CRYPTO 2023 – A LOOK AT INSOLVENCY, FINANCIAL CRIME AND REGULATORY TRENDS

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Introduction

The crypto industry had a catastrophic year in 2022. We witnessed several high-profile insolvencies (including FTX), plummeting cryptocurrency valuations (bitcoin fell by approximately 65%) and a myriad of frauds and scandals (the UK courts were extremely busy with cases dealing with crypto). Trust was eroded from the industry in 2022.

So how will the crypto community fare in 2023? From an insolvency, financial crime, and regulatory perspective, I will explore what to expect.

Insolvency

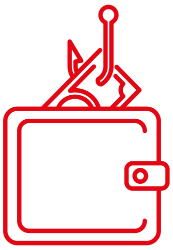
Globally, there were only one or two insolvencies a year between 2019 and 2021 in the crypto sector. Nine insolvencies occurred in 2022, including the collapse of FTX, whose impact on the crypto world is still being felt. We have already seen cryptocurrency lender Genesis file for Chapter 11 bankruptcy in the USA this year. There is no doubt that crypto contagion continues to be a significant issue facing crypto firms. Three Arrows Capital, whose demise last year was triggered by the crypto-token Luna's collapse, and Alameda Research, a trading company closely affiliated with FTX, had received significant loans from Genesis.

The continued fallout from 2022, coupled with a global economic recession, is likely to mean that markets will remain muted in 2023. Crypto firms have and continue to experience liquidity pressures and there have already been significant lay-offs in the sector. It is likely that the major players in the market will prosper and shore up market share from smaller competitors. M&A activity is also likely to increase, with a number of large banks such as Goldman Sachs expected to spend millions investing in crypto firms as company valuation appear more realistic or even undervalued.

You may be surprised to hear that at the time of authoring this article, bitcoin is currently the best-performing asset, up around 35% since the start of the year.

Whilst this may lead to increased trading in crypto markets, analysts believe that this rally is a bull trap, and will burn traders who mistake it as a mini-boom. Depending on how crypto participants react to the current uptick, the less cautious may also experience liquidity and insolvency issues if they have not contingency-planned for a potential crash.

I also anticipate that insolvency practitioners will upskill themselves in crypto technology and invest in the relevant people and relationships. We are seeing an increasing number of insolvencies where crypto comprises part of the estate and there are significant challenges in identifying, securing and realising cryptoassets for the benefit of creditors. There will also be new financial crime , compliance and risk factors that will need to be considered. Some insolvency practitioners have already started adding crypto on to their checklists when investigating distressed estates and a small number have invested in crypto tracing technology to assess the risks of financial crime and sanctions potentially associated with wallet addresses. Those who invest in developing the right skills, platforms and partnerships now will be best placed to take advantage of future opportunities.



Financial Crime

The substantial number of frauds and scandals in 2022 will forever leave its mark in cryptocurrency history. A number of the collapses previously mentioned are linked to allegations of fraud, with retail investors ultimately paying the price through lost or stolen cryptoasset. This leads me to believe that we are likely to see a shift away from consumers using custodial wallets operated by crypto exchanges and an increase in use of cold wallets.

As cryptoasset prices continue their upward trend (following the market crash resulting from the crypto winter), retail investors are likely to invest more with the belief there are significant returns to be had. As we enter a global recession, retail investors are more likely to look for get rich quick schemes when they are feeling an economic pinch but this is also when customers are most vulnerable in falling prey to financial crime. The potential for significant returns are not without significant risks, and bad actors will take advantage. I expect we will see an increase in fraud, particularly whilst prices continue to rise as well with fraudsters developing new and innovative methods to entice victims.

Chainalysis identified that 44% of illicit transaction volume (around USD 8.8bln) in 2022 came from activity associated with sanctioned entities and so it is likely that law enforcement agencies will increase the crackdown on cryptoassets for sanction violations in 2023.

We saw this at the tail end of last year when OFAC settled with cryptocurrency exchange Kraken in November in relation to apparent violations of Iranian sanctions.

In a move away from targeting individuals, sanctions regimes are increasingly targeting cryptocurrency services that facilitate financial crime. However, both Russia and Iran (two countries who face a considerable number of international sanctions), will look to bypass this by developing a new cryptocurrency backed by gold which can be used in their bilateral trade deals, bypassing the international banking system and avoiding the use of US dollars. It will be interesting to see how this progresses and what subsequent actions law enforcement take to counter these measures.

There are also likely to be more money-laundering and terrorist financing stories becoming known in 2023. Binance is alleged to have processed around USD 346m in BTC for the Bitzlato digital currency exchange, whose founder was arrested for allegedly running a ‘money laundering engine’. Crypto lender Nexo is currently being investigated by Bulgarian authorities on suspicion of money laundering and tax offenses. Anti-money laundering and KYC checks remain nascent in the crypto sector, with firms in the UK facing just their third year of AML supervision. As regulators start getting to grips with crypto, I expect crypto firms, in jurisdictions where regulation is forthcoming, to invest heavily in compliance tools, technology and people to demonstrate they are taking appropriate steps to mitigate financial crime risk.

Regulatory

We should expect to see the further development of the regulatory and legal framework around crypto in the UK. The Law Commission published a consultation paper last year on law reform proposals to ensure that the law recognises and protects digital assets (including crypto-tokens and other cryptoassets). A policy paper off the back of that consultation is expected in 2023, and its conclusion could result in changes to how the current law defines and recognises individual property rights so as to include digital assets.

On the regulatory front, with HM Treasury due to consult in Q1 2023 on its proposals for the regulation of a wider set of cryptoasset activities, and the Financial Services and Markets Bill looking to introduce the concept of digital settlement assets (I.e. stablecoins) and a broader definition of cryptoassets, we should expect to see increased regulation around cryptoassets in the not so distant future. Indeed, the introduction of the concept of digital settlement assets will help provide some of the legal and regulatory structure the Government needs to get its Central Bank Digital Currency of the ground. Looking to Europe, the Markets in Crypto-Assets (MiCA) Regulation is expected to be implemented in early 2023, closing gaps in EU financial services legislation by creating a unified set of rules for crypto-assets and related activities.

With the increase of the regulatory and legal framework of crypto, it should eventually translate into more legal rights which can be enforced; therefore, one would hope, providing more protection in insolvency and to victims of financial crime.

There is also likely to be greater focus around segregation of client deposits and proof of reserve requirements for crypto exchanges not dissimilar to the CASS rules and BASEL capital adequacy requirements which UK financial institutions have to abide by.