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Phone: +1 646 783 7100 | Fax: +1 646 783 7161 | customerservice@law360.com

Anti-Money Laundering Risks Amid Rising NFT Popularity

By **Katherine Kirkpatrick, Luke Roniger and Read Mills**
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Katherine Kirkpatrick

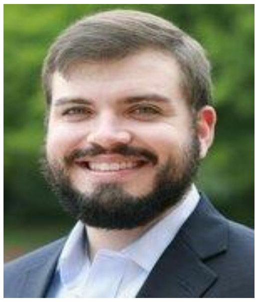
While nonfungible tokens, or NFTs, have existed for several years, the market for NFTs grew considerably during 2020 and into 2021, as a number of high-profile NFT sales grabbed headlines and well-known brands and organizations began exploring the use of NFTs.

One report shows that NFT sales in the first quarter of 2021 grew to more than $2 billion, over 20 times the volume of the previous quarter.[1]

Luke Roniger

As the NFT market and the digital art world continue to grow and as prices soar, NFT marketplaces specializing in digital art may become subject to suspicious activity reporting standards under the Bank Secrecy Act. On Jan. 1, Congress passed the Anti-Money Laundering Act, which provides the most comprehensive update to anti-money laundering laws under the BSA since the USA Patriot Act.[2]

Both the AMLA and BSA enable the U.S. Department of the Treasury's Financial Crimes Enforcement Network to regulate the activity of financial institutions, including through various record-keeping 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.



Read Mills

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 long-standing 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.[3]

This requires cryptocurrency exchanges to engage in customer due diligence 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.[4]

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.[5] 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 the U.S. Department of Justice's recently published Asset Forfeiture Policy Manual that provided guidance regarding seizure of cryptocurrencies and digital tokens.[6] 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?

As explained more fully below, Congress is in the process of expanding the BSA's reach and could reasonably conclude that NFT exchanges constitute art dealers and should therefore be 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."[7]

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."[8]

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,"[9] and Mark Cuban is building an online art gallery to display his NFTs.[10]

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, nontransparent pricing, [and] high value transactions," according to a Standard Chartered PLC report.[11]

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.[12]

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.[13]

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.[14] 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,[15] and those firms should be mindful that the compliance considerations applicable to traditional art sales should be applied to NFT sales as well.

Tumblers present NFT and anti-money laundering risks.

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, as each transaction is publicly recorded on the blockchain.[16]

Cryptocurrencies are held in wallets, which function as the digital address, or identity, of the wallet holder.[17] When a cryptocurrency coin is passed to another wallet, the data is recorded in a transaction block that lists the digital wallet addresses of the sender and recipient.[18] Each transaction block is then automatically recorded and stored publicly on the blockchain, which functions as a public digital ledger of all transactions.[19]

Working backward, it is generally possible to trace the ownership history of a coin by analyzing the coin's transaction blocks to see all the digital wallets through which it has passed.[20] 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.[21]

Cryptocurrency tumblers can increase the difficulty of tracing a coin's ownership history, however, by circulating that coin through multiple transactions[22] and thus washing its potential connection to suspicious wallets or transactions.[23] Significant time, patience, data and processing power is required to "untumble" coins — the more a coin is tumbled, the harder it is to trace.[24]

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.[25]

This guidance has been tested and upheld in U.S. v. Harmon, an ongoing criminal money laundering case in the U.S. District Court for the District of Columbia 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.[26]

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."[27]

The Harmon prosecution is still ongoing with jury selection set for later this year,[28] 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.[29] 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.

By repeating this process, 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.[30]

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 DappRadar blog post described an NFT marketplace as "eBay on the blockchain."[31]

Given that NFT marketplaces pose similar money laundering risks as auction houses and art dealers involved in high-value transactions, 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, or 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."[32] 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 reexamining their existing anti-money laundering compliance programs to meet the needs of their clients and federal regulators.

Katherine Kirkpatrick is a partner, and Luke Roniger and Read William Mills are associates, at King & Spalding LLP.

