

# Cryptocurrency: compliance and controls

Forensic & Integrity Services  
November 2021

# Summary

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Cryptocurrency and blockchain technology continue to become more prevalent in the financial world. As use becomes larger and more integrated, regulations and regulatory scrutiny continue to progress. This growth has not gone unnoticed as many brokers, exchanges, investors and other crypto-involved entities are facing increased scrutiny from US regulators, tax authorities and enforcement agencies across the globe.

Compliance missteps can be costly and hinder the progress of growing organizations, potentially determining the success or failure of a crypto-involved business during this turbulent period. It is imperative that the issuers and trading platforms of crypto assets are flexible and adaptable as the legal requirements and regulatory frameworks are ever-evolving. Addressing these compliance issues and taking full advantage of the available technology and expertise is vital to successfully navigating the cryptocurrency and blockchain world.

# Navigating challenges unique to the Financial Services industry

## 1 Proper classification of the different ranges of cryptocurrencies

- ▶ Various US regulators and states have devised unique approaches to address and regulate cryptocurrencies, but a cohesive framework of regulation has yet to be created, and governments continue to struggle to address the nuances of the various cryptocurrencies across the globe.

## 2 Cryptocurrency as money

- ▶ In certain instances, US regulators have avoided classifying cryptocurrency as “money,” referring to it rather as crypto assets. Developers of coins attempting to provide an alternative to money have launched “stablecoins,” which are crypto-currencies that are fully backed by fiat currency, making them a suitable alternative to traditional money and bringing the industry closer to unavoidable regulatory intervention.

## 3 Transition from traditional markets to markets of the future

- ▶ US regulators have historically leveraged existing regulations and guidelines to respond quickly to developments in the market under the philosophy that activities performing the same function should be treated under the same set of rules. As a result, many US regulators across various US states and jurisdictions use rules from existing laws for securities investments regarding cryptocurrencies and tokens.
- ▶ Because the crypto asset space changes rapidly and the functions are continuously shifting and expanding, the institutions participating in crypto activities and associated US regulators ultimately will likely need to create entirely new structures to respond to the industry.

## 4 Classifying investors

- ▶ Traditionally, US regulators classify investors based on metrics, including indicators such as wealth, deal size and legal status. This has typically applied to the primary market rather than secondary markets. This poses issues with investors operating in decentralized markets.

## 5 Relying on intermediaries

- ▶ Self-custody using personal cryptocurrency wallets eliminates intermediaries, which is a core component of securities regulation.

## 6 Criminal activity

- ▶ Cryptocurrencies pose a threat when it comes to money laundering, tax evasion and other criminal activities. However, the manners in which they may be manipulated are still evolving and can be different than fiat currency because of their properties. Nonetheless, cryptocurrencies, like other more traditional forms of currency, are susceptible to criminal exploitation.

# Regulations in action

Cryptocurrencies, their issuers and crypto platforms facilitating payments and trading are regulated by several agencies, depending on the specific act or action. These agencies operate independently using their own divergent methodologies and considerations regarding regulation of cryptocurrencies. The US Department of Justice (DOJ), US Securities and Exchange Commission (SEC), Federal Trade Commission (FTC), Internal Revenue Service (IRS), Financial Crimes Enforcement Network (FinCEN), Office of the Comptroller of the Currency (OCC), Office of Foreign Assets Control (OFAC), and Commodity Futures Trading Commission (CFTC) all regulate different aspects of virtual currency based on their specific classification of virtual currency and their view of the underlying properties thereof.

**SEC:** Current SEC Commissioner Gensler said the SEC's authority is restricted to securities and products or asset managers that might invest in cryptocurrencies.

