Risky Business- Cryptocurrency, Money Laundering, and Smart Contracts

Part 1 of 2

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Agenda

Part 1:

- A Primer on Money Laundering with Cryptocurrency
- Cryptocurrency Regulators
- Law Enforcement and Cryptocurrency

Part 2:

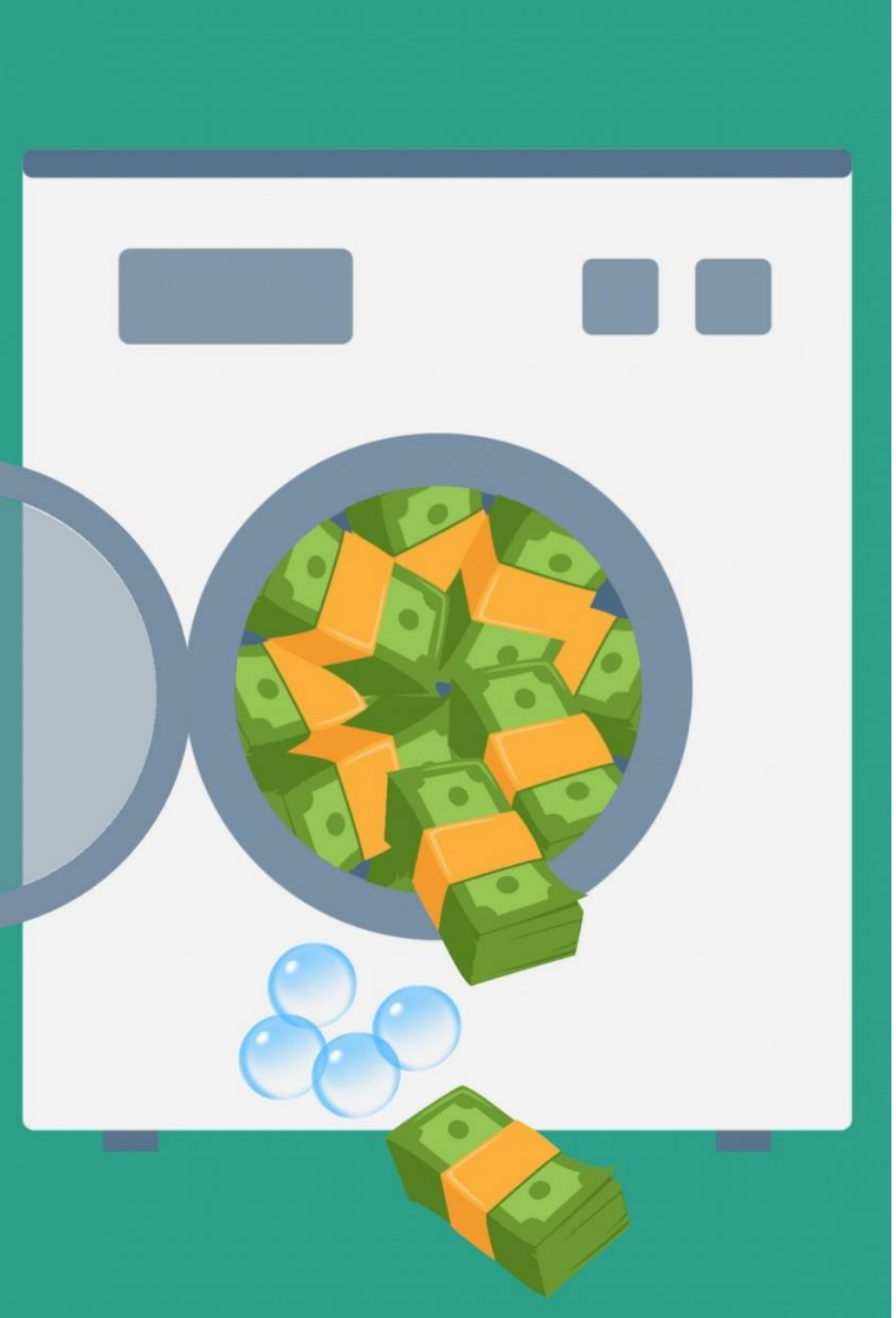
- Smart Contracts: The Good, The Bad and The Ugly
- Survey of Recent Investigations and Legal Actions
- Key Takeaways

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A Primer on Money Laundering with Cryptocurrency

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A Primer on Money Laundering with Cryptocurrency

