Crypto_Part II

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crypto, validators, administrative law, tax, block, people, proof, decentralized, discussion, wallet, transactions, tokens, blockchain, bitcoin, electricity, custody, stake, world, government, jason

SPEAKERS

Steven Valentino, Introductory Voice, Ed Leaf, Jason Schwartz

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I   Introductory Voice   00:03

Welcome to a hard look, the Administrative Law Review podcast from the Washington College of Law. We'll discuss how administrative law impacts your daily life from regulatory actions by agencies and the litigation over them to the balance of power among branches of the government. This is a hard look.

S   Steven Valentino   00:27

Everybody welcome back to A Hard Look on this episode, we're going to continue our discussion of cryptocurrencies and other digital assets and the regulatory void presently surrounding them. On this half the discussion we're going to begin discussing current events in the cryptocurrency space and how it sort of interwoven itself into the modern fabric, in addition to regulatory considerations that government should consider if it decides to begin regulating cryptocurrency. Before we dive into this part of the discussion allow me to reintroduce my guest host and guest. Ed is currently an articles editor here for the Administrative Law Review. Edie has published comment on the Accord which is our online companion publication at the Administrative Law Review, which is entitled Tick Tock Tick Tock: How the Committee on Foreign investment in the United States can Mitigate Threats Posed by Foreign Made Software Applications. And our guest for this episode is Administrative Law Review alum Jason Schwartz. Jason is currently a tax partner of Fried Frank. He has represented banks funds, asset managers, investors and other parties on tax issues relating to securitizations, financial products funds lending and importantly for our discussion today, crypto. His work is widely published, including a recent article in Tax Notes entitled the taxation of decentralized finance, which is most relevant to our topic today. At Fried Frank Jason also oversees a web3 friendly pro bono project that incorporates and obtains tax exemption for fledgling nonprofits, including charitable decentralized autonomous organizations, or DAOs, which are native to the crypto ecosystem. And welcome back to A Hard Look for this continuation of our discussion. So picking up where we left off, we are in a really interesting time with how cryptocurrency has begun to grow in popularity. This has happened so much so that El Salvador has actually adopted it as a form of legal tender. Is El Salvador a good test case for how cryptocurrency can enter the broader financial ecosystem? Or if not, what significant questions still require an answer?

Jason Schwartz 02:09

Yeah, yeah. So this is a really, really, you know, timely topic, right? Because for because of the current events that you're mentioning, so, you know, I'll just remind you of like a few of the things that have happened in the last few weeks. Yeah, a few weeks ago, Canada, froze the bank accounts of, you know, its own citizens, right. Ukraine solicited donations in crypto, Russia was the Swift right Russia was was basically kicked out of the of the international banking system. It would be foolish, I think, for countries to not hold some amount of their reserves in self custody, in light of all those things. And frankly, I think it would be foolish, not financial advice here. I think it'd be, you know, personally, I think it's foolish for an individual not to hold some amount of assets in self custody in light of these things. So yeah, I think that crypto has entered the public imagination, in part because of these because of these events. I will say that I don't I don't know that El Salvador adopting Bitcoin as a as legal tender really moves the needle, though. You know, I don't think that that's, I don't think that that's the thing that really moves the needle. I think it's the other things that this realization that that the US dollar can be weaponized. And you mentioned CBDCs, before central bank digital currencies and asked me about them, and I, I think I forgot to respond. But but like CBDCs are one example of like, the, you know, the fact that central banks are thinking about issuing their own crypto tokens, one just shows that blockchain technology is here to stay and and it has, it has a tremendous value proposition, even for centralized entities. But at the same time, CBDCs will still be subject to the same, you know, weaponization potential that, you know, that digital currency that effectively our current digital currency is subject to right, where we have digital currency, it's just not on a blockchain right now. And I, as a result, I actually don't think that CBDCs are going to be an appropriate replacement for like crypto back stable coins or algorithmic stable coins. And I don't I don't think that they'll crowd out the market or other crypto tokens, because I think that there's something much bigger going on here. And I think that that bigger thing is this idea that like, maybe the idea of, you know, nation states, controlling, you know, control Pulling the money supply? Maybe that's somewhat old fashioned, like maybe we have to start rethinking everything we thought we knew about, you know, currency, certainly about, like regulation, because because I think, again, we're moving away from an intermediated system to a sort of self, you know, custody wallet based system. And I think that those other current events, like, you know, like Canada, freezing bank gowns, Ukraine, Russia, I think that those are more illustrative of, you know, the things that are going to get crypto Macedon adoption.

