

What To Note In FinCEN, DOJ Action Against Crypto Exchange

By **Melissa Goldstein, Betty Santangelo and Rebecca Raskind** (April 18, 2023)

On Jan. 18, the U.S. Department of the Treasury's Financial Crimes Enforcement Network issued an order^[1] identifying Bitzlato Ltd., a Hong Kong-based virtual currency exchange with global operations, as a financial institution of primary money laundering concern in connection with illicit Russian finance.

FinCEN's order bars any covered financial institution from engaging in certain transmittals of funds involving Bitzlato.

It also marks the first order issued under Section 9714(a) of the Combating Russian Money Laundering Act.

In a coordinated action, the U.S. Department of Justice arrested Bitzlato's founder and majority owner, Anatoly Legkodymov, for conducting an unlicensed money transmitting business under Title 18 of the U.S. Code, Section 1960.^[2]

Both the order and the DOJ's complaint and arrest warrant highlight that Bitzlato had severe and pervasive anti-money laundering deficiencies and significant connections to Russia and Russian illicit finance.

Background

The Combating Russian Money Laundering Act was enacted in 2021 as part of the 2021 National Defense Authorization Act, which included other notable anti-money laundering-related legislation, such as the Anti-Money Laundering Act of 2020 and the Corporate Transparency Act.

Section 9714(a) of the act allows FinCEN, upon determining "reasonable grounds for concluding" that one or more covered financial institutions operating outside of the U.S. is of "primary money laundering concern in connection with Russian illicit finance," to prohibit or impose conditions upon certain transmittals of funds by any domestic financial institution.^[3]

Noting that FinCEN has long interpreted the term "financial institutions" to cover money transmitters, including entities that accept and transmit value that substitutes for currency, like convertible virtual currencies,^[4] FinCEN highlights Bitzlato's exchange and peer-to-peer services to explain why Bitzlato constitutes a financial institution for the purposes of Section 9714(a) of the act.

FinCEN's Findings

To support its conclusion that Bitzlato is a "financial institution operating outside of the United States of primary money laundering concern in connection with Russian illicit finance," FinCEN alleges four separate patterns of behavior underlying its assessment.



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Facilitating Processing and Laundering of Funds Used to Finance Ransomware Attacks

The order asserts that Bitzlato plays a significant role in facilitating transactions for various ransomware groups that have connections to illicit Russian finance, including Conti.

Specifically, FinCEN notes that it has documented transactions between Conti-associated convertible virtual currency addresses and Bitzlato.

In addition, the order indicates that, based on blockchain analysis, other ransomware groups and virtual asset service providers designated by the Office of Foreign Assets Control have used Bitzlato to facilitate transactions.

FinCEN notes that Bitzlato

provides an enabling environment for such ransomware criminals to utilize its services to cash out ransomware proceeds due to its minimal Anti-Money Laundering/Countering the Financing of Terrorism (AML/CFT) protocols, solidifying its reputation as a go-to CVC exchanger for such groups.[5]

Facilitating Darknet Markets and Scams

The order also finds that Bitzlato's incoming and outgoing transactional activity reflects connections to counterparties that are associated with darknet markets and scams with connections to and operations in Russia.

In particular, the order states that certain of Bitzlato's top incoming and outgoing counterparties — such as Hydra, a Russia-connected darknet market, and the alleged Russia-based Ponzi scheme TheFiniko — are associated with such illicit activities.

Engaging in Illicit Russian Finance Transactions

FinCEN alleges that, based on analysis conducted by a blockchain analytics company, the value of transactions that involve illicit Russian finance or "otherwise risky sources" made up 48% of all Bitzlato transactions between 2019 and 2021.[6]

Failing to Combat Anti-Money Laundering and Illicit Finance

According to the order, publicly available information indicates that, despite featuring a "know your client" policy on its website, Bitzlato does not implement effective policies and procedures to combat AML and illicit finance.[7]

Specifically, the order highlights language on Bitzlato's website suggesting "simple registration" that only requires an email address to create an account on the platform.[8]

Such a procedure runs counter to common, effective AML controls, such as collecting more thorough identifying information about the customer.

In addition, the order describes Bitzlato's policy of user privacy and anonymity, allowing users to exchange fiat currency and cryptocurrency directly with another person, as well as transfers to and from financial institutions and other methods.

Bitzlato advertises that its users do not need to go through the same know-your-

client procedures that are typically required on other exchanges.

FinCEN notes that this anonymous exchange policy, along with the advertised simple registration process, is indicative of ineffective AML/CFT controls.