- Three key stages:
  - Placement
  - Layering
  - Integration

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Placement

- **Placement** is the introduction of unlawful proceeds into the financial system and involves taking illicit funds and moving it into the financial ecosystem. This is like an exchange - Ransomware, Drugs, Weapons, Passports
- **Structuring**, which is considered a type of placement activity, is any attempt to evade legal reporting requirements for cash/currency transactions conducted with a financial institution. Examples of structuring may include, but are not limited to:
  - Cashing checks for amounts just below reporting or recordkeeping thresholds.
  - Dividing large amounts of currency into smaller sums that fall below reporting thresholds and then depositing the funds directly into a bank account on one or more days.
- As this is considered the riskiest stage of money laundering, this risk increases the distinctive traits of the crypto economy, making it more attractive to money launderers.

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Layering: Hiding the Origin of the Money

- **Layering** involves moving funds around in the financial system to conceal the origin of the funds.
- The most common methods is **Cryptocurrency Mixing (Tumblers)** which involve mixing a user's cryptocurrency with other user's cryptocurrency by sending it through a series of different addresses and recombining them to give a "clean" appearance.
- Other examples include, but are not limited to:
  - Third-party wallets;
  - Alt-coins, which is where the best-known cryptocurrencies are exchanged for less well-known cryptocurrencies;
  - Buying or selling securities through numerous accounts;
  - Obtaining a loan in one or more financial institutions; and
  - Gambling sites (dual purpose in integration).

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Integration: Using the Funds to Buy Legitimate Assets

- **Integration** is the goal of the money laundering process. In this stage, the illicit funds may appear legitimate and are often used to purchase other assets. For example:
  - Real estate or other assets;
  - Securities investments; and
  - Cash Intensive Businesses.
- This is often conducted through peer-to-peer (P2P) networks in other countries with more lax security controls than those in the U.S.
- Specifically, crypto P2P networks are often based in countries with limited enforcement and less Anti-Money Laundering (AML) regulations.
- Gambling sites often accept cryptocurrency in exchange for chips and allow the user to cash out in fiat.

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Cryptocurrency Regulators

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Anti-Money Laundering Regulations - The Impact of Crypto

- The Financial Action Task Force (FATF) published its guidance for virtual assets and virtual asset service providers (VASP) in 2019.
- The Monitory Authority of Singapore published their Payment Services Act in 2019.
- The European Union's directive on the "Prevention of the use of the financial system for the purposes of money laundering or terrorist financing" (AML 5) entered in force in 2018.
- The Financial Crimes Enforcement Network (FinCEN).

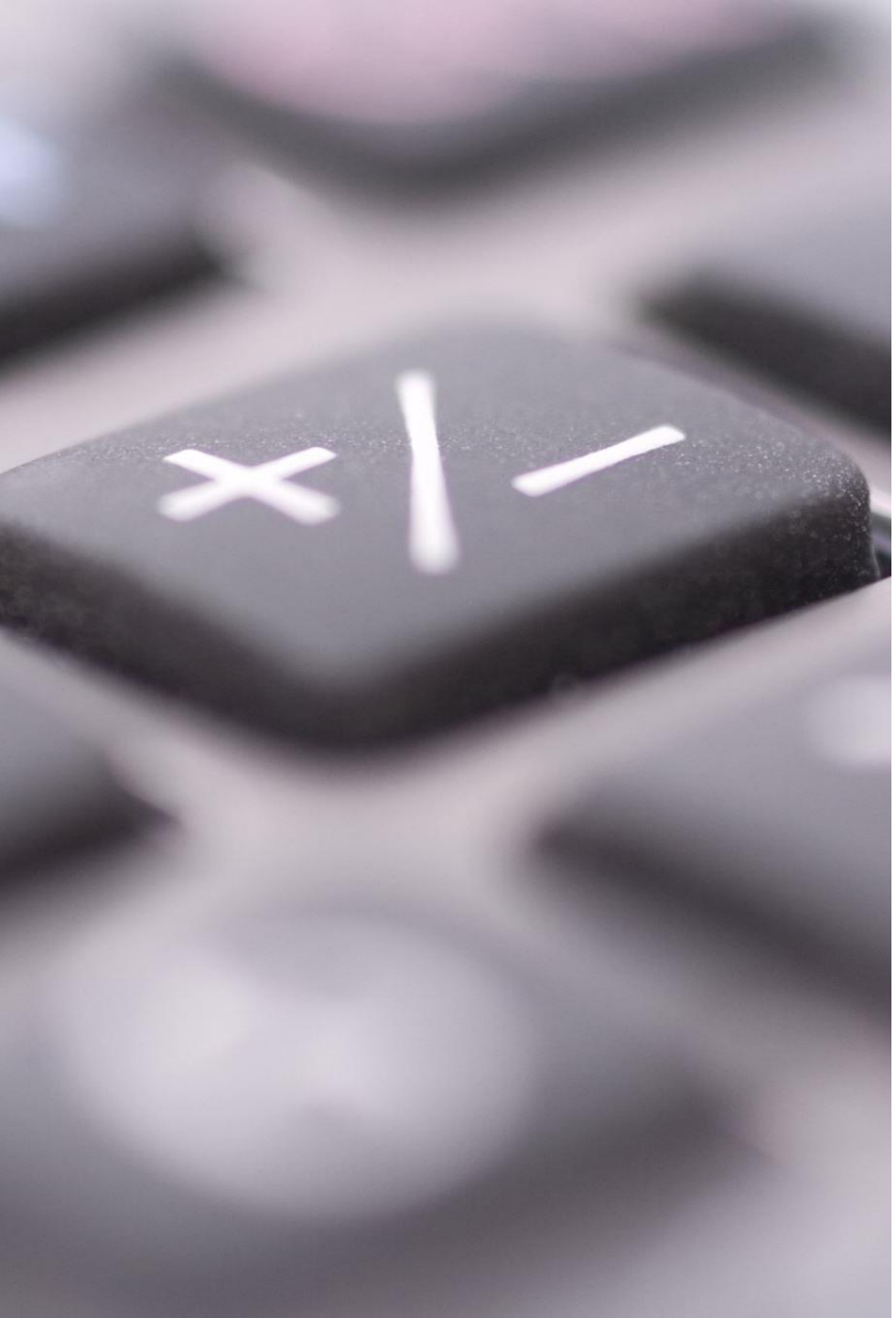
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Regulatory Landscape

