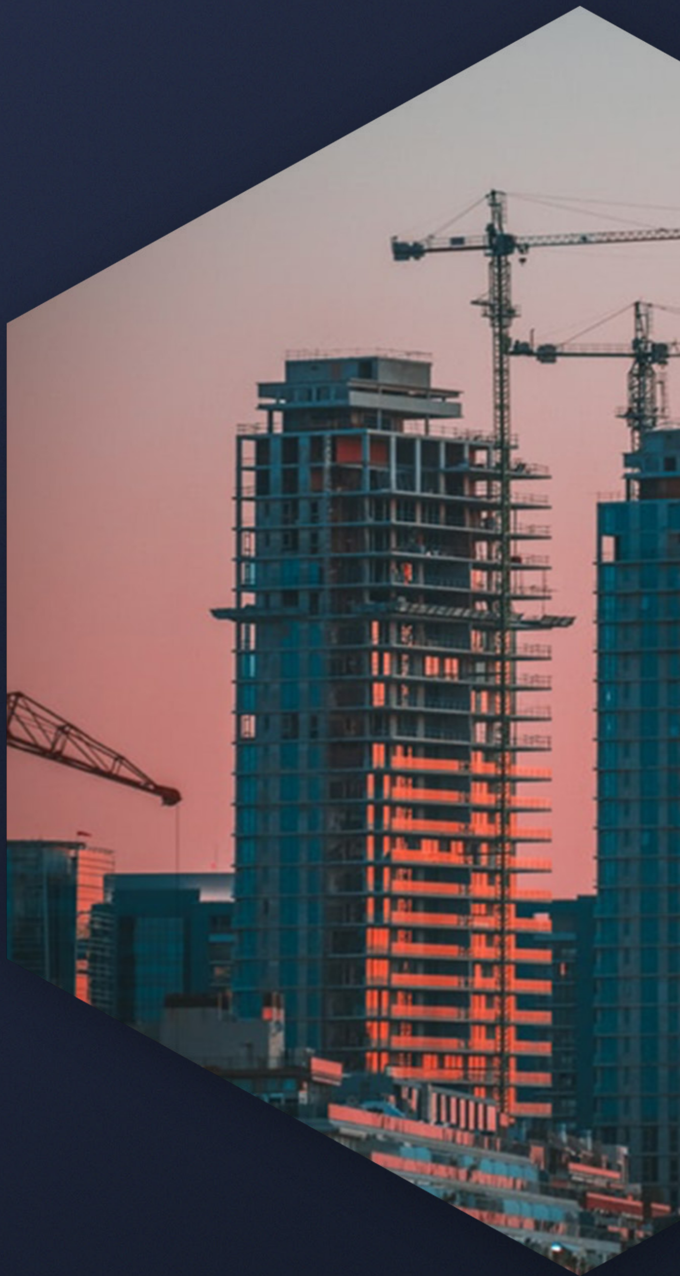
Best practice guide to KYC / AML compliance for ICOs



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Initial Coin Offerings (ICOs): Innovation Accelerators or Risky Endeavors?

In recent years, ICOs - also known as 'token sales' - have gained in popularity as a way for companies to raise capital to fuel expansion and future growth.

Sometimes compared to a "kickstarter" or crowdfunding campaign, ICOs involve companies offering tokens or "coins" that can confer different types of value and benefits to their owners.

For many companies, this has meant that the power to raise funds has been based purely on how compelling their business proposition is: which is undoubtedly a positive development in the history of entrepreneurialism and innovation.

Unfortunately, as with most new opportunities, there is also a new underside of risk and the potential for fraud. This means that the need for effective KYC and AML measures is critical - even if regulations have yet to fully catch up with the space.

In this guide, we'll be breaking down some of the key ICO concepts, challenges and opportunities - and presenting how automated KYC technology can be used to optimize and secure the space for both providers and investors.

How do ICOs work?

In order to participate in an ICO, investors usually transfer digital currency - such as Bitcoin or Ethereum - to the listing company's website. Some projects also make investing possible with fiat currency or credit cards. In return, investors receive digital tokens issued by the listing company.

During ICOs, most listing companies will sell "utility tokens" to investors. These are digital coupons that provide their holders access to the features of the project once it has launched.

Utility tokens do not represent ownership in the project (as shares or securities would) - but they can be traded on the open market. For investors who believe a certain project shows promise of growth - this can be a way of profiting from a project's success without actually owning a part of it.