Order Requirements and Penalties

The order prohibits covered financial institutions — which are defined to include, among other entities, banks, broker-dealers, money services businesses, mutual funds, futures commission merchants and introducing brokers in commodities[9] — from engaging in transmittals of funds to or from Bitzlato, as well as to or from "any account or CVC address administered by or on behalf of Bitzlato." [10]

Should a covered financial institution receive convertible virtual currencies from Bitzlato or from an account administered by or on behalf of Bitzlato, FinCEN notes that it would not be a violation of the order for the covered financial institution to reject the transaction by (1) "preventing the intended recipient from accessing such CVC"; and (2) "returning the CVC to Bitzlato, or to the account or CVC address from which the CVC originated." [11]

FinCEN also notes that covered financial institutions are not required to reject such convertible virtual currency transfers where doing so would violate sanctions laws. [12]

FinCEN notes that previous transactions involving Bitzlato do not violate the order, but expects covered financial institutions to

take such steps that a reasonable and prudent financial institution would take to identify any transactions that are prohibited by the Order, including determining risk exposure with any person associated with Russian illicit finance or violations of applicable law. [13]

In addition, FinCEN underscores that the order does not impose any additional suspicious activity reporting requirements on covered financial institutions, but encourages covered financial institutions to "consider, as warranted and appropriate, Bitzlato's identification as a primary money laundering concern related to Russian illicit finance" in connection with existing suspicious activity reporting obligations. [14]

The terms of the order became effective Feb. 1, with no cessation date. Penalties for noncompliance with the order, which applies to officers, directors, employees and agents of covered financial institutions, could include civil or criminal penalties under Title 31 of the U.S. Code, Sections 5321 and 5322.

DOJ Action

As discussed above, the DOJ, in a coordinated action with FinCEN, arrested Bitzlato's founder and majority owner Legkodymov, a Russian national residing in the People's Republic of China, and charged him with conducting an unlicensed money transmitting business and processing over \$700 million in illicit funds.

The complaint alleges that Legkodymov and Bizlato's other managers knew about and allowed Bizlato's many violations, including accounts with illicit money, users registered under other identities and users with U.S.-based IP addresses, despite Bizlato's claim that it did not accept users from the U.S. [15]

If convicted, Legkodymov faces a maximum penalty of five years in prison.

Implications

This landmark action from FinCEN is indicative of the agency's regulatory and enforcement priorities and holds several important implications.

First, the order marks FinCEN's first action under Section 9714(a) of the act, which reflects an aggressive stance by FinCEN to take action against entities engaging in Russian illicit finance to the full extent of its authority.

Indeed, in addition to exercising its authority under the act, FinCEN has taken a variety of steps recently to highlight risks related to Russian illicit finance.

Such steps include issuing alerts — four since March 2022 — warning covered financial institutions of potential sanctions evasion by Russian oligarchs, elites, their families, and the entities through which they act through investment in commercial and residential real estate and luxury goods.[16]

They also include releasing data analysis of financial trends of sanctioned Russian oligarchs and other high-ranking officials.[17]

The order follows in FinCEN's pattern of recent close scrutiny of Russian illicit finance, and the exercise of this relatively new authority is another important tool in FinCEN's arsenal to take meaningful action against entities with severe and pervasive AML-related compliance deficiencies.

In addition, in light of the AML and know-your-client deficiencies identified by FinCEN, covered financial institutions should take care to ensure their AML and know-your-client controls are up to date, efficient and effective.

Such controls should particularly ensure that a robust set of identifying information is collected at customer onboarding, that initial and ongoing screening against the sanctions list is also conducted, and that a comprehensive transaction monitoring program is maintained.

Finally, covered financial institutions should ensure that they do not engage in covered transactions with Bitzlato. As discussed above, penalties for violating the order could include civil and criminal penalties.

As to individuals, the DOJ's action signals active efforts by U.S. law enforcement to hold accountable persons responsible for knowingly operating financial institutions that are bound by, but fail to meet, U.S. anti-money laundering standards — particularly as it relates to cryptocurrency.

In late 2021, the DOJ established a National Cryptocurrency Enforcement Team in its Criminal Division, which, along with the U.S. Attorney's Office for the Eastern District of New York, is prosecuting the case against Legkodymov.

This action, brought in parallel with the FinCEN order discussed above, and action by French law enforcement authorities, is also an example of the type of interagency and international coordination we are likely to see in such cases going forward.

