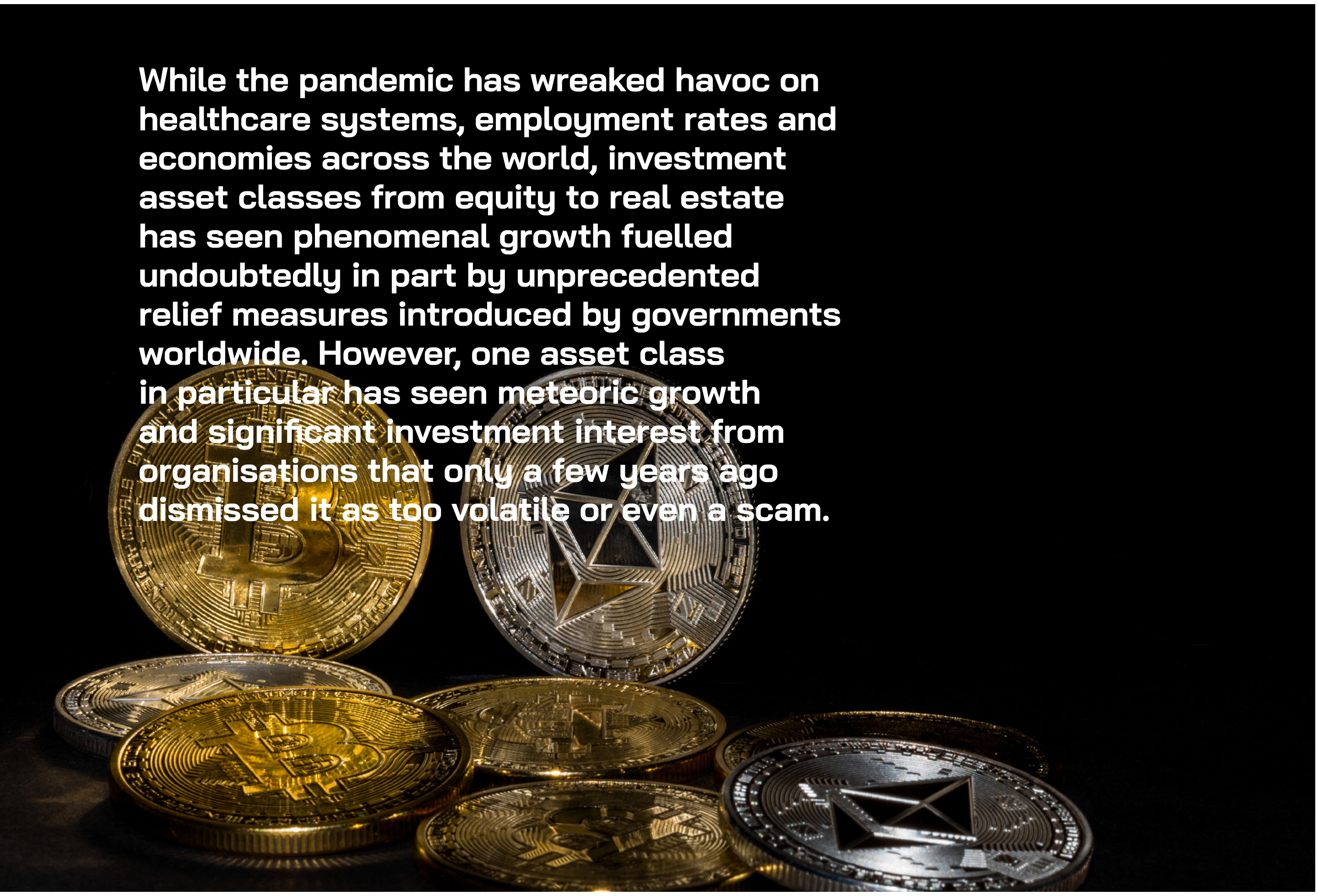
Established Tools for New Assets: Decrypting the problem of Asset Tracing in Cryptocurrencies.

While the pandemic has wreaked havoc on healthcare systems, employment rates and economies across the world, investment asset classes from equity to real estate has seen phenomenal growth fuelled undoubtedly in part by unprecedented relief measures introduced by governments worldwide. However, one asset class in particular has seen meteoric growth and significant investment interest from organisations that only a few years ago dismissed it as too volatile or even a scam.



