

# Potential Threats of Using Digital Money to Legalize Shadow Income

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**Abstract**—The article discusses the changes in legislation of the Russian Federation related to the regulation of the cryptocurrency market. Irreversibility of performed operations (transactions), absence of centralized data storage on servers and, as a result, much lower data vulnerability, ability to sign and manage smart contracts directly between the parties without intermediaries, convenience of round-the-clock service of the system, low cost of transactions and shortened production (business) chain through elimination of intermediaries - all these factors are the grounds for increasing popularity of digital assets. Digital currencies do not act as a supplement to the existing financial infrastructure, they create a new one – transparent, reliable and seamless (independent from intermediaries). This is how the creator of Blockchain and Bitcoin envisioned the future of new digital technologies. As the crypto-currency consumer market expands, so does the number of legalization factors associated with its use. Despite the fact that shadow economy benefits from safety of cryptocurrency transactions in the dark web, the blockchain technology is still aimed at ordinary people and protecting their personal data from leaking to third parties.

**Keywords**—digital assets, digital money, cryptocurrency, token, crypto crimes, AML / CFT

## I. INTRODUCTION

The emergence of new monetary instruments is dictated by the current need to overcome the crisis of overproduction of money in the world. Especially in this respect succeeded the U.S. with the issuance of the American dollar. The official statistics as of May 2020 show that the volume of money supply M0 in the U.S. accounted for 5 001 978 million dollars. The U.S. Federal Reserve continuously issues cash, which provokes an increase in the money supply and, as a result, a high inflation rate. Yet, given the tremendous demand for the dollar in the global economy, inflationary processes are balanced out by the withdrawal of cash outside the country.

According to Katasonov V.Y., Russian citizens own from 40 to 80 billion U.S. dollars in cash.

The safest approach to monetary reform in the U.S. to prevent default could be terminating the circulation of the national fiat currency which can be achieved by transitioning

to a digital dollar. For example, China has intensified the promotion of digital yuan in the last few months of 2020, with its subsequent exchange for the fiat yuan. There are some progressive countries where the cryptocurrency regulation is treated as an innovation strategy, and where all interested parties work together to develop rules of the game. Their number today, however, is insignificant. On the European side, these countries are Switzerland, Germany, Malta, Slovenia, Gibraltar, Estonia, Belarus and Georgia. The Asian market is represented by Hong Kong, Japan, Singapore and Bermuda Islands. The prominent representative of the Middle East is forward Dubai, positioning itself as the world's Blockchain capital.

These governments take steps to establish control over digital business in order to prevent its migration into shadow economy, thus preventing the loss of a significant budget revenue portion.

## II. METHODOLOGY

According to expert assessments, as of early September 2020, the capitalization of all cryptocurrencies amounted to 315.24 billion dollars. Of these, Bitcoin (\$195 billion), Ethereum (\$43 billion) and Ripple (\$25 billion) have the largest volume [6].

Presently, the popularity of digital assets as an object of comprehensive scientific research is due to a set of economic and technical qualities of distributed ledger technology (DLT): irreversibility of performed operations (transactions), absence of centralized data storage on servers and, as a result, much lower data vulnerability, ability to sign and manage smart contracts directly between the parties without intermediaries, convenience of round-the-clock service of the system, low cost of transactions and shortened production (business) chain through elimination of intermediaries, as well as other factors [11].

In our judgement, the main reason why the crypto market has reached such scale globally and has been developing rapidly is its decentralized nature, which brings together participants from all over the world - governments, the banking sector, private companies, investors and traders.

The higher participants' interest in coin, the higher its cost and total capitalization. One should also understand the difference between coins and tokens, which are not the same. The first is a digital currency (cryptocurrency) based on its own platform, within which it circulates independently, operates on its own blockchain and is a native currency. This type of coins does not require another platform (for example, Bitcoin, Ethereum). The second type is a cryptocurrency based on an existing block or protocol. Commonly, it is an asset (token shares - a kind of securities, coupons, which are used for investment, have the highest potential in the market and are the equivalent of a certain amount of goods or services, and are regulated within stock markets) or utility (is a program not designed for investors, used for transactions, exchange and does not fall under the laws governing the circulation of money). Tokens are easier to produce. Modern tokens are based on Ethereum blockchain [7].

