Shufti Pro

Launching an ICO? Learn Why KYC and AML Compliance Matters

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White Paper

Table of Contents

The Emergence of ICOs and Their Rapid Growth

The rise of ICOs (Initial Coin Offerings) has been one of the most significant developments in the cryptocurrency market. ICOs or 'token sales' are a form of crowdfunding used to raise funds for development projects and to launch new crypto projects [7]. ICO participants receive digital tokens in exchange for funds, which are usually provided in the form of bitcoins, ether, or any other form of digital currency. The funds raised are then used to support the development of a blockchain project, such as a cryptocurrency exchange or a cloud storage service. These blockchain technologies have the ability to cryptographically represent, record, store, and exchange any kind of assets including real estate, financial securities (bonds, derivatives, equity), etc.

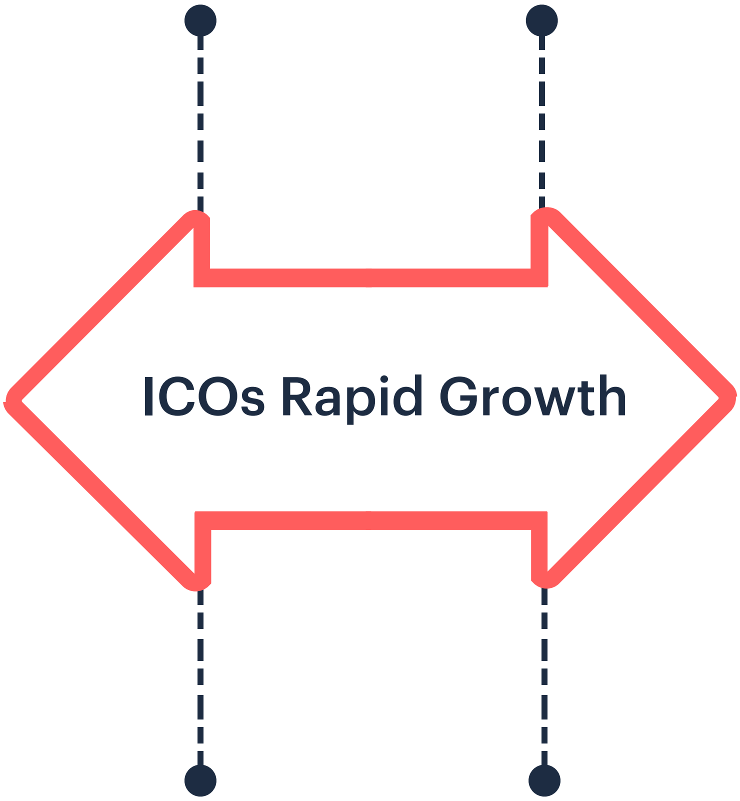
ICOs are somewhat similar to an Initial Public Offering (IPO). But unlike an IPO, it is less familiar to regulators [1], however, due to its association with cryptocurrencies, such as Bitcoin and its quick growth in value in the last quarter of 2017 attracted increased scrutiny from regulators around the globe. The total capital raised by ICOs in 2017 was $4bn, which is 40 times those compared to what was raised in 2016 [9] .

Initially, ICOs operated in a regulatory vacuum, profiting from the lack of clear guidance on how they fit within securities and financial crime regulations. In 2018, the Wall Street Journal [2] found out that one in every five ICOs was fraudulent. ICOs can be vulnerable in two ways. First, they can be used as a means to lure investors into investing in them or they can be used as a convenient place to dump illegal money by financial scammers and money launderers.

In July 2017, the SEC (Securities and Exchange Commission) [3] indicated that US securities laws may apply to some token sales and therefore they would be subjected to certain investor disclosure and registration requirements. In spite of these regulations, over 200 startups raised more than $3.2bn worldwide through ICOs in 2017, and proceeds from ICOs crossed a $4bn mark. As per CoinDesk, they outperformed venture capital funding into blockchain startups by more than double.

