

Podcast: Governing an Algorithm? The DeFi and Crypto Enforcement Landscape

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The regulatory framework for cryptocurrency and DeFi in general is still a little murky. That hasn't stopped regulatory bodies from bringing enforcement actions against players in this space. What's on the horizon when it comes to investigation and enforcement activity in the decentralized finance space?

Aaron Kouhoup: My name is **Aaron Kouhoup** and I am a Member in our consumer financial regulatory section out of Cleveland. And I do a lot of work with FinTech companies and banks in the consumer finance space, including issues that they might be having when trying to get into the cryptocurrency and decentralized finance space.

Today, we're very fortunate to have time to sit down with **Bob Driscoll**, who's a Member in our Washington DC office. He's the co-chair of our government and internal investigations practice. Bob is a former DOJ official. Having served as deputy assistant attorney general during the George W. Bush administration, he has decades of experience representing corporations and individuals before Congress and various regulatory bodies.

Aaron Kouhoup: So I thank you again for being with us today, Bob and I'll jump right into our first question. We've all witnessed the news coverage that's been out there about cryptocurrency and this generalized fear that cryptocurrency is really just a tool for illicit money movement or illicit activity. Have you seen an uptick in the regulatory enforcement actions, whether allegations of either Bank Secrecy Act [violations] or money laundering or other actions by the regulatory bodies or the government in this space?

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Bob Driscoll: I think certainly it's been unquestionable in the last couple years, Aaron, that various people in the

crypto space have been subject to, not only regulatory action by [Dept. of] Treasury or by FinCEN (Financial Crimes Enforcement Network) or by the FTC (Federal Trade Commission), but also prosecutions by DOJ (Dept. of Justice) for money laundering. And I saw it and thought was very helpful, [the intro to DeFi](#) that you and Robert Savoie did. And you know, I think when you understand the basics, you understand kind of what the problem is, because decentralized finance and crypto can serve many different purposes, and has many different use cases. It could be a store of value, can help facilitate transactions, can do lots of things. Those things traditionally are regulated separately under separate laws by the government. And so, depending on what you think this “good” is that people are trading in or are using to facilitate a transaction, colors your view of it.

So from the DOJ perspective, which is something I have some familiarity with, DOJ is very concerned when they think crypto might be being used for money laundering purposes, to hide the proceeds of illegal activity. The SEC might be concerned that, are some of these things securities? Are they being used as stores of value, and therefore have to make certain disclosures and only registered brokers can sell them? All these things are out there and they’re kind of conflicting all the time. So there’s definitely been an uptick. And people in this space, I think more so the people that are really the players in the space and facilitating, and the FinTech companies that are involved in crypto are issuing their own tokens, are the ones most at risk. But I think anybody who’s playing in the space at all, be it to facilitate transactions or on behalf of customers, needs to be paying attention. Because the regulatory landscape’s changing the time and it’s going to be very disruptive. Regardless of whether you think you’re involved in crypto at all, it’s going to disrupt the space you’re in.

Aaron Kauhaupt: I think that’s a really good point, Bob. And I think it’s one of the things that we really want to highlight to everybody out there. I think that there are sort of two false senses of security that people are thinking about. One is thinking about the fact that, well, there really isn’t a lot out there on cryptocurrency right now, and the government’s maybe been a little bit slow. So does that give me the ability to sort of go out and do what I want? I think the answer is pretty clearly no, that people are paying attention to this space. But then the second is, I love what you said about, this isn’t just for somebody that’s out there, mining cryptocurrency, right?

Two false senses of security that people are thinking about: one is thinking about the fact that, well, there really isn’t a lot out there on cryptocurrency right now... The second is, this isn’t just for somebody that’s out there mining cryptocurrency.

Bob Driscoll: Right.

Aaron Kauhaupt: I mean, this is affecting people that are ancillary, or maybe just, it’s not their primary business, but they’re in this space. So you do see some risk and you see some activity even in that ancillary space?

Bob Driscoll: Oh, yeah. And to give you a concrete example, Tornado Cash. And I don’t want to get too technical cause I know this is a basic kind of thing, but Tornado Cash was essentially, on the blockchain, Tornado Cash was used as kind of a mixer. And so it could be used to have privacy for your Bitcoin transactions or your crypto transactions. And it was just put on the OFAC (Office of Foreign Assets Control) list by Department of Treasury. And that didn’t just affect – there’s a couple things that are amazing about that from a legal perspective, for those of us used to regulation. Because as you explained last time, something like Tornado Cash is simply, it’s an algorithm that’s independent, that’s out there on the internet. It’s autonomous. It is not a person. It is not a

company. It is an address. And OFAC just essentially banned Americans from using this address. And so that is having all kinds of knock-on effects that people are trying to figure out.

