
***The Crypto Exchange* — S02 Ep05, Crypto Year in Review 2022: Crypto Enforcement and the U.S. Treasury
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Ethan Ostroff:

Welcome to another episode of *The Crypto Exchange*, a Troutman Pepper podcast focusing on the world of digital assets and payments. As longtime 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 and payment industries.

I'm Ethan Ostroff, one of the hosts of the podcast and a partner at Troutman Pepper. And before we jump into today's episode, which is going to be part four of our four-part year-end review for 2022, I want to remind you all to visit and subscribe to our blog, the Consumer Financial Services Law Monitor. And don't forget to check out our other podcasts on troutman.com/podcasts.html. We have episodes that focus on trends that drive enforcement activity, consumer financial services, the Fair Credit Reporting Act, and many other things. Make sure to subscribe to hear the latest episodes.

Jumping into today's episode, I'm happy to be joined by my colleagues, Keith Barnett and Colin McCrory to talk about FinCEN and OFAC generally, and how they function in the digital asset space. In the absence of regulations, these financial services regulators on the federal level generally have relied upon the BSA to deter activity in the digital assets industry, such as insufficient AML/CFT compliance, insufficient OFAC sanctions compliance, obfuscation of cryptocurrency transactions through mixing protocols, and transmission of value to individuals associated with OFAC designated jurisdictions.

I thought first, Carlin and Keith, that we could kick this off by talking a little bit about the Treasury Department and its activities in 2022, particularly the Treasury Department's report from September called *The Future of Money and Payment System*. Carlin, could you talk a little bit about that and explain to our listeners what the Treasury was talking about in that report and why it's important for them?

Carlin McCrory:

Sure. In September of 2022, the Treasury issued that report that you mentioned called *The Future of Money and Payments* in response to President Biden's Executive Order. The Treasury report reviewed the US system of money and payments, including things like instant payments, Stablecoins and a potential US CBDC, and also considered the implications of these developments for key public policy goals. This includes things like supporting the US global financial leadership, advancing financial inclusion and equity, and minimizing the risk associated with these things.

So, the Treasury report outlined four recommendations to the US government to improve the US money and payment systems. The first is advance work on a possible US CBDC in the event it's determined to be in the national interest. The second is to encourage use of instant payment systems to support a more competitive, efficient, and inclusive US payment landscape. The third is establishing a federal framework for payments regulation to protect users and the

financial system, while also still supporting responsible innovation in payments. And then the fourth and final is prioritizing efforts to improve cross-border payments.

Ethan Ostroff:

So, Carlin, I was thinking maybe we could dig in a little bit more about these four recommendations. Maybe just starting with the first one about advancing a US CBDC. What did the Treasury report specifically say about that?

Carlin McCrory:

The Treasury report found that a US CBDC could contribute to a payment system that's more efficient, provides a foundation for further technological innovation, and it would facilitate more efficient cross-border transactions. The report also found that a US CBDC could promote financial inclusion and equity by enabling access for a broad set of consumers and could also be designed to foster economic growth and stability and protect against cyber and operational risks. It could be consistent with individual rights and, also, they talk about possibly minimizing risks of illicit financial transactions. The report goes on to note that a US CBDC could have national security implications and should be designed to preserve US global financial leadership and support the effectiveness of sanctions.

Ethan Ostroff:

And so, the second recommendation in this Treasury report had to do with encouraging the use of instant payment systems. Could you talk a little bit about that, both about what the report discussed, but also its relationship to FedNow?

Carlin McCrory:

Yeah. The report found that enhancements are possible to make payment systems more competitive, efficient, and inclusive, and again, as I've said, reduce the costs and risks associated with cross-border transactions. But to maximize these benefits, the report recommended that the government continue its outreach efforts around instant payments, with a focus on inclusion of underserved communities, and promoting the development and use of innovative technologies that allow consumers to access instant payment systems more readily. So, the report also recommends that government agencies within the US consider and support the use of instant payment systems. And this year, as we all know, FedNow is expected to launch. I think it'll be interesting to see its adoption, or maybe lack of adoption, amongst financial institutions. We already have RTP real-time payments available, but, as we're seeing, there's a lot of fraud risk, and we've discussed on prior podcast episodes about the P2P fraud, and it's just running rampant. I mean, anytime you have access to any form of instant payment, naturally the fraud will rise as it's associated with those instant payments. So, while the Treasury is encouraging using instant payment systems, the adoption may be a little bit slower as our financial institutions are a bit apprehensive based off of the risks associated with them.