ICOs raised a total of almost $11.4 billion in 2018 (Medium, ADN's Outlook for Future ICOs)

In 2018, a total of 3,782 ICOs opened (Antier, Why ICOs are popular)



Filecoin with its most successful ICO raised $257,000,000 in 2019 (Fundera)

$400 million of the $3.7 billion raised through 372 ICOs have been stolen from 2018 to 2019 (Reuters, Ernst & Young's Research)

Launching an ICO

The process for an ICO is quite simple, ICOs usually raise capital by issuing a 'white paper' that provides details of the concept that the venture intends to build, the tokens that will be issued in exchange for cryptocurrency, and the mechanism for payment of cryptocurrency to the venture's account. It is more common now for payments to be made into an escrow account, for greater assurance of the venture's validity.

This is where the regulatory issues arise because the ICO offers a currency, or token, rather than shares that have not been considered (by proposers) to be a securities offering, so the associated regulation and controls have not been applied. The increase in ICOs has expanded initiatives well beyond blockchain developments to encompass various start-ups, and this expansion has increased the concerns about their status and risks [1].

Let's explore the advantages and disadvantages of ICO issuer and the risks associated with ICOs.

Pros and Cons for the ICO issuer

Advantages

Alternative to VCs

ICOs are becoming increasingly popular for startups who have been shut out of traditional venture capital channels or worried that their own equity stake will evaporate in successive financing rounds. After the token sale, the ICO issuers will still own 100% of their company and this lets them fund their project while it's still being conceptualized.

Lack of Regulation

One of the most cited advantages of ICOs is the lack of regulatory oversight. This normally depends on the jurisdiction. For instance, countries like Switzerland and Singapore are creating safe havens for cryptocurrency and are agreeing to cooperate on fintech rules and treat digital currencies as assets rather than securities. But these rules are different in other countries.

Marketing

Securities laws only allow traditional venture financings to authorized investors and prohibit publicly marketing the offering to increase demand. If ICOs are not considered to be securities, then issuing ICOs can influence press and smart marketing to boost interest for their ICO.

Disadvantages

Increased security risks

The lack of regulations make ICOs a potential haven for cybercriminals, fraudsters, and others who either don't want to register their offering or fail to provide necessary security to the public.

An unregistered ICO can result in devastating losses for benefactors who have a financial stake in the process, and with ICOs that are neither regulated nor registered, investors are often not able to recover their assets if something goes wrong.

Tax disincentives

A company selling equity to raise money doesn't have to pay any income tax on the proceeds. But when a company raises capital through a token sale, the proceeds are then treated as revenue, and therefore subject to tax. In the US, you have to pay around 40% of every dollar raised [10]. While some sales may be structured through tax-exempt and/or offshore entities, that structuring is more expensive, complicated and riskier than a traditional venture financing.

Lost private keys

In a traditional financing process, the issuer is a trusted third party, and if you lose your stock certificate, the issues will probably give you a new one. But because of the irreversible nature of cryptocurrencies, the security and integrity of private keys issued during ICOs is problematic. This means that if you lose the private key for your wallet or in case your wallet is compromised, you will not be able to retrieve your tokens.

Risk and Regulations

Risks for investors

Understanding the risks and issues that are perceived around ICOs provides a necessary context for the increased regulatory involvement. Let's look at the risks in relation to each party involved in the ICO chain [1].

Fraudulent investments

Publicity about the rapid growth of cryptocurrencies has contributed to the increase in its activity, making ICOs a potentially easy way for fraudsters to make money. When a large group of people sees an opportunity to make a fast return and don't want to miss out on 'the next big thing' it attracts players with devious motives. This scenario has become more intense by the anonymous elements of the underlying blockchain distributed ledger.