In the crypto world it is very difficult to assess genuine projects from the fraudulent ones. Only time can show which is which.

Cryptocurrency is often associated with fraud for a number of reasons: primarily because of anonymity of transactions, high speed of transfers whilst bypassing financial institutions, regulated by law, and, of course, absence of date of any taxation mechanism. At the state level and in terms of security in general, the crypto market is a platform for tax evasion, money laundering and sponsorship of terrorism.

In the context of turnover and creation of cryptocurrencies, the question of their legal regulation at the national and international levels arises. There are many obstacles that need to be overcome in the future. The evident one is that many people are not even aware of its existence.

In 2016, there were reports that the Russian Ministry of Finance has prepared a new bill to ban the cryptographic currency. The bill already criminalized the issue and circulation of digital money. The introduction of this bill has been repeatedly postponed. At the end of April 2016, the deputy director of Rosfinmonitoring suggested that the cryptocurrency should be considered not from the side of prohibition, but from the side of regulation, since the tool is developing worldwide. And in May, Deputy Finance Minister Alexei Moiseev acknowledged the imperfection of the bill and called the new deadlines for its submission to the State Duma: until the end of 2016. In October 2016 Alexei Moiseev also said that the Russian Ministry of Finance has decided to "wait and see how the situation will develop at the international level", and with this in mind make a decision. As a result, work on the proposed law was suspended. On June 9, 2017 Deputy Finance Minister Alexei Moiseev expressed that cryptocurrency in Russia may be qualified as "other property", i.e. given a more or less legal status. He added that customers will be identified when conducting transactions with domestic digital currency. He also stressed that when conducting transactions with cryptocurrency, it is necessary to introduce customer identification and ensure protection of customers' rights. Thus, it was discussed to design a complete analogue of Bitcoin. The domestic cryptocurrency will not be anonymous and will be issued from a single center that can be easily controlled [9].

### III. RESULTS AND DISCUSSION

As of today, Russia partially regulates the issues of cryptocurrency in the Federal Law "On the National Payment

System" from 2011 and Article 140 of the Civil Code of the Russian Federation [11].

The Federal Law of 31.07.2020 N 259-FL "On Digital Financial Assets, Digital Currency and on Amendments to Certain Legislative Acts of the Russian Federation" introduces the concept of "digital currency", establishes the right of the Bank of Russia to determine the cases of issuance and use of digital operating units, as well as to establish the procedure for their issuance and use.

Accordingly to Article 1 of the above law, digital currency is a set of electronic data (a digital code or designation) contained in an information system which is offered and /or can be accepted as a means of payment that is not a monetary unit of the Russian Federation, a monetary unit of a foreign state and /or an international monetary or account unit and /or as an investment and in respect of which there is no person obliged to each owner of such electronic data, except for operations) except for the operator and/or hosts of the information system, which are obliged only to ensure compliance of the procedure for release of such electronic data and performance in respect thereof of actions for making (changing) records in such information system with its rules.

Crypto-currencies and tokens are grouped together under the term "digital asset", which means "property in electronic form created using cryptographic means". In that connection, property rights to it are certified in the "registry of digital transactions". Meanwhile, the law does not provide clear frame and definition of the registry. Also, the entries in the registry shall be made by a so-called "validator", a "legal entity or individual who is a member of the registry of digital transactions and carries out activities to validate digital records".

The Federal Law from March 18, 2019, N 34-FL "On Amending Parts One, Two and Article 1124 of Part Three of the Civil Code of the Russian Federation" ("On Digital Rights") is quite short and, in fact, is a set of amendments to the Civil Code, introducing new concepts, namely, "digital rights" and "digital money".

The document incorporates into the legislation the necessary legal relations that arise in the process of cryptographic currency circulation. Acquisition of tokens will also be difficult since the law stipulates a limit on the maximum amount set for purchase by "unqualified investors". It will be possible to exchange tokens for fiat money only through the "digital financial assets exchange operator". To do this, the investor will have to be identified in accordance with the "anti-money laundering" law and open an electronic wallet with the operator.

