

The Distributed Ledger

Blockchain, Digital Assets and Smart Contracts

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In the First Use of Its Section 9714 Powers, the U.S. Treasury Designates Bitzlato as a Russian-Linked Primary Money Laundering Concern

On January 17, 2023, U.S. law enforcement authorities in Miami arrested Anatoly Legkodymov, a Russian national and the founder and majority owner of Hong Kong-based virtual currency exchange Bitzlato Ltd., on charges of money laundering and violations of the Bank Secrecy Act (BSA). Among other things, Bitzlato is alleged to have knowingly exchanged over \$700 million in convertible virtual currency (CVC) with Hydra Market, a now-defunct darknet marketplace known for illicit activities, while conducting little to no know-your-customer (KYC) investigation of users.

Bitzlato also allegedly facilitated transactions for Russian-affiliated ransomware groups and received millions in ransomware payments. Coinciding with Legkodymov's arrest, French and other European authorities took enforcement action to target Bitzlato's online infrastructure and seize its assets.

Significantly, the following day, the U.S. Treasury Department's Financial Crimes Enforcement Network (FinCEN) issued an order identifying Bitzlato as a "primary money laundering concern" under section 9714 of the Combatting Russian Money Laundering Act (Act). The order is FinCEN's first under section 9714, a relatively new provision, which authorizes the Secretary of the Treasury to identify non-U.S. financial institutions, classes of transactions, or types of accounts as primary money laundering concerns in connection with Russian illicit finance and impose "special measures" to combat such concerns.

Under the special measures applicable to Bitzlato, effective February 1, 2023, U.S. financial institutions are prohibited from engaging in any transmittal of funds to or from Bitzlato, or from any account or CVC address administered by or on behalf of Bitzlato.

As explored in greater detail below, section 9714 is a powerful tool that allows the Treasury Department to move quickly to address perceived threats to the U.S. financial system. Section 9714 special measures can be imposed immediately through written order, thereby avoiding the more onerous and time-consuming rulemaking process required under similar anti-money laundering (AML) authorities.

The highly coordinated nature of FinCEN's order and the actions of U.S. and European law enforcement, which involved multiple agencies and jurisdictions, is in keeping with the increasingly multilateral approach that the U.S., EU, and other partners have adopted

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to combat money laundering, terrorist financing and other illicit financial activities. The actions involve both Russian illicit finance and the digital asset space, two areas that will remain a top priority for the international law enforcement community in 2023. Furthermore, the use of section 9714 to target and effectively blacklist Bitzlato from the U.S. financial system is further indication that the U.S. government is prepared to use all tools at its disposal to combat Russian illicit finance.

Section 9714 Authority

Section 9714 of the Act, which became law as part of the National Defense Authorization Act (NDAA) for Fiscal Year 2021, expressed Congress's concerns that the Russian government, state-owned enterprises, and sanctioned Russian oligarchs and elites would use a variety of mechanisms to disguise and launder their assets.¹ Such actions, according to Congress, could further enable Russia's influence and destabilization operations and threaten U.S. and European democracy and national security.

Specifically, section 9714 authorizes FinCEN, acting on authority delegated by the Treasury Secretary, to designate as a primary money laundering concern in connection with Russian illicit finance (i) financial institutions operating outside of the United States; (ii) classes of transactions within, or involving, a jurisdiction outside of the United States; or (iii) types of accounts within, or involving, a jurisdiction outside of the United States. FinCEN may then impose one or more enhanced due diligence requirements or restrictions (often referred to as "special measures") with respect to the designated financial institution, class of transactions, or type of account.

The special measures available under section 9714 are:

- those described in section 311 of the USA PATRIOT Act (section 311), such as certain recordkeeping and transaction reporting requirements, beneficial ownership reporting requirements, and a prohibition or imposition of conditions on the opening and maintenance of correspondent or payable-through accounts; and
- prohibiting or restricting certain transmittals of funds by any U.S. financial institution if the funds transmittal involves the designated financial institution, class of transactions, or type of account.

¹ Our January 7, 2021, client alert, "[US Enacts Historic Legislation To Strengthen Anti-Money Laundering and Counterterrorist Financing Legal Framework](#)," provides additional detail on the NDAA for Fiscal Year 2021 and the other significant pieces of AML-related legislation it contained, including the Anti-Money Laundering Act of 2020, the Corporate Transparency Act and the Kleptocracy Asset Recovery Rewards Act.