Details about the location of several ICOs companies are often vague and most of them are often 'virtual' entities, with just a website, and no specific geographic location. Those investing outside their local country are not familiar with the business environment and its regulation in the country where the ICO's actors are based. This makes it hard to confirm their authenticity and if a scheme does collapse, it can be difficult, if not impossible, to trace the scheme's operators. Some ICOs, sensing this caution, are now using escrow accounts to give investors increased confidence that their money is secure.

Stamp out scammers with Shufti Pro

Shufti Pro's automated AML solution provides a solid risk cover to ICOs against money launderers, terrorist financiers, and identity thieves with 1700+ global databases that are updated every 15 minutes.

Security risks

Tokens are based on new, rapidly evolving technology, and they are combined with the cryptocurrency foundation and large monetary values, it makes token stores vulnerable to attack from hackers. If someone hacks into a token repository and steals them, investors typically have no recourse, especially if they are unregulated. There have been many examples of token thefts in the past, such as in January 2018, a cryptocurrency exchange, CoinCheck admitted theft of over $530m of funds [8]. Moreover, around 32 cryptocurrency thefts have been reported as occurring between 2011 and November 2017 by BitcoinExchangeGuide (2017), including an $8.5bn theft from Veritaseum in July 2017 [1].

Risk for Regulators

The threat of ML and TF

The anonymity of transactions and the ability to raise large amounts very quickly make ICOs a huge target for money laundering and terror financing.

An ICO takes one asset (such as ether or bitcoin) and redeems it for a token that can be freely transferred, and traded for other cryptocurrencies or fiat currencies on exchanges present worldwide. This mechanism poses a major risk for ICOs being used for laundering proceeds of crime. By redeeming cryptocurrency for tokens, ICO issuers are potentially exchanging cryptocurrency that originated from the illegal activity for fresh tokens that can then be sold for US Dollars, Euros or other fiat currency. Several of the regulators (including those in China, Hong Kong, Russia, Singapore, and Switzerland) have sought to bring ICOs within the boundaries of KYC (Know Your Customer) and AML (Anti Money Laundering) controls.

There is no formal procedure to audit ICO organizations. Many teams undergo token sales before making any notable progress in building out a functional product. The team may document their business plans and technology in a white paper, but there may be little evidence that the technology can be built as described or that the company will operate as expected.

Flaws in these technologies may not be discovered until significant amounts of money have already been invested. Furthermore, some organizations have a clause in their ICO terms that require contributors to accept the risk of project abandonment.

DO YOU KNOW?

