FINANCIAL CRIME

Opening Pandora's box - new adventures in cryptocurrency risk

Over 16 months have passed since we published "Taming the Crypto Wild West", where we discussed some of the ways criminals utilise cryptocurrency to dump their ill-gotten gains, and the burgeoning efforts of regulators to bring crypto-firms under their remit.

We have seen an explosion of crypto-crime cases since then, and it's clear that criminals have been having the time of their lives flouting international laws whilst using the technology to stay one step ahead of regulators and law enforcement.

In October 2019, the CEO of Crypto Capital was arrested for allegedly laundering £350 million in drug sales through the business[1]. A month later key figures at One Coin were convicted for their part in defrauding investors out of $4 billion in one of the largest Ponzi schemes of all time[2]. And the Mueller report[3] has pointed to Russian agents using Bitcoin to buy computer equipment to interfere with the 2016 presidential election.

These cases highlight that crypto is being utilised to conduct money laundering on an industrial scale, and that it has become a key weapon in the arsenal of criminal groups, terrorists and authoritarian regimes. For this reason, regulatory attempts to clamp down on crypto should be welcomed. The Fifth Money Laundering Directive (5MLD) has now been incorporated into UK law, finally bringing crypto firms under the financial crime regulatory regime.

But will the new framework make a difference?

It's too early to say, but things certainly aren't working right now. The prosecutor that brought down Silk Road estimates that "*99.9% of all money laundering goes unprosecuted…*" and that "*our current system is doing a pretty terrible j*ob[4]". So, any new regulations must be a step in the right direction, and hopefully new requirements will compel traders to do the right thing. That's really a question for another day, and no doubt a Financial Conduct Authority (FCA) Thematic Review on this subject will follow in the next year or so.

1 https://www.bloomberg.com/news/articles/2019-10-25/crypto-capital-official-nabbed-in-polish-money-laundering-probe

2 https://www.bbc.co.uk/news/technology-50417908

3 https://www.justice.gov/storage/report.pdf

4 https://cointelegraph.com/news/silk-road-prosecutor-999-of-fiat-money-laundering-goes-unprosecuted

The point that has not been given enough attention is that there are wider, societal risks associated with cryptocurrencies, which legislators and regulators are either reluctant or unable to address. Financial crime is not the only issue, and it is not the only risk. The very nature of a decentralised, alternative currency creates a new Pandora's box, which we are only just starting to break open.

What does the new regulatory regime say?

We know that crypto traders will be compelled to adhere to Anti Money Laundering (AML) requirements. So, from that perspective, they will have to start behaving like other financial institutions, carrying out due diligence and enhanced due diligence, monitoring transactions and reporting SARs. Hopefully they'll do a better job of things than banks have done, but at least the framework is now there.

However, AML checks aren't the only things that financial institutions are required to do. For example, they are required to adhere to standards around conduct, treating customers fairly, holding sufficient liquidity, keeping deposits safe, and not providing misleading information to customers.

FCA Guidance from July 2019[5], indicates that sometimes these extra rules will apply to crypto, and sometimes they won't. The applicability of the wider rule set will depend on the type of crypto and the nature of the product. There is a confusing disconnect – AML rules for all, and conduct rules for a few specific firms and product types. This apparent misalignment may lead to confusion, and significant ongoing risk for consumers.

Securities and exchange tokens: what's the difference?

The FCA distinguishes between securities tokens and exchange tokens.

A securities token is defined by its similarity to purchase of ordinary securities. The crypto asset might relate to shares in an entity, units in an investment scheme, or another form of financial instrument. The logic is that the token has been purchased through crypto, but it is analogous to ordinary, vanilla financial instruments. Due to this apparent similarity, it is covered by the Financial Services and Markets Act (FSMA) and additional customer protections and regulatory provisions will apply.

The picture with exchange tokens, however, is very different. Exchange tokens are what most people think of when they think about cryptocurrency. I'd call this "*retail crypto*" or "*your annoying mate at the pub crypto*". Exchange tokens are all about the buying of alternative, decentralised currency, hoping to sell it on for more than you paid for it. That's the key model that most people understand to be associated with cryptocurrency.

5 https://www.fca.org.uk/publication/policy/ps19-22.pdf

> *It should be noted that this [5MLD] refers to an AML regime and does not have the effect of bringing any participant into the full FSMA regulatory perimeter.*

The 5MLD requirements will be extended to such activity, but wider consumer protections will not. The FCA is very clear on this point:

"*It should be noted that this [5MLD] refers to an AML regime and does not have the effect of bringing any participant into the full FSMA regulatory perimeter*[6]".

The FCA notes that it is unable to widen the regulatory perimeter by itself so further legislation would be needed to afford greater regulatory protection. The FCA position is understandable, it cannot, of course, extend its own brief – but at present, the wider risks associated with crypto will continue unabated.

What are the risks to everyday consumers, businesses and friends who go on about crypto a bit too much?

Mis-selling and market volatility

The PPI scandal has rumbled on for over a decade, with banks paying out 50 billion to their customers. The banks were liable to pay compensation as they mis-sold insurance products to customers, in some cases not considering individuals' needs and circumstances, and in others outright lying to them. It has been a costly scandal for the banks, and it has highlighted the responsibilities of financial institutions and the legal rights of the individual consumers.