[1] See Robert Frank, NFT sales top $2 billion in first quarter, with twice as many buyers as sellers, CNBC (Apr. 13, 2021), available at https://www.cnbc.com/2021/04/13/nft-sales-top-2-billion-in-first-quarter-with-interest-from-newcomers.html.

[2] Anti-Money Laundering Act of 2020, Pub. L. No. 116-283, H.R. 6395, 116th Cong. § 6101 et seq. (enacted Jan. 1, 2021) (to be codified at 31 U.S.C. § 5323), available at https://www.govtrack.us/congress/bills/116/hr6395/text.

[3] Fin. Crimes Enf't Network, U.S. Dep't of the Treasury, FIN-2019-G001, Application of FinCEN's Regulations to Certain Business Models Involving Convertible Virtual Currencies 3 (2019), available at https://www.fincen.gov/sites/default/files/2019-05/FinCEN%20Guidance%20CVC%20FINAL%20508.pdf.

[4] See 31 C.F.R. § 1010 et seq.

[5] C.f. United States v. Faiella, 39 F. Supp. 3d 544, 545 (S.D.N.Y. 2014) (finding that Bitcoin qualifies as

money precisely because "Bitcoin can be easily purchased in exchange for ordinary currency, acts as a denominator of value, and is used to conduct financial transactions"); United States v. Ulbricht, 31 F. Supp. 3d 540, 570 (S.D.N.Y. 2014) (defining "money" as "an object used to buy things" and concluding that "the only value for Bitcoin lies in its ability to pay for things" because "Bitcoins can be either used directly to pay for certain things or can act as a medium of exchange and be converted into a currency which can pay for things"). See also Sebastian Omlor, The CISG and Libra: A Monetary Revolution for International Commercial Transactions?, 3 Stan. J. Blockchain L. & Pol'y 83, 90 ("The two basic functions of money are to be a unit of account and a universal means of exchange.").

[6] See U.S. Dep't of Justice, Asset Forfeiture Policy Manual 26 (2021), available at https://www.justice.gov/criminal-afmls/file/839521/download.

[7] Combating Illegal Antiquities Trade, Standard Charted Bank (Dec. 2018), available at https://av.sc.com/corp-en/others/Combating-Illegal-Antiquities-Trade_FINAL.pdf.

[8] Transnational Crime Issues: Arts and Antiquities Trafficking, Congressional Research Service (Mar. 1, 2021), https://crsreports.congress.gov/product/pdf/IF/IF11776.

[9] Frequently Asked Questions, SuperRare (last visited May 3, 2021), available at https://superrare.co/about.

[10] Shalini Nagarajan, Billionaire Mark Cuban is setting up a digital art gallery that allows users to display NFTs in any form, report says, Business Insider (Mar. 24, 2021), available at https://markets.businessinsider.com/news/stocks/billionaire-mark-cuban-setting-up-digital-art-gallery-for-nfts-2021-3-1030240151.

[11] Combating Illegal Antiquities Trade, supra at note 12, available at https://av.sc.com/corp-en/others/Combating-Illegal-Antiquities-Trade_FINAL.pdf.

[12] See Jamie Redman, Burned Banksy NFT Sale Captures Close to $400K, Critics Claim Buyers Are 'Morons', Bitcoin.com (Mar. 8, 2021), available at https://news.bitcoin.com/burned-banksy-nft-sale-captures-close-to-400k-critics-claim-buyers-are-morons/; User Profile: "Galaxy", OpenSea, available at https://opensea.io/accounts/GALAXY.

[13] Robert Frank, Crypto investor who bought Beeple's NFT for $69 million says he would have paid even more, CNBC (Mar. 30, 2021), available at https://www.cnbc.com/2021/03/30/vignesh-sundaresan-known-as-metakovan-on-paying-69-million-for-beeple-nft.html.

[14] See United States v. Harmon, No. 19-CR-395-BAH, 2021 WL 1518344 (D.D.C. Apr. 16, 2021) (explaining the role of cryptocurrency "tumblers" in relation to multi-count money laundering indictment against the operator of a tumbler service). For a general overview of the difficulty of tracing the ownership history of cryptocurrencies, see P. Vigna and C. Ostroff, Why Hackers Use Bitcoin and Why It Is So Difficult to Trace, Wall Street J. (July 16, 2020) available at https://www.wsj.com/articles/why-hackers-use-bitcoin-and-why-it-is-so-difficult-to-trace-11594931595.