Ethan Ostroff:

Interesting intersection here with the instant payments, and FedNow and RTP, and the possibility of a US CBDC. Going back to the third recommendation, what did the Treasury report talk about with respect to the establishment of a federal framework for payments regulation?

Carlin McCrory:

They found that a federal framework for payments regulation could support some responsible innovation and payments by establishing some sort of federal oversight over non-bank companies that are involved in the issuance, custody, or transfer of money, or money like assets. So, I think what they're driving at here are FinTechs, these companies that may be issuing their own sort of currencies. The recommendation recognizes that these non-bank companies are increasingly providing payment services, and that newer entrants may contribute to competition, which we've seen the FTC heavily wants to promote competition, inclusion, as we've mentioned, but also innovation. And the report noted that current oversight of non-bank payment providers is generally at the state level, which we've seen various state regulators heavily look at some of our FinTech companies. But the level of regulation widely varies from state to state, especially as it relates to regulation over digital assets. And because of this, it may not address certain risks in a consistent and comprehensive manner. The report also stated that a federal framework could provide a more common, floor-level minimum of the resource requirements and other standards that may need to exist that are currently varying at the state level. And in doing this, we could also make it complement existing federal BSA/AML obligations that exist to protect consumers and prevent fraud.

Ethan Ostroff:

With respect to the final recommendation in the report about prioritizing efforts to improve cross-border payments, what did the Treasury report discuss in that regard?

Carlin McCrory:

The goal here is to develop a faster, cheaper, and more transparent way of transmitting international payments while also considering at the same time the potential risks of faster and easier cross-border payment systems.

So, the report found that the private sector payment innovations have been driven in part by inefficiencies in the current cross-border payment systems, and in response to those inefficiencies, countries are actively making efforts to improve existing systems, and trying to leverage some new technologies. The Treasury report noted that the US has a strong national interest in being at the forefront of technological development and supporting global standards for cross-border payment systems that reflect US values, including privacy and human rights. But they also want to balance that with BSA and AML, and national security. Lastly, the report noted that the US is active in its efforts to improve cross-border payments including through the G20 FSBN Committee on Payments and Market Infrastructure.

Ethan Ostroff:

Thanks very much for that. Super interesting report last year, covering a wide range of ground. Keith, switching gears a little bit, talking more specifically about FinCEN. We had a civil monetary penalty issued against Helix by FinCEN back in 2020. Think you could give us a brief overview of what happened in 2022 and what's going on now?

Keith Barnett:

Yeah, thanks Ethan. Appreciate that. And also thank you everyone for listening to our final episode of the year in review for 2022. Just to back up a little bit, on October 19, 2020, FinCEN issued a civil monetary penalty in the amount of \$60 million against Helix, and Helix was a virtual currency mixer.

The penalty also applied to its owner, Larry Dean Harmon, for failing to register as a money services business, failing to implement an effective AML program, and failing to file suspicious activity reports in violation of the Bank Secrecy Act. FinCEN in that particular case alleged that Harmon failed to register Helix MSB from its inception in June 2014 to its wind down in December of 2017. And also, from July of 2017 through February 2020, FinCEN alleged that Harmon began operating another virtual currency mixer called Coin Ninja LLC, and similarly failed to register it as a money services business. Also, from June 2014 through February 2020, Harmon operated two unregistered MSBs that, like the others, neither developed AML programs nor filed any SARs, notwithstanding the frequent engagement both platforms received from darknet marketplaces and other illicit actors. And FinCEN concluded that Helix had conducted over 1.2 million transactions for customers and was associated with virtual currency wallet addresses that sent or received more than \$311 million.

Now, that's just the background. Let me fast-forward to what happened in 2022. On October 19th of 2022, the DOJ, on behalf of FinCEN, filed a lawsuit against Harmon, and the DOJ's lawsuit seeks to recover the \$60 million civil penalty FinCEN had imposed against Harmon in 2020.

