ROLE OF LEGAL REGULATION IN PREVENTING CORRUPTION IN THE MARKET OF DIGITAL FINANCIAL ASSETS IN THE CONTEXT OF SUSTAINABLE DEVELOPMENT

a Dmitry Smirnov, b Olga Baklanova, c Evgenia Sagalaeva, d Alexey Zhukov, e Elena Tereshchenko, f Kirill Dolgopolov

ABSTRACT

Objective: The study considers the main trends in the legal regulation of cryptocurrency in different countries. The authors conduct a systematic analysis of the impact of digital financial assets on corruption.

Method: The authors have analyzed legal acts and compared data from different countries to study the legal regulation of digital financial assets.

Result: The authors have shown that there is no legal regulation of digital financial assets, in particular cryptocurrencies. There are no clear definitions and rules regarding these assets, which causes problems with taxation, money laundering, and the identification of parties to transactions.

Conclusion: Based on the data obtained, the authors have substantiated the need for the proper legal regulation of digital financial assets, including cryptocurrencies. The state shall resolve issues related to terminology, legal status, taxation, and cryptocurrency exchange. In addition, the study highlights the importance of KYC and AML mechanisms to prevent corruption and money laundering with the use of digital financial assets. A comprehensive legal framework will provide certainty and protect both individual and institutional investors dealing with digital financial assets.

Keywords: legal regulation, digital financial asset, cryptocurrency, financial system.

Received: 15/05/2023
Accepted: 10/08/2023
DOI: https://doi.org/10.55908/sdgs.v11i5.557

a Doctor of Legal Sciences, North Caucasian Federal University, Stavropol, Russia, E-mail: dmi197526@yandex.ru, Orcid: https://orcid.org/0000-0002-8300-0828
b PhD (c) of Philosophy, North Caucasian Federal University, Stavropol, Russia, E-mail: mikeewa@yandex.ru, Orcid: https://orcid.org/0000-0002-2762-3668
c PhD (c) of Legal Sciences, North Caucasian Federal University, Stavropol, Russia, E-mail: 9624390000@mail.ru, Orcid: https://orcid.org/0000-0002-9371-9991
d PhD (c) of Legal Sciences, North Caucasian Federal University, Stavropol, Russia, E-mail: zhykov_alex@mail.ru, Orcid: https://orcid.org/0000-0002-2956-905X
e PhD (c) of Legal Sciences, North Caucasian Federal University, Stavropol, Russia, E-mail: elena-tereshchenk@yandex.ru, Orcid: https://orcid.org/0000-0002-4422-7488
f PhD (c) of Legal Sciences, North Caucasian Federal University, Stavropol, Russia, E-mail: nadal06@mail.ru, Orcid: https://orcid.org/0000-0002-1504-1089
PAPEL DA REGULAÇÃO LEGAL NA PREVENÇÃO DA CORRUPÇÃO NO MERCADO DE ATIVOS FINANCEIROS DIGITAIS NO CONTEXTO DO DESENVOLVIMENTO SUSTENTÁVEL

RESUMO

Objetivo: O estudo considera as principais tendências na regulamentação legal de criptomoedas em diferentes países. Os autores realizam uma análise sistemática do impacto dos ativos financeiros digitais na corrupção.

Método: Os autores analisaram atos jurídicos e compararam dados de diferentes países para estudar a regulamentação legal de ativos financeiros digitais.

Resultado: Os autores demonstraram que não há regulamentação legal dos ativos financeiros digitais, em especial das criptomoedas. Não há definições e regras claras sobre esses ativos, o que causa problemas de tributação, lavagem de dinheiro e identificação das partes nas transações.

Conclusão: Com base nos dados obtidos, os autores fundamentaram a necessidade de regulamentação legal adequada dos ativos financeiros digitais, incluindo as criptomoedas. O estado deve resolver questões relacionadas à terminologia, status legal, tributação e troca de criptomoedas. Além disso, o estudo destaca a importância dos mecanismos KYC e AML para prevenir a corrupção e a lavagem de dinheiro com o uso de ativos financeiros digitais. Uma estrutura legal abrangente fornecerá segurança e protegerá investidores individuais e institucionais que lidam com ativos financeiros digitais.

Palavras-chave: regulação legal, ativo financeiro digital, criptomoeda, sistema financeiro.

