REPRINT

CRYPTOASSET FRAUD: INVESTIGATIONS AND ASSET TRACING

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MINI-ROUNDTABLE

CRYPTOASSET FRAUD: INVESTIGATIONS AND ASSET TRACING

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Hakob Stepanyan serves as a core team member of BOO forensics' blockchain and digital assets initiative. Having worked with cryptocurrency-centric and -adjacent companies since 2017, he helps the team enhance advisory services related to blockchain-based digital assets. While at BOO, he has held traditional forensic accounting roles on a monitorship regarding export control compliance.

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Anthony Aniello is a financial services tax principal based in Boston who also serves as the Northeast tax leader for digital assets. He has more than 20 years of public accounting experience in the financial services industry focused on taxation for alternative investments funds. He has dedicated the past six years to the digital asset and cryptocurrency industry.

R&C: Could you provide an overview of the growth of cryptocurrencies and cryptoassets in recent years? How would you characterise their evolution and popularity?

Stepanyan: The emergence of cryptoassets represents the next stage of evolution in the broader FinTech and global payments space. This nascent industry is starting to show significant signs of maturity, with platforms implementing security and compliance measures to curb market manipulation and illicit activity. This increased vigilance is largely driven by the desire to accommodate compliance risk requirements for institutional players. These institutions are eager to participate in public blockchain product offerings, which grew to more than $3 trillion by the end of 2021. Industry growth has been driven by several factors, including the rise of cryptocurrencies as speculative investments, the growing adoption of cryptocurrencies by merchants and businesses, and the development of new technologies and applications in the crypto space. We would highlight three key trends. First, increasing institutional adoption. Most recently, we have seen several banks experimenting with public and private blockchain-based products and solutions, including the tokenisation of real-world assets and reimagining of correspondent bank networks. Second, growing mainstream adoption. Consumers are becoming more comfortable with owning, storing and transacting with cryptocurrencies. This is the first step in the manifestation of equitable access to financial services without the barriers of conventional banking. While the adoption is primarily in emerging economies and dominated by the use of stablecoins, greater regulatory clarity, including tax and accounting, and implementation by merchants will drive broader retail adoption. And third, rapid technological innovation. The crypto space is constantly evolving, with new technologies and applications being developed all the time. This includes innovations in blockchain technology, decentralised finance (DeFi), non-fungible tokens (NFTs) and, more recently, tokenisation of real-world assets.

R&C: To what extent does a lack of systemic safeguards intensify the risks around cryptocurrencies and cryptoassets?

Aniello: While the industry is still relatively young and may not yet pose a systemic risk to the broader global economy, the lack of safeguards indicates the relatively early stage of the industry's maturation path. Ultimately, systemic safeguards will need to come from legislatures, regulators and industry participants acting in the best interest of their constituents and customers. The recent turmoil that led to the downfall of several major centralised and decentralised platforms was a clear example of the failure to apply necessary safeguards. This series of events appeared to stem from three main deficiencies: regulatory clarity and jurisdiction domain for regulators, operational risk controls, and transparent reporting of risks within centralised platforms. Going forward, it is important for regulators and industry players to work together on how to properly disclose risks, reduce market manipulation and effectively safeguard leveraged trading.

R&C: What trends and developments are you seeing in crypto regulation?

Stepanyan: Aside from ongoing efforts across different nations to provide a comprehensive framework for the digital assets industry, the recent collapse of centralised exchanges has put additional emphasis on consumer protection, focused legislation and regulatory guidance. Should it be passed, the Responsible Financial Innovation Act (RFIA) and the Digital Commodity Exchange Act of 2022 would require crypto exchanges to register with the Commodity Futures Trading Commission (CFTC) and comply with several consumer protection requirements, such as providing clear and accurate information about their products and services, disclosing their fees and costs, implementing safeguards to protect customer assets, prohibiting insider trading and market manipulation, and maintaining customer assets in segregated accounts. While the US has made concerted efforts to provide a clear framework for the digital assets industry, the overall position remains ambiguous and restrictive. This has led established and upstart projects and organisations to seek jurisdictions with more established regulatory regimes, such as Hong Kong and the United Arab Emirates (UAE).

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R&C: Could you outline some of the key regulatory challenges facing centralised and decentralised entities in the current market?

Aniello: Regulatory compliance, while extremely important to protect consumers and maintain fair and orderly markets, can be challenging. This is especially the case for less mature entities and decentralised platforms. Some of the challenges include implementation costs, uniformity across jurisdictions and the continued lack of regulatory clarity. Some regulatory compliance challenges unique to centralised entities include the Travel Rule, reserve requirements, and disclosures for banks and custodians, as well as consumer protection challenges resulting from complex corporate structures and conflicting operations. As for decentralised entities, overall regulatory compliance and legal structure remain a challenge, particularly in jurisdictions where an established regulatory framework does not exist. While a decentralised protocol does not have the means to comply with regulatory requirements, projects that support these protocols through application and user interface development have started to implement certain regulatory compliance provisions into these platforms.

R&C: To what extent are crypto firms improving their systems and processes to boost regulatory compliance efforts? What tools and innovations are being deployed?

Stepanyan: Entities providing applications and interfaces to the decentralised protocols have introduced anti-money laundering (AML) and know your customer (KYC) measures. They have also begun implementing several governance mechanisms, including changes to on-chain voting and dispute resolution processes, to ensure fair and transparent operations. In the wake of recent collapses and continued regulatory pressures, centralised entities continue to leverage the most recent technological developments for consumer protection, regulatory compliance and risk management. Some specific implementations

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include leveraging artificial intelligence (AI) to detect and prevent fraud, segregated customer accounts, multi-signature and multiparty computation wallets, and disintermediating conflicting operations, such as outsourcing customer fund custody.

R&C: What advice would you offer to centralised and decentralised entities on understanding their regulatory compliance obligations, and managing and mitigating their exposure?

Aniello: While there is no 'one size fits all' model, each entity should consider the complexity of their legal structure, jurisdictional exposure and the inherent risks associated with their user base. More complex operations with exposure to multiple jurisdictions and a larger user base should implement a comprehensive compliance infrastructure that includes solutions for KYC, AML, cyber security, data privacy and financial risk management, as well as strong governance models and internal controls. This requires a mature and competent compliance team. Entities should also consult outside counsel and consultants who specialise in corporate and regulatory compliance across multiple jurisdictions.

R&C: What are your predictions for crypto regulation in the months and years ahead? Should we expect to see more intense scrutiny of centralised and decentralised entities, with additional requirements and greater harmonisation of rules across borders?

Stepanyan: Looking forward, there is increasing appetite for regulators to establish common sense rules, which will allow both centralised and decentralised entities to develop new frameworks to implement regulatory compliance measures. While regulatory frameworks will vary across different jurisdictions, regulators are actively working toward a more harmonious approach for cross-border rules. More importantly, in the US, we predict legal precedence will be established in the courts and comprehensive legislation will be passed. These changes will lead to a reduction in the 'regulation by enforcement' approach and jurisdictional ambiguity for various regulators and enforcement agencies. R&C