Ed Leaf 05:38

Yeah, and I think kind of jumping on your point about self custody. I mean, one of my personal reactions to the the tragic events in Ukraine is I just think about all those people that are just picking up and leaving at a moment's notice. And maybe they can't access their capital, or they get somewhere else in there, their capital has been seized or frozen. Just the value of having, you know, having a digital wallet that you can take with you anywhere in the world and plug in and access your own capital, I think is pretty amazing. So kind of shifting a common critique of crypto currency originates from the mining process. And so Bitcoin especially uses a lot of electricity to mine to produce these coins and verify the transactions. So, you know, it's a common critique. And I just wonder, What's your response to that?

Jason Schwartz 06:32

Yeah, I look, I think it's a fair critique. I mean, you know, I think, I think that there are counter arguments, right. And then, and I don't really, I don't really feel strongly one way or the other as to, which is like the winning argument, like, you know, on one hand, the approved proof of work consensus mechanism uses up a lot of electricity, on the other hand, so does our current banking system. So I'm not really sure you know, which, which cuts which way. At the same time, though, proof of stake is is somewhat old fashioned, right? I mean, Bitcoin uses proof of work. And Dogecoin uses proof of work, but Aetherium uses proof of work, but it's in the process of switching to proof of stake and the expectation is that it will switch to proof of stake, June or July, I don't know if your listeners, you know, should like should have a quick primer on what each of those two things are, I'm happy to give a quick primer might be helpful. So so like just just very broadly, so you have this distributed ledger, right. So so rather than, like a bank, or a central bank, or whatever, you know, keeping track of, you know, credit, so this person's account, debit from this person's account, etc, you have, you know, hundreds of thousands of validators keeping track of these transactions, but you needed a consensus mechanism to allow these validators to, you know, agree on what the current state of the ledger is. So they're broadly you know, two primary consensus mechanisms, one is proof of work. One is proof of stake, under proof of work. The validators more accurately their computers, but the validators go, and they collect a bunch of data that was submitted, right, like all of these transactions that are sitting in a memory pool somewhere. And once they've collected the data into a block, they want to propose their block for inclusion on the chain on the ledger. So they have this data block and they want to propose it. But in proof of work, there's a there's a step that they have to get past before they can propose that block. And that step is their computers have to get to work on an arbitrary Charlie, difficult guessing game. The protocol has a number in its head, and the first person to guess that number gets to submit their block. So the other validators. Okay, so that's where the electricity comes from. All of these validators are using a bunch of electricity. In solving this guessing game, the first person to solve that guessing game gets to broadcast their block, and if that block contains any malicious transaction, right, like a fraudulent transaction, and the other validators saw software picks up on that then the proposed block gets booted right, it doesn't get included and thus there's like this stick the stick is that the validator who propose this block has spent all of this money on electricity only to see their block rejected. Okay, so they're out of their out of pocket actual money to carry it on the other hand, is if their block gets verified, if you know the block looks all legit, then they get you know, they get inflationary tokens from the Bitcoin protocol. Okay, so So Bitcoin the Bitcoin protocol automatically mints new Bitcoin and gives it to the validator. I'm speaking very, very Generally, but that's sort of how it works. Now, the way proof of stake works, by contrast is forget about the, you know, the electricity. Okay? We're not going to require people to solve an arbitrarily difficult computational puzzle. Instead, each validator has to ante up, have to ante up. Well, let's talk about ether, because ether, Ethereum is going to be proof of stake, you know, in a few months, so the ante up ether, the more ether the ante up, the more likely it is that they get chosen to broadcast their block. Okay, if the block if if the other validators determine that there's a fraudulent transaction in the block, then the proposing validator gets slashed, they just lose their ether. So So you've replaced this like work mechanism with a stake mechanism, right, where like, I've just anteed up. So there's still a stick, but the stick is economic, like within its self contained within the theorem ecosystem, rather than being sort of, you know, external to the theorem ecosystem, and the carrot is effectively still the same. It's still, you know, you get inflationary tokens, if you get your block verified, proof of stake is, is way more efficient. You know, it doesn't, it doesn't place the same kind of burden on the electrical grid, on the power grid, that proof of work does, it's like 99.9%, more, you know, more efficient or something, it's also I would posit, more decentralized, because one of the, like, sort of perverse results of proof of work is that you end up you know, as the computational puzzle