The SEC considers "tokens" that act like securities – or cash or cash equivalents – fall under its jurisdiction. Many crypto assets do not appear, on their face, to be "securities" because often they do not take the form of stocks, bonds, etc. But the definition of "security" contains a catchall term – namely, "investment contract," which picks up esoteric instruments that, in substance if not form, have the same basic attributes of the types of financial instruments expressly named as securities in the definition. That being said, the SEC has already taken the position that bitcoin and Ethereum are not securities. But companies like Coinbase, which is "effectively making a market" in cryptocurrencies, are subject to SEC regulation.<sup>1</sup>

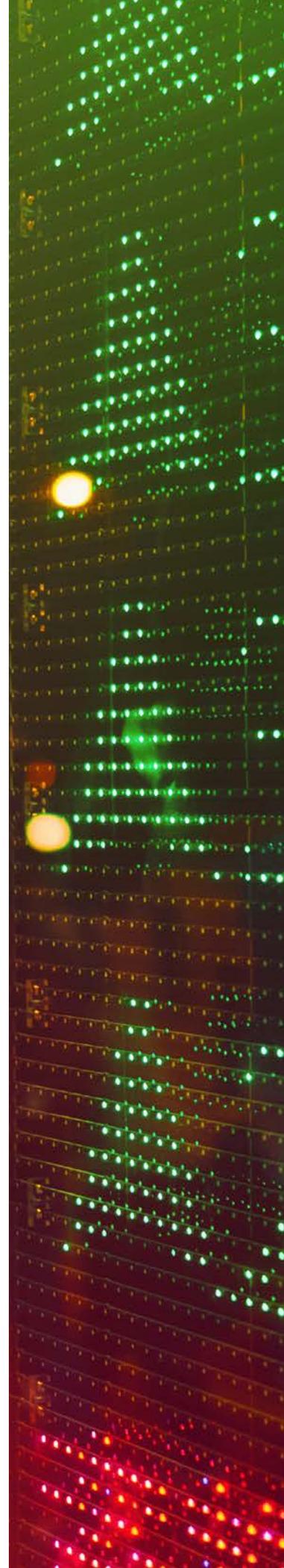
**CFTC:** The CFTC takes the position that virtual currencies are encompassed under the definition of a "commodity," including bitcoin and Ether. The CFTC has stated that while its regulatory oversight authority over commodity cash markets is limited, it maintains general antifraud and manipulation enforcement authority over virtual currency cash markets as a commodity in interstate commerce.

Traders, advisors, agents and exchanges in the commodities market, as well as cryptocurrency fund managers investing in futures contracts tied to digital assets, must register with the CFTC or as a commodity trading advisor (CTA) and commodity pool operator (CPO) with the CFTC.

**FinCEN:** FinCEN considers virtual currency to be a money service business (MSB) subject to FinCEN regulations. Virtual currency service providers must (1) obtain a license from FinCEN, (2) implement an anti-money laundering/countering the financing of terrorism and sanctions program, and (3) maintain records and submit reports to authorities. FinCEN's proposed rules and regulations related to cryptocurrency are anticipated to be finalized by September of 2021.

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<sup>1</sup> The oversight of the SEC may increase as Chairman Gensler has suggested that Congress could take a role in bringing overarching regulation for crypto exchanges, similar to those for equities. SEC Commissioner Hester Peirce has stated that she believes the US is falling behind the curve compared to other countries' regulatory framework for the blockchain and cryptocurrency industries.





**OFAC:** OFAC considers virtual currency to be treated the same as fiat currency and emphasized compliance obligations are the same. In addition, OFAC has started to include virtual currency addresses linked to sanctioned persons in its Specially Designated Nationals and Blocked Persons List (SDN List).

**IRS:** The IRS considers cryptocurrency to be property and has issued tax guidance describing when virtual currencies are subject to taxation. The IRS has indicated that virtual currency operates like a traditional currency, but it does not have legal tender status in any jurisdiction. The same tax principles that apply to property apply to virtual currencies from the perspective of the IRS. Under state or federal law, the sale of virtual currency is regulated if the relevant transaction constitutes the sale of a security, is considered a money transmission under state law, or an MSB under federal law.