- There is no one regulator for cryptocurrency in the United States, at both the state and federal level. There are, however, many regulators with different definitions.
- The U.S Treasury's views crypto as a virtual decentralized currency - not legal tender. If an individual processes it, it may be considered a money transmitter subject to FinCEN requirements.
- The Internal Revenue Service (IRS) defines cryptocurrency as property – focusing on capital gains.
- The Commodity Futures Trading Commission (CFTC) defines Bitcoin as a commodity.

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Public Policy

- The objectives of public policy surrounding crypto currency include:
  - Ensuring financial stability;
  - Protecting investors against fraud and other threats;
  - Ensuring the integrity of markets; and
  - Guarding against illicit activities.

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Public Policy in the United States

- 37 states have addressed legislation regarding cryptocurrency, virtual currencies and other digital assets. Examples of enacted legislation include:
  - Connecticut required the Board of Regents for Higher Education to develop seminar programs to assist small businesses with adapting to the business environment in the aftermath of the COVID-19 pandemic.
  - Indiana enacted legislation adding a new chapter to the Uniform Commercial Code (UCC) that governs transactions involving controllable electronic records.
  - South Dakota required that a licensee transmitting virtual currencies must hold like-kind virtual currencies of the same volume as that obligated to consumers, in lieu of the permissible investments otherwise required.

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Vermont

- Blockchain to be considered a regularly conducted business activity establishing a presumption that the information in blockchain is correct.
- Cryptocurrency is legally categorized as property instead of currency the Vermont Money Services Act (VMSA):
  - "Virtual currency owned by the licensee is permissible to the extent of outstanding transmission obligations received by the licensee in the identical denomination of virtual currency."*

** 12 V.S.A. § 1913*

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Nevada

- Recognizes blockchain as a form of electronic records satisfying the requirement for a written record in city and county government.*
- Nevada Senate Bill 163 (2019):
  - Revises the definition of "electronic transmission" to include the use of a blockchain or public blockchain; and
  - Authorizes certain business to store records on a blockchain.**

** Uniform Electronic Transactions Act*

*** SB163*

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Delaware

- Authorizes registration of shares of Delaware companies in blockchain form.
- The Delaware General Corporation Law (2017) authorizes:
  - The use of blockchain for the administration of corporate records; and
  - The use of blockchain for the electronic transmission of stockholders' communications.*

**2017 Delaware Code Title 8*

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Wyoming

- In 2019, Wyoming became the first state to enact blockchain-enabling legislation.
- The Wyoming Digital Asset Statute was amended in 2021 to:
  - Establish the treatment of digital assets as intangible property under Article 9 of UCC; and
  - Makes digital assets property subject to the UCC – allowing security interest to be perfected, opposable in all U.S. jurisdictions.*

** Bill No. HB0043, Wyoming*

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Law Enforcement and Cryptocurrency

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The "Wild West" Crypto Economy

- The SEC's Chairman, Gary Gensler noted that they will "police cryptocurrency markets to the maximum extent possible." However, he describes the current level of protection for investors in crypto as the "wild west."
- The Chairman continues to call on Congress to approve the "agency with more authority and resources to regulate the sector."
- As there is no single regulator overseeing crypto exchanges or brokers, scams and the market value of the asset class has drastically increased.