gets harder and harder over time, you end up basically with like, you know, these huge conglomerates that build warehouses of supercomputers to be, you know, professional miners, right. And that's actually quite centralized, like, you end up with, with with just a few like mining conglomerates, whereas in proof of stake, assuming that it's easy enough to be a validator, and that's, that's actually a big assumption, but assuming that it's easy enough to run your own validation node, literally anyone can do, right, and the goal of the Etherium I feel like an Aetherium, you know, cheerleader here, and I guess I am, the goal of the theorem. Foundation's work is to ensure that the that staking on a theorem is, in fact, and validating on a theorem is, in fact very easy to do. So, you know, Vitalik Butyrin, who is sort of like the, the spirit animal of Aetherium, he's like one of the one of the creators, you know, that it's not a company, right? There's no stock, but he's sort of like, he's sort of a thought leader in Aetherium. He suggests that, like, within a few years, you'll be able to run a validation node from your iPhone, that's highly decentralized.

E Ed Leaf 12:57

And I think that's fascinating. I mean, that you could you could earn income by by validating a theory and from your iPhone, or whatever mobile device you might have. I think, in general, our discussion is highlighted that the crypto has really gone mainstream, and does not just exist in the shadows and is used by bad actors to circumnavigate the laws. But still, I think it's pretty clear that there are a lot of what we'll call "unknown unknowns" surrounding crypto and the broader, broader digital asset space. You know, there's no way to know where things are going, which I think is exciting, but also maybe a little bit terrifying. At the same time, the executive order takes the position that many activities involving digital assets fit under current domestic laws. I know we've touched on this a little bit. But do you agree or disagree, in part or in full? And beyond that? What are your kind of general predictions for the future?

J Jason Schwartz 13:51

Yeah. So you know, I disagree, because I've already, I've already tipped my hand there. I think the laws of old simply were not equipped to deal with a disintermediated world. So I really do think that that, like policymakers will have to rethink, you know, the old ways as Krypto becomes more and more mainstream. I'm not saying that it's essential that they do that immediately. What I do think is that we need more of a regulatory sandbox approach that allows innovators to innovate, without being concerned about being thrown in jail, you know, something that was really disheartening to hear I went to eath Denver, which is an annual conference focused around a theory that takes place every February and and all around me, I heard, you know, tremendously creative, ambitious, young people talking very openly about expatriating from the US, right. I have never been in a previously and a situation like that I've never heard heard about people talking so openly about that, but it makes perfect sense. Like, I totally understand them, that their most valuable asset is in their head. So they don't, they don't suffer a potential tax total charge on exiting the US as as like I would like if you exit the US from a tax perspective, you have an automatic Dean sale of all of your assets at fair market value, which is, like quite a toll charge for people who have held stock for any period of time, right. But for like someone in their 20s, they don't really have to worry, and and like the dis, the decentralized world doesn't care where you live. Right. So I think that, you know, it's really, it's really problematic that, you know, we have these these laws that are made that are made for an intermediated world that simply don't work. And like the regulators are, you know, kind of