**OCC:** January 2021, the OCC published a letter confirming national banks' and federal savings associations' authority to connect to blockchains as validator nodes on independent node verification networks (INVN), where they may validate, store and record payment transactions in virtual currencies. It was clarified that banks may use INVNs and related stablecoins, or virtual assets backed by fiat currencies, to carry out other permissible payment activities. This letter recommended that banks continue to expand compliance programs to align with Bank Secrecy Act (BSA) reporting and record-keeping requirements as well as address risks associated with cryptocurrency transactions. In May 2020, the OCC published a letter indicating that national banks may conduct activities involving virtual currencies, in any state, even if aspects of its activities fall within the state's definition of money transmission and the bank is not licensed by the state as a money transmitter.

In 2016, the OCC issued a special-purpose charter, permitting non-depository FinTech companies to operate under a federal charter overseen by the OCC without the burdens of state-by-state regulation and licensing. In 2018, before any companies submitted an application, the New York Department of Financial Services (DFS) filed suit against the OCC challenging the OCC's authority to provide the FinTech charter under the National Bank Act (NBA). The lawsuit has gone through several rounds of appeal, and in June 2021 the Second Circuit overturned DFS's challenge. It is unclear at this point how the OCC, or those challenging it, will proceed if a potential applicant applies for a FinTech charter.

**State regulations:** Individual states have also implemented regulations, as New York became the first state to regulate virtual currencies in June of 2015. Since then, most US states have created their own regulations for virtual currencies. Certain states have passed less stringent regulations, which exempt virtual currencies from state securities laws and money transmission statuses to promote the use of cryptocurrencies. Below are some examples of state regulations:

- ▶ The DFS issued requirements requiring any persons who resides, is located, has a place of business or is conducting business in New York State to obtain a license (BitLicense) before engaging in any virtual currency business activity. These regulations were updated in June 2020 to provide a new framework for entities to apply for a conditional BitLicense when partnering with an existing entity already authorized by DFS to engage in virtual currency business activity. However, the existing licensee is required to provide staffing, as well as operational and other needed support, to the conditional licensee until a full license has been granted by the DFS.
- ▶ In September 2018, the Governor of California approved the creation of a “blockchain working group” that will research blockchain’s benefits, risks and legal implications. Additionally, California’s state legislature enacted Assembly Bill 2658, introducing legal definitions of “blockchain technology” and “smart contracts.” In 2020, the governor signed the California Consumer Financial Protection Law, creating a new division to monitor markets and research cryptocurrency.
- ▶ In February 2021, the Illinois House introduced a new bill amending the current Blockchain Business Development Act to include the Department of Financial and Professional Regulation and the adoption of rules, opinions or interpretive letters regarding the custody of digital assets. Additionally, another bill indicated virtual currency is abandoned if it is unclaimed for five years. Once considered abandoned, the virtual currency will be liquidated, and the proceeds will be remitted to the state treasurer. As a result of the bill, Illinois will also be the second state allowing special trusts to hold digital assets. The bill received unanimous support as there are high hopes that boosting FinTech and cryptocurrencies will drive positive economic growth.

**Eliminate Barriers to Innovation Act of 2021:** This new bill was introduced into Congress in March 2021. If enacted into law, this bill would create a digital asset working group between the SEC, the CFTC and various representatives from the private sector. The working group will clarify situations in which the SEC or the CFTC has jurisdiction over the virtual currency.



# Recent enforcement actions

As regulation has grown with heightened scrutiny, there has been an uptick in recent regulatory and enforcement actions involving virtual currencies. Through these enforcement actions, US regulators are expressing that compliance with their specific regulations is necessary and expected. In addition, the enforcement actions provide issuers, platforms, users and exchanges insight into the different regulators expectations. Below are some recent enforcement actions:

**Helix and Coin Ninja LLC:** In October 2020, FinCEN imposed a civil money penalty of \$60 million against Larry Dean Harmon (Harmon), the primary operator of Helix as well as CEO and primary operator of Coin Ninja LLC. These companies operated as “exchangers” of convertible virtual currencies that accept Bitcoin and transmit Bitcoin to another person or location by a variety of means. FinCEN determined that from June 2014 through December 2019, Harmon, doing business as those entities, willfully violated the Bank Secrecy Act by (1) failing to register as a money services business, (2) failing to implement and maintain an effective anti-money laundering (AML) program and (3) failing to report certain suspicious activity.

