Are Non-Fungible Tokens the Perfect Money Laundering Tool?

A Look at Mitigating AML/CFT Risks

7 July 2021

Draft – For discussion purposes only

Agenda

Disclaimers

- This presentation is not designed to be a “how to” manual on laundering money using non-fungible tokens (“NFTs”) .
- This is an ever-evolving area as new technologies and use cases constantly emerge and may render this information obsolete.
- All opinions are my own and do not represent those of my employer or any organization that I am affiliated with.

ARE NFTS THE PERFECT MONEY LAUNDERING TOOL?

Non-Fungible Tokens (NFTs) - The Perfect Money Laundering Tool?

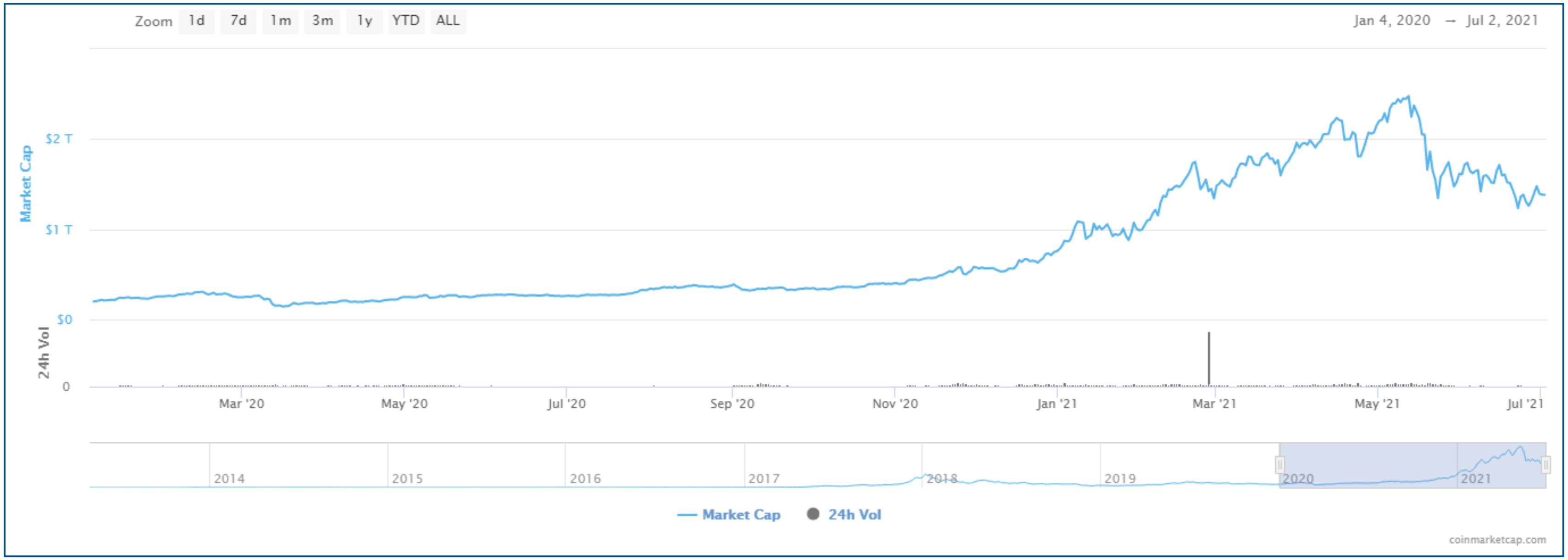
Before we can answer the question of whether NFTs are the perfect money laundering tool, lets take a step back and look at a few facts.

- The flow of funds into cryptocurrencies and virtual assets is rapidly accelerating.
- There has been a corresponding growth in the development of blockchain centered technologies.
- The existing regulatory frameworks around the world are generally reactionary in nature and have struggled to adjust the innovations in the 'cryptosphere.'

Global Growth in Cryptocurrency Market Capitalization

The global market for cryptocurrencies and virtual assets has exploded in 2021 and remains extremely volatile.