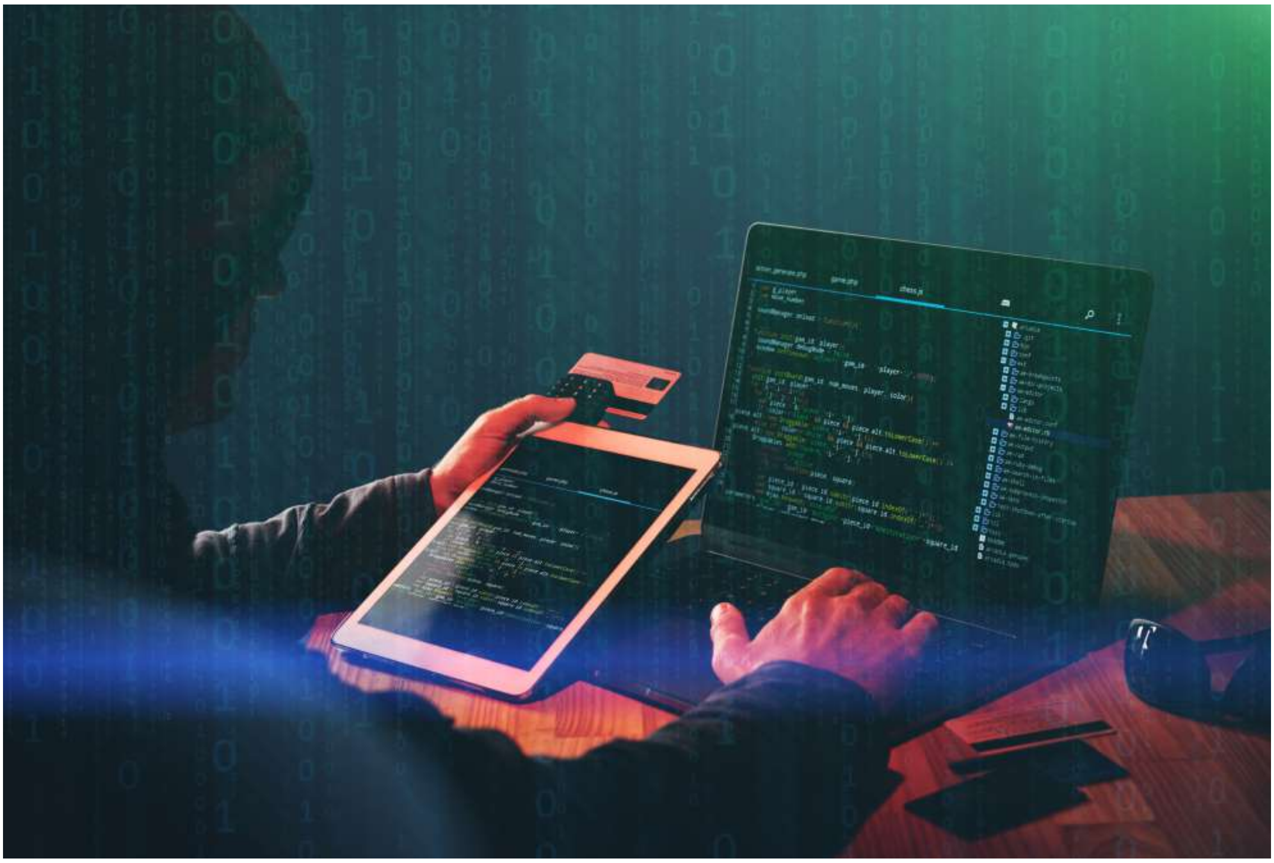
INTERESTING FACT

Shufti Pro empowers businesses to perform KYC and AML screening on their clients in seconds through a single API request.

Phishing scams

A scammer may fraudulently imitate a company that is conducting a token sale and persuade buyers to transfer cryptocurrency payments to an address that is unaffiliated with the organization. Since cryptocurrency payments cannot be reversed, the impersonator can easily steal all the payments that are sent to that unaffiliated address.

Scammers often operate on Slack and other social media sites. They try to hack into the organization's account or create a domain name or username that is similar to the organization's name. They then claim to speak on behalf of the organization and then ask token buyers to send payments to the wrong address. They may also hack into an organization's website and change the company's payment address to their own.



The Importance of AML and KYC Compliance

Any organization that is considering launching an ICO, or wants to exchange the resulting tokens, needs to be thorough in their documentation, legal structuring, and due diligence. Unfortunately, many companies considering an ICO do not consider what this means from a compliance point of view.

There are many people who want full transaction anonymity, but governments have a legitimate reason to thwart corruption and money laundering. The current AML system was originally created to address existing centralized financial services systems. Let's go through some of the key reasons, indicating why it is necessary to comply with KYC and AML laws.

Reasons why ICOs should comply with KYC and AML

Build a credible image in front of regulators and banks

Effective KYC during the token raising event makes it easier to work with banks and follow AML regulations. Performing voluntary compliance in a token sale increases the legitimacy status of a project. Regulators and banks trust those token sales more, which follow required KYC laws during their process.

Any organization that wants to succeed in the long run needs to understand the existing legal framework and ensure regulatory compliance at all cost. Businesses can establish legitimacy by properly designing and protecting the initial crypto-asset and its governance contract. Good governance (such as oversight, yields predictability, security, and effectiveness) can create high value and credibility for all token holders.