For example, a lot of companies that are holding crypto for different customers, or people finding accounts frozen if they took payment from Tornado Cash at some point. Or if they're on Tornado Cash on the blockchain, how's that all going to work? Can the government block an algorithm? It's almost like regulation hits philosophy at some point. How you can do this? So I think that is why one has to be paying attention, even if you're not setting up; you and I probably aren't going to set up our own coins. Although, I actually just had a friend in the industry who's going to set up a Driscoll coin for me just to show me how easy it is to do!

But people like us and our clients aren't necessarily going to be setting up our own BitMex. But it's still important to know that BitMex got prosecuted and their founders got prosecuted because they were treated like a financial institution. They didn't have "know your customer" protocols that were sufficient, and those are criminal violations. And the founders and a couple of high up executives were criminally prosecuted and have pled guilty to crimes under the Bank Secrecy Act (BSA) related to failure to implement efficient compliance protocols. And I think that sometimes you're not going to be thinking of that. If you're talking about a DeFi contract in the art space or in some other space, you're not necessarily thinking yourself as a financial institution. But I think that all of these things are worthy of paying attention to, for anyone who even has a toe in the water here.

How's that all going to work? Can the government block an algorithm? It's almost like regulation hits philosophy at some point.

Aaron Kouhoup: I appreciate that. And I think it's an important point that you made at the end, especially if you're in the Bank Secrecy Act/Anti-Money Laundering space. It's not just civil, there's some criminal implications there.

You've already touched on this a little bit, Bob, but you know, the Bank Secrecy Act/Anti-Money Laundering, some statements that have come out from the government about this implication that there's illicit activity when you're in crypto is getting a lot of the headlines. But there are other enforcement actions and things to worry about. And I know earlier you talked a little bit about securities. Can you talk about a little bit more? Are we seeing enforcement actions where there are allegations that the crypto activity is moving its way into licensed securities, and that businesses are dealing with unlicensed securities as a result?

Bob Driscoll: Yes. And there is a very important case working its way through the system, and I want to break it down for people so they understand likely what is going to happen. And why it's significant. There's obviously been a debate for a long time among the industry, among regulators, as to whether or not different crypto tokens are a security that needs to be registered under the securities and exchange act by the SEC. The SEC, if you listen to Gary Gensler, the head of the SEC, talk, you get the feeling that's coming, that they feel like these things are essentially stores of value. And so I think what people in the industry would say is that you're taking something that is many things at once, and you're making it one thing by saying it's a regulated security.

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On the securities front, one case that's moving is an insider trading case against former employees for a crypto exchange that allegedly purchased certain tokens prior to the tokens being listed on the exchange, which caused a run up in price. And frankly from the DOJ perspective, it's a straightforward case. It's just mail fraud and wire fraud. And the former employees of the exchange are being prosecuted. And it's not great news for them, but there's nothing particularly controversial about the prosecution.

But what's interesting is a parallel SEC case. And the SEC case is truly an insider trading case. And one of the predicates for the SEC to bring an insider trading case, which is a civil case in this instance, is that the item being traded is a security, or should be a registered security.

The government, in classic fashion, has put itself in the wonderful position of bringing a civil case parallel to a criminal case. And the civil case will probably be lightly, if at all, defended. And so [the government] will likely get a judgment in their favor, adopting their legal theory that the token must be regulated under the SEC act. And then it'll be interesting to see how the industry reacts to that, and whether that's essentially a bargaining chip as the SEC drafts regulations.

So I think that that is going to be something to follow to see. And I think that, you know, like a lot of these things, there will be regulatory uncertainty.

For example, we mentioned the BSA earlier on some of these things, the Bank Secrecy Act, the "know your customer" kind of regulations. There's a real question as to whether or not those regulations should apply at all, or that law should apply at all, in the crypto space. But so far, the government is just acting as though it does. And no one has been willing to kind of fight the fight and take that all the way up to see how an appellate court would handle it.

And frankly, having represented some people in that space, I don't blame them. But the government takes that uncertainty and uses it to their advantage. So they've had people plead guilty to Bank Secrecy Act violations in the crypto space, even though as an academic matter, if we were teaching a law school class on it, there would be a real open question as to whether or not, if you read the Bank Secrecy Act, it would apply in the crypto space where you're not dealing with fiat currency or a traditional banking system.

