

## **FINCEN "IN THE MIX" UNPRECEDENTED USE OF 311 AUTHORITY TO TARGET CLASS OF TRANSACTIONS INVOLVING CVC MIXING AS PRIMARY MONEY LAUNDERING CONCERN**

On 19 October 2023, the Financial Crime Enforcement Network ("FinCEN") published a [notice](#) of proposed rulemaking ("NPRM") that identifies convertible virtual currency ("CVC") mixing within or involving a jurisdiction outside the United States as a primary money laundering concern<sup>1</sup> under Section 311 of the Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism Act of 2001 ("**USA PATRIOT Act**") and proposes as the special measure that "covered financial institutions" report and retain information on certain transactions involving CVC mixing "within or involving a jurisdiction outside the United States." FinCEN has issued the NPRM to combat the illicit use of the intentional anonymity provided CVC Mixing to obscure the proceeds of criminal activity by private and state-back cyber criminals, sanctions evaders and other nefarious actors. This is not the first time the U.S. Department of Treasury ("**Treasury**") has expressed concerns about anonymity-enhancement technologies including mixers,<sup>2</sup> but it is the first time FinCEN has designated a class of transactions as a primary money laundering concern. The NPRM is expected to garner significant industry comment, due by January 22, 2024, and has the potential to shape future development in the virtual currency sector. The NPRM may also

<sup>1</sup> Proposal of Special Measure Regarding Convertible Virtual Currency Mixing, as a Class of Transactions of Primary Money Laundering Concern, 88 Fed. Reg. at 72,701.

<sup>2</sup> See Department of Treasury, *National Money Laundering Risk Assessment* 43 (February 2022) (<https://home.treasury.gov/system/files/136/2022-National-Money-Laundering-Risk-Assessment.pdf>)

pave the way for future use of the "class of transactions" tool in other sectors to address specific money laundering concerns.

## **BACKGROUND**

CVC refers to a type of virtual currency that can be exchanged for other virtual currencies or fiat currency through various platforms or exchanges. Bitcoin, Ethereum, and other popular types of virtual currencies are examples of CVCs. Generally, CVCs are based on blockchain technology which provides a permanent, and effectively transparent, recorded history of all previous transactions. However, CVC transactions can become anonymized and untraceable through CVC mixing.

CVC mixing involves the facilitation of CVC transactions in a manner that obfuscates the source, destination, or amount involved. Whether for purposes of protecting privacy or illicit activity, CVC mixing is intended to make CVC transactions untraceable and anonymous. FinCEN is focused more on the bad uses, stating that CVC mixing has been increasingly used by illicit actors including cyber hacking groups, ransomware actors and darknet market participants to launder illicit proceeds. For example, the Axie Infinity Ronin Bridge heist worth almost \$620 million committed in March 2022 by the Lazarus Group, a North Korea-sponsored cyber hacking group, involved two CVC mixers – Tornado Cash and Blender.io – which were used to launder the proceeds of the heist to finance North Korea's weapons of mass destruction programs. The Office of Foreign Assets Control ("**OFAC**") subsequently sanctioned both mixers. CVC mixers are also often used by Russia-affiliated threat actors for ransomware attack and sanctions evasion. FinCEN cites in its notice a report by the U.S. Department of Justice ("**DOJ**"), stating that CVC mixing techniques to hide identities have been used to finance terrorism by Hamas and others.

FinCEN asserts that no CVC mixers have registered with FinCEN, while also noting that they are required to do so if they do business as money transmitters, wholly or in substantial part, within the United States.<sup>3</sup> In 2019, FinCEN issued guidance interpreting its rules to cover anonymizing services, such as CVC mixers, as money transmitters while clarifying at the same time that providers of anonymizing software were not money transmitters.<sup>4</sup> Within this context, although Section 311 is a powerful tool designed to enable the U.S. Government to target threats to the U.S. financial system originating outside of the United States, in this instance, it appears intended to have a broad impact on future developments in the virtual currency space, domestically and abroad, by helping to address gaps in FinCEN's regulatory coverage and lack of compliance by CVC mixers providing anonymizing services even when they may be covered under FinCEN's regulations.

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<sup>3</sup> FinCEN defines "money transmitter" as to include a "person that provides money transmission services," or "any other person engaged in the transfer of funds." See 31 C.F.R. § 1010.100(ff)(5); see also FinCEN Guidance FIN-2019-G001 (May 9, 2019), available at <https://www.fincen.gov/sites/default/files/2019-05/FinCEN%20Guidance%20CVC%20FINAL%20508.pdf>.