**BitGo, Inc:** In December 2020, OFAC announced a settlement of \$98,380 with BitGo, Inc. (BitGo) due to apparent violations of multiple sanctions programs related to digital currency transactions. From March 2015 through December 2019, BitGo failed to prevent individuals and/or entities located in Crimea, Cuba, Iran, Sudan and Syria from using its non-custodial secure digital wallet management service. All of these jurisdictions were subject to comprehensive embargoes under OFAC regulations during at least part of the time that transactions occurred. This civil settlement represents the first OFAC enforcement action against an entity operating in the blockchain industry.

**LBRY, Inc:** In March 2021, the SEC charged LBRY, Inc. (LBRY) with conducting an unregistered offering of LBRY credits, its digital asset securities. LBRY sold LBRY credits to several investors, some of which were based in the United States, without filing a registration statement with the SEC for the offering which is in violation of the registration provisions of Sections 5(a) and 5(c) of the Securities Act of 1933. Through the unregistered offering, LBRY received over \$11 million in US dollars, Bitcoin and services from its purchasers. Currently, the SEC is seeking yet-to-be-determined civil penalties, permanent injunctive relief and disgorgement plus prejudgment interest.

**BitMEX:** In August 2021, FinCEN, as part of a global settlement with the CFTC, assessed a civil monetary penalty of \$100 million against Bitcoin Mercantile Exchange (BitMEX) for violations of the BSA and FinCEN’s implementing regulations. The penalty was in response to the CFTC and DOJ having previously filed enforcement actions against the owners of BitMEX in October 2020. Although BitMEX is incorporated in Seychelles, it was discovered that BitMEX had several American investors who would disguise their location. Creating an account with BitMEX only requires IP verification through VPN software or the Tor network, and a significant portion of BitMEX’s business operations were located in the US. The CFTC filed a civil suit against the owners of BitMEX for failing to incorporate required US anti-money laundering procedures and operating an unregistered trading platform. Additionally, the DOJ and FinCEN charged the owners with criminal violations of the BSA and conspiracy for willfully failing to establish, implement and maintain an adequate AML program.

# Items to consider

**Proactive action:** Crypto entities can avoid current and future noncompliance by pre-emptively constructing a compliance program framework and taking advantage of “regulatory sandboxes” made available by US regulators. Regulatory sandboxes are closed environments that serve as testing grounds to assess the impact and regulatory adherence of new business models prior to large-scale rollouts. These sandboxes are provided by regulatory authorities including the Financial Conduct Authority (FCA) in the UK and the Consumer Financial Protection Bureau (CFPB) and CFTC in the US. As regulations heighten, crypto entities must develop an understanding of what falls under the purview of which regulation and with which regulatory bodies the entity must register. Registration systems should be adequately designed to detect and deter criminal activities, even if the entity is currently operating in a jurisdiction that is currently underregulated. Entities can help protect themselves against potential noncompliance ramifications by prioritizing strong know-your-customer (KYC) procedures and AML programs from the beginning and implementing continuous monitoring of new and changing regulations. These are all integral, proactive steps in developing and maintaining compliance.

**Dealings with US persons:** Proper monitoring and disclosure of dealings with US persons, whether located in the US or not, is a crucial point of compliance for crypto entities. Conducting business with US persons opens an organization to the more rigorous regulatory standards of the US. It is also critical to consider state-specific regulations, such as those in New York and California, that apply to those conducting business in the state or for those incorporated in the state. The state of New York currently levies some of the strictest compliance legislation in the United States.