Ethan Ostroff:

Interesting. We had another big case brought by FinCEN involving Bittrex in late 2022. Could you talk a little bit about what was the issue there and this enforcement action that FinCEN brought?

Keith Barnett:

Yeah, Bittrex was a pretty big deal. In October of 2022, FinCEN assessed a civil monetary penalty in the amount of over \$29 million against Bittrex. Now, Bittrex, like Helix, was a cryptocurrency exchange and, like the others, failed to implement a sufficient AML program and failed to file SARs over an extended period of time in violation of the Bank Secrecy Act. And FinCEN's civil enforcement action against Bittrex was a part of a global resolution with OFAC.

So, you had these two regulators joined together, and you see the similar themes here, failing to register as a money services business, failing to file a SAR, failing to have an AML/BSA

program. And in the case of Bittrex, they had committed over 116,000 violations of sanctions programs by failing to prevent persons from the Crimea region of Ukraine, also from Cuba, Iran, Sudan, and Syria, from using its platform. They engaged in over \$260 million worth of virtual currency-related transactions from those particular regions. So, it also points out the importance of doing KYCs and also regional checks by looking at IP addresses.

The other part of this was that OFAC discovered that during a two-year period, Bittrex had not developed an internal sanctions compliance program. When Bittrex did devise and implement a sanctions compliance program later on, it screened only for hits against OFAC's specially designated nationals list and did not screen customers or transactions for a nexus to a sanctioned jurisdiction like what we had before with Cuba, Iran, Sudan, Syria, and the Crimea region of Ukraine. It's also worth noting that, at its peak, Bittrex had averaged an approximate transaction volume of 24,000 transactions per day, but its AML program consisted solely of two employees who were fully responsible for it, and for reviewing the transactions. And in the consent order, FinCEN described Bittrex's manual transaction review process as demonstrably ineffective.

And in addition to the insufficient AML program, according to FinCEN, FinCEN alleged that Bittrex impermissibly operated as a MSB for three years. Notably, in August of 2015, Bittrex applied to the New York State Department of Financial Services to obtain New York's BitLicense, which is required to engage in virtual currency business in New York. But on April 10th, 2019, the New York State Department of Financial Services denied Bittrex's application for a BitLicense for the same reason that prompted FinCEN's enforcement action that I just told you about. We had a lot going on with Bittrex, but also more of a global issue showing that the regulators are looking at BSA, AML, and OFAC compliance.

Ethan Ostroff:

It's really interesting in that Bittrex case that you had the NYDFS kicking the tires on them sufficiently in April of 2019 to deny a BitLicense application, but it takes more than three years later for FinCEN to come out with this enforcement action. And it just seems like it's odd that it would take such a long time between a state regulator identifying these deficiencies and denying an application for a license, and for the federal regulator to take some sort of action.

Keith Barnett:

Yeah, but it also is indicative of the notion that the state regulator and the federal regulator were sharing information. And given all of the regulatory agencies that were involved, it's not terribly surprising to see a lag. I know three years is a long time, but we've seen other instances where you would have an enforcement action by the federal government, and then a year or two later, the state will have its own enforcement action based upon the same nexus of circumstances, and vice versa. I agree with you that three years is a long time, but it's also not surprising, your tax dollars at work a little bit slowly.

Ethan Ostroff:

It's very interesting. And the communication, or lack thereof, between state and federal regulators is always something to pay attention to, in my view. Talking a little bit about OFAC and its sanctioning of two cryptocurrency mixers in 2022, cryptocurrency transactions commonly

recorded on a blockchain and the movement of cryptocurrencies from one party to another remains visible to anyone. And so, to anonymize those crypto transactions, people sometimes rely upon a mixer. Leveraging smart contract technology, they are self-executing lines of computer code that automate finality of a transaction when certain predetermined conditions are met. Practically speaking, a user sends the crypto he or she would like to anonymize to a smart contract. Once the mixing process is complete, the user may withdraw the crypto initially deposited to the smart contract. And upon return, the transactional origins of the user's crypto will be difficult to determine, not impossible necessarily, but potentially very difficult. And the smart contract mixer muddles the public origin and public destination associated with crypto transactions in an attempt to sever the link between a sender and a recipient of the crypto. Smart contracts are integral to DeFi, which seeks to disintermediate traditional financial markets through autonomous execution of transactions. Thought it'll be interesting, Carlin, if you could tell us a little bit more about OFAC's sanctioning of these two cryptocurrency mixers that we saw in 2022.

