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The Anti-Money Laundering Act and Crypto Collide: Non-Fungible Tokens

As NFTs gain popularity, buyers and sellers should consider the potential issues related to federal anti-money laundering laws.

While non-fungible tokens ("NFTs") have existed for several years, the market for NFTs grew considerably during 2020 and into 2021, as a number of high-profile NFT sales grabbed headlines and well-known brands and organizations began exploring the use of NFTs. Amid this continued growth in adoption, and the expanding range of use cases, industry participants should make sure they are aware of the legal implications for issuing, purchasing, and trading these new assets.

For now, existing laws and regulations will likely be applied to promote transparency and to address several aspects of NFTs, including the potential investment value, the risk of speculation and volatile pricing, and potentially anonymous market participants. This article, which is the first in a multi-part series highlighting the legal and regulatory implications surrounding NFTs, explores the current state of play, potential risks, and likely regulatory developments relating to NFTs and federal anti-money laundering laws.

WHAT ARE NFTs?

NFTs are digital assets encoded on a blockchain that represent ownership of a unique asset or set of rights. Most blockchain tokens that represent digital assets (including cryptocurrencies) are fungible, meaning that the characteristics of any two tokens are the same. As a result, any two fungible tokens of the same type will generally have equal value. The technology underlying NFTs, on the other hand, ensures that each token is unique, and NFT creators have leveraged those characteristics of the technology to create a broad range of unique digital assets. NFTs range from digital artwork (including the $69 million sale of an NFT by digital artist

Beeple),[1] to virtual real estate (one buyer recently purchased nine digital plots of land in an online game for approximately $1.5 million),[2] to digital Lebron James trading cards,[3] to virtual race horses,[4] to an entry ticket for a virtual celebrity beer pong tournament.[5] NFTs are "minted" by issuers or creators and purchased through online exchanges or marketplaces.

NFTs are not limited to the digital space; rather, they "can also represent any type of physical asset, acting as a kind of 'digital twin' to anything existing in the real world and enabling the ownership and exchange of physical possessions within digital marketplaces."[6] One key characteristic of NFTs is provable ownership—that is, given the reliability of blockchain technology and decentralized ledgers, an NFT holder can be confident that his or her ownership of the underlying asset(s) is secure. NFTs are accompanied by "smart contracts," which allow the seller to place conditions on the token-holder's ownership rights, such as generating automatic royalty payments to the original NFT creator at each subsequent sale.[7] The conditions of an NFT's underlying smart contract are designed to be automatically enforced by the NFT's code on the blockchain.

According to one study conducted in partnership with a financial institution, the NFT market has grown rapidly in recent years:[8]

	2018	2019	2020
Active Wallets*	110,551	112,731	222,179
USD Traded	$159.1 million	$62.9 million	$250.8 million
Market Capitalization	$40.9 million	$141.6 million	$338 million

* *Wallets allow users to send, receive, and spend cryptocurrency. This row indicates the # of wallets that have interacted with an NFT Smart Contract, including buyers, sellers, and anyone who has played a game or interacted with a project using NFTs*

And that trend has continued during 2021. Indeed, one report shows that NFT sales in the first quarter of 2021 grew to more than $2 billion, over twenty times the volume of the previous quarter.[9] On one major marketplace, NFT sales grew from $8 million in January 2021, to $95 million in February, to almost $150 million in March.[10] While sales volume dropped to $94 million in April, the larger trend shows a marked increase from last year, during which the same marketplace had an average sales volume of only $1 million per month.[11]

RISKS AND COMPLIANCE: THE ANTI-MONEY LAUNDERING ACT OF 2020

As the digital art world grows and prices soar, NFT marketplaces specializing in digital art may become subject to suspicious activity reporting standards under the Bank Secrecy Act ("BSA"). On January 1, 2021, Congress passed the Anti-Money Laundering Act of 2020 ("AMLA") which provides the most comprehensive update to anti-money laundering laws under the BSA since the Patriot Act.[12] Both the AMLA and BSA enable the Treasury Department's Financial Crimes Enforcement Network ("FinCEN") to regulate the activity of financial institutions, including through various recordkeeping and reporting obligations. Although the AMLA does not directly mention NFTs, several provisions ought to be considered by individuals and financial institutions contemplating NFT transactions.

Is an NFT a "value that substitutes for currency or funds"?

