

# Virtual Currency: New Challenge in AML/CFT Regime

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## ABSTRACT

*In the present international regime, virtual currencies, such as Bitcoin is receiving an ever growing recognition as the most powerful payment option with global acceptance. Virtual Currency is a digital representation of the value that is controlled by its developers. Virtual currencies are very unique and unfamiliar mode of payment but at the same time are cheap and flexible. The key appeal is that the virtual currencies industry attracts a lot of criminals in their anonymous nature allowing them to take part in the financial markets and transfer, convert and withdraw funds without detection. While some countries are embracing this new technology some are severely limiting its use.*

*Virtual currencies are basically virtual money exchanges that occupy a grey area for the exploitation of the criminals which requires an immediate address by its developers. Its legitimate use offers many benefits such as increased payment efficiency and lower transaction costs. However, other characteristics of virtual currencies, coupled with their global*

*reach, present potential Anti Money Laundering (AML) /Countering Financing of Terrorism (CFT) risks, such as:*

- the anonymity provided by the trade in virtual currencies on the internet*
- the limited identification and verification of participants*
- the lack of clarity regarding the responsibility for AML/CFT compliance, supervision and enforcement for these transactions that are segmented across several countries*
- the lack of a central oversight body*

*Virtual currencies present a twofold risk in terms of committing criminal offences, as it facilitates the commission of the underlying crime and serves as a tool for laundering the proceeds of such a crime. Regulations concerning virtual currency exchanges should be harmonized at international levels to prevent international virtual exchanges circumventing foreign laws.*

## INTRODUCTION

In the present International regime the use of virtual currencies such as BITCOIN<sup>1</sup>, for payment transactions and speculative investments in virtual currencies is rapidly expanding in the world. The governments of various countries are grappling with new ways to regulate such currencies to protect the consumers and investors, maintain the stability of the financial system, and deter the use of virtual currency systems in money laundering and terrorist financing.

Traditional payment systems afford consumers protection against a variety of risks. Virtual currencies have the potential to expand consumer choice and spur new technology development and investment. However, because virtual currencies are subject to limited regulation and, as further discussed below, due to structural aspects of the virtual currency ecosystem, many such consumer protections currently are absent in the virtual currency context. Bitcoin is one such form of unregulated virtual currency, designed as an alternative to official

currencies but with no guarantee of reimbursement created in 2009 by Satoshi Nakamoto, Bitcoins are a virtual unit of account stored on an electronic device, which allow a community of users to exchange goods and services without using an official currency (i.e. a currency with legal tender status).

Bitcoin was designed to carry out the three traditional functions of money:

- (i) it represents a unit of account, i.e. a standard unit of measurement of the market value of goods, services and assets;
- (ii) it facilitates commercial exchanges, and
- (iii) it allows users to store value for future use.<sup>2</sup>

Consequently, the circulation of bitcoins was not seen to infringe the central banks' monopoly in the issuance of money. In addition, bitcoins can be regarded as a means of payment, or even be termed as electronic money but unlike electronic

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<sup>1</sup> "Bitcoin" (capitalised) refers to both the open source software used to create the virtual currency and the peer-to-peer (P2P) network formed as a result; "bitcoin" (lowercase) refers to the individual units of the virtual currency.

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<sup>2</sup> Risks and Challenges Associated with Bitcoin Transaction Monitoring for AML, Olivia Greene retrieved from [https://www.dhglp.com/Portals/4/ResourceMedia/publications/Risk-Advisory\\_Bitcoin.pdf](https://www.dhglp.com/Portals/4/ResourceMedia/publications/Risk-Advisory_Bitcoin.pdf) on 11/09/2016 at 11.30 am.

money; there is no legal obligation to reimburse bitcoin owners at face value and at any time.

Bitcoins are generated by an online community of operators, known as “miners”, using open-source software which they download onto their computers. The main features of bitcoin issuance are as follows:

- (i) the number of bitcoins that can be created is limited to 21 million, and this threshold is expected to be reached in 2140;
- (ii) the rate of bitcoin creation is controlled and fluctuates to take into account the number of miners in operation and the increase in the processing capacity of their computers.<sup>3</sup>

By limiting the maximum number of bitcoins that can be created and varying the rate at which they are produced, the designers have in effect engineered an artificial shortage of the currency, making it

highly speculative. Once they have been created, bitcoins are stored in digital “wallets” on a home computer, tablet computer or smart phone. They can then be transferred completely anonymously via Internet between members of the virtual community. All transfers are made outside the traditional payment circuit. A number of internet platforms now offer to buy/sell bitcoins in exchange for official currencies, but with no guarantee of price or liquidity. Bitcoins have attracted interest from a growing number of internet users, drawn by the guarantee of anonymity – no personal details are required to carry out exchanges – and the promise of low transaction fees.

