Podcast: A Deep Dive into DeFi, or Decentralized Finance

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The world of decentralized finance, blockchains, virtual and cryptocurrency has grown exponentially in recent years. Many financial institutions are looking to enter or expand their operations in the digital economy, but the regulatory environment gives many pause.

Over the coming months, McGlinchey attorneys from various practice groups will dive into the world of DeFi and explore it from every angle. In this episode of “More with McGlinchey,” **Aaron Kouhoupt** and **Robert Savoie** (Cleveland) discuss this fascinating and vibrant subject matter while giving a breakdown of content coming – from articles, podcasts, and webinars on hot topics to a client-only, live Q&A session, drilled down right to the good stuff – **what is DeFi and how does it impact traditional finance?**

NEW: This introduction is also available to watch as a video.

Robert Savoie: Hey, I’m Robert Savoie. I’m a partner in McGlinchey Stafford’s regulatory compliance team and chair of our FinTech practice.

Aaron Kouhoupt: Hi, I’m Aaron Kouhoupt. I am also a partner with McGlinchey Stafford in the Cleveland office. I work with Robert in our consumer financial regulatory team.

Robert: Awesome. So we are here today to talk about DeFi and decentralized finance and what it is. And so what we’re going to do is talk a little bit at a high level about what the concept is. And then Aaron is going to talk about what we are trying to accomplish and what we are going to go through over the course of this deep dive.

So, to start off, at a high level, DeFi is decentralized finance. When you think about “what is DeFi?” it’s important to think about, you know, what is traditional finance? What is this concept of centralized finance that they’re referring to? When you think about the way financial services, particularly in the U.S., but also in other developed countries, exist, they exist through this concept of a trusted custodian or a trusted intermediary, enshrined with protections in law.

The simplest example is: you go to your bank account, right? And you deposit funds into a bank. And what you’re doing is you’re taking money that you’ve earned, and you’re putting it into a bank account. Well, you don’t have access to that unless the bank agrees to give it to you. And so, while it is your money, and you have a legal right to it, you have chosen a trusted custodian, one subject to many protections and governmental restrictions and regulations, but nonetheless, a custodian that holds assets for you.

When you go to take out a loan, you take out a loan traditionally from a bank or credit union or a non-depository licensed lender. And in each instance, you’re borrowing funds from a mainstream centralized finance entity. What decentralized finance seeks to do is essentially take that intermediary or that trusted custodian out of its role and place humans in those roles.

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So if you think about it from the context of the way in which banks traditionally and classically operate, you put your deposits into the bank, and the bank pays you a rate of interest. Then the bank pools that money and they make loans to other people that need to borrow that money. What decentralized finance tries to do is say, hey, what happens if we take out the bank and you have the individual giving their money directly to somebody else that may pay them for use of that money, or, for example, borrowing money from another individual instead of through an intermediary?

And so if you think about the most prominent use case for DeFi being cryptocurrency, you think about cryptocurrency exchanges. Due to, particularly in the U.S., the regulatory hostility from traditional banking regulators to cryptocurrency, you see a lot of that go through non-depository money transmitters who are licensed across the states. And so while they may seem like they’re DeFi, those are a form of centralized finance, because they, again, are the custodian. You go to the exchange, you buy Bitcoin, you buy other cryptocurrencies, and you have that, but to go get your crypto out or to go get your cash out, you have to go actually log onto your account and request access to those funds. So that’s a different, but similar, form of centralized finance.

What cryptocurrency seeks to do, from a decentralized perspective, when you’re not utilizing an exchange, is have you go and buy your cryptocurrency through algorithms from other people. And so somebody goes, and they’re gonna sell you the cryptocurrency. And that’s the premise of the blockchain, is this immutable record that, as opposed to the record of your deposit at your bank being held with the bank with copies on file with regulatory agencies and records all maintained by this custodian, it’s all held in the blockchain. And so the blockchain creates the record of when I bought my cryptocurrency from Aaron. And so the cryptocurrency is now mine.

And that’s the premise of the blockchain, is this immutable record that, as opposed to the record of your deposit at your bank being held with the bank with copies on file with regulatory agencies and records all maintained by this custodian, it’s all held in the blockchain.

