



King's Research Portal

Document Version

Version created as part of publication process; publisher's layout; not normally made publicly available

[Link to publication record in King's Research Portal](#)

Citation for published version (APA):

Jordanoska, A. (2021). The exciting world of NFTs: a consideration of regulatory and financial crime risks. *BUTTERWORTHS JOURNAL OF INTERNATIONAL BANKING AND FINANCIAL LAW*, 10, 716.

Citing this paper

Please note that where the full-text provided on King's Research Portal is the Author Accepted Manuscript or Post-Print version this may differ from the final Published version. If citing, it is advised that you check and use the publisher's definitive version for pagination, volume/issue, and date of publication details. And where the final published version is provided on the Research Portal, if citing you are again advised to check the publisher's website for any subsequent corrections.

General rights

Copyright and moral rights for the publications made accessible in the Research Portal are retained by the authors and/or other copyright owners and it is a condition of accessing publications that users recognize and abide by the legal requirements associated with these rights.

- Users may download and print one copy of any publication from the Research Portal for the purpose of private study or research.
- You may not further distribute the material or use it for any profit-making activity or commercial gain
- You may freely distribute the URL identifying the publication in the Research Portal

Take down policy

If you believe that this document breaches copyright please contact librarypure@kcl.ac.uk providing details, and we will remove access to the work immediately and investigate your claim.

Feature

KEY POINTS

- Similar to the early days of Initial Coin Offerings (ICOs), the booming non-fungible tokens (NFT) market may be subject to risks for investors, including market manipulation through pump-and-dump schemes.
- Investing in NFTs that have been characterised as unregulated tokens is not subject to the requirements on fair, clear and non-misleading promotions under the FCA rules (COBS 4) and investors are unlikely to have access to regulatory protections such as the Financial Services Compensation Scheme or the Financial Ombudsman.
- NFTs may fall within the AML supervisory perimeter depending on whether the NFT issuer or marketplace amounts to an exchange or a custodian.

Author Aleksandra Jordanoska

The exciting world of NFTs: a consideration of regulatory and financial crime risks

The recent resurgence of, and then the explosion in, trading in non-fungible tokens (NFTs) represents one of the most interesting and legally challenging developments in the cryptoassets space. This article discusses some of the regulatory and financial crime risks surrounding trading in NFTs, with a particular focus on investor protection, fraud and money laundering and examines aspects of the regulatory frameworks in this space.

WHAT ARE NFTs?

Non-fungible tokens (NFTs) are digital assets that act as proof of title to an underlying asset they reference which can be digital (images, music, videos, virtual and in-game objects) or physical (eg using NFTs for the verification of the authenticity of Nike trainers). An NFT starts with registering ownership of the referenced asset in a smart contract on a public blockchain, commonly on the Ethereum network (a process called “minting”). Thereafter NFTs can be bought and sold like any other cryptoasset, commonly with cryptocurrencies. NFTs are commonly traded on specialised marketplaces such as Opensea for digital artwork, Rarible for digital collectables (eg gummy bear GIFs), NBA Top Shot for sports collectables such as virtual trading cards with famous basketball moves video clips, and Decentraland for real estate in virtual worlds. Some marketplaces also offer services of “minting” NFTs.

RISKS BEHIND THE NATURE OF NFTs AND NFT MARKETPLACES

Trading in NFTs may pose investor risks as well as risks of being abused to facilitate financial crime such as fraud and money laundering. These risks are associated with the nature of NFTs and their marketplaces,

and notably concern the volatility and anonymity in NFT trading.