Although the AMLA formally extended BSA reporting obligations to cryptocurrency exchanges, direct regulation of NFTs and related marketplaces will require additional action by Congress. Section 6102(d) of the AMLA expanded the definition of "financial institutions" to include businesses involved in the exchange of "value that substitutes for currency or funds," thus codifying FinCEN's longstanding position that cryptocurrency exchanges—which convert fiat currency

such as the U.S. dollar into cryptocurrency and vice versa—are "money services businesses" subject to BSA reporting requirements.[13] This requires cryptocurrency exchanges to engage in customer due diligence ("CDD") to verify the identity of their customers, identify any beneficial owners of accounts, develop customer risk profiles, and monitor transactions to submit suspicious activity reports among other things.[14]

Cryptocurrencies are clearly a "value that substitutes for currency," but it is less likely NFTs would be deemed the same. Currencies and their substitutes derive their utility, in part, from their inherently fungible nature.[15] Generally speaking, NFTs would not be considered a currency nor a substitute because, by definition, they lack fungibility. NFTs are more akin to legal instruments, such as a deed, containing a unique signature demonstrating ownership of an asset. That lack of fungibility arguably pushes NFTs outside the reach of the AMLA, and further action from Congress would be necessary to apply anti-money laundering regulations to NFTs and their marketplaces directly.

FinCEN has yet to issue anything specifically on NFTs, and has similarly not indicated whether NFT players are or may become subject to the AML regime. That said, regulators have certainly begun formalizing procedures for applying current laws to digital assets. Just one example is DOJ's recently published Asset Forfeiture Policy Manual that provided guidance regarding seizure of cryptocurrencies and digital tokens.[16] And given the high degree of scrutiny and ongoing expansion of AML obligations to the cryptocurrency space, NFTs may not escape additional rulemaking or legislation.

Are NFT marketplaces "art dealers"?

Congress is in the process of expanding the BSA's reach and could reasonably conclude that NFT exchanges should be included among the list of entities subject to the law's reporting requirements.

The AMLA sought to address, among other things, the multibillion-dollar black market trade in art and antiquities, which is estimated to be the "third largest type of black market after illegal drugs and the arms trade."[17] Forthcoming regulations from FinCEN are expected to expand BSA reporting obligations to antiquities dealers, and in January 2022 Congress is scheduled to receive the results of an ongoing study by FinCEN that will "inform debates over whether to extend BSA requirements to art dealers." [18] As discussed more fully below, extending reporting obligations to art dealers could have the effect of sweeping NFT exchanges into the scope of such obligations. If reporting obligations are extended, art dealers will be required to grapple with a number of anti-money laundering protocols more familiar to financial services entities. The rule would also make it far more difficult for buyers and sellers to obscure their identities through shell companies or offshore entities.

NFT marketplaces such as OpenSea, Rarible, and SuperRare function much like an auction house or an art dealer by connecting buyers and sellers who transact directly. In fact, SuperRare describes itself as "Instagram meets Christies,"[19] and Mark Cuban is building an online art gallery to display his NFTs.[20] Given their similarities, NFT marketplaces share many of the characteristics that make the art trade susceptible to money laundering—namely, "buyer secrecy, informal and self-regulated markets, non-transparent pricing, [and] high value transactions."[21] In early March, for example, an NFT consisting of a digital copy of a limited-edition Banksy print sold for nearly $400,000 in Ethereum on OpenSea to a bidder with the screen name "GALAXY," whose profile lacks any identifying information.[22] The buyer behind the $69.3 million sale of *Everydays: The First 5000 Days* by Beeple was also initially pseudonymous, although the purchaser later revealed his identity.[23] Given that many of these transactions are completed using cryptocurrencies—which can be hard to trace to actual individuals—the NFT trade faces similar money laundering risks as the art trade more generally.[24] Of course, as Congress considers subjecting art dealers to the BSA, it could also decide to define "art dealers" broadly to bring NFT marketplaces specializing in digital art within the BSA's ambit. In addition, several prominent auction houses have started to participate in NFT sales,[25] and those firms should be mindful that the compliance considerations applicable to traditional art sales should be applied to NFT sales as well.

NFTs and anti-money laundering risks from "tumblers".

So-called "tumbling" poses an added layer of anti-money laundering concerns with respect to NFTs. One distinct feature of cryptocurrencies is that the ownership history of a particular coin can be traced.[26] In theory, one can trace the owner-history of cryptocurrencies because each transaction involving a particular coin is publicly recorded on the blockchain.[27] Cryptocurrencies are held in virtual "wallets" which function as the digital address, or identity, of the wallet holder.[28] When a cryptocurrency coin is passed to another wallet, the data is recorded in a transaction "block" which lists the digital wallet addresses of the sender and recipient.[29] Each transaction block is then automatically recorded and stored publicly on the blockchain, which functions as a public digital ledger of all transactions.[30] Working backwards, it is generally possible to trace the ownership history of a coin by analyzing the coin's transaction blocks to see all of the digital wallets through which it has passed.[31] Although the digital addresses of each wallet do not directly identify the actual owner, wallets can be linked to real people by mapping IP addresses and other forms of data analytics.[32]