## Fundamentals of compliance programs

While a financial service organization’s regulatory program contains a wide array of requirements to comply with various US regulations, the following items are strong components of a compliance program as it relates specifically to financial crime risks:

- ▶ Performing customer due diligence based on assessed levels of risk
- ▶ Identification of politically exposed persons (PEPs)
- ▶ Proper vetting and screening of clients against sanctions lists and OFAC
- ▶ Implementing appropriate programs related to compliance with the Foreign Corrupt Practices Act (FCPA) and anti-bribery and anti-corruption (ABAC) regulations that seek to prevent corrupt practices and bribery
- ▶ Conducting ongoing monitoring of activity to identify unusual or suspicious activity
- ▶ Identification of ultimate beneficial owners (UBOs) of client entities
- ▶ Appropriate retention of documentation and response to law enforcement to provide documentation as lawful and necessary
- ▶ Implementing data analytics and technology tools to assist in maintaining an effective and efficient compliance program



# Relevant EY Forensic & Integrity Services experience

EY teams have access to a broad array of technological solutions and services, in addition to subject-matter resources, to address regulatory, compliance and enforcement challenges. EY technologies can provide a distributed ledger shared between stakeholders enabling simultaneous work in a trusted and tamper-resistant environment; provide solutions built on EY platforms that enable companies to run private, secure, end-to-end procurement activities on the public Ethereum blockchain; and more. EY teams also have the skill set to provide blockchain consulting, audit innovation, KYC program compliance, and AML risk assessments and transaction monitoring services. Below are examples of services EY teams have provided to major companies in the crypto space:

Client	EY services and capabilities
Blockchain company	Assisted a blockchain company prepare for a DFS review and certification to NYDFS Part 504. In doing so, reviewed relevant BSA/AML and sanctions compliance program documentation and assessed program, identifying potential gaps and issues that could impact certification. Mapped elements to remediation activities already conducted and the planned remediation actions. Also assisted in designing a sustainable recertification protocol and framework, which included identifying process owners, subcertifiers and a roll-up process.
International FinTech platform	Assisted an international FinTech platform with the development of its AML, sanctions, fraud and training programs for the purposes of preparing for a US banking partnership and the filing of money transmitter license applications across the United States.
Global e-commerce company	Assisted a global e-commerce corporation to support its AML and sanctions programs both in the United States and other international jurisdictions. Worked closely with the client to develop its risk assessment methodology and to identify AML and sanctions risks in relation to its business operations, customers, geographic presence and products. As part of this engagement, also supported the client with the development and implementation of a customer risk rating methodology and advised the client around its AML compliance governance structure.
Crypto asset management company	Assisted a crypto asset management company to perform the SOX testing for cryptocurrency trusts. Supported management in testing entity-level, financial, technology and transaction controls. Coordinated with the external auditor and reported our findings to management on a quarterly basis.
FinTech company	Created a findings and recommendations report on the design effectiveness of the company's procedures and controls environment centered around minting, burning, custodian, operator, contract owner and key management of the platform.
Digital asset custody bank	Engaged by a digital asset custody bank to perform a Program Assessment of its BSA/AML and OFAC Sanctions compliance program as it relates to US regulatory requirements and US sanctions. Provided a findings and recommendations report for the program assessment.
Crypto asset money service business	Prepared the DFS BitLicense application for a blockchain technology provider and cryptocurrency trading platform by providing recommendations to enhance the entity's current customer risk rating methodology (CRRM). Provided written recommendations to improve the CRRM, additional customer data points to consider in customer risk ratings, and updates to the CRRM ratings and procedures.

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The only way that blockchains will deliver upon their true promise to the world is if public blockchain networks are the preferred path for enterprises and investors.

Paul R. Brody

EY Global Blockchain Leader

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SCORE no. 14165-211US

2106-3805800

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