And that creates certainly different outcomes from centralized finance because you don’t have FDIC insurance necessarily. And so you read stories about the person that bought a bunch of cryptocurrency and had it, and the key to access it on the blockchain, on a hard drive. And then they threw it away because they thought cryptocurrency would never go anywhere and would never do anything. And they threw away the hard drive where they stored it, and it's now worth 50 million dollars. And so there's the story of that person going nuts, digging in a local dump, trying to find their hard drive.

So when you think about it, there are interesting opportunities for decentralized finance, when individuals think about the benefits of being sort of outside of control or crutch of custodians, if they have a mistrust for those institutions.

But there are also risks, right? Because at the same time, you don't have that institution. When you think about how DeFi is going to impact consumers or, you know, U.S. citizens, and citizens all over the world, it is an interesting thing to break apart the different use cases and the regulatory infrastructure that surrounds that, then think about, how do you build DeFi programs? How do you use DeFi programs? And what are the legal underpinnings for those structures, you know, when you're outside sort of traditional, mainstream, consumer financial services institutions, and you're doing things like borrowing money, buying assets, paying interest, and offering insurance, and other things through a decentralized framework where it's person-to-person as opposed to person-to-institution?

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And so those are some of the concepts that are so fascinating about DeFi, but when you think about how you break that down, you know, those are the issues that you run through.

Aaron, do you want to talk a little bit about sort of what we're going to dive into?

Aaron: Yeah, that's a great background. So what we're going to do over the next few weeks, a couple of months, really, is to talk a little bit about DeFi in general: what DeFi is, how it impacts traditional finance. And we're going to talk a little bit about the interplay between DeFi and traditional finance.

We're going to look at a variety of different methods of getting some content out to everybody with podcasts, webinars, and some written articles. They're going talk about things like "when is virtual currency currency?" Robert earlier talked about money transmission. What is it? Is cryptocurrency money? Is it counted by the state as money? If I'm sitting in between two parties and I'm transmitting that virtual currency, do I need a license in order to do that or not? Does the state consider that money? What is money, as the state defines it?

Is cryptocurrency money? Is it counted by the state as money? If I'm sitting in between two parties, and I'm transmitting that virtual currency, do I need a license in order to do that?

We're also going to talk a little bit about enforcement actions in this space. We're going to spend some time in a podcast talking about some of the more prominent enforcement actions that have come down in this space and why you should care about whether or not you are in a traditional finance space, but might be offering something that touches this DeFi world.

So, for example, if you're offering cryptocurrency as a reward for a standard loan product, cryptocurrency is the way in which you reward and incentivize a consumer for utilizing your product. What's the impact of that? And how are you sort of brought into this world when you're offering that kind of a reward product, or accepting it as a merchant, and you're accepting cryptocurrency as payment? How does that affect the payment rails and what your obligations are?

So we're going to talk a lot over the next couple of months about this DeFi world, how these different cryptocurrencies and different things that seem like they aren't going to touch you, right? Like you're sitting back going, no, I don't do this, this isn't something I'm worried about. I don't offer cryptocurrency. I'm not mining cryptocurrency. It's more than that. And it can touch your business in so many different ways that you're just not even thinking about because you think, yeah, I've partnered with somebody and they have a license to mine crypto, and they offer cryptocurrency, and I'm not doing anything as part of this. But you are, or you could be. And what are the implications if you get caught up in that?

As with all of our Deep Dive presentations, most of this content is going to be on our website and free for anybody that wants to take a look at what we have going on. At the end, we do have a client-only webinar where we will send a special link out to clients that are interested, and we will do a live Q&A session, and, on an anonymous basis, just talk about any questions you have, or really just do a roundtable about this space and what we've talked about over the last few weeks.

I appreciate Robert joining me on this introduction. You're going to see Robert and I in a couple of different pieces of content, but you're also going to see other partners, other associates, and some other of counsel that we have both in our division and in other divisions of the firm because again, it's not just consumer finance, there are other areas of your entity that might be impacted by this. So you're also going to hear from some of our colleagues in litigation, and enforcement, and in human resources.

So we look forward to bringing it to you and are excited to get this rolling!

Robert: Thanks so much, Aaron, looking forward to it.

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