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Department of Financial Protection and Innovation, Legal Division
Attn: Sandra Navarro
Regulations Coordinator
2101 Arena Boulevard
Sacramento, CA 95834

Sent electronically via email to regulations@dfpi.ca.gov.

Re: Invitation for Comments on Crypto Asset-Related Financial Products and Services Under the California Consumer Financial Protection Law

Dear Commissioner Hewlett:

Chainalysis Inc. (“Chainalysis”) appreciates the opportunity to provide its input in response to the Department of Financial Protection and Innovation’s (“DFPI”) Request for Comment on “Crypto Asset-Related Financial Products and Services Under the California Consumer Financial Protection Law.” We appreciate DFPI’s thoughtful approach to regulation in this field. Below we provide background on Chainalysis and our role in combating financial crime involving cryptocurrencies, as well as our comments on specific questions from the RFC.

Background on Chainalysis

Chainalysis is a blockchain data and analytics company with public and private sector customers in over 70 countries.¹ We are a partner to regulators implementing and enforcing anti-money laundering (“AML”) and countering the financing of terrorism (“CFT”) and other public policy goals involving cryptocurrency. We are also a partner to law enforcement and other government agencies, which rely on our products to investigate criminal activity involving cryptocurrency. Our products are also used by cryptocurrency businesses that use our products to conduct transaction monitoring and meet their compliance requirements from the Bank Secrecy Act and other AML/CFT and related requirements.

Our tools have been used in a number of successful cryptocurrency investigations, including, but not limited to, the Mt. Gox hack,² North Korean crypto hacking cases,³ and the OFAC designation of Suex, a cryptocurrency exchange that facilitated money laundering for a

¹ Chainalysis website, <http://www.chainalysis.com>

² See e.g., Chainalysis Says They've Found the Missing \$1.7 Billion Dollar Mt Gox Bitcoins, June 22, 2017, <https://news.bitcoin.com/chainalysis-says-theyve-found-the-missing-1-7-billion-dollar-mt-gox-bitcoins/>

³ See e.g., Chainalysis in Action: Justice Department Demands Forfeiture of 280 Cryptocurrency Addresses Associated with North Korea Exchange Hackers, Aug. 28, 2020, <https://blog.chainalysis.com/reports/lazarus-group-north-korea-doj-complaint-august-2020/>

number of illicit actors, including ransomware gangs.⁴

Chainalysis' proprietary data products and solutions are underpinned by data from public blockchains. This public blockchain data is enriched with external data and proprietary algorithms that produce actionable data for our customers, delivered in customer-friendly data explorer interfaces or application programming interfaces ("APIs"). We monitor all cryptocurrencies and services to identify those that would most benefit from our coverage, e.g., because of their risks or size. New blockchains and tokens, including level-2 tokens such as stablecoins,⁵ are added regularly to meet our customers' public purpose and regulatory compliance needs. Chainalysis has mapped over 18,000 unique entities on the blockchain, including both legitimate services, such as cryptocurrency exchanges, and illicit services, such as Darknet marketplaces and child sexual abuse material sites.

Response to RFC Questions

- 1. What steps should the DFPI take to better protect consumers from scams and frauds associated with crypto asset-related financial products and services?*
- 2. What steps should the DFPI take to improve consumer education and outreach for crypto asset-related financial products and services?*
- 3. What steps should the DFPI take to better ensure consumer protection in the offering and provision of crypto asset-related financial products and services?*
- 4. What steps should the DFPI take to better ensure investor protection in the offering and provision of crypto asset-related financial products and services?*

As cryptocurrency grows as an asset class and is increasingly adopted, government agencies like DFPI must do their best to root out fraud, manipulation, and abusive practices. According to a study from Pew Research, at least 16 percent of Americans have invested in, traded, or otherwise used cryptocurrency, and 86 percent of Americans have heard of it.⁶ Just as in other parts of the financial system, fraud and scams exist in cryptocurrency. Scams are the largest category of cryptocurrency-related crime that we track. Our data shows that in 2019, there was \$9.4 billion in scam activity in crypto. This number fell to \$4.2 billion in 2020 and rose again to \$7.7 billion in 2021.⁷