Carlin McCrory:

In 2022, OFAC sanctioned two cryptocurrency mixers, which Ethan just described, that process transactions executed by individuals on OFAC's SDN list and settled with one cryptocurrency exchange for processing transactions in violation of the Iranian Transactions and Sanctions Regulations. The first one we're going to talk about happened last year, May 6th, 2022. Under Executive Order 13694, OFAC sanctioned Blender.io, which was a centralized crypto mixer that provided Bitcoin mixing services to users. In this case, OFAC had added various unique cryptographic Bitcoin addresses associated with Blender.io to the SDN list. This Executive Order that I mentioned enabled OFAC to impose sanctions on individuals and entities determined to be responsible for or complicit in malicious cyber-enabled activities that are likely to be a significant threat to the national security.

And then on August 8th, 2022, OFAC sanctioned Tornado Cash, which was a smart contract cryptocurrency mixer, for allegedly assisting the Lazarus Group, which was a Democratic People's Republic of Korea state-sponsored hacking group. It alleged that Tornado Cash helped this group launder more than \$7 billion worth of crypto. So OFAC sanctioned Tornado Cash pursuant to Executive Order 13694.

In effect, OFAC's designation of Tornado Cash prohibiting US persons from engaging in transactions involving the identified Tornado Cash mixing smart contract addresses, froze movement of preexisting crypto deposits already existing in Tornado Cash's mixing smart contracts at the time of OFAC's designation. In addition to adding Tornado Cash to the SDN list, OFAC also added 38 unique cryptographic addresses associated with Tornado Cash, many of which corresponded to mixing smart contracts offered on Tornado Cash's platform. The designation here is absolutely unprecedented. It does mark the second time that OFAC has sanctioned a cryptocurrency mixer, but the first time OFAC has sanctioned a decentralized crypto mixer whose functionality depends exclusively on smart contracts that are disassociated from the original developers of the mixer and can basically be run in perpetuity.

A key operational distinction here between Blender.io and Tornado Cash is that Blender.io offered a service that natural persons controlled under the Bitcoin addresses associated with Blender.io, and those people could dictate which users would be allowed to utilize Blender.io's mixing services. Since Blender.io was a blockchain service offered and managed by natural people, the broader crypto community didn't really oppose OFAC's usage of its sanctioning

authority here. In contrast, with Tornado Cash, it was decentralized. The operations had generally got a lot of pushback by stakeholders in the digital asset industry because these weren't natural people here like we had with Blender.io.

In September of 2022, six individuals actually filed a lawsuit challenging OFAC's sanctioning of Tornado Cash, basically alleging that OFAC's sanction authority under this executive order is limited to individuals and entities, and Tornado Cash, just being an opensource software tool without any formal governing body, doesn't fall within the definitional scope of being a person or an entity subject to the order.

Ethan Ostroff:

Very interesting. A Lot of people in the industry chiming in on that lawsuit and wanting to get their views in front of that court as well. And then probably not coincidentally, about less than a week later, we got some new guidance from OFAC. Can you explain a little bit about that, Carlin?

Carlin McCrory:

Yeah. September 13th, 2022, like Ethan said, less than a week later, OFAC issued interpretive guidance in the form of responses to FAQs. Interestingly enough, in FAQ 1076, OFAC clarified that US persons are prohibited from engaging in transactions with Tornado Cash, but US persons are not prohibited from copying Tornado Cash's opensource code and making it available online for others to view.

So, in this FAQ, OFAC noted that individuals who deposited crypto to a Tornado Cash mixing contract prior to Tornado Cash's designation in August of 2022 could request a license from OFAC to withdraw the crypto that the person had put into the mixer provided that the underlying transaction didn't involve any other sanctionable conduct. So that makes sense. If I put my crypto in it before all these sanctions occurred, I can get it back out as long as there was no other sanctionable conduct.