1 INTRODUCTION

1.1 MODERN DIGITAL SOCIETY AS RISK SOCIETY

Modern society is undergoing a major transformation caused by the rapid development of technology. In particular, the emergence of digital financial assets, including cryptocurrencies and non-fungible tokens (NFTs), has disrupted traditional financial systems and opened up new opportunities and challenges.

Firstly, these are industrial technologies that ensure the best adaptation of a person and society to the external natural environment and satisfy the anthropological and social needs of parties to economic relations (Longo et al., 2020). Secondly, these are social technologies (Latour, 2005) that contribute to the formation, intensification, and diversification of various communication practices (Hopster, 2021; Klimczuk et al., 2022). The most important components are communication in the process of managing society (the political sphere) (Danshina & Britchenko, 2018) and communication associated with the process of reproducing a cultural pattern (Faraj Allah et al., 2019; Hasyim & Bahar Akkase, 2020). In the latter case, these are sociocultural practices that
constitute an integral sociocultural landscape and become a kind of second nature/environment for the existence and life of individuals, their groups, and the whole society (Bruiger, 2006; Siddiqui et al., 2022c). Throughout historical development, sociocultural practices become increasingly diversified and, most importantly, technologized.

The technologization of sociocultural practices can be studied with due regard to the discontinuity and continuity of reproduction of behavioral patterns of social actors, including their relationship to law and legal principles (Cheshko, 2019). The technologization of sociocultural practices and the introduction of innovations contribute to the emergence of risks, threats, and challenges, existing orders and practices, as well as the sustainability of sociocultural development (Tahir Naveed et al., 2022). As the number of communities and collectives grows, the pragmatic significance of innovations for the existence of these communities also increases (Chiffi et al., 2022). This is due to the fact that it is rather difficult to maintain uniform and strictly unified rules of behavior in large areas and groups due to their characteristics and differences in life experience and access to basic resources and values. This necessitates the legal regulation of sociocultural processes, especially in the post-pandemic world (de Miguel Beriain & Rueda, 2022).

To regulate the behavior of people within society, various religious, moral, and legal norms are being formed. During the evolution of society, there is a transfer of social impact and social significance from religious norms to moral and legal rules. The more society is directed towards the future, the more important the norms of morality and rights become, the more complicated they are, i.e. apply to new subjects and objects (bioethics, animal rights, and environmental ethics). Development risks are growing both quantitatively and qualitatively in societies open to the future and using various technological and social innovations in the economic, legal, political, and sociocultural environment (Dolgopolov et al., 2022). Risks increase quantitatively due to the growing number of interaction channels with the external environment and qualitatively due to the diversification of modern technologies and the emergence of new risk factors (Godinić & Obrenovic, 2020). However, the number of communication channels is also associated with the emergence of new actors in society that are entering the modern socio-political environment (Phuong et al., 2020).
The emergence of various risks is intensified due to the technologization of sociocultural practices. Among different trends in the technologization of social practices, digitalization processes are of particular importance. These processes are based on the circulation of information flows in the sociocultural environment through the use of computers and innovative technologies that contribute to the creation of communication devices. As for digitalization (informatization) processes within the sociocultural environment, they have significantly influenced scientific ideas about the evolution of social structures. This refers to representation within the framework of integrative social theory, i.e. the emerging configuration of social structures and elements as an information society (1960-1970s) (Floridi, 2013, 2016), a knowledge society (Jose, 2019; Nadin, 1996) (the turn of the 20th-21st centuries) and, finally, a digital society that exists today (Serpa et al., 2020). The digital society is a stage in the active and purposeful use of information technologies in the sociocultural environment associated with the introduction of information technologies into the daily lives of individuals when people use various electronic devices (smartphones, personal computers, and communicators) in their sociocultural practices almost every hour and every minute. State and economic structures are trying to control the behavior of their consumers and their values through electronic devices and to regulate relations between the subjects of society (Aslanov & Mirzagayeva, 2022; Siddiqui et al., 2022b). The digitalization trends of modern sociocultural practices pose obvious threats, challenges, and risks for social and personal development, as well as for the existence of people and their communities (Salman, 2022). Along with these technological advances, the issue of corruption is acute as the unique characteristics of digital financial assets create potential risks for illicit activity (Hickey et al., 2016; Issa, 2017).

The pseudonymity of crypto assets (only digital identification is required for transactions) makes them a potential tool for illegal flows, including proceeds of corruption (Alnasaa et al., 2022).