To put this in context, Chainalysis data showed that the overall illicit share of cryptocurrency transactions was 0.15% in 2021.⁸ As always, we would like to caveat this number, which does not include proceeds from off-chain criminal activity that has moved on-chain for laundering or illicit on-chain activity that has not yet been identified. This estimate should be considered a lower bound estimate and will increase over time as more illicit activity is identified, but we believe this metric is useful in that it provides a good estimate of the order of magnitude. Cryptocurrency usage is growing faster than ever before, so while

⁴ Chainalysis in Action: OFAC Sanctions Russian Cryptocurrency OTC Suex that Received Over \$160 million from Ransomware Attackers, Scammers, and Darknet Markets, Sept. 22, 2021, <https://blog.chainalysis.com/reports/ofac-sanction-suex-september-2021/>

⁵ Chainalysis Brings Anti-Money Laundering Solution to Booming Stablecoin Market, Jan. 24, 2019, <https://blog.chainalysis.com/reports/stablecoin-press/>

⁶ Pew Research, 16% of Americans say they have ever invested in, traded or used cryptocurrency, Nov. 11, 2021, <https://www.pewresearch.org/fact-tank/2021/11/11/16-of-americans-say-they-have-ever-invested-in-traded-or-used-cryptocurrency/>

⁷ The Biggest Threat to Trust in Cryptocurrency: Rug Pulls Put 2021 Cryptocurrency Scam Revenue Close to All-time Highs, December 16, 2020, <https://blog.chainalysis.com/reports/2021-crypto-scam-revenues/>

⁸ Crypto Crime Trends for 2022: Illicit Transaction Activity Reaches All-Time High in Value, All-Time Low in Share of All Cryptocurrency Activity, Jan 6, 2022. <https://blog.chainalysis.com/reports/2022-crypto-crime-report-introduction/>

cryptocurrency-related crime is increasing, the legitimate use of cryptocurrency is far outpacing its use by illicit actors. This is good news for the cryptocurrency ecosystem, but government and industry must still put in place and implement the appropriate controls to mitigate risks in the system. There are three areas we recommend DFPI consider to protect consumers and investors and ensure consumer protection: 1) embrace training and technology to improve DFPI capacity, 2) develop consumer education initiatives, and 3) invest in public-private partnerships to share information related to illicit finance and cryptocurrency.

Embrace Training and Technology to Improve DFPI Cryptocurrency Capacity

In order to cut off scammers and protect consumers, one of the most important steps that DFPI can take is to ensure that the agency and its partners in law enforcement have a robust capacity for investigating these crimes and bringing illicit actors to justice. In a recent survey of our North American public sector customers, respondents overwhelmingly agreed that they believe employees at their agencies are currently not well-equipped enough to investigate cryptocurrency-related crimes.⁹ In discussing their agencies' current capabilities, respondents noted that the lack of staffing resources, technological resources to adequately investigate crimes, and training and educational opportunities to adequately investigate crimes were top of mind. These results underscore the government-wide need for adequate training, implementation of blockchain analysis tools in investigations and enforcement. Government agencies that have already embraced blockchain analysis have seized millions of dollars in cryptocurrency¹⁰ and stopped a number of illicit actors exploiting cryptocurrency, so allocating appropriate financial and personnel resources to these efforts would ensure that DFPI can address illicit activity in this space.

Cryptocurrency, like many other financial assets, is an instrument used by illicit actors, whose tactics are forever evolving as new technologies come along. A unique advantage to cryptocurrency is that, when fraud or scams do occur, the transparency provided by many cryptocurrencies' public ledgers makes transaction tracing much easier than other traditional forms of value transfer. Using blockchain analysis tools, government agencies can trace cryptocurrency transactions to identify their origination and/or its cashout points at cryptocurrency exchanges. Enforcement agencies and law enforcement can serve subpoenas to these cryptocurrency exchanges and collect Know Your Customer ("KYC") information from their customers. In their response to legal process, the exchange will provide any identifying information that they have related to the cryptocurrency address, such as name, address, and government identification documentation, allowing agencies to further their investigation. Cryptocurrency exchanges can proactively freeze accounts and illicit funds on their platform when they detect illicit activity, which provides a mechanism to make it more difficult for bad actors to profit.