In a separate FAQ, FAQ 1095, which OFAC issued in November of 2022, OFAC stated that the term "person" as defined in Executive Order 13722 and Executive Order 13694 encompasses, and I quote, "A partnership, association, joint venture, corporation, group, subgroup, or other organization." So here, OFAC concluded that Tornado Cash's organizational structure, which consisted of its founders and the Tornado Cash DAO, constituted an organization that could be designated pursuant to the IEEPA.

OFAC's counteracting guidance suggests that it's aware of the potentially interesting questions sparked by the designation of Tornado Cash and the hoopla it caused, so to speak. For example, should an individual who deposited crypto to a Tornado Cash mixing contract, but didn't engage in any illicit activity, be precluded from withdrawing the crypto or otherwise engaging in the Tornado Cash platform? And moreover, do the functional aspects of a particular opensource software which may enable a user to facilitate money laundering alone render the software subject to OFAC sanctions?

Back in 2019, the virtual currency guidance issued by FinCEN distinguished that an anonymizing software provider just like Tornado Cash, as to an anonymizing service provider like Blender.io, is not a money transmitter because suppliers of tools that may be used in money transmission are engaged in trade and not money transmission. Although OFAC is not bound by

FinCEN's interpretive guidance, they try to act in concert, and are trying to eliminate some of these money laundering and terrorist financing risks. And we think they may look to promulgate similar outlooks on this decentralized cryptocurrency mixer issue in the future so that they can maintain some sort of regulatory continuity, if you will.

Ethan Ostroff:

Thanks for that, Carlin. So, we have this action against Tornado Cash, and then we have these FAQs, including the second one you mentioned that came out in the second week of November of 2022. And then fast-forward a couple weeks later, November 28th, 2022, Keith, we had this OFAC settlement with Kraken, a cryptocurrency exchange, for over \$362,000, related to the Iranian Transactions and Sanctions program, which generally prohibits US-based entities from supplying technology to Iran. Could you talk a little bit about the settlement with Kraken?

Keith Barnett:

Once again, if you're not going to have any other takeaway from these programs, think of several words, compliance and internal controls. And in the case of Kraken, just like the others, OFAC alleged that their internal controls prevented users from opening an account on its platform while located in a jurisdiction subject to sanctions. So that's the good part.

But the bad part is Kraken's controls did not include IP address blocking, which would have insulated the exchange from users who opened accounts outside of sanctioned jurisdictions and subsequently accessed those accounts within a sanctioned jurisdiction. OFAC discovered that during a three-and-a-half-year period or so, Kraken processed 826 transactions in the amount of about \$1.6 million on behalf of users who had circumvented Kraken's controls by initially opening an account in a jurisdiction not subject to OFAC sanctions. So, you see that end-around there. And OFAC calculated that Kraken's conduct warranted a pretty hefty maximum civil monetary penalty of \$272,228,964.

But due to Kraken's self-disclosure of the violations, its agreement to spend an additional \$100,000 to invest in a sanctions compliance control and training program, and other significant remedial actions, OFAC determined to settle for about \$362,000. They thought that was appropriate in light of the mitigating factors.

The civil monetary penalty OFAC required Kraken to pay certainly pales in comparison to the civil monetary penalty with respect to Bittrex, although both enforcement actions involved inadequate geolocation tools and compliance and internal controls. But because Bittrex operated without an effective sanctions compliance program for approximately two years and almost 120,000 violative transactions totaling more than \$260 million, it seems like these factors greatly contributed to the civil monetary penalty that OFAC had imposed upon it.

Ethan Ostroff:

Wow. It's an interesting juxtaposition between those two enforcement actions. So, we've seen a lot of activity over the past year from Treasury, in particular, enforcement activity by OFAC and FinCEN. Thinking about what our listeners and actors in this ecosystem should be thinking about and considering going forward in 2023 and beyond, Keith, wanted to just start with you, any takeaways, insights, or crystal ball thoughts?