Although there is no sufficient research in this area, many scholars emphasize the potential adverse risks of using cryptocurrencies for corruption (Adam & Fazekas, 2021; Ogunlela et al., 2021).
1.2 LAW, FINANCE AND DIGITAL WORLD: RISKS AND CHALLENGES

Society and the state are undergoing significant changes due to the emergence of new technologies and large-scale virtualization (Herrera-Joancomartí, 2015). About half (or even more) of social life has shifted to the digital world, which leads to the emergence of a new sphere for regulation by law. This area is fundamentally different from the usual tangible reality that is almost completely regulated by the current law (Ogunlela ye al., 2021). Technologies transfer a significant part of activities to a virtual environment, and the boundaries of individual activities are blurred (Liu et al., 2022; Potnis et al., 2023). Technologies are developing so fast that law lags far behind, leaving most of the living space outside legal regulation (da Rosa Righi et al., 2020; Seebacher & Schüritz, 2017).

Technologies such as cryptocurrency, Bitcoin, and Nfterrium are digital financial assets (Crosby et al., 2016; Omote & Yano, 2020; Vujičić et al., 2018) that have a real value but undefined legal nature (Herrera-Joancomartí, 2015).

Digital financial assets are digital rights, including monetary claims, the possibility of exercising rights under equity securities, the right to participate in the capital of a non-public joint-stock company, the right to demand the transfer of equity securities provided for by the decision to issue digital financial assets in the manner prescribed by federal law, whose issue, accounting and circulation is possible only by making (changing) records in an information system based on a distributed registry, as well as in other information systems. For the first time, this definition was legally enshrined in Clause 2 of Article 1 of Federal Law No. 259-FZ (July 31, 2020).

Transactions with digital financial assets are allowed but they cannot be used as a means of payment. In particular, this applies to cryptocurrencies and NFTs, as well as the use of blockchain technology in the Russian financial system. Federal Law No. 259-FZ does not disclose the concept of cryptocurrency, mining, NFTs, and other phenomena of the international digital financial market. Since this sphere of public relations is unregulated, corruption risks arise. First of all, this concerns the taxation of operations with digital financial assets and the laundering of criminal funds. There are other problems, for example, paying for electricity at underestimated prices when mining digital financial assets.

Federal Law No. 324-FZ (July 14, 2022) amended the Tax Code of the Russian Federation regarding VAT, personal income tax, and income tax on operations with
digital financial assets. The law entered into force on July 14, 2022, and its provisions were applied to the legal relations arising from that date.

Thus, this article aims at studying the risks and problems associated with corruption in the context of digital financial assets and exploring the role of legal regulation in addressing these issues.

2 METHODOLOGY

The methodology used in this study aims at examining the risks and issues associated with corruption in the context of digital financial assets and analyzing the role of legal regulation in addressing these issues. We used a combination of theoretical and practical approaches to conduct a comprehensive study of the problem.

At the theoretical level, the study drew on various theories related to the functioning and dynamics of institutional structures, such as risk society theory, network society theory, systems theory, and the concept of social reality. These theories provided a conceptual framework for understanding the impact of technological advances on sociocultural practices and the emergence of new forms of communication (Beck, 2002, 2009).

The practical aspect of the study was to analyze the regulations governing digital financial assets in various jurisdictions. The research examined the relevant legal regulations, including Federal Law No. 259-FZ of the Russian Federation, which defines digital financial assets and their legal nature. In addition, the study considered amendments to tax codes and other legislative measures aimed at resolving tax issues related to digital financial assets.

To conduct a comprehensive analysis, we used several scientific research methods. Theoretical methods such as analysis and synthesis were used to study legal acts and regulations regarding digital financial assets. The article also used formal-legal and comparative-legal methods to analyze the legal status and regulation of cryptocurrencies, mining, NFTs, and other phenomena in the international digital financial market.

