Cryptocurrency and Combatting Modern Slavery in the Financial Sector

By Nargiz Mammadova & Lois Bosatta

Abstract

This report aims to identify key drawbacks in legislation of the financial sector, as well as the possibilities it creates for perpetrators of modern slavery. By dissecting the possibilities of cryptocurrency mechanisms, this report aims to show the potential reality of using the rise of cryptocurrency to reduce modern slavery, human trafficking and financial crime.

What is Modern Slavery?

Modern slavery is the exploitation of individuals or groups for commercial or personal gain. It affects millions of people who are trapped in jobs or positions of exploitation in many sectors; including garment manufacturing, food production, domestic work, forced marriage, and construction. These occurrences are most common in low-income economies, due to financial pressures and a possibility to provide for one's family. Contrary to assumptions, modern slavery victims can be of any ethnicity, citizenship, race, gender, or economic background. Often, modern slavery hides in plain sight and victims are often intimidated or threatened into remaining in an exploitative situation. Human trafficking, sexual exploitation, organ harvesting, criminal exploitation and forced labour are all categories of instances of modern slavery. The implicitness and out of sight nature of modern slavery makes it incredibly difficult to pinpoint statistics and causation, with the intent of minimizing future probability.

Palermo Protocol

According to the Palermo Protocol, modern slavery includes three aspects: the action, the means, and the purpose. In other words, the way of acquisition (recruitment, transportation, etc.), the methods of acquiring control over the entity (coercion, manipulation, monetary gain), and the proposed reasoning behind the exploitation (sexual, economic, organ harvesting)[1].

Whilst collecting data in relation to modern slavery remains difficult, it can be observed that the threat of modern slavery is ever-growing. According to the UK Office for National Statistics, there were 5,144 recorded modern slavery offences in England and Wales, showing a per annum increase of 51%[2]. As of March 2020, the UK Office for National Statistics has only released one combined data report on the issue of modern slavery.

Existing Modern Slavery Legislation

Existing legislation in England, Wales, Northern Ireland, and Scotland aims to combat modern slavery. For instance, the Modern Slavery Act 2015 makes it easier for persons to be identified as victims or charged as perpetrators of modern slavery.

Along with the implementation of the act, victim support programs are further widened and punishment for modern slavery offenders is extended to life imprisonment. Whilst the 2015 Act focuses on law enforcement, punishment, and victim victim care, the Act also includes Section 54, requiring businesses to assess, respond to and report annually on the risk of modern slavery in their operations and supply chains. Many financial sector institutions who have less clear 'business supply chains' were slow to respond to the legislation.

[1] United Nations, 2000. *Protocol to Prevent, Suppress and Punish Trafficking in Persons Especially Women and Children, supplementing the United Nations Convention against Transnational Organized Crime*. United Nations Office o f the High Commissioner.

[2] Office for National Statistics, 2020. *Modern slavery in the UK: March 2020*. Modern slavery in the UK. [online] Office for National Statistics. Available at: <https://www.ons.gov.uk/peoplepopulationandcommunity/crimeandjustice/articles/modernslaveryintheuk/march2020> [Accessed 6 June 2022].

Since, opportunities to identify victims and perpetrators of the crime through transactions, personal data and even security around high street presence of banks have been noted and the financial sector are growing in their observations of 'suspicious activity' regarding this specific form of financial crime.

The scope of this report is more closely related to crime within the financial sector, hence raising the question of financial legislation regarding modern slavery. As of March 2022, the UK government has aimed to combat money laundering and sanctions breaches with the introduction of the Economic Crime Act. As a response to the Ukraine Crises, the report comprises of three main economic targets; a register of oversees entities, UWO (Unexplained Wealth Order) reforms, and further sanctions legislation. It aims to provide checks for property owners, with information controls such as the Persons with Significant Control (PSCs), as well as alleviate the difficulty of issuing UWOs. Promises of a Second Economic Crime Bill have been outlined in the government's White Paper[3], with further focus on identification procedures and corporate transparency.

The alignment of the Modern Slavery Act and the Economic Crime Act only goes so far in managing modern slavery within the financial sector. Government legislation has not been sufficient in providing guidance for companies and individuals, meaning there are adequate legislative opportunities for perpetrators. There is considerate space for progress regarding the British government's efforts to tackle modern slavery on a financial level, made more explicit by recent legislation by foreign governments.

Legislation Abroad

The Modern Slavery Act in Australia as well as the proposed Act in Canada are, along with the UK, some of the leading worldwide efforts to tackle modern slavery from a legislative point of view. The creation of anti-slavery commissioners, promotion of support for victims, and stricter transparency controls on larger corporations envelops all three acts[4]. However, there is no mention of specific inter-company controls on transactions, customer controls and personal databases. As for the United States, their "Transparency in Supply Chains Act" mirrors that of the UK and Australia, but only applies on a state level. One of the US government's focal legislative mentions of modern slavery hides within the "Trade Facilitation and Trade Enforcement Act" – an act banning imports of goods manufactured through means of modern slavery. An overarching pattern within the question of foreign legislation seems to be the combatting of modern slavery post facto, rather than dealing with the problem at the root.

Modern Slavery and the Finance Sector

What is Cryptocurrency?

The journey towards using cryptocurrency to combat financial crime and modern slavery requires an understanding of cryptocurrency and its mechanisms. The prevalence of cryptocurrency in the recent years can be characterized by its advantageous differences as opposed to traditional banking systems. The key difference being – the absence of central banks, which shortens the chain of intermediaries as well as minimises the chance of devaluation due to the lack of quantitative easing (essentially, no more currency can be created so it does not lose its value as easily).