Keith Barnett:

Yeah, sure. Well, I guess since we're recording this in February of 2023, my crystal ball is a little bit more clear than it would've been in December or even January of this year. But all kidding aside, as reflected by the substantial civil monetary penalty imposed on Bittrex, insufficient AML compliance is poised to remain the predominant basis for enforcement actions filed against crypto related entities in 2023. And we've already seen it. For example, there are international exchanges that affect US commerce that have also come within the sphere of the regulators. More specifically, just last month, FinCEN issued an order that identifies a virtual currency exchange as a "Primary money laundering concern in connection with Russian illicit finance." But this is actually the first order issued pursuant to Section 9714 of the Combating Russian Money Laundering Act. That particular order in January is important because it affirms FinCEN's commitment to ensuring that financial institutions engage in meaningful due diligence. Also, it shows FinCEN's commitment to following through with enforcing US sanctions against Russia. And then it also affirms FinCEN's commitment with respect to regulating the virtual currency industry concerning payments.

Getting back to other issues, for the time being FinCEN, along with other federal regulators and also state regulators, they perceive cryptocurrencies as a technological innovation that is commonly used to anonymously perpetrate a wide variety of cybercrime. So, from the enforcement actions, it appears that FinCEN is looking for and will continue to look for financial institutions seeking to integrate cryptocurrency transactions within their business models, and they should therefore look to make sure that they have adequate employee training programs, suspicious activity report filings, and a strong and robust AML compliance program along with making sure you keep up with OFAC sanctioned jurisdictions and the SDN list.

Federal financial institution regulators have been very wary of financial institution interactions with virtual currencies for a whole variety of reasons, not only related to BSA/AML compliance, but also the volatility of the market has brought in other regulators beyond Treasury. So, we also have the CFTC, SEC, and others to deal with.

Ethan Ostroff:

Thanks, Keith. Really insightful thoughts you had there. I think one of the things I'm looking forward to watching this year is, as both the regulators and people from the industry, along with academics and others, are brought before the relevant Senate and House committees to see how Congress is viewing all this and to get a sense of where Congress' concerns are, and how in particular Congress members interact with and question the regulators themselves about what they're doing and why, or, with respect to some regulators, why they aren't doing more.

Carlin, what about you? Do you have any takeaways from last year, and a sense of things that people should be on the lookout going forward in 2023?

Carlin McCrory:

Yeah, I think going back to the beginning of our podcast, the Treasury report really noted that new innovations, and a potential US CBDC, and things of that nature, could be beneficial to the US economy, provided they are taken along with BSA/AML concerns like money laundering and fraud. There's certainly potential there, and we won't see a CBDC this year, I don't think.

But then we can also look at some of the things we just talked about, like OFAC's designation of Tornado Cash, and some of this software that blurs who is associated with the specific crypto. Theoretically, a lot of these transactions maybe don't involve illicit activity, but clearly some do, and OFAC is not willing to subject itself to that risk involved with not knowing potentially who's crypto is who's, or just making it harder to determine who owns the crypto.

And so, we're seeing OFAC come out with these FAQs, which aren't laws, regulations, et cetera, but they're putting their stamp on what they think is okay and not okay by issuing these FAQs. And I think we can definitely expect more of the same from OFAC in issuing some guidance there that isn't law or regulation. We're going to see more on compliance in what they expect from companies, but the overall idea here that I'm at least getting from OFAC is that when we're starting to blur the lines and we can't tell who's doing what or who owns what, it's certainly not favored.

Ethan Ostroff:

It'll be interesting to see certainly what sort of enforcement activity and what kind of additional guidance, if any, we get, particularly from OFAC and FinCEN, as we follow the Treasury Department and its activities in the virtual currency space.

Wanted to thank you both for joining us today and thank the listeners for joining us as well. Again, we hope you found our four-part series reviewing various types of activities on the federal and state level in the virtual currency space helpful and insightful. We're looking forward to presenting more episodes to you later this year on a variety of different topics. Don't forget to visit our blog, consumerfinancialserviceslawmonitor.com, and subscribe so you can get the latest updates. And please make sure you subscribe to this podcast via Apple Podcasts, Google Play, Stitcher, or whatever platform you use.

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