Aaron Kouhoup: Thanks, Bob. I think that's a great point and it kind of brings us full circle to our last question. There is an academic question out there about the applicability of some of these laws to decentralized finance, cryptocurrency, all of these innovations that maybe our laws have not kept up with, and maybe they don't fit neatly within the definitions, but we're still seeing the enforcement action. And that sort of leads you into the

very unenviable position where it starts to look a little bit like legislation or regulation by enforcement action. And you're stuck sort of tracking these enforcement actions to guide you on what you may be able to do, without really any framework to work within. Do you anticipate there being any sort of federal or state movement in trying to build some framework here, so that we're not just following enforcement actions and frankly having people out doing things not knowing where the government is going to land on it?

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Bob Driscoll: Well, it's great question. And if we knew the answer, well we could retire to a private island, because we would know the answer and we would sell it to everybody. But I think sitting in Washington, the thing to remember is that bureaucracy moves slowly, and legislation moves more slowly than the bureaucracy. And so although there have been many proposals, things have been slow-moving through Congress. And so the problem now has been parallel in regulation, the DOJ is issuing white papers, Treasury is issuing white papers. The government's been trying to coordinate with this across the agencies, but that's always difficult to do.

So for right now, I think that there is going to be some uncertainty for the foreseeable future. But that is where I think a firm like us, or lawyers like us, come in, and that you at least need to talk through – this is a phase of this where issue-spotting is the most important thing. There may not be a rock solid answer, but the issue has to be spotted. So the business people can assess the risk and say, okay this is a little bit of a gray area. But here, based on what we've seen, this is a risk we feel comfortable taking, or this is a risk we don't. And that's at least an informed decision. What's going to really get people in trouble is if they kind of jump into the pool without having thought about any of it. That's when you get in real risk of getting yourself sideways with a government agency, or hopefully not, but sideways even criminally with the government on some of these crypto issues. So I think that's the most important thing is when you see these things, have a conversation with your regular banking and regulatory lawyers to see if there might be an application and consider for a moment that it may not be obvious that there is an application. Because we're seeing a lot of these transactions looked at from different angles and regulated different ways.

There may not be a rock solid answer, but the issue has to be spotted so the business people can assess the risk and say, okay this is a little bit of a gray area. But here, based on what we've seen, this is a risk we feel comfortable taking, or this is a risk we don't. And that's at least an informed decision.

Aaron Kouhoupt: Thanks, Bob. I really appreciate your time and going through this and your expertise in defending these type of actions is invaluable. And I think the moral of the story here is that there is real risk if you are in the crypto space, even just touching it, even being ancillary to it. The government is taking action and they are bringing cases. So being aware of it and issue spotting, as you said, becomes critical if you're rolling out a product that has a cryptocurrency or a DeFi implication.

Bob Driscoll: And if there's one piece of advice I could give, just having represented some clients on my side of the fence, is: always understand, if you're involved in this space, what the business case is for what you're doing.

What the legitimate business case is. Because that is what stops more, I don't want to say it stops investigations, but it slows down the seriousness of them. When you're able to explain quickly in a way that makes sense to the government, no, this is not necessarily money laundering. Here's the legitimate business use case, that I'm doing this to facilitate cross border transactions. I'm doing this as an alternative to foreign remittance payments. I'm doing this as a way to pay bills in foreign currency and hedge some currency risk.

There are all kinds of different ways our clients are using crypto. The government's behind the times on almost all of them and doesn't know many of the use cases. The government's still at the point, or at least the DOJ is, a lot of prosecutors are still at the point where they see crypto and they think money laundering. They see crypto, they start thinking like it's a duffle bag full of cash in your trunk, which gives them the same kind of thing. It may not be illegal per se, but they immediately think, oh my God, this guy's got a duffle bag full of cash. What crime is he involved in? And if the government's going to have that attitude, it's very important to say that, and also to help suss out some of our own clients, or our clients' clients, so to speak.

If there's one piece of advice I could give: always understand, if you're involved in this space, what the business case is for what you're doing. I don't want to say it stops investigations, but it slows down the seriousness of them, when you're able to explain quickly in a way that makes sense to the government.

If they're not able to articulate why they don't want to do something in a traditional way, if they do want to use a cryptocurrency mixer, why is that, if it's not to hide the source of funds? And if there's not a legitimate reason, that's when you have to start getting your own antenna up for your own sake and the client's sake, to say, all right, well, why are we doing this then? Why isn't this a wire transfer transaction? And if there's not a legit business that case can be explained in 30 seconds to the government, maybe talk more to the attorneys and explore. But I think that as long as people have their antenna up, they can get through it, muddle through with their counsel. And it's certainly an exciting time if nothing else.

Aaron Kouhopt: Thanks, Bob. That's great advice. We want to thank everyone for listening to this. Much more to come on crypto and DeFi, and we appreciate all of your time. And again, thank you, Bob, for sitting down with me.

Bob Driscoll: Thanks, Aaron.

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