Unlike other tokens such as Bitcoin or Ethereum, NFTs are non-interchangeable, indivisible, and unique. This scarcity adds to their attractiveness for collectors and investors. However, as with cryptocurrencies and other cryptoassets (eg Initial Coin Offerings), the value of the NFT may be extremely volatile and subject to significant fluctuations (eg due to a hype around specific NFT sale). The value of NFTs is therefore subject to unregulated offer and demand and this poses risks for investors. Similar to the early days of Initial Coin Offerings (ICOs), the booming market may also be subject to market manipulation through pump-and-dump schemes. The value of NFTs may be artificially inflated through social media hype (Lee, 2021; accessed at: <https://www.bloomberg.com/news/articles/2021-09-03/nfts-boom-anew-as-dog-coin-becomes-550-million-asset-overnight>), and also users trading with themselves (wash trading).

A key risk for investors resides also in the overarching anonymity that surrounds NFT trading. NFTs may differ from many other tokens in that there is usually some attribution in the process of minting for commercial reasons (eg for gaining popularity

as a creator of digital artwork). However, NFT marketplaces often do not undertake significant checks of their users’ identities or the (ongoing) authenticity of the NFT. This creates risks for potential abuses. For example, a person may register for selling an NFT that was minted without the owner’s consent thus breaching the copyright of the asset’s owner. Buyers may also be misled by fake NFTs. In a very recent example, an NFT collector called Pranksy was tricked into spending 100 Ethereum coins (around £244,000) to buy an NFT on the Opensea marketplace that fraudulently claimed to have been created by street artist Banksy. The NFT was fraudulently linked to the artist’s website by a hacker (Rea, 2021; accessed at: <https://news.artnet.com/market/fake-banksy-nft-2004518>). Issues of anonymity may also create vulnerabilities for NFTs being abused to facilitate money laundering. For example, criminal groups may create an NFT in an anonymous or pseudonymous way, register it on a marketplace and then purchase it from themselves (Sumsb, 2021; accessed at: <https://sumsub.com/blog/nft-aml-compliance/>). Traditional money laundering typologies may also find application in this space, for example, NFTs may be bought and sold by criminal groups via third parties, including through shell companies or companies with suspect beneficial ownership.

NFTs IN THE FINANCIAL SERVICES REGULATORY REGIME

Cryptoassets have attracted significant attention from the UK Financial Conduct

Authority (FCA) with some tokens already under its regulatory perimeter. According to the authoritative FCA taxonomy in its *Guidance on Cryptoassets* (PS19/22) (<https://www.fca.org.uk/publication/policy/ps19-22.pdf>), cryptoassets may be divided into:

- Regulated tokens, subject to the FCA authorisation and supervision regime:
 - **E-money tokens:** regulated under the Electronic Money Regulations 2011 (EMRs);
 - **Security tokens:** that provide the same rights as other specified investments under the Financial Services and Markets Act 2000 (Regulated Activities Order) 2001 (RAO);
- Unregulated tokens:
 - **Exchange tokens:** primarily used as a means of exchange and conferring limited or no rights for the token holder (eg cryptocurrencies);
 - **Utility tokens:** giving access to a current or prospective good or service, or to a distributed ledger technology (DLT) platform (eg loyalty rewards tokens).

In general, unless they exhibit characteristics of e-money or security tokens in giving additional rights, most NFTs would fall in the category of unregulated tokens and therefore outside of the regulatory perimeter. The FCA Guidance specifically provides examples of tokens that may be considered unregulated “non-fungible” utility tokens, even if they exhibit characteristics of being transferable in concrete situations (eg see Case Studies 7 and 8). Some developing practices around NFTs, however, may amount to security tokens. For example, through “fractionalising”, an NFT can be parsed into smaller and fungible pieces sold on to investors in secondary markets. Recently, PleasrDAO “fractionalised” the NFT of the Doge coin meme into billions of tokens called DOG. These grant investors a stake in the ownership of the Doge meme NFT and participation in future decision-making around the NFT (Locke, 2021; accessed at: [\[cnbc.com/2021/09/01/fans-can-buy-a-fraction-of-original-doge-meme-nft-owned-by-pleasrdao.html\]\(https://www.cnb.com/2021/09/01/fans-can-buy-a-fraction-of-original-doge-meme-nft-owned-by-pleasrdao.html\)\). Such tokens may fall within the regulatory perimeter as they provide securities-type rights but this would need to be determined on the basis of the structure and nature of each NFT.](https://www.</p>
</div>
<div data-bbox=)