Tokens: Key Considerations

Tokens offered for sale in ICOs are typically divided into two categories:

- Utility tokens, which allow whoever holds them to access and use the company's features and services, or to exercise voting rights on a company or project's decisions, and
- Security tokens, which confer equity ownership of a company or project

Utility tokens

A good example of a utility token is KEY, which is used on our partner network's SelfKey Marketplace. In order to use the SelfKey Marketplace, you would need to buy KEY tokens, which are then used to pay the fees for services such as opening a bank account or incorporating an offshore company through safe transactions on the blockchain.

KEY is therefore considered a utility token. It does not confer ownership of anything; it is a coupon that is bought and then used for a service.

Security tokens

Security tokens are different to utility tokens in a number of ways. First, they are usually tied to an existing asset, such as a company. They also confer ownership, through some kind of pre-established contractual agreement between the buyer and the seller.

While their value may fluctuate according to the laws of supply and demand, their value should also in theory increase or decrease according to the underlying value of the asset they confer ownership over.

ICOs: Benefits

ICOs have provided a wide range of different companies and organizations with a new avenue to raise funds. This has unsurprisingly driven a proliferation of new and innovative projects, many of which wouldn't have been possible without ICOs. For projects and companies that choose to take the ICO route, advantages include:

Liquidity

Projects may have previously faced restrictive challenges in raising funds from institutional or conventional sources like venture capital funds or banks. Since ICOs offer a way of raising funds without selling shares of a company, startups can avoid the threat of losing control of their project to investors in successive funding rounds.

Simplicity

ICOs offer companies and prospective projects the chance to gain seed capital with very little effort, beyond having a compelling idea and plan for growth, which is usually communicated through a whitepaper. Added to that, a lack of systematic or uniform regulation means that ICOs can be realized with minimal bureaucracy (though this of course brings risks too).

Democratization

ICOs allow companies to leverage the power of the blockchain in order to reach a far wider pool of potential investors. Whereas fundraising in the past was restricted to smaller business networks or involved lengthy and highly bureaucratic Initial Public Offerings (IPOs) on stock markets, investors in an ICO tend to only need an internet connection (and funds to invest).

ICOs: Risks

When it comes to ICOs, risk can assume various different shapes and sizes, but in general can be divided into the following:

Failure

The risk that the ICO provider fails to deliver on its promises to investors.

Fraud

The ICO space has unfortunately been plagued by fraudulent schemes that promise large returns but effectively just defraud investors, such as through the now infamous "pump-and-dump" method. From the other side, there is also a risk that an ICO provider is defrauded by pseudo-investors who use stolen credit card information to buy tokens. Once the owners of the stolen cards make a report to their banks, the bank will send a chargeback order to the ICO provider requiring a return of the funds.

Money Laundering (ML) and Criminal / Terrorist Financing (TF)

As ICOs usually involve the exchange of digital currency into a new asset (the company's tokens) this provides a very attractive way for criminals and terrorists to launder proceeds that have been acquired illegally - or which they do not want to pay tax on. Without adequate KYC measures, ICOs can serve as ideal systems for laundering cash anonymously.

What all of these situations have in common is a lack of due diligence from both parties.

- For ICO providers, having a clear and verifiable understanding of who their investors are is a critical step to reducing the risk of being defrauded - and of falling foul of global regulators.
- For investors, knowing that the project they are considering investing in has implemented robust AML / KYC measures can reduce the risk that the project is sanctioned by authorities for AML violations, which can potentially result in the loss of the invested capital. Similarly, knowing that the ICO provider you are considering investing in takes KYC and regulation seriously is a good first step to ensuring they are serious about their project - and not out to just make some fast cash.

ICO Regulation

Many regulators around the world are now beginning to treat all tokens offered through ICOs as securities. This is critical from a regulatory standpoint, as dealing in securities involves complying with complex regulations designed to minimize the risk of fraud and money laundering that is all too common in securities trading.

Therefore, any company that seeks to issue a security token will need to ensure they are complying with the regulations governing this type of asset class in the jurisdictions whose laws they are subject to.

And it's also important to remember that although you may consider your token to be a utility and not a security, that doesn't mean that regulators will take the same view.

KYC Compliance: How important is it for ICOs?

KYC-Chain is constantly evaluating the impact of expanding regulatory frameworks on Virtual Asset Service Providers (VASPs) and how they will need to conduct business in the future.

When it comes to ICOs, the need for compliance – and the forms it has to take – is hard to generalize, as they can vary significantly from one jurisdiction to the next.

