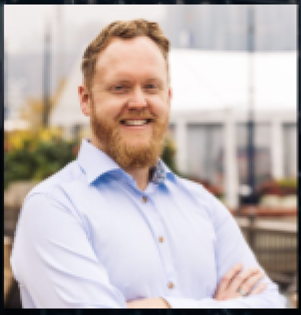
diffusetap
Virtual Event Series

How to Make Money on DEXs

Guest Speaker:

John Bugnacki
Deputy General Counsel &
Director of Regulatory Policy
Tacen

Hosts:



Kenny Estes
CEO & Founder
Diffuse

Ayla Kremb
COO & Co-Founder
Diffuse

DiffuseTap: How to Make Money on DEXs

Last time on DiffuseTap, John Bugnacki, Deputy General Counsel and Director of Regulatory Policy of Tacen, talked to us about the difference between a decentralized and centralized exchange, how the 1933 and 1934 securities acts apply differently to both of them, and whether DEXs are generally safer or more risky for end users.

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DiffuseTap

This networking session is part of our weekly virtual events series. Networking (you'll bump into at least a dozen high caliber fund managers) meets purposeful (you'll tap into brand-new sources of ideas)… straight from your armchair like a boss.

Meet the Speaker

JOHN BUGNACKI is Associate General Counsel and Director of Regulatory Policy of Tacen. Tacen is a leading non-custodial decentralized exchange that helps entrepreneurs launch tokens and traders trade more securely. Tacen is also an industry leader for boosting advocacy in important trends in crypto regulation.

LinkedIn: @john-bugnacki

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KENNY ESTES: John, would you mind telling the folks a little bit about your background and what you're up to over at Tacen?

JOHN BUGNACKI: Yeah, thanks so much. Really happy to be here. I think that events like this are really cool and really important to help advance not only our personal interests and projects, but the industry as a whole. So, thank you again. My name is John Bugnacki. I'm the Deputy General Counsel and Director of Regulatory Policy for Tacen, Inc. We are a blockchain software developer headquartered in the United States.

We have people all around the world, but our worldwide headquarters is here in Cheyenne, Wyoming. I attended law school at the University of Chicago. Prior to doing that, I worked in governmental affairs in the United States and Europe. I was an adjunct Fellow at a national security think tank, and I was mostly based in D.C. At the same time, I had a really strong interest in technology and how it's changing all of our lives and advancing it.

I was also a Senior Product Manager at a startup based in Washington D.C. called Public Spend Forum. Then, while attending the University of Chicago I did some internships at the Department of Justice and Fried Frank and other organizations, I then joined Tacen, working under our former general counsel and the chief legal officer of the HBAR Foundation, Jorge Pesok. After that, I've assumed the lead attorney role over here.

And so, as my background would tend to indicate, I'm very interested in the intersection of government policy, technology, law, and business. That's where I'm coming from.

AYLA KREMB: Thanks so much for giving a little introduction. We'll toss you right into the questions. I think everybody on this call knows what DEXs are, but do you want to give a little overview of what the main difference is between a decentralized exchange and a centralized exchange? Maybe from a legal structure and operational perspective.

JOHN: Yeah, sure. Within the digital asset ecosystem, there are a lot of different types of structures. But if we were to put it into two broad categories, a centralized exchange would be something like Coinbase or Kraken, or unfortunately, FTX. It's an exchange that is very similar to something like RobinHood or a traditional securities or brokerage exchange application or system.

In these exchanges, you have a certain amount of money that you transfer via wire or credit card into a relevant brokerage account, then that brokerage account allows you to trade and do things like limit orders and market orders.

In most of these scenarios, the centralized exchange itself is in custody of your money and is subject to many different types of applicable legal regimes in the same way that a traditional centralized securities exchange or brokerage service would be.

In contrast, a decentralized exchange focuses on separating the ability to trade on the exchange from the exchange or an affiliated entity of that exchange that is custodying and holding your money. There are many types and many prominent examples of a decentralized exchange, including Uniswap or dYdX.

A lot of these decentralized exchanges like Uniswap do not use a traditional centralized exchange or centralized securities exchange model, like market makers. They use alternative models like liquidity pools. If you are a centralized or even a decentralized digital assets exchange, there are many applicable regulatory regimes that could affect what you're doing.

In particular, there is the Securities Act of 1933 and Securities Act of 1934, and all the potential regulations that relate to insider trading and fraud and how that's addressed in the context of a centralized versus a decentralized exchange.