Investing in NFTs characterised as unregulated tokens is not subject to the requirements on fair, clear and non-misleading promotions under the Financial Services and Markets Act (Financial Promotions Order) 2005 and the FCA rules in COBS 4. Investors are also unlikely to have access to regulatory protections such as the Financial Services Compensation Scheme or the Financial Ombudsman. In addition, while the 2020 HM Treasury Consultation on Cryptoasset Promotions showcases plans to expand financial promotions even further, its proposals do not capture NFTs (https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/902891/Cryptoasset_promotions_consultation.pdf). In fact, the Consultation proposed to specifically exclude NFTs from the promotions regime as they do not exhibit the qualifying characteristics of being “fungible” and “transferable” (at 4.26). The Consultation acknowledged that NFTs may represent speculative and high-risk purchases or even be used as means for exchange. However, it concluded that they are not readily interchangeable hence do not pose sufficient consumer risk to justify regulatory intervention. In this respect, the FCA’s powers to intervene in the NFT market for consumer protection would be highly limited, consisting of consumer education or warnings on crypto investment scams. The FCA is already undertaking some work along these lines, for example, by creating a £11m digital marketing campaign on cryptoassets risks (Rathi, 2021; accessed at: <https://www.fca.org.uk/news/speeches/transforming-forward-looking-proactive-regulator>). The outcome of the Consultation is still pending, but the position may need to be revisited in the future due to the fast-

paced innovation in the industry and the continuous development of new ways to integrate NFT features.

NFTs WITHIN THE ANTI-MONEY LAUNDERING (AML) REGIME

AML requirements may capture different NFTs and their marketplaces through the cryptoassets regime and, potentially, through the art market participants regime. Both sectors have attracted an increased scrutiny under the 5th Anti-Money Laundering Directive (Directive (EU) 2018/843) and its transposition through the Money Laundering, Terrorist Financing and Transfer of Funds (Information on the Payer) Regulations 2017 (as amended in 2019) (MLRs).

Under the MLRs, both regulated and unregulated tokens may attract AML supervision and the key focus is on the nature of the cryptoasset activity. The MLRs (Regulation 14A) classify cryptoasset exchanges and custodial wallet providers as relevant persons that must register with the FCA to be able to carry out crypto business as well as implement a range of due diligence checks and controls. Cryptoasset exchanges facilitate the exchange of crypto for money, money for crypto or one crypto asset for another. Custodian wallet providers host cryptoassets for their customers or manage customers’ private keys that enable them to hold, store and transfer cryptoassets.

NFTs have not been specifically addressed within current AML cryptoassets guidance. Marketplaces that complete or authorise transactions where sellers and buyers exchange NFTs for cryptocurrencies may be captured as cryptoasset exchanges. Yet, as NFTs can represent different types of digital assets and can also be created and traded in a variety of manners, whether a particular NFT-activity or business model falls within the AML regime may require assessment on a case-by-case basis. The establishing of a supervisory perimeter will depend on the cryptoassets definition, in particular, whether the NFT amounts to a “digital representation of value or contractual rights” (Regulation 14A(3)(a)) and on the definition on cryptoasset activities,

Feature

Biog box

Dr Aleksandra Jordanoska is a Senior Lecturer at the Dickson Poon School of Law, King's College London. The research for this article was supported by a small research grant by the British Academy/Leverhulme (no. SRG1819\190970) on the management of financial crime risks in the FinTech industry. Email: aleksandra.jordanoska@kcl.ac.uk

in particular whether the NFT issuer or marketplace amounts to an exchange or a custodian.