<sup>4</sup> *FinCEN*, *supra* note 3, at 4.5.1(a and b).

## WHAT IS FINCEN'S SECTION 311 AUTHORITY?

Section 311 of the USA PATRIOT Act provides FinCEN with broad discretion to identify a foreign jurisdiction, institution, class of transactions, or type of account as a "primary money laundering concern" and to require domestic financial institutions to take certain "special measures" with respect to the primary money laundering concern. The five potential special measures listed in Section 311 are intended to serve as preventive safeguards aimed at defending the U.S. financial system from the risks of money laundering and terrorist financing. (For more general information on Section 311 please refer to our client alert on this topic [here](#)).

Over the years, FinCEN has used Section 311 to designate a number of financial institutions it identified as a primary money laundering concern.<sup>5</sup> In the virtual currency context, earlier use of Section 311 authority,<sup>6</sup> and a separate but similarly structured authority to focus on Russia-related illicit activity under Section 9714 of the Combating Russian Money Laundering Act,<sup>7</sup> were focused on specific entities. However, the newly proposed rule is FinCEN's first ever use of the Section 311 authority to target "a class of transactions" as a primary money laundering concern.

## PROPOSED RULE ON CVC MIXING: INFORMATION REPORTING AND EFFORT TO CLOSE GAPS

Although generally supportive of innovation and advances in digital and distributed ledger technology for financial services, FinCEN finds that CVC mixing provides foreign illicit actors with enhanced anonymity that allows them to launder illicit proceeds posing threats to the U.S. financial system and national security.<sup>8</sup> In this regard, "CVC mixing" is defined as any of a number of activities that obfuscates CVC transactions, which includes use of anonymizing software and other techniques.

To mitigate the threats posed by mixing activity both within and outside of the United States, the NPRM would require covered financial institutions to implement certain recordkeeping and reporting requirements relating to transactions "in CVC" that involve CVC mixing. Through these measures, FinCEN aims to focus on CVC exchanges and others that engage directly in CVC and not institutions that simply engage in fiat transactions associated with CVC transactions. FinCEN asserts that the information collection will assist law enforcement with identifying the perpetrators behind illicit transactions and render this class of transactions less attractive and useful to illicit actors by enhancing transparency.<sup>9</sup>

### Covered Class of Transactions

The proposed rule would require covered financial institutions to collect and report certain information regarding transactions in CVC that the financial institution

<sup>5</sup> For example, FinCEN imposed special measure five on FBME Bank Ltd in 2017 and ABLV Bank of Latvia in 2018.

<sup>6</sup> See *Imposition of Special Measure Against Liberty Reserve S.A. as a Financial Institution of Primary Money Laundering Concern*, 78 Fed. Reg. 34008 (proposed but ultimately rescinded).

<sup>7</sup> See e.g., *FinCEN, Imposition of Special Measure Prohibiting the Transmittal of Funds Involving Bitzlato*, 88 Fed. Reg. 3919 (Jan. 23, 2023); see also, *Treasury Issues First-Ever Section 9714 Order Prohibiting Transmittal of Funds Involving Bitzlato*, Clifford Chance Client Briefing (Feb. 7, 2023) available at <https://www.cliffordchance.com/briefings/2023/02/treasury-issues-first-ever-section-9714-order-prohibiting-transm.html>.

<sup>8</sup> See *supra* note 1 at 72,702.

<sup>9</sup> See *id.*

knows, suspects or has reason to suspect involve CVC mixing. FinCEN identifies in a non-exhaustive list seven examples of mixing activities that trigger a reporting requirement. This list includes, for example, pooling or aggregating CVC from multiple individuals, wallets, or accounts into a single transaction or transactions; splitting an amount into multiple amounts and transmitting the CVC as a series of smaller independent transactions; or leveraging code to coordinate, manage, or manipulate the structure of the transaction.

Covered financial institutions that conduct mixing activities strictly for internal processes are exempted from the class of transactions, and do not trigger a reporting requirement. Thus, for example, banks, broker-dealers, or money services businesses, including virtual asset service providers ("**VASPs**") that use internal protocols or processes to execute transactions, are not subjected to the reporting requirement. However, under the NPRM, these institutions must maintain records of the source and destination of CVC transactions through their internal protocols and provide such records to regulators and law enforcement as required by law.