The argument made by many decentralized exchanges is that one, whether they are considered to be an exchange, and two, whether they're actually helping to exchange relevant assets that are considered to be securities. It's also a question of whether they are subject to an enormous number of regulatory requirements in terms of customer disclosures, and in terms of maintaining a certain amount of funds within the organization. These are more or less the guardrails on what you can and can't do.

The reason why we haven't seen more innovation within this area is that the registration and filing requirements under the '34 Act and the '33 Act are very intense. But with decentralized exchanges, many of them have at least attempted to make the argument that they don't constitute as an exchange under the '34 Act.

Because rather than serving as the entity that brings together relevant trades and facilitates the trading of the securities, they merely provide a forum, or a peer-to-peer system that they aren't controlling and that they couldn't use to embezzle customer funds. Instead, it merely provides a venue to do that.

And then, in terms of money service business regulation, many of the decentralized exchanges argue that they don't constitute money services businesses facilitating the exchange of money and resources across relevant state borders and international jurisdictions. That's because they don't custody the money themselves.

You can also get into the regulations around FinCEN and the relevant sanctions. Whereas, in the case of a centralized exchange, a lot of them attempt to block out relevant jurisdictions that are prohibited under FinCEN or the Patriot Act which they would be applicable to in order to comply with these regulations. Some decentralized exchanges have gone down a similar path.

Then, of course, people can use technology to be able to break some of these VPNs and the SEC asserted jurisdiction, at least in one case, over a relevant exchange that was accessed by U.S. users that didn't use anti-VPN blocking technology, which is interesting.

There are a lot of other things that could be considered. For instance, are specific tokens or exchanges under U.S. law? Are these securities or commodities? And then, what should be the designated regulator of the digital assets spot market? There are a lot of different considerations at play.

KENNY: It sounds like the people that are doing everything on-chain are making the argument that they are tech providers, even if they are doing custody, so they really shouldn't be regulated by either the SEC, the CFTC, or the Department of Justice and FinCEN.

I guess the question then would be, does that make them less safe? I know FTX has really eroded a lot of trust in the industry, and there's been a groundswell for regulators to come down hard. We're seeing the SEC doing that. How do you see that playing out in the current environment?

JOHN: The interaction between the SEC and these various digital asset service providers?

KENNY: Exactly.What do you expect to happen over the next three to six months in the regulatory environment with these various on-chain DEX solutions? And the corollary of that is, who are the users? Is this slowing down institutional adoption? Is it going to be all retail? What are your thoughts?

JOHN: When we talk about securities regulation in the United States, one of the main things you have to take into account is that historically, the idea is that the most important role the SEC plays is consumer protection. It's there so I can't come out and sell a bunch of shares in some non-existent enterprise and then either flee the jurisdiction or dump them on you, or something like that. We see this come up time and time again where there isn't another regulatory regime that governs a particular product.

For instance, generally in the case of many banking products, if you look at the Howey Test for an investment contract for instance, or the Reves test for a note, they could be considered within the purview of the SEC. However, because they're covered by another regulatory regime that provides sufficient protection toward those consumers, then it wouldn't be covered.

But if the potential security is not covered and if it's not being used in and of itself primarily for its utility rather than its speculative character, as the SEC elaborated in the 2019 staff guidance, then the SEC will at least try to assert jurisdiction over it. So, how does that attitude govern what we are seeing currently with the SEC? In my opinion, in terms of current Chairman Gensler's approach towards digital assets and cryptocurrencies, the gold standard for him is Bitcoin.

But how is Bitcoin and Ethereum different in his opinion than a lot of these other cryptocurrencies? The entire idea there is that the creator of it, Satoshi, at least to our existing knowledge, never took his tokens and sold them into the market, or sold them into the market to fund a particular product or something like that.

It's a true decentralized protocol. And so, there are unusual circumstances there. No one knows what really happened to Satoshi. Many people believe that he might be dead or incapacitated or something. That's why he never spent any of his coins.

Some projects, at least according to the 2019 SEC staff guidance, would have been considered not decentralized at the beginning but then became more decentralized. This is because of the governance, and the utility of the underlying digital asset or token that's being offered turning from a security into a non-security over time.

The issue with this is that other than this 2019 staff guidance, the main process by which the SEC is making this law is through enforcement actions. And when we have enforcement actions, we don't get much insight other than just reading the tea leaves, various statements by Chairman Gensler, and various statements by other heads of agencies.