While there is clear overlap between section 9714 and section 311, there are also important distinctions. Section 9714 and section 311 both authorize the designation of primary money laundering concerns and the imposition of special measures, and section 311 has been used in the past against a virtual currency provider.² Notably, though, section 311 special measures may be imposed with respect to any designated primary money laundering concern, whereas section 9714 requires that the primary money laundering concern relate to Russian illicit finance.

Moreover, a section 9714 designation can be made by order, regulation, or other means, whereas a section 311 designation must be made through the rulemaking process, including a notice and comment period. Section 9714, therefore, provides FinCEN with significant latitude to determine the most appropriate mechanism and move expeditiously to implement the chosen special measures if there is a Russian connection. Unlike section 311, section 9714 also authorizes FinCEN to restrict or outright prohibit certain funds transmittals involving the designated target.

The NDAA for Fiscal Year 2022 amended the Act to specify that the civil and criminal penalties applicable to violations of section 311 special measures will also apply to violations of section 9714 special measures. These penalties can be severe and a financial institution that engages in a transaction that violates a section 9714 order faces a civil penalty of no less than twice the value of the transaction up to and no greater than \$1,667,030 (under today's penalty figures) and a criminal fine of no less than twice the value of the transaction and no greater than \$1,000,000.

Bitzlato's Designation

The January 18 order imposing special measures was FinCEN's first since section 9714 became law. The order includes a detailed narrative setting forth the basis for FinCEN's determination that Bitzlato is a primary money laundering concern in connection with Russian illicit finance. FinCEN also noted that Bitzlato has significant operations in Russia, it has been used to facilitate the deposit and transfer of funds by Russian ransomware groups and their affiliates, and it has facilitated transactions on Russian dark-net markets on behalf of both customers and vendors. The order also highlights Bitzlato's lack of any meaningful AML policies, procedures or internal controls, and underscored its failure to perform KYC on its users.

² See "[Treasury Identifies Virtual Currency Provider Liberty Reserve as a Financial Institution of Primary Money Laundering Concern under USA Patriot Act Section 311](#)" (May 28, 2013, press release)

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Pursuant to the order, “covered financial institutions” are prohibited from engaging in any transmittal of funds from or to Bitzlato, or from or to any account or CVC address administered for or on behalf of Bitzlato. The order defines “transmittal of funds” as the sending or receiving of any funds, including CVC, and it defines “covered financial institution” as any financial institution under the BSA.

FinCEN published frequently asked questions alongside the section 9714 order, which provide additional clarity on covered financial institutions’ obligations. In addition to complying with the relevant prohibitions, the guidance specifies that covered financial institutions should incorporate Bitzlato’s designation into their AML compliance programs. To identify transactions that may be prohibited by the order, the guidance advises the use of both traditional screening and monitoring technology as well as blockchain tracing software.

With respect to a traditional funds transfer involving fiat currency, such as a bank wire or Automated Clearing House transfer, FinCEN’s guidance states that covered financial institutions must reject the transaction without accepting the funds. The order and the guidance both acknowledge, though, that the nature of CVCs may make it difficult for covered financial institutions to proactively decline or reject incoming transfers that are prohibited under the order. For this reason, the order explains that a covered financial institution will not be in violation of the order where, upon identifying that it has received CVC that originated from Bitzlato or from an account or CVC address administered by or on behalf

of Bitzlato, the financial institution (i) prevents the intended recipient from accessing the CVC, and (ii) returns the CVC to Bitzlato or the CVC address from which it originated.

The guidance explains that covered financial institutions are not required to reject CVC transfers in this way where doing so would violate other laws or regulations, such as the sanctions administered by the Treasury Department’s Office of Foreign Assets Control (OFAC). If a transaction involving Bitzlato also involves a Specially Designated National or another blocked person, for instance, the covered financial institution must comply with OFAC’s blocking and reporting requirements.

While the order does not impose new suspicious activity reporting obligations, it does not relieve covered financial institutions of their existing obligations and, depending on the facts and circumstances, a suspicious activity report may be required for a transaction that an institution declines or rejects in compliance with the order.

Conclusion

While FinCEN’s identification of Bitzlato as a money laundering concern under section 9714 is unprecedented, we believe it is unlikely to be the last. Enforcing sanctions, export controls and other restrictive measures that have been imposed against Russia since the 2022 invasion of Ukraine remains a top U.S. foreign policy and national security priority. Section 9714 provides a powerful tool for the U.S. government to target financial institutions identified as enabling or facilitating the evasion of these restrictions or other forms of Russian illicit finance.

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