In addition, the study provided for the generalization and systematization of the main directions and trends in the legal regulation of digital financial assets.
3 RESULTS AND DISCUSSION

The legislator has clarified only some aspects related to the taxation of digital financial assets. Unfortunately, the basic terms remain undefined. In particular, the legal status of cryptocurrency is relevant. In Russia, the use of cryptocurrencies in civil relations is not prohibited, but their functioning is limited since they cannot be used as a means of payment. Federal Law No. 259-FZ does not define a cryptocurrency, a token or a coin, or other categories that are actively used in the financial market. The law enforcer classifies cryptocurrency as a digital currency. As a result, a paradox arises when the legal regulation of actual market relations based on significant capitalization lags (Siddiqui et al., 2022a). At the moment, it is only planned to adopt some laws aimed at regulating cryptocurrency relations. A special role is played by the norms of tax, administrative, and civil law. In particular, there are unresolved issues related to the activities of cryptocurrency exchanges (Latour, 2005) that exchange digital currencies for fiat money and other digital currencies; the functioning of crypto wallets and crypto exchangers; the participation of individuals and legal entities in the primary and other sales of cryptocurrencies; the introduction of NFT technologies (tokenization (digitalization) of art objects, electronic games of other material objects) and blockchain, income taxation; the functioning of new entities on the market, including using new organizational and legal forms (Longo et al., 2020; Ulendeeva, Keropyan, 2022), etc.

The cryptocurrency market has been functioning for more than a decade but taxation issues have been settled only in relation to digital financial assets and utilitarian digital rights, although cryptocurrency is classified as a digital financial asset. Cryptocurrencies and NFTs are not distinguished as separate categories by law, therefore the legal regulation of their circulation remains unsettled in Russia. Prior to the adoption of Federal Law No. 259-FZ, there was practically no legal framework for regulating digital financial assets, which provided numerous opportunities to avoid paying income taxes. This situation has hardly changed for several reasons. Let us consider them in more detail.

Firstly, a fundamental amendment and addition to Federal Law No. 259-FZ is required which will regulate the status of legal entities and individuals as parties to cryptocurrency legal relations. There is also a need for the law on mining and the regulation of new organizational and legal forms known to the global financial system. With no legislative definition of the most important terms, law enforcers have to draw
conclusions based on enforcement practice. This leads to different interpretations of the application of financial and other laws.

Secondly, it is necessary to legalize the functioning of centralized and decentralized cryptocurrency exchanges in Russia. A clear understanding of the legality and illegality of the actions of taxpayers in relation to domestic and foreign exchanges when making financial transactions with digital financial assets such as cryptocurrencies and NFTs will increase the level of law and order. Many Russian citizens use digital financial assets but have no idea about the taxation procedure and responsibility for tax offenses in this area.

Thirdly, it is difficult to control the payment of taxes in relation to digital financial assets in the cases of using foreign Internet services based on blockchain technology (Chris et al., 2019). In this regard, there is no clear mechanism for the participation of tax and other regulatory authorities, as well as law enforcement agencies of the Russian Federation, in checking the compliance of taxpayers’ income and expenses to determine the real tax base (Botasheva et al., 2018). Accounting should be kept by taxpayers but legal acts do not establish any procedure. There is no interaction between state bodies and financial platforms, foreign exchanges, and other entities providing full-fledged services. This is especially relevant for decentralized tools (protocols), with the help of which individuals and legal entities generate income based on smart contracts. The state can only control the receipt of real income when funds are received in the accounts of financial market participants. However, it is not always effective in the current conditions of digitalization and the possibility of using some digital financial assets to pay for real services. For example, there are cryptocurrency cards that can be used as payment means. There are real facts about the use of cryptocurrency to buy real estate, cars, and motorcycles, pay for hotels, purchase tourist tours, etc. It is often enough to use a smartphone to carry out transactions. Crypto wallets allow effectively using Bitcoin and other cryptocurrencies (such stablecoins as USDT, USDC, BUSD, etc.) to pay for services and buy property.

There are other corruption issues but we will consider only some of them. Blockchain allows performing various operations with digital financial assets impersonally since most platforms are decentralized. In other words, any market participant can register on a platform and make a transaction. It is not always possible to determine who did it. One can only track the digital footprint but several tokens and coins
are created as mixers that hinder the identification of financial transactions. In this regard, there is an urgent need to use KYC and AML mechanisms.

Russia has already recorded some cases of giving and receiving bribes with the use of cryptocurrencies and other digital financial assets, which is convenient for corruption since it is difficult to identify participants in such transactions (Cheshko, 2019). Complexity is also represented by the inconsistency of judicial and other law enforcement practices (Tereshchenko et al., 2022). Courts make conflicting decisions when some recognize cryptocurrency as property and others do not. The Prosecutor General’s Office of the Russian Federation and the Federal Financial Monitoring Service of the Russian Federation has the same opinion that virtual assets or digital currencies should be equated with property, which will allow them to be recognized as objects of crimes, including money laundering and terrorist financing.