Some guidance in the broader AML cryptoassets space that may be of relevance to NFTs has been provided by the Joint Money Laundering Steering Group (JMLSG) in its Sectoral Guidance on Prevention of Money Laundering/Combating Terrorist Financing (https://securervercdn.net/160.153.138.163/a3a.8f7.myftpupload.com/wp-content/uploads/2020/07/JMLSG-Guidance_Part-II_-July-2020.pdf). For example, the Sectoral Guidance highlights that the definition of cryptoassets is broad enough to include in-game currencies. Firms in the gaming space should consider whether the cryptoasset can only be used within a specific game environment or whether it can also be exchanged for value that may then be used outside that environment (the exchange may happen inside the game or on a forum outside the game) (at 22.8). Certain gaming ecosystems utilise cross-platform NFTs which means that in-game purchases may confer benefits not only across interconnected games but can also be exchanged for money or other digital assets (Cryptopedia staff, 2021; accessed at: <https://www.gemini.com/cryptopedia/nft-blockchain-gaming-industry>). This may indicate that such intermediaries may need to register as cryptoasset exchanges.

Further, direct peer-to-peer transactions (P2P) through non-custodial wallets are not captured under the MLRs. Non-custodial (self-hosted or unhosted) wallets allow the completion of P2P transactions without an intermediary, enabling their users to

maintain full control over their private keys and funds. Questions then arise as to how to assess NFT marketplaces that operate on a decentralised basis. For example, Featured by Binance is a decentralised platform that showcases NFTs but it does not require setting up an account. The trading also happens between non-custodial wallets. According to the JMLSG Sectoral Guidance, the MLRs definition is not intended to capture a firm that only provides a forum where buyers and sellers can post their bids and offers (eg a bulletin board), but where the parties trade at an outside venue either through individual wallets or other wallets not hosted by the forum or a connected firm (at 22.11). This raises questions as to whether such providers amount to a centralised entity that should be brought into the scope of the MLRs as completing, matching or authorising transactions between two people as per the HM Treasury Transposition of the Fifth Money Laundering Directive: Response to the Consultation (https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/860491/5MLD_Consultation_Response.pdf). Such business models need to be considered on a case-by-case basis underscoring the importance of continuous guidance and dialogue between NFT innovators and the regulator.

A further avenue of capturing digital artwork NFTs and their marketplaces under the AML regime may be through the MLRs provisions on art market participants (AMPs). An AMP is a firm or sole practitioner who trades in, or acts as

an intermediary in the trading of works of art, providing that the transaction amounts to €10,000 or more (Regulation 14(1)(d)). AMPs include dealers, auction houses, and freeports, but exclude artists who sell their own work. AMPs must be registered with the HMRC and must undertake rigorous due diligence checks. However, it is unlikely that crypto art NFTs, even if we consider them digital artwork rather than a representation of an underlying digital artwork, would fall under the current definition of "work of art" for the purposes of the MLRs. The definition, provided by s 21 of the Value Added Tax Act 1994, lists only physical art and is silent on digital art. Further regulatory interventions in this space may specifically bring NFT art intermediaries under the AML regime but in the meantime more guidance in this space would be welcome.

In summary, NFTs represent a trend that is unlikely to fade away any time soon, but more clarity and guidance is needed by regulators on whether and how NFTs fall under the scope of the regulatory frameworks. ■

Further Reading:

- Crypto comes of age? (also DeFi, NFTs, Web3 and the metaverse) (2021) 6 JIBFL 434.
- The Digital Dispute Resolution Rules: the future of digital disputes (2021) 7 JIBFL 475.
- LexisPSL: Commercial: Q&As: What are non-fungible tokens (NFTs)?

Corporate Rescue and Insolvency

Subscribe today to CRI for just £483

Corporate Rescue and Insolvency is an authoritative, well-researched and incisive journal which offers commentary and analysis on all areas of insolvency and restructuring law (domestic and international) for the busy insolvency practitioner and professionals in related industries.

Visit www.lexisnexis.co.uk/store/uk/



 LexisNexis®