- **Global Cryptocurrency Market Capitalization** (USD)[1]:
  - January 2020 – $192 billion
  - December 2020 – $775 billion
  - May 2021 - $2.5 trillion
  - June 2021 - $1.4 trillion



[1] www.coinmarketcap.com

Evolution of Blockchain/Cryptocurrency Technologies

Simplified timeline of key developments:

- **1991:**
  - The first blockchain is developed.
- **2008/2009:**
  - Bitcoin white paper is published, and first bitcoin transaction occurs.
- **2014/2015:**
  - The Ethereum blockchain is launched and introduces smart contracts.
- **2017:**
  - Initial Coin Offerings (ICOs)
- **2020:**
  - DeFi (Decentralized Finance)
- **2021:**
  - Non-Fungible Tokens

Stress on Existing Regulations

Regulators around the world are struggling to stay current on cryptocurrency/virtual asset developments:

- **India:**
  - Reserve Bank of India’s Enforcement Directorate issued a show-cause notice to WazirX for facilitating money laundering and violating KYC/AML rules.
- **Thailand:**
  - SEC Secretary-General Ruenvadee Suwanmongkol – “exchanges are banned from trading assets with the following characteristics: they have no clear objectives, and their prices are influenced by social media, are assets tokenized by influencers or fan-based tokens, are any token that is unique and can’t be interchanged with other digital tokens of the same type, and are any tokens used in a blockchain transaction which are issued by digital asset exchanges.
- **United States**:
  - IRS Commissioner Rettig – “nonfungible tokens are essentially collectibles in the crypto world. These are not visible items by design. The crypto world is not visible.”
- **United Kingdom:**
  - FCA - “A significantly high number of crypto-asset businesses are not meeting required standards under money laundering regulations.”

What is an NFT?

What is an NFT?

You can’t feel it, you can’t hold it, you can’t smell or taste it, so what is an NFT?

- In simple terms, NFTs are unique virtual assets that confer some degree of rights to the owner.
- NFTs can be associated with tangible and intangible property, everything from real estate to artwork to online gaming items.
- While units of cryptocurrencies (Bitcoin, Ethereum, etc.) are interchangeable like fiat currency, NFTs are unique in the same way no two humans are alike.
- The majority of NFTs in existence today are based on the Ethereum blockchain (ERC-721 tokens).

NFT Basics

NFTs are constantly evolving offering new ways to buy, sell, and use these assets.

Creating NFTs

- NFTs are created via process known as "Minting"
- In exchange for fee ("Gas" or "Gwei") an item can be added to the blockchain and become an NFT

Exchanging NFTs

- NFTs can be transferred via exchanges, in auctions, or sent directly to another party

Digital Property and Tools

- Immersive Virtual environments
  - Decentraland
  - Gaming Platforms

Representations of Physical Items

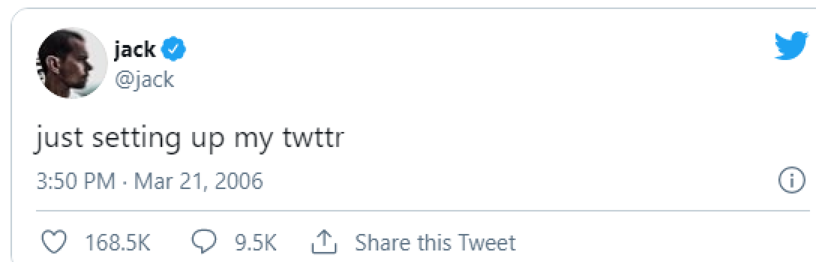
- Artwork
- Wine
- Real Estate
- Certifications

Examples of Famous NFTs

Beeple's collage, *Everydays: The First 5000 Days*, sold at Christie's. | Image: Beeple

Beeple: Everydays: The First 5000 Days
Christies Auction House = $69 million USD

Cryptopunks #7804
$7.57 million USD



First Twitter Tweet
$2.9 million USD

53 Never Forgotten
Art Moments Jakarta Online

Specific Risk Factors for NFTs

The digital nature of NFTs, from the ease of creation to the low transaction barriers, create a high risk that they can be abused for money laundering and tax evasion purposes:

- Links to the Traditional Art World:
  - Just as the traditional artworld has struggled with allegations of money laundering, NFTs are experiencing the digital crossover

- Value is hard to ascertain:
  - Similar to the fine art world – "Value is in the eye of the beholder"

- The assets are borderless:
  - NFTs are virtual assets and exist across a particular blockchain network.