The technologization and algorithmization of financial assets are developing in the context of self-regulation and the lack of a unified strategy and policy (Kjaer, 2021; Botasheva et al., 2021). Until the state position on digital financial assets is formed in most countries of the world, they formally remain outside the legal scope. The speed of implementation of digital financial assets varies in different countries as their legal statuses do. The authors of the article “What predicts the legal status of cryptocurrencies?” cite data that cryptocurrencies are legal and widely used in the USA, Canada, Australia, and Hong Kong while their circulation is prohibited in such jurisdictions as Pakistan, the UAE, or Vietnam. In some countries (for example, China), they are completely illegal. Referring to a report from the Law Library of Congress (2018), the authors claim that 25 countries directly or indirectly prohibit the use of cryptocurrencies (Stolbov & Shchepeleva, 2020).

The situation in the world is changing: recently an Arizona State Senator introduced several cryptocurrency bills, one of which is aimed at making Bitcoin legal tender. Senator W. Rogers had a serious argument: “Centralized digital money controlled by the central bankers is slavery. Decentralized Bitcoin is freedom” (Griffith & Clancey-Shang, 2023, p. 5).

In the State of New York, a bill has been introduced to allow government agencies to accept payments in cryptocurrencies, i.e. the legislator proposes to use cryptocurrencies as a means of paying fines, civil sanctions, rental charges, rates, taxes, and duties. Thus, it is the second state after Arizona to adopt such legislation.
The NiraEx crypto platform is successfully operating in Nigeria, offering the exchange of more than a dozen cryptocurrencies for the country’s national currency.

Since the inception of Bitcoin in 2009, cryptocurrencies have been attracting the attention of investors, businesses, and governments. The popularity of Bitcoin and other cryptocurrencies has increased over the past few years. Currently, central banks around the world are trying to launch their cryptocurrencies to digitalize the financial sector, and cybersecurity is one of their main concerns. The global goal is to create a digital infrastructure free from illegal activities (Almaqableh et al., 2023).

While some people view the idea of a digital currency as complex and unreliable, others see opportunities for significant economic development and anonymity. Anonymity is one of the opportunities to conceal one’s criminal behavior through illegal activities such as cybercrime and ransomware attacks (Orr, 2023).

Due to their unique characteristics (anonymity and decentralization), Bitcoin and other crypto assets allow to quickly and more easily transfer assets in larger quantities than cash, including across national borders. These qualities cause many concerns and studies on whether cryptocurrency contributes to criminal activity as the globalized market is growing at an incredible rate (Bao et al., 2022).

The persons involved in bribery and corruption are constantly looking for new areas and opportunities to commit offenses, launder their incomes and evade the control of law enforcement bodies and other government agencies (Komarevceva et al., 2022; Umarov, 2021). Cryptocurrencies and other digital financial assets are potential tools for laundering the proceeds of corruption (Raymond Choo, 2015). Corruption is a widespread phenomenon affecting individuals, organizations, industries, and governments. Technological advances and digitalization have had a major impact on corruption, presenting new opportunities and challenges for minimizing and exploiting corrupt behavior. For example, digitalization can be used to track financial transactions and provide greater transparency, while new digital payment methods (blockchain technology for cryptocurrencies) can conceal cases of bribery (Malik & Jintae Froese, 2022).

4 CONCLUSION

Having studied the legal practices related to the sustainable development of modern society (exemplified by digital financial assets as a potentially corrupted zone), we concluded that there is no proper legal regulation of cryptocurrency. In particular,
Russian citizens actively use cryptocurrencies and other digital assets. Unlike the stock market, these are not insured in any way against fraudulent activities and the possibility of losing financial resources since the state does not have a mechanism for the legal regulation of this area that provides guarantees for using these digital tools. When a large number of international sanctions are imposed on traditional settlement mechanisms, it becomes necessary to find new payment methods, including blockchain as an innovative technology in the financial world. At the state level, there is a need for a rapid settlement of the digital financial assets market with due regard to modern realities. It is necessary to legalize mining and the use of cryptocurrencies for international settlements and introduce the full legality of acquiring and using digital financial assets by institutional investors and ordinary citizens.
REFERENCES


Federal Law No. 324-FZ (July 14, 2022)


Ulendeeva, N. I., & Keropyan, M. O. (2022). Opportunities for the implementation of blockchain technology in the document flow of institutions and organizations. Eurasian Legal Journal, 10(173), 471-472.