Indeed, the U.S. Securities and Exchange Commission (SEC) ruled in 2018 that although Bitcoin and Ethereum were not securities (principally due to their lack of a centralized, controlling organization), tokens offered in ICOs were most likely to fall under the definition of a security. Added to that, the SEC's own guidelines on ICOs also leave a lot of room for interpretation on what will be treated as a security under U.S. law.

The Financial Action Task Force (FATF) has recently proposed a much more restricted definition of ICOs. The global regulatory watchdog's updated draft guidance for Virtual Asset Service Providers (VASPs) leaves little room for an absence of regulation in the space, essentially proposing that any company offering or supporting the issuance of digital tokens should be considered a VASP - and regulated as such. The updated draft guidance also makes special note of ICOs presenting "ML/TF, fraud and market manipulation risks," and argues that:

As a result of the legal ambiguity surrounding ICOs – and the likelihood that regulations will become tighter and more coherent in the future – the general and widely-recommended option is to err on the side of caution. In other words, to voluntarily ensure that diligent Know Your Customer (KYC) processes are in place and part of a robust Anti-Money Laundering (AML) protocol.

However, employing teams of legal and compliance professionals to manually vet every potential investor or purchaser of a coin in an ICO is not really an option for any company, let alone a startup seeking funding to get off the ground.

7 Reasons to use Automated KYC for your ICO

Once you've weighed the potential pros and cons and decided to launch an ICO - the next question will be how to manage (and mitigate) the risks involved.

Answering this question will involve considering which jurisdictions you want to engage investors from and do business in, and what kind of regulations that will make you subject to. It's important to remember that regulators around the world consider ICOs and other crypto-based financial activity to be a largely uncontrollable hotbed of money laundering.

In parallel, the nature and scope of your project and industry will also have an effect on the types of regulations you may be subject to - and might be subject to in the future.

If you want to ensure a smooth, efficient and scalable ICO process, automated KYC software like KYC-Chain can make all the difference.

Here's how it can help:

1. Optimize your resources and expand your investor pool

When it comes to ensuring your ICO remains compliant with complex and evolving global financial regulations, relying on human compliance teams is not only extremely resource-intensive - it is also going to limit the amount of investors you can realistically process, thus restricting your ICO's potential investor pool.

2. Stay ahead of the Regulatory Axe

Financial regulators are constantly expanding and evolving the laws VASPs are subject to, and many in the world's larger markets are leaning towards classifying all tokens offered in ICOs as securities. As such, it makes sense to have the right KYC/AML measures in place, even if they are not yet definitively required.

3. Comply with KYC regulations for future tracking and regulatory audits

Understanding who purchases a token is important for being able to track what happens to the token in the future. Some countries, such as the U.S., have rules governing the amount of time required for a security to be held before it can be sold again. So knowing who your customers are and where they are located is critical for remaining compliant.

4. Create a verified track record to ease access to banks and the broader financial network

Most banks will want to have clear and verified information on sources of funds. By implementing a robust KYC procedure during your ICO, you'll be better equipped to prove your funds were generated from legitimate sources, and that they have not been used for money laundering or other illicit activities.

5. Quickly and safely screen all token customers for presence on sanctions lists or risk

Using a risk-based approach, you can use KYC-Chain to segregate low risk from high risk customers, funneling the latter into more rigorous screening processes and Enhanced Due Diligence (EDD) techniques.

6. Build trust

While there is a common misconception that KYC processes can have the effect of discouraging certain potential customers from finalizing their purchase, the reality is that most people and institutions feel safer doing business with companies that demonstrate they take security and compliance seriously.

7. Expand your potential pool of investors

As KYC-Chain is built to factor in a wide variety of different jurisdictional regulatory frameworks, integrating the technology as your KYC tool will provide expanded access to potential customers and investors across the world while ensuring compliance with each jurisdiction's legal regimes.

How to reach KYC/AML Compliance with your ICO

Integrating an automated KYC onboarding process with your ICO allows you to screen investors' identities and credentials prior to them gaining permission to invest in the token sale.

The KYC onboarding process should be customizable to the specific needs and regulatory requirements of the listing company - such as its jurisdictions of operation, its industry and planned business activity.

Once configured, the process will guide prospective investors through a series of checks that are specially designed to ascertain their identity - and the relevant risk that they might bring to the project if they are to invest in it.