Other than the existing 2019 SEC staff guidance, we really don't have a lot of insight into how they are evaluating a particular product, for instance, in determining whether it's decentralized versus centralized. That's what I was seeing with Bitcoin and certain decentralized networks.

Whereas, if we had movements from Congress, they would say "okay, this is what the definition of a security is versus a non-security within the digital assets context." For instance, in the Lummis Gillibrand bill, we really don't have any of that when we have enforcement actions.

And things come up in the news. Why did the SEC consider this to be decentralized or centralized? A lot of it happens behind closed doors. We don't get a lot of insight for future projects, and people are not able to angle themselves to participate in a compliant way. What I've been seeing is that a lot of these projects come out with a lack of regulatory security in the United States. That's why they're moving instead overseas and to other jurisdictions.

AYLA: That was a very long and thorough answer. I love it. A couple more questions along the lines of security. A DEX is a little bit like a DIY environment. Not that FTX is super secure itself (it got massively hacked in the middle of everything). But how should folks be thinking about DEXs from a security perspective?

JOHN: If you have a centralized exchange, there are a number of relevant challenges both from the user perspective and the security perspective. As you were alluding to, Ayla, if the exchange has your funds, then it can be hacked. But also, if the company is on a systematic basis or on an individual basis taking custody of your funds, the money that's being held in the DEX could be embezzled or messed around with in terms of trading for certain centralized exchanges. Many have argued this trading blockchain point with RobinHood, so it goes beyond the digital asset context.

We've seen that there have been concerns, at least on the part of retail traders, that the exchange itself has suspended trading or withdrawals in order to advantage commercial entities that the exchange might be associated with. In contrast, decentralized exchanges are much more secure. That's because there are different models to do this.

Some exchanges that claim they're decentralized are not actually decentralized. But a lot of the prominent ones I would consider are. If you're merely holding it in your Metamask wallet and you're signing a smart contract to allow your funds to be exchanged on a certain decentralized network, then those funds would be entirely secure in my opinion.

The only issue potentially is that if a decentralized exchange uses wrapping or bridging to enable cross-chain settlement and trading. That has obviously led to hacks, I believe, in the hundreds of millions, if not more.

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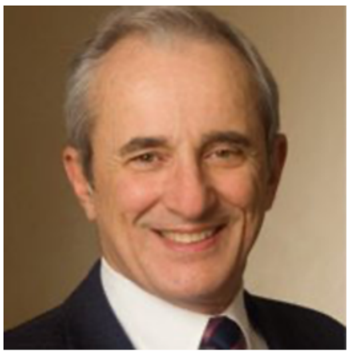
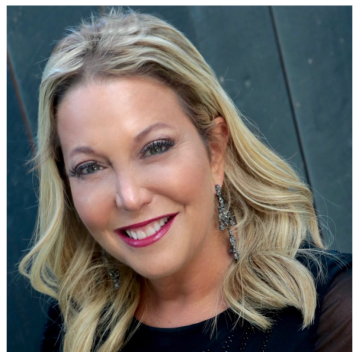


Dennis Chookaszian

Corporate Director, CME Group

DiffuseTap: Institutional Grade Governance

Sharing his decades-long expertise on corporate governance, Dennis talked about how to avoid a co-partnership going sour, the problem with overly idealistic CEOs, and the importance of keeping your board in check. Read on

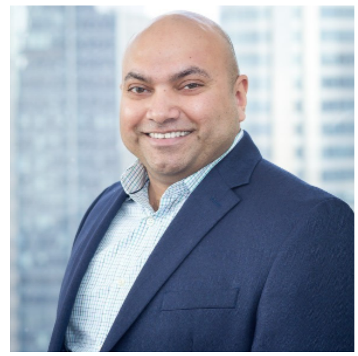


Susan Brazer

CEO & Founder, LionShare Media

DiffuseTap: Media Metaverse 2022

Susan described the 2020 digital media landscape; the evolution of media distribution; how converging, emerging technology points to the metaverse; and the prospect of having an open, decentralized, and free Web 3.0 marketplace. Read on



Raj Mukherjee J.D.

VP/Global Head of Tax, Binance.US

DiffuseTap: Crypto Taxes Decoded with Binance.US

Raj explained the complexities of the US crypto tax landscape, how he built a dynamic tax information system for Coinbase and Binance from scratch, and how investors can profit from crypto without getting caught in a taxation mess. Read on

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