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[1] U.S. Department of the Treasury, Financial Crimes Enforcement Network, Imposition of Special Measure Prohibiting the Transmittal of Funds Involving Bitzlato, 88 Fed. Reg. 3919 (Jan. 23, 2023), available here: <https://www.govinfo.gov/content/pkg/FR-2023-01-23/pdf/2023-01189.pdf>. [hereinafter "Order"]; Press Release, Financial Crimes Enforcement Network, FinCEN Identifies Virtual Currency Exchange Bitzlato as a "Primary Money Laundering Concern" in Connection with Russian Illicit Finance (Jan. 18, 2023), available here: <https://www.fincen.gov/news/news-releases/fincen-identifies-virtual-currency-exchange-bitzlato-primary-money-laundering>.

[2] Press Release, U.S. Department of Justice, Founder and Majority Owner of Bitzlato, a Cryptocurrency Exchange, Charged with Unlicensed Money Transmitting (Jan. 18, 2023), <https://www.justice.gov/usao-edny/pr/founder-and-majority-owner-bitzlato-cryptocurrency-exchange-charged-unlicensed-money>.

[3] Section 9714 (as amended) can be found in a note to 31 U.S.C. § 5318A. <https://www.govinfo.gov/content/pkg/PLAW-116publ283/pdf/PLAW-116publ283.pdf>.

[4] Order, 88 Fed. Reg. at 3920.

[5] *Id.* at 3922.

[6] *Id.*

[7] *Id.* at 3923.

[8] *Id.*

[9] 31 C.F.R. § 1010.100(t).

[10] Order, 88 Fed. Reg. at 3926.

[11] U.S. Department of the Treasury, Financial Crimes Enforcement Network, Frequently Asked Questions: Section 9714 Order Prohibits Certain Transmittals of Funds Involving Bitzlato (Jan. 18, 2023) [hereinafter FAQs], available here: https://www.fincen.gov/sites/default/files/shared/FAQs_Bitzlato%20FINAL%20508.pdf, at 4.

[12] Id.

[13] Id. at 5.

[14] Id. at 5.

[15] Press Release, U.S. Department of Justice, Founder and Majority Owner of Cryptocurrency Exchange Charged with Processing Over \$700 Million of Illicit Funds (Jan. 18, 2023), <https://www.justice.gov/opa/pr/founder-and-majority-owner-cryptocurrency-exchange-charged-processing-over-700-million>.

[16] FIN-2022-Alert 0001, FinCEN Advises Increased vigilance for Potential Russian Sanctions Evasion Attempts (Mar. 7, 2022), available at <https://www.fincen.gov/sites/default/files/2022-03/FinCEN%20Alert%20Russian%20Sanctions%20Evasion%20FINAL%20508.pdf>; FIN-2022-Alert002, FinCEN Alert on Real Estate, Luxury Goods, and Other High-Value Assets Involving Russian Elites, Oligarchs, and their Family Members (Mar. 16, 2022), available at https://www.fincen.gov/sites/default/files/2022-03/FinCEN%20Alert%20Russian%20Elites%20High%20Value%20Assets_508%20FINAL.pdf; FIN-2022-Alert003, FinCEN and the U.S. Department of Commerce's Bureau of Industry and Security Urge Increased Vigilance for Potential Russian and Belarusian Export Control Evasion Attempts (June 28, 2022), available at <https://www.fincen.gov/sites/default/files/2022-06/FinCEN%20and%20Bis%20Joint%20Alert%20FINAL.pdf>; FIN-2023-Alert002, FinCEN Alert on Potential U.S. Commercial Real Estate Investments by Sanctioned Russian Elites, Oligarchs, and Their Proxies (Jan. 25, 2023), available at https://www.fincen.gov/sites/default/files/shared/FinCEN%20Alert%20Real%20Estate%20FINAL%20508_1-25-23%20FINAL%20FINAL.pdf.

[17] U.S. Department of the Treasury, Financial Crimes Enforcement Network, Financial Trend Analysis, Trends in Bank Secrecy Act Data: Financial Activity by Russian Oligarchs in 2022, available at https://www.fincen.gov/sites/default/files/2022-12/Financial%20Trend%20Analysis_Russian%20Oligarchs%20FTA%20_Final.pdf; Press Release, U.S. Department of the Treasury, Financial Crimes Enforcement Network, New FinCEN Analysis of BSA Data Reveals Trends on the Financial Activity of Russian Oligarchs (Dec. 22, 2022), <https://www.fincen.gov/news/news-releases/new-fincen-analysis-bsa-data-reveals-trends-financial-activity-russian-oligarchs>.