Using encryption algarithms, cryptocurrency has become an alternative currency. Its unique nature allows it to be used for both virtual accounting and payment. Its operational globally world and does not rely on a regulating authority to be controlled. Transactions made through crypto are stored in an online cloud and require all exchanges to be recorded in a public ledger.

Opportunities for Perpetrators of Modern Slavery Within the Financial Sector

[3] Secretary of State for Digital, Culture, Media and Sport, 2020. *Online Harms White Paper: Full government response to the consultation*.

[4] Modern Slavery Legislation Around The World (UK, Canada & Australia) | Sedex. (2020). Retrieved 20 June 2022, from https://www.sedex.com/modern-slavery-legislation-progresses-in-the-uk-australia-and-canad/

Traditional banking broadens the realm of opportunities for perpetrators in numerous ways. Primarily, involvement in modern slavery through the financial sector is manifested through the spending, transferring, and laundering of illegal profits. With the emergence of cryptocurrency, perpetrators have turned to the pseudo-anonymity of unregulated crypto markets; amongst other things, this entails purchasing advertisements by traffickers and paying for memberships by consumers. Most commonly occurring in peer-to-peer networks, traffickers take advantage of a lack of Know-Your-Customer controls.

The nature of online crime allows perpetrators to refer to a centralised database of potential buyers, meaning more access to victim recruitment and clients. Online criminals develop reputations, build customer bases, and build familiarity with such illicit marketplaces.

The Mekong Club reported more criminals turning to cryptocurrency to avoid strict controls of traditional banking [5]

Case Studies of Past Offences

In 2019, an investigation into Welcome to Video, the largest sexual exploitation market, resulted in the arrest of 337 subjects worldwide. The website contained hundreds of thousands of child exploitation videos, available for purchase through bitcoin. The US along with law enforcement agencies followed the flow of funds on the blockchain, tracing it back to Welcome to Video and identifying personal financial information.

How to Combat Financial Crime?

Blockchain Technology

Blockchain technology allows the facilitation and tracking of transactions in a business network, making it an essential aspect of security with cryptocurrency use. Such technology allows for a decentralized network whereby all transactions are recored in a tamper-proof database.

On a more technical level, blockchain differs from traditional databases by holding information in groups. The corresponding groups are held together, in the order of creation. No changes to an element of the blockchain can be made without the awareness of all involved members. The blockchain permanently stores information on the originating address, destination address, and amount of funds associated with a transaction. Apart from this, the difficulty of identifying more personal information such as a Social Security number can be mitigated by analyzing blockchain technology for patterns.

The Mekong Club suggests that blockchain technology could be used to reduce fraud within supply chains, as it presents all reliable information to all involved members and allows for reliable tracking.

A further possibility with blockchain technology is obfuscation techniques, which are a form of structuring on the blockchain that signial money laundering attempts. This allows the blockchain to flag suspicious activity, whereby a crypto wallet is seen making purchases through darket materials and unregulated transactions.

A possible drawback of blockchain technology, however, is that it does not test the reliability of the information initially put into the blockchain and does not fully mitigate the risk of forced labour use. If the noncorruption of the involved individuals in the supply chain can not be guaranteed, the blockchain is flawed. This leads one to believe the use of Blockchain along with law enforcement and further data analytics can work in amalgamation to minimise modern slavery.

Anti-Money Laundering (AML)

Anti-money Laundering regulation in the crypto market has significant gaps due to its recent engagement. As of 2008, the EU allowed the application of AML rules to cryptocurrency exchanges. Further, The Anti-Money Laundering Directive (5AMLD) issued as a response to the Panama Papers scandal and the terrorist attacks in

[5] Aydin, B. (2021). Cryptocurrency & Modern Slavery - The Mekong Club. Retrieved 29 June 2022, from https://themekongclub.org/blog/cryptocurrency-modern-slavery/

Paris, introduces regulation on a multitude of financial aspects, such as regulation of virtual currencies, information on beneficial owners, use of prepaid cards, powers of financial intelligence units, due diligence for high-risk countries. [6] Such regulation is very prominent in South Korea and Japan, countries where online safety is taken more seriously.

Know-Your-Customer Controls

KYC systems are a further element of regulation for both traditional banking and the crypto market. AML programs often include KYC processing, but it is important to understand the mechanism of Know-Your-Customer Controls particularly.

KYC requires each new member of a financial institution to provide authentication of their identity, involving the collection of PII (Personal Identifiable Information), to be verified by government issued identification. This allows for all customers to be screened against official criminal databses, reducing the likelihood of exposing more victims to modern slavery. Whilst this form of control is prevalent in many existing account creation processes, it is yet to become a default step in the cryprocurrency market[7].

Recommendations for Rights Lab

- Produce further research into foreign policy regarding AML and anti-slavery regulation
- Investigate the effectiveness of Blockchain technology in identifying personal identification information and preventing the occurrence of modern slavery offences
- Continue the research into financial crime and the possible repercussions for modern slavery

Recommendations for Businesses and Policy Makers

- Introduce AML and KYC processes to all crypto transactions
- Ensure cooperation between the public (such as JMLIT) and private sector to create synergy of anti-trafficking government legislation and corporate responsibility
- Guarantee the verification of transactions within supply chains through blockchain
- Conduct a human rights due diligence process by Introducing risk assessment and identification within firms, such as annual Modern Slavery Reports, and Potential Human Rights Risks within Supply Chains

[6] Dehio, A. (2022). EU opens door for cryptocurrency exchanges to apply AML rules [Blog]. Retrieved from https://www.linklaters.com/en/insights/blogs/fintechlinks/2018/june/eu-opens-door-for-cryptocurrency-exchanges-to-apply-aml-rules

[7] The 2022 Guide to KYC/AML for Crypto Exchanges & Wallets - GetID. (2022). Retrieved 29 June 2022, from https://getid.com/aml-kyc-crypto-exchanges-wallets/