The law does not contain the definition of "cryptocurrency" and only prescribes the circulation of tokens and the procedure for exchanging them into fiat money.

In our opinion, the lack of legal regulation of the relationships on usage of cryptocurrency as a means of payment significantly impedes the process of digitalization of the economy as a whole. Rosfinmonitoring draws attention to the fact that due to the complete decentralization of the process of issuance and circulation of cryptocurrencies, there is no possibility of its regulation, including by the state, and the actual position of crypto-currencies outside the legal field does not provide an opportunity to implement legal

mechanisms to ensure the fulfillment of obligations by the parties to the transaction [7].

There have been no recorded cases of cyber currencies utilization in the course of economic crimes on the territory of the Russian Federation. At the same time, cryptocurrencies may be involved at various stages of drug trafficking, including payments for drugs by drug users, legalization of generated criminal income and distribution of funds among OCG (organized criminal groups) leaders, as well as compensation to drug dealers/droppers and drug lab workers.

In 2017, it was discovered that the Bitcoin was in circulation in the financial structure of drug trafficking in 23 Russian regions. The anonymous nature of cryptographic payments promotes the popularity of this method in the commission of crimes and also complicates the investigation process.

Accordingly to Dudin M.N. and Lyasnikov N.V., the state impact on the relations formed in the sphere of circulation of cryptocurrency should be within certain areas of influence, which may include the following:

- area of regulating circulation of crypto-currency on exchanges and its use within payment systems;
- area of responsibility for preservation of crypto-currency (first of all, by means of technical protection of information);
- area of application of crypto-currency for joint investments;
- area of application of crypto-currency in civil law relations [9].

The popularity of the new financial instrument in the criminal environment is explained by the fact that so far no legal criteria have been developed for the cryptographic currency and the limits of its secure circulation have not been established. To a large extent, this is due to misunderstanding on the part of domestic and international experts of the importance of research on cryptocurrency within the framework of a risk-oriented approach, when economic advantages and the criminal potential of cryptographic instruments are simultaneously correlated [5].

In the opinion of several authors (S.V. Ivantsov, E.L. Sidorenko, B.A. Spasennikov, Y.M. Berezkin, and Y.A. Sukhodolov), in the light of the above, it is timely and practically significant to conduct a criminological analysis of crypto-crime as a relatively independent object of scientific cognition and, at the same time, as a subsystem of the criminological model of Internet crime. Crypto-crime is proposed to be understood as a set of acts with uniform system properties committed against a virtual currency or with its use.

Since this phenomenon is at the stage of its institutionalization, the use of this term is conditional. There are three main segments of crypto-crime: - illegal sale of psychoactive substances (narcotic drugs, psychotropic substances, etc.), other prohibited goods, content or services; - laundering of criminal proceeds using new digital currency; - theft of cryptographic currency and other crimes against property. At present, a wide range of illegal goods and services can be purchased for cryptocurrency. Virtual money is used in the pornography industry, in the illicit trafficking of personal data, in the trade of counterfeit documents, illegal

drugs, and even in ordering contract killing. Still, the most widespread segment of crypto crime remains the illicit trafficking of narcotic drugs and psychotropic substances (80% of the total market for illegal goods) [10].

An important issue of criminal use of cryptocurrencies is the laundering of criminal proceeds, as the Bank of Russia pointed to the danger of a new segment of criminal business in its newsletter "On the use of "virtual currencies" in transactions, in particular, Bitcoin" dated January 27, 2014.

The warning about the usage of virtual currency in legal economic activity was repeated in the information message of the Federal Service for Financial Monitoring of the Russian Federation "On the use of cryptocurrencies"[12] and the newsletter of the Bank of Russia "On the use of private "virtual currencies" (cryptocurrencies)" dated September 4, 2017. In the letter of 2017 the Bank of the Russia identified the anonymity and latent nature (of utilization by individuals and legal entities for transaction purposes) as criminological risks of cryptocurrency turnover.

As the cryptocurrency consumer market expands, so does the number of legalization factors associated with its use. While four years ago this segment of crime accounted for 5-7% of the total volume of crypto crime, in 2018 it increased by 8 times.