GET IN TOUCH

View Nicola Roberts's Profile

View Jayesh Chatlani's Profile

BY:
NICOLA ROBERTS
Partner and Head of Litigation,
Restructuring and Insolvency

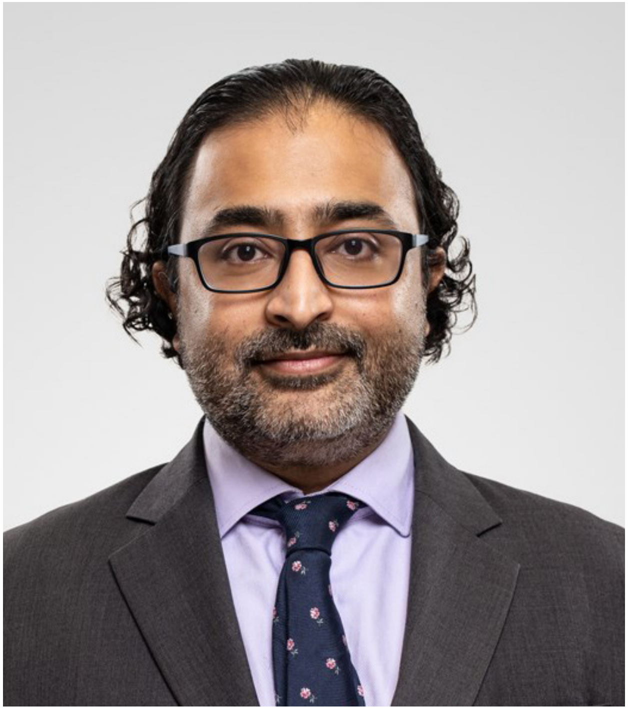
JAYESH CHATLANI
Counsel, Harneys

NICOLA ROBERTS
Harneys

The current market capitalisation of cryptocurrencies is approximately USD2 trillion (up from approximately USD180 billion in April 2020), approximately half of which is attributable to the now ubiquitous Bitcoin. Naturally this parabolic growth has drawn significant interest from younger investors and dynamic family offices as wealth shifts from more traditional asset classes to cryptocurrencies. Indeed, Southeast Asia and Asia Pacific are the fastest growing sources of investment into cryptocurrencies. While this trend creates massive opportunities, it also carries with it concomitant risks as more wealth in the asset class creates more incentive for fraud. This article explores these risks and how investors can protect themselves against fraud, and if they do fall victim to fraud, what steps might be taken to trace and recover stolen cryptocurrencies.

An often cited but less practiced axiom in the world of cryptocurrencies is that it is critical that you hold your own private keys, for without that, you don't truly own the cryptocurrency. This is true in its strictest sense –the private key is necessarily paired with the public key to facilitate a transaction dealing with assets held in a given wallet. Accordingly, the safest means for an investor storing cryptocurrencies would be to hold those assets in a cold storage wallet (i.e. one that is not connected to the internet) or to use a hardware wallet which contains an encrypted form of the private key, and from which transactions may take place. Many investors, will however, prefer the liquidity, flexibility and ease of use that comes from storing their cryptocurrencies on an exchange itself. In this case, it is important to choose an exchange that is large enough to withstand attacks, that has a track record of compensating investors for any hacking events, and which has adequate insurance or regulation in place. Counterparty due diligence (viz the exchange) is therefore as important in the world of cryptocurrencies as it is in more traditional investments, and this is all the more so if cryptocurrencies are being purchased on a peer to peer or OTC basis. It is important in those cases of large transactions that appropriate escrow and custodian safeguards are put in place in order to ensure that fiat currencies are in fact sent, and cryptocurrencies are in fact received as contracted. If one side of the transaction involving cryptocurrencies fail, it becomes all the more difficult to trace and recover the assets.

One of the key benefits of cryptocurrencies is that, for the most part (with the exception of a handful of 'privacy tokens', all transactions are recorded on the blockchain for that cryptocurrency and it can be traced with precision accuracy. The difficulty arises in identifying who is behind a particular wallet (with wallet addresses providing a pseudonym to the real identity). In a significant number of cases, the cryptocurrencies are either sent to or passed through exchange accounts (this often provides the liquidity for the cryptocurrencies that a fraudster needs), which is why it is important, when being a target of a crypto scam to track the currency on the block chain, and notify all the major exchanges that the cryptocurrency in question represents proceeds of crime. For most reputable exchanges, this will at least trigger a self-imposed freeze, and will provide notice so that steps can be taken to recover assets. The exchanges due diligence protocols are important in this regard as they will also be able to provide disclosure (likely with



JAYESH CHATLANI
Harneys

the appropriate court order) requiring KYC information pertaining to the account to which the proceeds of fraud were transferred.

In terms of the basis upon which one might apply to Court, the nature of cryptocurrencies is important. The common law courts have now repeatedly held that cryptocurrencies are property. This is significant as this gives rise, prospectively to proprietary claims, and an equitable tracing right over misappropriate assets. The first English authority to consider the question of proprietary relief in respect of cryptocurrencies was ***Vorotyntseva v Money-4 Ltd (t/a Nebeus.com) [2018] EWHC 2596 (Ch)*** in which the Court granted a proprietary freezing order over some bitcoin and ethereum currency. This position was subsequently affirmed in England in *AA v Persons Unknown* [2019] EWHC 3556, and later in New Zealand in ***Ruscoe v Cryptopia Limited (in Liquidation) [2020] NZHW 728***. Accordingly, the tools traditionally available in proprietary claims, namely robust disclosure orders and freezing injunctions are also available when dealing with cryptocurrencies.

While cryptocurrencies are a new and exciting class of investments, investors should be alive to unique risks in the cryptocurrency space, but also be rest assured that there is a body of professionals who can assist in mitigating risk, or recovering assets if things go wrong. Harneys has a significant depth and knowledge in dealing with cryptocurrencies, being involved in all aspects of industry both contentious and non-contentious. Most recently, Harneys has acted for a large institution that had been the target of a multi-million dollar theft of various cryptocurrencies and assisted in obtaining disclosure orders, and freezing injunctions in the BVI and Cayman Islands and in the eventual recovery of several million dollars of cryptocurrencies. ■