In order to ensure effective consumer and investor protection, DFPI should establish robust blockchain supervision capabilities. This includes training of enforcement staff, as well as leveraging the use of blockchain analysis tools. In this fast-moving space, it is important that DFPI's team is aware of the latest trends in the cryptocurrency ecosystem and understands how they can conduct supervision. Training on different types of cryptocurrency and the

⁹The Chainalysis 2022 State of Cryptocurrency Investigations Survey, July 2022, <https://go.chainalysis.com/public-sector-crypto-investigations-survey-2022.html>

¹⁰Chainalysis in Action: US Government Agencies Seize More Than \$1 Billion in Cryptocurrency Connected to Infamous Darknet Market Silk Road, November 5, 2020, <https://blog.chainalysis.com/reports/silk-road-doj-seizure-november-2020/>

different players in this space will be critical. The right tools will also be very important - blockchain analysis enables regulators to monitor on an ongoing basis for illicit activities and ensure that the entities they supervise are meeting their regulatory obligations, which is vital to keeping customers and investors protected.

In addition to employing these tools themselves, DFPI should encourage cryptocurrency businesses to employ blockchain analytics tools in their AML and compliance processes. Blockchain analytics play a critical role in AML compliance, and we have seen government agencies, like the U.S. Department of Treasury's Office of Foreign Assets Control and the New York State Department of Financial Services, recommend its use.^{11, 12} Blockchain analysis tools enable transaction monitoring so that cryptocurrency businesses can identify illicit use of cryptocurrency and meet their AML obligations. DFPI policies can include tailored transaction monitoring guidance for cryptocurrency businesses, and highlight applicable typologies, red flags, and counterparty or AML risks specific to cryptocurrency.

Consumer Education

To ensure that consumers and investors are knowledgeable about and protected when engaging with cryptocurrencies and other cryptocurrency-related financial products and services, DFPI should promote public education on cryptocurrency. Education and training are vital not only for regulators and government agencies, but also for consumers and investors. A quarter of consumers say they are familiar with cryptocurrency but "don't know where to start," with research suggesting that education is the best way to help build more comfort with the asset.¹³ In an effort to protect consumers and investors, the DFPI could consider augmenting department-developed and -led cryptocurrency education initiatives by partnering with the private sector, including cryptocurrency businesses, to develop education campaigns about the space with risk protections in mind. Chainalysis, for example, has launched a free, public cryptocurrency [academy](#) to teach consumers about cryptocurrency.¹⁴ We have also developed consumer education videos for other states to improve consumer and investor awareness and education.

Public-Private Partnerships

DFPI could also consider replicating a similar model to the U.S. Department of Treasury's Financial Crimes Enforcement Network ("FinCEN") Exchange program, which brings together representatives from FinCEN, law enforcement, regulators, and industry members in a voluntary public-private information-sharing partnership.¹⁵ These exchanges enable FinCEN to collect and share information in a less formal setting, as well as learn about challenges faced by industry members in their efforts to prevent illicit finance. These sorts of public-private partnerships help to build and improve relationships and sharing mechanisms between the involved parties, with the shared goal of preventing illicit financing and protecting national security.

¹¹ OFAC Sanctions Compliance Guidance for the Virtual Currency Industry, October 2021, https://home.treasury.gov/system/files/126/virtual_currency_guidance_brochure.pdf

¹² NYDFS Guidance on Use of Blockchain Analytics, April 28, 2022, https://www.dfs.ny.gov/industry_guidance/industry_letters/il20220428_guidance_use_blockchain_analytics

¹³ See Bakkt U.S. Customer Crypto Survey, https://publicdocs.bakkt.com/collateral/Survey_Crypto_Exec_Summary_090121.pdf, and The Crypto Phenomenon: Consumer Attitudes & Usage

<https://usa.visa.com/dam/VCOM/regional/na/us/Solutions/documents/the-crypto-phenomenon-technical-paper.pdf>

¹⁴ Chainalysis Academy, <https://academy.chainalysis.com/>

¹⁵ FinCEN Exchange, <https://www.fincen.gov/resources/financial-crime-enforcement-network-exchange>

We thank you for your consideration and look forward to being of service to the DFPI as you work to establish a framework for enhancing California's economic competitiveness in, and leveraging of, crypto asset-related financial products and services.

Sincerely,
Clark Flynt-Barr
Senior Policy Advisor
Chainalysis