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Money Laundering and High-Value Art: Treasury's Study Discusses Financial Crimes and NFTs

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With the advent of blockchain technology, vendors are increasingly accepting payments of goods, including artwork, with digital currency. The decentralized nature of digital currency makes it attractive for a lot of reasons, but it also makes legal oversight a challenge. Add to that the emerging (or already emerged) high-value market for digital art. For example, Beeple's Non-Fungible Token ("NFT") collection sold for more than $69 million at an auction, and a CryptoPunk NFT sold for $23 million.

NFTs, which are often used as a digital tokenized representation of a physical item, are susceptible to money laundering risks just like traditional high-value art. The money laundering risks presented by NFTs are not unique to NFTs, they are simply another avenue that criminal actors attempt to exploit. However, because NFTs are on a blockchain, they are publicly verifiable, auditable, and digitally unique which makes thwarting bad actors possible. In fact, a report from a blockchain analytics firm found that in 2021 there was "small but visible" money laundering activity in NFTs. The report continued, "[o]ur report demonstrates that thanks to the inherent transparency of blockchains, NFT platforms with the right data and tools can effectively monitor their platforms to shut down and prevent abuse such as money laundering." These recent developments prompted the Treasury Department to take a closer look.

On February 4, 2022, the Department of the Treasury published a study on the facilitation of money laundering and terrorist financing through the art trade. Among other considerations, the report discussed the risks of financial crimes in connection with high-value art, including NFTs (see our previous blogs about NFTs here and here). The study found that the high-value art market has certain inherent qualities that make it potentially vulnerable to a range of financial crimes, as we noted above. NFT purchasers, marketplaces, issuers, and other intermediaries in NFT transactions should be aware of the Treasury Department's interest in regulation and the potential for abuse through NFT transactions.

Monitoring the movement of artwork is inherently more difficult than tracing currency because there is no automated, mandated electronic registry for artwork. This risk could be magnified in the NFT context:

- NFTs, like anything else of value, can be used to conduct "self-laundering," a process by which criminals purchase a thing of value using tainted funds and proceed to sell and repurchase that thing of value to themselves in order to create seemingly legitimate sales. In the case of NFTs, the record of sale lives on the blockchain. The criminal then sells the "washed" thing of value to an unrelated party and receives untainted funds in return.

- The structure of NFTs allows parties to transfer digital art without incurring potential financial, regulatory, or investigative costs related to the physical shipment of the art.

- NFTs are pseudonymously held, which may make them particularly vulnerable to illicit use. However, NFTs are stored on a blockchain with a unique crypto wallet address. Some crypto wallets may reveal the identity of the owner, while others only reveal a string of characters known as a "public key."

Digital art is one of the fastest growing sector of use-cases for NFT technology. The Treasury study states that "in the first three months of 2021, the market for NFTs generated a record $1.5 billion in trading and grew 2,627 percent over the previous quarter." As a result, regulators are increasingly focused on preventing the illicit use of the technology. The Treasury study includes several considerations going forward for NFTs and other high-value art market participants:

- Encourage the creation and enhancement of private-sector information-sharing programs to foster transparency among art market participants;

- Update guidance and training for law enforcement, customs enforcement, and asset recovery agencies;

- Use FinCEN recordkeeping authorities to support information collection and enhanced due diligence; and

- Bring certain art market participants under the U.S. Anti-Money Laundering ("AML") and Countering the Financing of Terrorism ("CFT") legal framework and obligate them to create and maintain AML/CFT programs.

Key Takeaways:

- Stay ahead of the curve: assess whether your compliance program is compliant with AML/CFT obligations in the event NFTs come under their purview.

- Have robust/comprehensive screening procedures: evaluate whether your screening procedures are sufficiently robust/comprehensive so as to know the ultimate natural owner of the artwork.

- NFT market participants should be aware of any red flags in secondary marketplaces and of regulatory developments that could impact the industry.

Regulation is lagging behind this revolutionary technology. This Treasury Department report is the latest in a series of studies and reports by federal regulatory agencies that aim to warn investors about the potential for abuse and provide a path for mainstream adoption. This is a quickly-evolving area and we will continue to update you on regulatory and compliance trends as they evolve.

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