As a result, a number of internet platforms have been set up to allow users to buy and sell bitcoins in exchange for official currencies (euro, dollar, etc.), allowing them to acquire virtual money without actually taking part in the creation process.

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<sup>3</sup>Monetary and Capital Markets, Legal, and Strategy and Policy Review Departments Virtual Currencies and Beyond: Initial Considerations retrieved from <https://www.imf.org/external/pubs/ft/sdn/2016/sdn1603.pdf> on 09/09/2016 at 4.35 pm.

## ASPECTS OF VIRTUAL CURRENCIES THAT ARE THE MAIN CAUSE OF CONCERN

Assessing the risks associated with virtual currencies must factor in how these currencies are issued, how they are used and in particular transparency of flows, issues of liquidity and their convertibility to legal tender. There are various types of virtual currencies, and they operate in different ways. However, they share a certain number of characteristics, three of which we would like to focus on, as they can be the source of risks:

□ The presence of unregulated participants:

Examination of a sampling of virtual currencies shows that they are produced by a variety of stakeholders. These include natural persons, activists and private-sector companies. In some cases, a virtual currency was designed to meet the needs of individuals engaged in illegal activities. Issuance of a virtual currency is not covered by current banking and financial legislation. Thus, a virtual currency may be issued either by a community of "miners" (decentralized crypto currency) or by a single entity (centralized virtual currency). Given the lack

of a legal status and a regulatory framework, virtual currencies provide no certainty with respect to either price or liquidity. With respect to volatility and liquidity risks, it should be emphasized that the value of a virtual currency is not guaranteed and that the value of crypto currencies is generated solely by the interaction of supply and demand. For Bitcoin and other crypto currencies, limiting the number of units issued without indexing the currencies' value introduces the risk of speculation that in turn leads to excessive price volatility. Finally, the operational risks of virtual currencies must be reckoned with.<sup>4</sup>

□ Lack of transparency:

Currently, there are no special requirements for setting up a virtual currency wallet, particularly where this is accomplished by downloading a software application. A virtual currency wallet can also be opened by a service provider who may, although under no legal obligation to do so, carry out an identity check. One of the primary advantages of virtual currencies is that they provide total anonymity for transactions. For

<sup>4</sup> Retrieved from <http://www.compliancenet.it/virtual-currencies-and-aml-risks-the-italian-supervisors-opinions-april-18-2015> on 2/09/2016 at 10.30 am.

many crypto currencies, although the identities of principals and beneficiaries are encrypted, transactions are recorded in a public register, thus ensuring their traceability. Nevertheless, traceability of crypto currency flows does not address the issue of the identities of the principal and effective beneficiary. On the one hand, this traceability is neither assured nor systematically possible – some crypto currencies offer anonymity and non-traceability, and there are tools and applications that can be used to combine payments from multiple users – and on the other hand, the usability of transactions is uncertain, from both a technical and legal standpoint.<sup>5</sup>

#### □ Extraterritoriality:

Thanks to the Internet, the use of virtual currencies can dematerialize and expand money laundering and fraud techniques. The difficulties created by virtual currencies stem as much from the elusiveness of the various stakeholders as from the international (and extraterritorial) nature of both transactions and participants. This is

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<sup>5</sup> Retrieved from [http://thecommonwealth.org/sites/default/files/press\\_release/documents/P14195\\_ROL\\_Virtual\\_Currencies\\_D\\_Tait\\_V5\\_LoRes.pdf](http://thecommonwealth.org/sites/default/files/press_release/documents/P14195_ROL_Virtual_Currencies_D_Tait_V5_LoRes.pdf) on 12/09/2016 at 5.00 pm.

particularly the case when the servers and the individuals and legal entities that use