A KYC onboarding process will include the following steps:

1. ID document verification

Scanning uploaded identity documents for visual authenticity, image integrity, and document data validation. This can use advanced technologies such as algorithmic and digital tampering detection. Optical Character Recognition (OCR) Extraction can automatically extract data from identity documents and images uploaded by users, and then cross reference this information with verified data stored on government registries and other public databases.

2. Passive Liveness checks

A relatively new process that is able to verify whether an individual taking part in an onboarding process is in fact the individual being presented in an uploaded selfie image - and not an imposter or fabrication.

3. AML Screening

Checking an onboarded individual or entity name against a comprehensive selection of global watchlists that include sanctioned entities, Politically Exposed Persons (PEPs), and references in adverse media.

4. Crypto Wallet screening

For ICOs that are accepting investment from crypto wallets, understanding the history of a wallet - as well as other key credentials - is a critical step for mitigating the risk that it is a conduit for money laundering and other financial crimes.

5. Jurisdiction assessment

Many ICOs need to restrict access to investors from certain countries and jurisdictions for different reasons - from complying with global sanctions regimes to tax purposes and avoiding certain regulatory regimes. A robust automated KYC process will be able to filter eligible investors according to where they are based, or where their main place of business is.

6. Risk Scoring

Once an individual or corporate customer’s identity and credentials have been established, an automated KYC tool will assign a risk score to that investor. This score will then inform a decision on whether to automatically grant that customer access to the ICO, apply further checks and scrutiny, or to reject them.

7. Enhanced Due Diligence (EDD)

For potential investors who have been flagged as a potential risk, EDD processes can be applied that do not necessarily require human intervention from compliance teams. However, many KYC automation tools do also provide customizable options for high-risk subjects to be forwarded to a compliance team, ensuring that restrictions on investment are checked and justified.

Choosing the Right KYC Provider

When selecting a KYC provider for your token sale, there are some key points to consider in order to ensure that the technology and services they offer are what you need. Asking the following questions will help you build a clearer picture of the quality and scope of the KYC technology on offer, and whether it will suit the specific requirements and dynamics of your ICO:

1. Spread

Is it an end-to-end solution? Does the KYC technology cover a full suite of KYC, AML and anti-fraud measures? Can it integrate a risk-based approach that escalates screening based on a user's risk rating?

2. Scope

How many jurisdictions does it cover? Can the provider demonstrate specialized legal expertise for all the regulatory frameworks that you may be subject to, including where your customers are based?

3. Sources

What sanctions lists does the KYC provider screen your customers against? Make sure your provider isn't limited to just the obvious ones.

4. Scalability

ICO life cycles tend to be short, which means your KYC provider must be able to ensure that their technical infrastructure can handle processing a sudden, large influx of checks simultaneously. The last thing you want is your system to crash during the ICO.

5. Security

What measures does the provider have in place to ensure data, privacy and identity security?

6. Usability

How complex is integration? Is their UX / UI simple and attractive enough to ensure you don't lose conversions?

Final Thoughts

Token sales / ICOs have provided a radical new way for companies to raise funds. This new potential has allowed individuals, startups and other small businesses to dream big and innovate, relying on the merits of their project's value proposition to attract investment - while still retaining control of their project.

However, the ICO industry is still a highly unregulated, often-volatile space, with unfortunately high levels of fraud, losses of investment - and the potential for exploitation by criminals. This volatility has understandably discouraged many potential investors from becoming involved, to the detriment of the many compelling and well-managed projects out there seeking to use ICOs to innovate and grow. In parallel, it has attracted the attention of global regulators who are tasked with building the legal framework to manage this new financial ecosystem.

By implementing effective, efficient and seamless KYC onboarding processes, listing companies can demonstrate their credibility and commitment to long-term growth. They can also stay ahead of the regulatory curve and build trust in the broader crypto space, paving the way for a healthier and more vibrant economy of innovation as we move into the future.

About KYC-Chain

KYC-Chain is a compliance dashboard and whitelabel customer on-boarding portal enabling companies to perform due diligence on their customers in accordance with CDD/AML/KYC requirements.

Our solutions provide KYC on-boarding that is quick, easy, and for both corporates and individuals, in a blockchain enabled financial world.

KYC-Chain enables automated on-boarding of people and legal entities by leveraging technology such as robotic process automation, biometric matching neural networks, and blockchain based identity credentials.

Have any questions on how to comply with KYC and AML regulations for your upcoming ICO? Get in touch and we'll be happy to arrange a demo.