Improved public image

Being transparent in your financial dealings is something that most investors appreciate. The more the team communicates its overall plans, financial structure, use of funds, incentives, associated risks, and other information with the investors the more the public can weigh the value of the offering. As more and more ICOs subject themselves to voluntary KYC and AML compliance, the frauds and scams are becoming known and the offerings that have real promise are rising to the top. The investors feel more secure and trust those organizations and businesses that follow necessary regulations and are compliant.

Enhanced market exposure

More than lending legitimacy to businesses, voluntary AML and KYC compliance may help ICOs reach a large audience and increase the number of jurisdictions in which they can participate and raise more funds. For instance, such compliant ICOs can be offered to a subset of accredited investors in the US, UK, and Canada. On the other hand, issuing token sales in countries with a less rigid regulatory framework may give companies access to a more limited pool of potential investors.

How to comply with regulations

The objectives of AML and KYC guidelines have been to prevent regulated businesses from being used, intentionally or unintentionally, by criminal entities for money laundering or terror financing. As ICOs are becoming more mainstream, the potential for fraud increases as well. To avoid such fraud events and to keep complaint the organizations must:

- Verify the investor's identity
- Understand the customer's profile, business, and account activity
- Identify risks and relevant adverse information
- Assess the ML and TF potential to support actionable decisions while controlling financial, regulatory and reputational risk

How Shufti Pro OCR Can Help You Stay Compliant

Identity verification with AI

Shufti Pro verifies identities with its AI-based identity verification solutions that utilize advanced OCT. AI OCR engine scans the personal information of a potential customer directly from their official identity document and automatically uploads the information in the verification form, that is forwarded for authentication after formal approval from the end-user. Shufti Pro has the ability to validate identity documents from 230+ countries and territories in 150+ languages. Other features and aspects of the KYC solution of Shufti Pro include:

- Proof of verification
- Restful API and mobile SDKs for integration
- Two verification formats
- Flexible pricing (Pay as you go and monthly commitment)

AML compliance solution

Shufti Pro's automated AML compliance solution can help businesses identify high-risk clients, perform PEP screening, and real-time sanction list monitoring. Shufti Pro offers access to 1700+ datasets acquired from international sources including OFAC, EU, HMT, and others with the AML data bank being updated every 15 minutes. The AML software leverages big data and hybrid technology for higher accuracy and consistent results. Global AML verifications are done in real-time to enable organizations to mitigate the financial risk associated with high-risk customers.

Conclusion

Launching an ICO and making sure that it gets the necessary attention from the investors is not an easy task, but if your organization is following all KYC and AML regulations present in your region, this task surely becomes much easier. There are many processes and operations that need attention while launching an ICO, which makes managing compliance operations a hefty task for organizations. But by using automated solutions like Shufti Pro you can automate these operations and can focus on other tasks properly.

Do you want to learn more about how Shufti Pro can help in data automation?

Discuss it with our experts

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Get non-discriminatory access to all features of the selective service of **Shufti Pro for 15 days.**

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Shufti Pro True Identity Builds Trust

Expanding services to 230+ countries and territories in a short period of time, Shufti Pro envisioned playing a pivotal role in creating cyberspace where every transaction is verifiable and secure. With enough experience in technologies like machine learning (ML), OCR, artificial intelligence, and Natural Language Processing (NLP), Shufti Pro strives to provide the best identity verification services to verify customers and businesses online.

Shufti Pro's cost-effective solutions help businesses to prevent fraud and illicit crimes that can ruin the integrity and brand reputation of your business. Our perfect solution suite consisting of KYC verification, AML screening, ID verification, Facial Recognition, Biometric Authentication, Video KYC, OCR, and KYB helps to improve your company's fraud prevention, Know your Customer (KYC) and Anti Money Laundering (AML) regulatory efforts by automating the workflow. With single API integration, Shufti Pro empowers you to verify customers with document checks from 3000+ ID templates and business entities from 200 million companies data.

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