### RISKS CONNECTED TO THE THREE MAIN USES FOR VIRTUAL CURRENCIES

#### □ Settling a transaction in a virtual currency

Virtual currencies can be used to settle Internet-based transactions, but they may also be used in the wider economy with merchants that accept them. Supporters of virtual currencies often emphasize the low cost; speed and irreversibility of transactions, as well as the ability to them are located in non-cooperative countries and territories. They also enable micro-payments and purchases abroad free from currency exchange fees. It should be emphasized that any analysis of payment method costs needs to take into account security and the guarantees offered. Examples of risks connected to this use: There are no guarantees as to whether a virtual currency is reimbursable or convertible into a currency with legal tender. There are also serious risks with respect to price volatility. Since virtual currencies are not legal tender, settlements with such currencies do not have a discharging effect. Consumers should be

alerted that it is extremely risky to pay with virtual currency on websites about which they have doubts. This is equivalent to giving cash to an unknown person in the street in payment for a product that he promises to deliver to you later. There are no consumer protection measures applicable to virtual currencies. Virtual currencies do not fall within its the scope, and thus, unlike traditional payment methods, offer no protection against fraud. The operational security of these new methods of payment is also not guaranteed. <sup>6</sup>

#### □ Transferring money

The technical and functional infrastructures that ensure the circulation of virtual currency units are not regulated, and may be used to transfer money at lower rates than those charged by the banking network and international money transfer services. A recent study estimates that, as things currently stand, using Bitcoin would cut transfer fees by 90%. Nevertheless, any analysis of cost needs to take into account the level of security provided. Finally, it remains to be seen whether these

competitive fees can be maintained in the face of increasing regulation of virtual currencies. Examples of risks connected to this use: The exchange risk is an obstacle to more widespread adoption of this use and the operational risks of these transfers continue to pose a problem

#### □ Virtual-currency-linked investments

In addition to speculative purchase and sale of virtual currencies by individuals, there is a move to develop investment products indexed to the price of Bitcoins. It is thus possible to invest in virtual-currency-linked products. Funds develop investment strategies based on virtual currencies and their ecosystem. Funds or financial products could be exposed to the risks inherent in virtual currencies contracts for differences (CFDs) have already been offered to the general public. Examples of risks connected to this use: Virtual currency exchanges present problems for users due to, among other things, a lack of transparency with respect to executing payment orders and price formation (information asymmetry) and to the risk of market abuse. There is no compensation for these anonymous, Internet based over-the-counter transactions, and the

<sup>6</sup>Retrieved from <http://www.fatf-gafi.org/media/fatf/documents/reports/Virtual-currency-key-definitions-and-potential-aml-cft-risks.pdf> on 12/09/2016 at 3.30 pm.

market lacks depth. - There is also a risk of regulatory arbitrage as certain stakeholders can carry out their activities in offshore financial centers.<sup>7</sup>

#### □ Other possible uses

Virtual currency loans are just beginning to emerge based largely on trust, particularly via social networks. On crowd funding sites, the use of virtual currencies could allow payment in return for fulfillment of certain conditions.

### VIRTUAL CURRENCIES – A VECTOR FOR FACILITATING FRAUD AND MONEY-LAUNDERING

When it comes to perpetrating fraud, the anonymity provided by virtual currencies allows fraudsters to collect money without leaving a footprint of the transaction. This is similar to a cash-based transaction, but one conducted on the Internet without the criminal and the victim ever meeting face-to-face. Here we are dealing with standard criminal activities tailored to new

technologies and the possibilities they open up. For example, fraudsters might set up a fake e-commerce site that accepts payment in virtual currency, then shut down the site and have access to the funds collected in any country whatsoever, without leaving behind the slightest trace of any transaction. The risk of money laundering is all the higher since the operation is divided into three stages – purchasing virtual currency with cash, setting up an ecommerce site from which fictitious purchases of goods are made from a number of computers using virtual currency, and collecting often large sums of money, which can then be exchanged for legal tender. The use of a virtual currency can render Internet-based money laundering techniques even more opaque. Examples of this include online gaming, fraudulent e-commerce transactions, online auctions or fake projects listed on foreign crowd funding sites. Although virtual currencies satisfy money launderers' needs for speed, discretion and global reach, funds converted into virtual currencies are vulnerable to operational risks and to volatility. In light of these limitations, the use of virtual currencies for money laundering appears more suitable for small scale money laundering or the laundering of

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<sup>7</sup> FATF (2013), FATF Guidance for a Risk-Based Approach to Prepaid Cards, Mobile Payments and Internet-Based Payment Services, FATF, Paris retrieved from [http://www.fatf-gafi.org/publications/fatf\\_recommendations/documents/rbanpps-2013.html](http://www.fatf-gafi.org/publications/fatf_recommendations/documents/rbanpps-2013.html) on 11/09/2016 at 12.30pm.

the proceeds of cybercrime. This said, the creation of gold-backed virtual currencies, such as Gold Backed Coin (GBC), lessens the financial risk connected to virtual currency price volatility.