Cryptocurrency "tumblers" can increase the difficulty of tracing a coin's ownership history, however, by circulating that coin through multiple transactions[33] and thus "washing" its potential connection to suspicious wallets or transactions.[34] Significant time, patience, data, and processing power is required to "untumble" coins—the more a coin is tumbled, the harder it is to trace.[35]

FinCEN guidance considers cryptocurrency tumbling to be a "money transmitting business," thus requiring registration with FinCEN, compliance with both BSA reporting requirements and "know your customer" due diligence obligations, and implementation of an anti-money laundering compliance program.[36] This guidance has been tested and upheld in *United States v. Harmon*, an ongoing criminal money laundering case against Larry Dean Harmon for operating Helix—a tumbling service that was allegedly used on the dark web to conceal cryptocurrencies used for black-market activities.[37] Harmon was indicted for money-laundering and operating an unlicensed monetary business in violation of the BSA. In upholding the indictment, the court noted that tumblers "work by literally mixing up a user's payment with lots of other payments from other users" to obfuscate their ownership history, thus qualifying as a "money transmitting business" by "receiving bitcoin and transmitting that bitcoin to another location or person."[38] The *Harmon* prosecution is still ongoing with jury selection set for later this year,[39] and it is possible that the district court's rationale in upholding the indictment could be reevaluated on appeal.

Theoretically, NFT marketplaces could be leveraged to achieve the same result as tumbling.[40] Given the extraordinarily high value of some NFTs, individuals could execute multiple NFT transactions whereby a significant number of coins are spread to different accounts. Repeating this process over and over, individuals could distance themselves from coins linked to dark web activities or cryptocurrency exchanges that do not comply with anti-money laundering and customer due diligence requirements. In short, NFT transactions could be used as another way to add multiple "blocks" to a coin's ledger, thereby obfuscating the transaction history and associated accounts.[41]

Although NFT marketplaces may in some cases help obfuscate ownership of cryptocurrency linked to illicit activities, NFT marketplaces are unlikely to qualify as a "money transmitting business" because they merely (1) allow NFT purchasers and sellers to connect and transact without an intermediary (*i.e.*, a "peer-to-peer" platform) and (2) do not directly handle or otherwise process the cryptocurrencies used to purchase NFTs. Indeed, one commentator described an NFT marketplace as "eBay on the blockchain."[42] Given that NFT marketplaces pose similar money-laundering risks as auction houses and art dealers involved with in high-value transactions, however, Congress could decide to

independently subject NFT marketplaces to BSA reporting requirements, "know your customer" due diligence, and other requirements.

Regardless of future regulatory changes, crypto-exchanges and traditional financial institutions handling NFT transactions should beware of obligations for reporting suspicious activity.

Both cryptocurrency exchanges and traditional financial institutions are subject to the BSA and therefore may be required to file suspicious activity reports ("SARs") for transactions involving NFTs for digital art and other tethered assets. In fact, recent guidance from FinCEN was issued to "provide specific instructions for filing SARs related to trade in antiquities and art."[43] Under the guidance, to comply with BSA obligations, financial institutions—a definition that now includes cryptocurrency exchanges—are required to submit SARs for suspicious activity related to art and antiquities. The guidance explains that SAR filings should:

- include a detailed description of how the questionable activity is tied to art and antiquities;
- provide identifying information (including IP addresses) for the purchasers, sellers, and any other intermediaries or agents; and
- state the volume and dollar amount of the suspicious transactions.

Additionally, SARs ought to identify any "other transactions or proposed transactions that may involve antiquities or art" and identify where the reported individuals or entities are currently operating. Given the similar money-laundering risks shared between high-value art transactions and NFTs, financial institutions and cryptocurrency exchanges may be obligated to file SARs when executing NFT transactions on behalf of their clients. They should therefore have in place controls for identifying suspicious activity relating to NFTs, as well as determining when and how to report it.

CONCLUSION

Traditional financial institutions are no strangers to the stringent BSA and other anti-money laundering compliance requirements. Those institutions' involvement with NFT-related transactions may generate new compliance obligations. Unless and until NFT-specific guidance is provided, companies should look to guidance on analogous services and products. Given the money-laundering risks shared between NFTs and the art and antiquities markets, financial institutions should pay special attention to the opaque and often anonymous NFT market and should consider filing SARs if they detect any suspicious activity related to an NFT transaction. In this rapidly evolving area, both financial institutions and cryptocurrency exchanges should also consider re-examining their existing anti-money laundering compliance programs to meet the needs of their clients and federal regulators.

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