just tone deaf to that fact. And I think so is, you know, so as you know, so is Biden, and so are, you know, many, many lawmakers, unfortunately. And I think that the result, if they remain tone deaf, is going to be that we're going to lose some of our best and brightest. And that will, you know, we're in like the United States benefited tremendously by being friendly to the internet, when the internet was first coming up. And I fear that we're not going to, you know, we're not going to be able to get the same kind of, you know, boost here, which is, you know, basically like a reimagining of the internet that said, hey, you know, what makes it sort of more unfortunate, and I hope I'm proven wrong, by the way. But what makes it even more unfortunate is that crypto actually presents a tremendous opportunity for the government. If you think about it, some people have referred to public blockchains as Twitter for your wallet. Right? And that's like, not that that's not that inaccurate, I just told you, like, you could go, you know, knowing now that I own this crypto code, you can go and you can find my wallet, and you can see what assets I have in there. I'm not necessarily saying that the government should have access to, you know, to like every transaction that that people conduct, but it would be possible to devise a system whereby, you know, us people's, you know, self custody, crypto is readily auditable. Right, and thus, minimize fraud actually improve tax collection, right? If I had, if I had an election to mark to market my crypto each year, I would be more than happy to tell the IRS, here's, here's my wallet address, you can look at it right now, you can literally see its value this year, its value at the you know, on December 31 of 2022 is $100 more than its value on December 31 of 2021. And I will pay tax on that. $100. Right. That could be like, I'm just coming up with like a simplest of all tax systems, right? But I'm just showing you, I'm using that as an illustration of like, how easy it might be to create, you know, regulations that actually, you know, take into account how blockchain technology works, and uses that technology to minimize fraud and improve transparency and improve, you know, tax reporting. Instead, what the government seems to be doing is just hiding the ball from market participants, which makes, you know, even sophisticated tax planners, like myself pretty nervous about reporting taxes. What if I get it wrong? You know? So, yeah, as for the like, Shadow, ie SuperCoder, you know, Elizabeth Warren type, angle, look, cash, cash is king, in illicit activity. Okay? If you try if you're, if you're like, you know, buying and selling, you know, drugs or machine guns or something, using crypto, you're an idiot, you're just asking to get caught, okay. The, you know, consent consensus is, you know, very, very sophisticated at blockchain analysis, even the sort of, you know, like laundering protocols, and they do exist like tornado cash, which allows you to, to, you know, throw tokens into basically a, you know, a system that then spits the tokens out to another designated wallet and thereby sort of, you know, creates a break between yourself and the recipient wallet. Even those those systems have proven to be sort of, you know, auditable by by like sophisticated firms like like consensus, the FBI, you know, claims to have that type of technology. I don't doubt that they do. You're just you're just asking to be caught. If you use blockchain tech to I try to avoid to try to avoid the law and the suggestion that Russia can somehow avoid sanctions by, you know, moving whatever it is $450 billion through, you know, the Ethereum blockchain is just laughable. You know, like, you can see that.

S **Steven Valentino** 20:18

Everybody, I want to thank you for coming on to a hard look and discussing this really sort of almost frontier of the intersection of both technology and commerce and just financial ecosystems generally. Jason, do you have any parting comments for our listeners today?

J **Jason Schwartz** 20:32

Yeah. So crypto is like, pretty complicated, right? The user experience, it's just awful. That said, the internet user experience really sucks when it first came out. Okay. Like, I don't know, if you guys remember, like, you know, CompuServe prodigy there, you know, there were it was a disaster. Like when I was a kid, and I first saw the internet, I thought, like, you know, there's no fun in this, this is terrible, right? There's a lot that needs to get abstracted away. At this point, I can't even remember what HTML means. Or http, colon slash slash, like, I don't, I don't know what any of that means. And like, I wouldn't be surprised if you didn't either. But you still use the internet, you know, and it's highly intuitive. Right? Right. Now, we are at, like, the early days of crypto, right, very, very early days. And I will say that the user experience is a lot better than than the user experience on copy server, or prodigy was, but like, think think about it that way. But like, you know, I highly encourage anyone listening to take a little bit of time, you know, open a Coinbase account, transfer, you know, transfer some, you know, I can't, I can't say what to buy, but like, you know, get something obviously, like within reason, something you can afford, transfer it to a meta mask account or, or some other self custody wallet. Coinbase also has a self custody wallet, just just like, understand the experience of you know, what this is, I think it'll pay off in the long run. And I think that, you know, you, everyone in crypto right now is so amazingly early. It's a really exciting time. There's a lot going on behind the scenes. Some of you know, some of the world's best and brightest are, you know, building feverishly right now, you're not too late. You might be too late to like 200x your investment in the year. But like, come on, like that's not that's not what people should be getting into crypto for anyway, right. At the end of the day, like this is this is a revolution in technology and in culture, and in money. And, you know, I highly recommend that you take a little bit of time to to, you know, to understand that if you don't already. It's, it'll be worth your while in the long run, I think.

S Steven Valentino 22:59

Thank you. Ed, do you have any parting comments before we sign off for today?

E Ed Leaf 23:03

No, I mean, I think it was a really great discussion, and we really appreciate your expertise. And thanks so much, Steven, for agreeing to do this and facilitating everything.

S Steven Valentino 23:14

Awesome. Well, everybody,

J Jason Schwartz 23:16

Thank you for having me.

S Steven Valentino 23:16

Jason, thank you for coming back. Happy to see an ALR alum again. And everybody, as always,

I want to thank my guest and my co host for today for their substantial and important contributions to the discussion today, the American Bar Association's Administrative Law Section, the Administrative Law Review, and of course, the podcast's own, Kubra Babaturk for their continued support, resources and work on making this podcast and continued contributor to the important discussions happening in the world of Administrative Law. Thank you and see you on the next episode of A Hard Look.