### **Covered Financial Institutions**

Each Section 311 rule can cover a tailored set of financial institutions. In this instance, the rule covers banks, broker or dealers, money services businesses, futures commission merchant or introducing broker-commodities, mutual fund, card club, telegraph company and any entity subject to supervision by any state or Federal bank supervisory authority.<sup>10</sup> Certain financial sector entities, such as credit card operators and dealers in precious metals, precious stones or jewels are not included as covered financial institutions for purposes of the NPRM.

### **Reporting and Recordkeeping Requirement**

To address money laundering concerns involving CVC mixing, FinCEN is proposing to use special measure one, which would impose enhanced recordkeeping and reporting requirements for covered financial institutions. The new obligations would require covered financial institutions to report biographical and transactional information related to transactions involving CVC mixing when they know, suspect or have reason to suspect a CVC transaction involves the use to CVC mixing within or involving a jurisdiction outside of the U.S.

The NPRM proposes collection of (i) information regarding the covered transaction; and (ii) information regarding the customer associated with the covered transaction. Specifically, FinCEN is proposing to require reporting of information pertaining to the CVC when transferred (currency type, amount, and U.S.-dollar equivalent), the CVC mixer (identity and/or wallet address), the transaction (hash, date, IP addresses and timestamps, and narrative description), and information concerning the associated customer including name, date of birth, addresses (physical, CVC wallet, and associated email), phone number, and an entity-specific government-issued (alpha)numeric identifier. The reporting obligations would not apply to covered financial institutions that directly engage with CVC transactions, or to indirect fiat transactions, "such as a bank sending funds on behalf of a CVC exchanger that is acting on behalf of a customer purchasing CVC previously processed through a CVC mixer." **The NPRM does**

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<sup>10</sup> 31 C.F.R. § 1010.100(t).

**not require covered financial institutions to request additional information from a transactional counterparty, but only to report information in its possession.**

Significantly, "FinCEN is not, at this time, proposing that covered financial institutions be required to perform a lookback to identify covered transactions that occurred prior to the issuance of the final rule."<sup>11</sup>

Once a covered transaction has been identified, the covered financial institution would have 30 calendar days to report the information in its possession regarding the transaction involving CVC mixing in the manner that FinCEN may prescribe. The recordkeeping obligations require financial institution to keep the filing records for five years by: (1) maintaining a copy of any records related to CVC mixing transactions they have filed; and (2) obtaining and recording copies of documentation relating to compliance with the regulation. Importantly, providing the required information does not absolve the covered financial institutions from filing a SAR when warranted, regardless of whether they also filed a report required under the proposed rule.

## **SHAPING OF INDUSTRY BEHAVIOR AND FUTURE RULEMAKING**

Mixing activity is not banned outright in the United States, and as noted above, certain CVC mixers are subject to Bank Secrecy Act regulation consistent with FinCEN guidance. Nevertheless, the information and reporting requirements proposed in connection with transactions involving CVC mixing "within or involving a jurisdiction outside the United States" are likely in the short-term to cause covered U.S. financial institutions and others to enhance their scrutiny of CVC transactions to comply with the reporting rules, if finalized. Some may de-risk such transactions due to the additional cost to comply with these requirements.

As FinCEN briefly notes, not all mixing activity has an illicit purpose. The Section 311 action is crafted in a way that may more firmly encourage industry efforts to develop CVC mixing and other activities that can provide adequate transparency for law enforcement and national security purposes while still protecting privacy and individual liberties. What FinCEN means by activity "within or involving a jurisdiction outside of the United States" will be critical. Although it is unclear, the language can be read to cover both domestic mixing activity and foreign mixing activity. It can also be read to confirm that mixing activity in the United States that does not involve a foreign jurisdiction would NOT be subject to the additional information collection and reporting requirements. As more jurisdictions address the risks associated with CVC mixing and appropriately regulate it, FinCEN's views on the scope of the "primary money laundering concern" could evolve. In addition, the action may encourage current providers of anonymizing services to register with FinCEN and adhere to AML program requirements in an effort to demonstrate willingness to be part of a solution to address money laundering concerns rather than being blamed as part of the problem.

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<sup>11</sup> *Supra note 1*, at 72,710 n. 76.

## **CONCLUSION**

As we had predicted in our [alterter](#) early last year, FinCEN is set to further expand use of Section 311. Use of mixing activity as the basis for identifying a class of transactions may seem to be a fairly targeted focus on a particular area of concern, but it has big implications both with respect to the virtual currency sector and with respect to the future of other AML requirements.

Clifford Chance attorneys with rich experience in advising various financial industry participants stand ready to address the many questions that might arise as institutions navigate through the continuously changing regulatory environment.

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