The basic protections afforded to bank customers do not exist in the retail crypto or exchange token world, and there is no recourse for bad advice, or mis-sale of products, and no recourse to the Financial Ombudsman Service if things go wrong[7].

So why is that a problem? Well, there's a lot of slick marketing out there about cryptocurrency. You can see it in magazines, on the tube, on TV and social media, and it usually promises huge returns. But as the old mantra goes, if it seems too good to be true, it probably is.

6 https://www.fca.org.uk/publication/policy/ps19-22.pdf

7 https://www.fca.org.uk/consumers/cryptoassets

The House of Commons Treasury Select Committee on Digital Currency pointed to a deeply misleading article for Bitcoin in an EasyJet inflight magazine, that promised vast returns on investment. The article omitted key information, such as the volatility in the markets, and that the value of the coin had been decimated in the previous months[8]. The picture around Bitcoin volatility is unmistakeable – crashing and burning, before emerging like a Phoenix from the flame, then falling and rising once again.

> *Crypto assets are extremely risky...and investors should be prepared to lose all their money.*

People will always want to get rich quick, and many emerging providers will be happy to peddle untruths to secure investment. If retail crypto remains underregulated, then this behaviour will no doubt continue. As the Committee pointed out:

"*Crypto assets are extremely risky...and investors should be prepared to lose all their money.*"

That is a very stark, troubling message, and a world apart from the fanciful dreamy accounts of students making millions from their bedrooms.

Keeping your money safe from fraud

There are two main things to be worried about from a fraud perspective. Firstly, if the firm itself is genuine. Secondly, there's the potential for organised criminal groups to wander off with your hard- earned coins.

There have been numerous instances of firms being set up specifically to defraud customers. Action Fraud has seen a massive spike in confidence scams involving crypto, including £27 million in losses recorded in summer of 2019[9]. This is a massive problem for consumers, but one that regulators can do little to prevent.

An area where the regulator might become involved, however, is third party fraud: where your details or information are used to process a transaction without your consent. The scale of money stolen from crypto exchanges is eye-watering, totalling $US 1.2 billion in the first three months of 2019, and $US 1.7 billion in 2018. Again, if this happens to a banking customer – say if your credit card is stolen, the bank will be required to pay the money back. However, there is no such protection with retail crypto.

My first job after law school was as a fraud adjudicator at the Financial Ombudsman. So, I know how horrendous it is to be the victim of fraud, and the huge toll it can have on people having to fight against the bank to get their money back. But it was heartening to know that there was a system of recovery in place and that it was possible for customers to have redress.

Market integrity

The FCA has pointed out that crypto markets are particularly susceptible to market abuse and insider trading[10]. As there are fewer people active within these markets, there is a greater risk of individuals co-ordinating, and conspiring to influence pricing before cashing out. In fact, if you google "*pump and dump crypto*" the first hit is a user manual[11] on how to conduct market abuse through cryptocurrencies. At least they are honest about it I suppose.

And as retail crypto sits outside of the FSMA, market abuse provisions do not apply. This perpetuates a status quo, where a small group makes huge returns, at the expense of ordinary investors. So while such abusive behaviour may not be officially illegal, which is bad enough, it begs the question of whether it is ethical given that consumers are left entirely exposed with no means of getting their money back. The regulator has no power to fine, or otherwise discipline the industry.

The crypto regime: what's next?

The law has finally caught up with technology in the AML space. This is to be welcomed, and new AML legislation may help to stem the gargantuan tide of financial crime across the crypto world. But crypto risk is like the hydra, if you cut off one head three more will rise in its place. We are seeing this with fraud, mis-selling and market abuse, and so far, these areas have yet to fall within the regulator's remit. The FCA's hands are tied as it awaits guidance from the Treasury.

The loser in all of this is the consumer, whether they have been swayed by promises of vast returns, their account has been hacked, or they sit outside a cabal of traders, manipulating the market to their own ends.

What is needed is a coordinated, focussed attempt to bring all risks associated with crypto under the same regulatory framework. If cryptocurrencies are indeed the future, then their proponents should look to expanding the protections offered to individual users, and to stamp out shadier practises that benefit a small minority. Whether there is the will to deliver this, either at industry or legislative level, remains to be seen.

Over to the Treasury.

8 https://publications.parliament.uk/pa/cm201719/cmselect/cmtreasy/910/910.pdf

9 https://www.actionfraud.police.uk/news/over-27-milln-reported-lost-to-crypto-and-forex-investment-scams

10 https://www.fca.org.uk/publication/consultation/cp19-03.pdf

11 https://padl.mine.nu/crypto-how-to-pump-and-dump-coins-full-tutorial-guide.php

James Fanning
Director, Financial Services
+44 (0)20 3727 1846
james.fanning@fticonsulting.com

About FTI Consulting

FTI Consulting is an independent global business advisory firm dedicated to helping organisations manage change, mitigate risk and resolve disputes: financial, legal, operational, political & regulatory, reputational and transactional. FTI Consulting professionals, located in all major business centres throughout the world, work closely with clients to anticipate, illuminate and overcome complex business challenges and opportunities.

The views expressed in this article are those of the author(s) and not necessarily the views of FTI Consulting, its management, its subsidiaries, its affiliates, or its other professionals.

www.fticonsulting.com

©2020 FTI Consulting, Inc. All rights reserved.

937 - 03/20