### **RECOMMENDATIONS FOR REGULATING VIRTUAL CURRENCIES TO PREVENT THEM FROM BEING USED FOR FRAUDULENT PURPOSES AND MONEY LAUNDERING**

The nature and multi functionality of virtual currencies means that there is a risk of them being used for fraudulent purposes. Due to the upswing in new criminal activities in connection with virtual currencies, legislative and regulatory frameworks need to be updated and adapted in response to these new challenges, particularly with respect to the fight against money laundering and terrorist financing. One possible strategy would include three complementary components:

- Limiting the use of virtual currencies
  - Regulation and cooperation
  - Knowledge and investigation
- Limiting the use of virtual currencies – Key points

Without prejudice to the conclusions drawn from national and international discussions of the legal characterization of virtual currencies, proposals could be put forth to limit

□ The anonymity of users of virtual currencies, particularly by introducing mandatory proof of identity when opening a virtual currency account as well as an obligation to declare such accounts. In addition, it is important to have the tools for identifying and monitoring these accounts, at least when they exceed a certain amount.

□ The possibilities for using a virtual currency as an anonymous payment method, particularly by strictly capping the sums that can be paid in this way.

□ Cash/virtual currency flows, particularly when it comes to using Bitcoin ATMs, by setting caps and by ensuring that the identity of a party to a transaction is checked using reliable means. Regulation and cooperation – Key points Proposals should also be put forth to ensure that the AML/CFT system is capable of addressing the risks posed by virtual currencies and the upswing in new criminal activities in connection with these currencies.



To this end, we recommend:

□ Harmonizing regulations concerning virtual currency exchanges at India and international level and prevent virtual exchanges located abroad and who have Indian users from circumventing Indian law: subjecting virtual exchanges to the AML/CFT regime will, among other benefits, lift users' anonymity prior to converting virtual currencies into legal tender.

Requesting that professionals subject to AML/CFT reporting requirements exercise heightened vigilance with respect to flows in connection with individuals using virtual currencies.

□ Reminding individuals offering virtual currencies for sale or operating Bitcoin ATMs to work in accordance to the provisions of law. Knowledge and investigation – Key points given the rapid expansion of the virtual currency sector, explosive technological progress and the need to bolster international cooperation, we also propose that the risks and opportunities associated with virtual currencies be monitored:

□ Adapt the legal framework and investigative methods

□ Improve sector knowledge and risk monitoring<sup>8</sup>

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<sup>8</sup> Handbook of Digital Currency: Bitcoin, Innovation, Financial Instruments, Edited by David Lee Kuo Chuen retrieved from [https://books.google.co.in/books?id=RfWcBAAQBAJ&pg=PA325&lpq=PA325&dq=virtual+currency+pdf+CFT+and+AML&source=bl&ots=2LlQJgxybz&sig=2BOOGSpRUfQPONx9LtDm8SPiQZo&hl=en&sa=X&ved=0ahUKewjvt9\\_A7tPAhXKpI8KHe3OA0oQ6AEITjAI#v=onepage&q=virtual%20currency%20pdf%20CFT%20and%20AML&f=false](https://books.google.co.in/books?id=RfWcBAAQBAJ&pg=PA325&lpq=PA325&dq=virtual+currency+pdf+CFT+and+AML&source=bl&ots=2LlQJgxybz&sig=2BOOGSpRUfQPONx9LtDm8SPiQZo&hl=en&sa=X&ved=0ahUKewjvt9_A7tPAhXKpI8KHe3OA0oQ6AEITjAI#v=onepage&q=virtual%20currency%20pdf%20CFT%20and%20AML&f=false) on 12/09/2016 at 3.30 pm.