

Tornado Cash
GDF Advisory Council Roundtable
8th September 2022 – Zoom
Summary of Discussion Points

Introduction

The discussion on Tornado Cash is significant for the entire industry as it is the first time that the US government has imposed sanctions on a piece of software rather than an intermediary or person.

The US Treasury has stated that the reason for the sanctions was, among other things, the fact that nearly \$7 billion was laundered through Tornado Cash protocol, some of it connected to criminal actors such as the Lazarus group out of North Korea, or other state-sponsored hacking groups.

Nevertheless, the protocol has also been used for legitimate and humanitarian causes, which operations have also now been forbidden. This has raised questions in the community on the balance between compliance, transparency, and privacy.

GDF represents its members and wishes to solidify a position which articulates an arisen consensus in the industry. We therefore sought guidance from our Advisory Council and wider members on how to respond to the issue at hand, both in engagement with law enforcement and supporting the industry with guidance.

The roundtable discussion sought to address two key questions:

1. What are the currently identifiable unintended consequences of the sanctions imposed on Tornado Cash?
2. What are the actionable responses and policy guidance that would best support GDF members and the industry?

The following is a summary of the points discussed, and has been arranged by theme.

1. GDF supports the development of proportional regulation, and recognises the importance of cooperating with regulators, law-enforcement, and investigations in the crypto-industry

- Participants recognised the scale of this attack and the extent to which the Tornado Cash protocol was susceptible to misuse. The event shows that the crypto community does not exist in isolation, but plays an important role in the wider financial system
- There is a need to reflect on what the sanctions themselves say, as well as the wider regulatory landscape, and be balanced in our response to the ongoing development of regulation for crypto and digital assets.

2. There may be unintended consequences to banning the use of software, particularly those that may also have legitimate uses

- Although industry must be vigilant concerning weaknesses that make platforms susceptible to misuse, there is evidence of software such as Tornado Cash being used for legitimate reasons
- Both community and authorities must come to agreement over whether the software has legitimate uses, or it should be banned altogether. To address this we must be specific on what is being banned: whether the software itself or mixing activities
- If this is not addressed, there is a risk that the same software is replicated under different names.

3. There must be open and public conversations on the balance between privacy and transparency in digital finance, and how this can work in harmony with abiding with AML regulations

- Privacy-preserving technologies may be necessary in crisis situations, and have been used for humanitarian aid. There is a risk that banning all privacy-preserving technologies will have a profound impact globally
- Practical solutions to this challenge are necessary, particularly with a view to demonstrating a compliance-minded focus in the industry
- One solution would be to develop identity in the digital asset environment: for example, the technology could require a user's identity at layer 1, but privacy could be built into the applications beyond that. Responsible parties could disclose this to authorities when necessary, but allow transactional privacy in other cases.
- The inevitable end point of the current regulatory direction will be some sort of key, verifiable signature which will disclose the counterparties identity in a transaction and can be made transparent under certain circumstances. This will allow industry to meet both the AML and KYC rules, but also preserve the existing market structure. The current need is to find practical solutions and standards that the industry can agree with that will also accomplish those goals.
- There is a difference between privacy and anonymity, and the focus should be on how to deliver the first while at the same time respecting government needs and requirements.

4. There are complexities to remaining compliant with the sanctions

- Firms have raised questions on how to comply with the sanctions if one of your customers has been sent money through tornado cash, where you are unable to block the transfer. In this case, innocent receivers may have their account frozen.



- A lot of the compliance burden is on VASPs, which are often small and find it difficult to respond to them. It would be useful to find technological solutions such as automated verification systems, which would allow these services to exist, while at the same time mitigating the risks connected to their activity.

With these comments in mind, participants offered thoughts on the next steps for the community:

1. GDF should focus on the development of further guidance for the industry on the application of the sanctions

- The community must become familiar with the complexities of sanctions laws in order to respond adequately to the level of risk they are willing to take
- Using reg-tech solutions, firms must adjust their settings to become more sophisticated with the prohibition of illicit activity, rather than simply avoiding large groups of activity that may not be illegal.

2. Industry should focus on the development of practical solutions to these challenges

- Regulators and policymakers have policy objectives, which the industry needs to understand and help them achieve through technological solutions
- The industry must collaborate to ensure the development of clear solutions to address the issue of the balance between privacy and anonymity, demonstrating how crypto and digital assets can continue to take part in a wider financial market subject to laws and regulations
- The industry should continue to collaborate on the technical standards and verification systems that would provide a level playing field for the industry for regulatory compliance.

3. The GDF community should continue to engage with agencies on the development of proportionate regulation and policy that engenders meaningful compliance

- Although it is clear that regulators and law enforcement agencies thoroughly understand the risks, it is important to continue to engage on the complexities of an asset or product line
- Industry will need further guidance from agencies on how to remain compliant in the cryptoasset environment. Some questions/points of clarity include:
 - Given that transactions can be traced back further than in the traditional finance environment, how many transactions back should firms be concerned?
 - Industry needs clarity over when actors are implicated: if one was not engaging with Tornado Cash directly, but through digital connections you were ‘pulled in’ to transacting



with addresses who were (for example, through a ‘dusting’ attacks), what is your legal situation, and what steps should you take?