There is a number of factors that contribute to drastic increase in the crypto-crime rate:

1. The Internet network allows to sell psychoactive substances, pornography, etc., rather quickly and with no damage to quality, which, in turn, leads to the creation of completely new schemes and methods of money laundering;
2. Legal vacuum around the status of cryptocurrencies and systems of their financial control is a powerful incentive for the development of quasi-financial structures that ensure the safety of cash flows using the technology of blockchain or converting cryptocurrencies into fiat currency. In 2018, about a quarter of funds which came to the accounts of conversion services were from organizations engaged in illegal activities.
3. To date, there is still no unified approach being developed to defining prevention policy in this area. Among the main obstacles for governments to cooperate in detecting and combating the laundering of criminal proceeds using digital currency the FATF identified the uncontrollable scope of legalized funds, anonymous relationships between users, lack of customer identification, absence of a coordinating body for creating a consolidated criminal policy on illegal cryptographic transactions [4].

Today, neither in Russia nor in the world are criminal incomes legalized using virtual currency are being tracked. This, however, does not preclude the recognition and analysis of individual criminological trends. In particular, it is important to give attention to the full-scale development of services for the conversion of cryptocurrency and the cashing of fiat money.

As a general rule, these transactions have a P2P character (from person to person) using cryptomats. According to the Coin ATM Radar service, currently there are more than a thousand such devices installed in the world, and if we take into account the latency of data, we can talk about numbers 30 times more [3]. For a commission of 15% the service provides uninterrupted transfer and anonymity of the client.

Another way of legalization is by using "mixer programs". They offer clients to confuse transaction history or launder profits by buying goods for another person online for "dirty" money. The buyer reimburses the client's expenses, except for the amount of commission. As a result, the customer receives "net" money, and the buyer receives a discount on the goods [10].

However, special attention deserve the illegal cryptocurrency conversion services. The largest sums of money laundered in this way go through offshore zones, where financial control over cash flows is traditionally weaker. A new and popular way to legalize criminal proceeds is their laundering through gambling sites. It is through these services that nearly three-quarters of all dirty virtual money is laundered.

According to the data of Trend Micro, now criminals more frequently resort to game currencies as a way to preserve the value of the cryptographic currency. To do this, they buy the currency of the most popular virtual games. It is sold for cryptocurrency and is then exchanged into fiat currency via special conversion services [11].

Special sources often point to the high risks of using crypt currency to finance terrorism. S.V. Ivantsov, E.L. Sidorenko, etc., believe that these forecasts are somewhat exaggerated for now. The experts underestimate the traditional nature of this segment of crime and do not take into account the terrorists' unpreparedness to use new technologies in organizing criminal profits. For most terrorist organizations, the only way of tranching is to physically transport cash. However, as the use of crypt currency grows and the infrastructure of transactions develops, virtual currency will be increasingly used to finance terrorism [1].

#### IV. CONCLUSIONS

In conclusion, it should be emphasized that the legal regulation of the circulation of "cryptocurrency" requires a comprehensive approach, since the major trend in the development of cryptocurrency in modern conditions is the great potential of using it not only as a means of payment and exchange, but also as a security, for example, as a share or bill of exchange.

The priorities in regulating the new financial instruments include:

- ensuring security for all participants of the cyber financial market;
- integrating cryptocurrencies into the number of civil rights acts (Article 128 of the Civil Code of the Russian Federation) with simultaneous definition of the collective investment (crowdfunding) safety limits in special regulations;
- introducing obligatory identification of owners of digital assets and other persons involved in their turnover;
- establishing a transparent system for transferring virtual money into fiat currencies;

- determining legal criteria and standards to prevent the laundering of criminal proceeds, including through the use of cryptographic currency;
- instituting criminal and administrative liability for violations of cryptographic instruments circulation standards[11];
- creating an international database of individuals engaged in trafficking and use of digital financial assets [1] in the context of the used technologies and crypto-criminal entities;
- defining the model of tax administration of cryptocurrency and other digital assets, etc. [10, 14];
- requiring licensing of professional activities related to creation and circulation of new digital assets.

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