies, as well as the Executive Order, etc. Like, having covered what's going on from the federal, sort of regulatory and administration standpoint, is there any congressional activity, any legislative activity, relating to crypto that's been going on that we should have our eye on? What about that, Ethan?

[ETHAN OSTROFF]

Yeah. There's a lot. I mean to start with, picking up on the sanctions compliance issues that are really top of mind for a lot of our clients right now. You know, in mid-March there were Democratic senators who introduced the Digital Assets Sanctions Compliance Enhancement Act, which is an attempt to ensure that blacklisted Russian individuals and businesses do not use cryptocurrency to evade economic sanctions. And that bill is a good example of one of the tensions that exists right now, because while it may have a generally accepted principles that they're trying to put into legislation, that bill has controversy surrounding it. Because many in the industry think it would place sweeping restrictions on people who build, operate, and use cryptocurrency networks, even if they have no knowledge or intent to help anyone evade sanctions. So, you always have this tension going on with how federal lawmakers are trying to go about with good intentions in sharing various policy objectives are met, but at the same time, they're trying to do things in a way that people who are really working in this space find problems with. Now, in addition to that legislation back in February, the Keep Your Coins Act was introduced, which is intended to prohibit federal agencies from restricting the use of convertible virtual currency by a person to purchase goods, or services, for that person's own use or for other purposes. You also had a discussion draft of a bill called The Stablecoin Innovation and Protection Act, which is intended to define what it calls "qualified stablecoins" to differentiate them from more volatile cryptocurrencies. In late March, there were various Democratic members of the House, who introduced the Electronic Currency and Secure Hardware Act, or the ECASH Act, which would direct the Secretary of the Treasury to develop and issue a digital analogue to the U.S. dollar or what that bill calls e-cash, which is intended to replicate and preserve the privacy, the anonymity respecting, and minimal transactional data generating properties of physical currency instruments, like coins and bank notes, to the greatest extent technically and practically possible, all without requiring a bank account. So, in other words, under that Act, e-cash would be legal tender. And then you had, more recently, in early April, Senator Toomey, release a draft of his Stablecoin Transparency Reserves and Uniform Safe Transactions Act, or Stablecoin TRUST Act, and that bill contemplates a payment stablecoin, which is convertible directly to fiat currency by the issuer, and under that Act, only an insured depository institution, a money transmitting business, or a new national limited payment stablecoin issuer, would be eligible to issue payment stablecoins. Interestingly, under that bill, payment stablecoins would be exempt from the federal securities requirements, including the securities act of 1933. We are also, I think like many like us, are anxiously awaiting what is supposedly going to be bipartisan legislation that is going to be introduced by Senators Gillibrand and Lummis, covering a broad range of digital assets topics, in an effort to establish the first comprehensive federal digital asset strategy in the United States. So, there's a lot of activity going on. I think we expect there to be ongoing activity by both the federal regulators, as well as members of Congress and we're all going to be watching this with increased scrutiny, because while we have all of this activity going on all on a federal level, the President's Whole-of-Government approach conspicuously omits addressing what role, if any, state regulators are going to play in overseeing digital assets. There's a lot of activity going on at the state level as well. There's more than 150 pieces of legislation relating to cryptocurrency that have been proposed in 40 states just this year. And states are not expected to be silent in this area.

[KEITH BARNETT]

And also to that point, irrespective of what the federal government does with respect to regulatory issues, the states still have control over what they do with respect to money transmission, which is often controlled by the state banking departments. And, cryptocurrencies fall within one of three buckets in the states. One bucket is cryptocurrency is not legal tender and our state statutes authorize us to regulate legal tender so therefore we're not even going to regulate cryptocurrencies. And then you have the second bucket, which is we will regulate cryptocurrencies as if they are a part of the money transmitter statute and companies that engage in any type of cryptocurrency, even if you are not transmitting money, you need to register with the state banking authority. And then the third bucket is, we're not going to regulate you, but we're also not *not* going to regulate you, but let us know, whether or not you are engaging in any type of cryptocurrency activity. So, I expect over the next year or so, for these state regulators to crystalize their thought and have a little bit more uniformity with respect to the manner in which they want to regulate cryptocurrencies going forward.

[CHRIS WILLIS]

Thanks a lot, Keith. And, you too, Ethan. Before we close out the podcast, Keith, are there any parting comments, just some words of wisdom that you might leave industry participants with, about cryptocurrency regulation, if they're either in the industry or they're thinking about getting into the industry?

[KEITH BARNETT]

Yes, sure. Most of our clients are start-ups, but very successful start-ups and some of our clients come to us with the belief that, 'hey, we are going to be the next Uber, we're going to be very big and in following Uber, we're just going to innovate everything technologically and we'll worry about state and federal regulations later, because we are going to have so much money to be able to pay off any fine we possibly get, for not being compliant.' Well, obviously, that's a business decision that you make, but one of the things that I will recommend as a parting recommendation to you all, to at least make sure that you have your basic compliance policies in place. So, any money laundering and anything required by the Bank Secrecy Act, at least try to get all of your ducks in a row, if you're trying to be pennywise with respect to compliance. Try to get the basics out of the way so you won't have to take as big of a hit later on.

[CHRIS WILLIS]

I think that's great advice, Keith. And so, Keith, thank you to you and to you as well, Ethan, for sharing your experience and knowledge in this area on today's podcast. And thanks to our listeners for downloading the podcast and giving it a listen. As a reminder, be sure to visit us on our blog, ConsumerFinancialServicesLawMonitor.com. Subscribe to our updates there so that you get all of our new content from there and head over to either the blog or to troutman.com and add yourself to our Consumer Financial Services email list. That's the list where we send out alerts and our webinar invitations, as well. And most of all, check your podcast platform and stay tuned for a new episode of this podcast, every Thursday afternoon. Thank you all for listening.