[15] See, e.g., Lucas Matney, CryptoPunks NFT bundle goes for $17 million in Christie's auction, TechCrunch (May 11, 2021), available at https://techcrunch.com/2021/05/11/cryptopunks-nft-bundle-goes-for-17-million-in-christies-auction/.

[16] See John Bohannon, Why criminals can't hide behind Bitcoin, Science Magazine (Mar. 9, 2016), available at https://www.sciencemag.org/news/2016/03/why-criminals-cant-hide-behind-bitcoin.

[17] Id. at 17.

[18] Id.

[19] Id.

[20] See id. at 46.

[21] See John Bohannon, Why criminals can't hide behind Bitcoin, Science Magazine (Mar. 9, 2016), available at https://www.sciencemag.org/news/2016/03/why-criminals-cant-hide-behind-bitcoin.

[22] See Mark Rash, Bitcoin Tumbling Leads to Multicount Indictment, Security Boulevard (Feb. 27, 2020), available at https://securityboulevard.com/2020/02/bitcoin-tumbling-leads-to-multicount-indictment/.

[23] Toshendra Kumar Sharma, How is Blockchain Verifiable by Public and Yet Anonymous?, Blockchain Council (last visited May 2, 2021), available at https://www.blockchain-council.org/blockchain/how-is-blockchain-verifiable-by-public-and-yet-anonymous/.

[24] See id.

[25] See Fin. Crimes Enf't Network, U.S. Dep't of the Treasury, FIN-2019-G001, Application of FinCEN's Regulations to Certain Business Models Involving Convertible Virtual Currencies 21 (2019), available at https://www.fincen.gov/sites/default/files/2019-05/FinCEN%20Guidance%20CVC%20FINAL%20508.pdf; see also 31 U.S.C. § 5330; 31 C.F.R. § 1022.380.

[26] See United States v. Harmon, 474 F. Supp. 3d 76 (D.D.C. 2020) [Harmon I]; Harmon II, No. 19-CR-395 (BAH), 2020 WL 7668903 (D.D.C. Dec. 24, 2020); Harmon III, No. 19-CR-395 (BAH), 2021 WL 1518344 (Apr. 16, 2021).

[27] Harmon I, 474 F. Supp. 3d at 82, 109 (quoting Usha R. Rodrigues, Law and the Blockchain, 104 Iowa L. Rev. 679, 712 n.224 (2019)).

[28] See Joint Mot. to Continue Trial and Pretrial Dates, ECF No. 89, United States v. Harmon, No. 19-CR-395 (BAH) (D.D.C.).

[29] According to Tim Swanson, Head of Market Intelligence for the London-based blockchain firm Clearmatics: "NFTs are just another way of achieving the same goal, of breaking down the provenance and walking away with 'clean' or screened coins." See Simon Chandler, Money Laundering Might Taint NFTs Too, Prepare for Tighter Controls, CryptoNews (Mar. 27, 2021), available at https://cryptonews.com/exclusives/money-laundering-might-taint-nfts-too-prepare-for-tighter-co-9689.htm.

[30] Id.

[31] See Top NFT Marketplaces: Beginners Guide, DappRadar (Apr. 4, 2021), available at https://dappradar.com/blog/top-7-nft-marketplaces-beginners-guide ("OpenSea is the first and biggest peer-to-peer NFT marketplace for crypto goods. You can think of it as eBay on the blockchain.").

[32] Fin. Crimes Enf't Network, U.S. Dep't of the Treasury, FIN-2021-NTC2, FinCEN Informs Financial Institutions of Efforts Related to Trade in Antiquities and Art 1 (2021), available at https://www.fincen.gov/sites/default/files/2021-03/FinCEN%20Notice%20on%20Antiquities%20and%20Art_508C.pdf.