- Limited KYC Protocols:
  - Some NFT exchanges allow for direct transfers or single party auctions while disclaiming the responsibility of conducting KYC procedures

Varied Regulatory Framework Around the Globe

Crypto/Virtual Asset Regulations Around the Globe

Regulations specifically related to blockchain technology, cryptocurrencies, and virtual assets vary greatly from jurisdiction to jurisdiction.

India
Currently no legislative framework. Indian Supreme Court recently overturned Reserve Bank of India ban.

Singapore – "Crypto Haven"
Among the most progressive regimes, recent legislation centers on entities:
(i) facilitating the transmission of cryptocurrencies from one account to another;
(ii) custodial services for cryptocurrencies; and
(iii) facilitating the exchange of cryptocurrencies where the service provider does not come into possession of the moneys or cryptocurrencies involved.

Philippines
Implementing licensing requirements and regulatory expectations around AML/CFT

China
Restrictions are in place, recently cracked down on mining operations

Japan
Among the most progressive regimes, requires registration with Fiscal Services Agency

Crypto/Virtual Asset Regulations Around the Globe (cont.)

Regulations specifically related to blockchain technology, cryptocurrencies, and virtual assets vary greatly from jurisdiction to jurisdiction.

Australia
Subject to AML/CFT regulations set forth in Anti-Money Laundering and Counter-Terrorism Financing Act 2006; exchanges are regulated by the Australian Transaction Reports and Analysis Centre.

Russia
Restrictive, but legal

United Kingdom
Legal, but subject to applicable elements of UK AML regime

United States
Evolving. There is currently a web of various oversight/enforcement agencies focusing on different parts of the crypto ecosystem.

El Salvador
In June 2021, El Salvador became the first country to recognize bitcoin as legal tender.

Financial Action Taskforce Guidance

Select Financial Action Task Force (“FATF”) Red Flag Indicators:

- Transaction Related:
  - Structuring; multiple high-value transactions; transfers to/from less compliant jurisdictions
- User Related:
  - Large initial deposits; immediate withdrawals;
  - Access by multiple people; IP address consistency
  - Many small incoming transactions
  - Multiple accounts linked to the same IP address
- Anonymity:
  - Signs of transactions linked to mixers/tumblers or privacy enhanced exchanges
  - Unregistered/unlicensed VASPs; significant P2P platform transactions
  - Transactions from multiple exchanges / unrelated wallets
  - Account access by multiple users

https://www.fatf-gafi.org/media/fatf/documents/recommendations/Virtual-Assets-Red-Flag-Indicators.pdf
https://www.fatf-gafi.org/media/fatf/documents/recommendations/12-Month-Review-Revised-FATF-Standards-Virtual-Assets-VASPS.pdf

What can Financial Institutions do to mitigate AML/CFT Risks?

Mitigating AML/CFT risks related to Virtual Assts

Financial institutions can take a few proactive steps to better understand risks and avoid needlessly blocking virtual asset transactions:

- **Focus on Risk**
  - Transactions between compliant exchanges or known entities can be indicative of permissible activities.
  - Implement monitoring systems to identify potential transactions with sanctioned entities or blacklisted wallets

- **Leverage Data**
  - Existing customer data can inform the evaluation of crypto transactions
  - Analyze the wallet activity for links to bad actors (ransomware, sanctioned parties, Dark Web marketplaces, etc.
  - Augment with commercially available information
    - Blockchain analytics firms

- **Let the Transactions Tell the Story**
  - Blockchain transactions are generally transparent and traceable unless active steps are taken to hide activity.
  - Industry

Questions

Contact Information:

Linkedin:

- https://www.linkedin.com/in/rlohcfe/

Twitter:

- @RLOHCFE

Email:

- RLOH@HURON.COM

Thank You