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Law Enforcement Issues

- **Transaction Rules:** since nodes can span multiple locations around the world, it is difficult to establish which jurisdictions' laws and regulations apply to a given application.
- **Privacy:** since there is no single party responsible for the security of a blockchain network, there are claims that blockchain technology is incompatible with privacy laws.
  - Examples include the European Union's GDPR.

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Law Enforcement Issues (cont.)

- **Data Security**: public blockchains are at risk of tampering at each node which can lead to the dissemination of misleading or false information.
  - For example, attackers can divert cryptocurrency wallet destinations and amounts of payments under the guise of the intended transaction.
- **Accountability:** in relation to decentralized systems, a key question is who should be held accountable for breaches of law and regulation
  - Who should be held responsible, the network of users or the system owner?

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Law Enforcement Issues (cont.)

- **Smart Contracts:** traditional contract law will likely apply to the underlying transactions embodied by smart contracts; however, poorly written software code can result in the exploitation or incorrect execution of a transaction.

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Daniel Garrie, Esq. is the Co-Founder of Law & Forensics LLC, where he heads the Computer Forensics and digital discovery Cybersecurity teams. Daniel has been a dominant voice in the computer forensic and cybersecurity space for the past 20 years, as an attorney and technologist. He is an adjunct professor at Harvard for Computer Forensics and prior to Law & Forensics, he successfully built and sold several technology start-up companies.

Since co-founding Law & Forensics LLC in 2008, Daniel has built it into one of the leading boutique cybersecurity forensic engineering firms in the industry. He is a mediator, arbitrator, and e-discovery special master for JAMS and is a partner and head of the Cybersecurity at Zeichner, Ellman & Krause LLP. Daniel has both a Bachelor's and a Master's degree in computer science from Brandeis University, as well as a J.D. from Rutgers Law School.

Daniel has led cyber and forensic teams in some of the most visible and sensitive cyber incidents in the United States. He and his team have worked for two of the top five banks in the globe, and dozens of the largest private and public companies in the world. In addition, Daniel has been awarded several patents for advanced cybersecurity and forensic platform he built with his team that is currently used in the industry, TableTop.AI, CustodyTrack.IO, and Forensic Scan.

Daniel is also well-published in the cybersecurity space and has authored more than 200 articles and books. His work is cited by Black's Law Dictionary 10th Ed. In defining the terms "software", "internet", and "algorithm." Lastly, he has been recognized by several United States Supreme Court Justices for his legal scholarship and is a trusted source and thought leader for cybersecurity articles and opinions, being cited over 500 times to date.

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Josh is the firm's U.S. Head of Fintech and Head of Blockchain and Digital Assets. She is one of the best-known blockchain and cryptocurrency lawyers in the U.S. and globally, highly regarded for her extensive experience in, and deep knowledge of, blockchain, smart contracts, and cryptocurrency matters, including initial coin offerings (ICOs)/digital token offerings.

Josh has represented or consulted to global technology companies, token sellers, cryptocurrency exchanges and relayers; venture, hedge, and private equity funds and their portfolio companies; token marketers and broker-dealers; funds interested in trading digital assets; and major global investment banks, insurance companies, financial institutions, and asset managers, among others.

By background, Josh is a finance and corporate lawyer. She spent over 10 years representing lenders and borrowers in leveraged finance and banking transactions and public and private organizations in a broad array of commercial transactions and corporate governance matters. Before joining Linklaters, Josh co-founded a blockchain and smart contracts group at a global law firm and set up her own boutique blockchain consultancy.

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ANCHAIN.AI

Victor has over a decade of experience in Data Science leadership roles at FireEye Mandiant, Awake Security, Greylock, Pivotal, and EMC. He holds 15+ patents on AI for cybersecurity and fraud detection solutions.

Recognized as the Face of FireEye in 2017, the machine learning models Victor's team innovated now underpin more than $800 million of annual product line, defending against the world's most sophisticated APT malware adversaries.

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