The Uncharted Territory of NFTs: Unraveling the Risks of Money Laundering in the Digital Asset Market

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1.- Introduction

In the first decades of the twenty- first century we have seen new technologies that promise to be more efficient and affordable for the financial services sector, and also offer an opportunity to reach more users than ever before. Criminals, have also used the opportunities that new technologies provide. Regulators, law enforcement and other government institutions must adapt and respond appropriately and opportunely to the challenges that technology represents in the financial digital sector. (Goldbarshat, 2022)

Non-Fungible tokens (NFTs) are part of the new revolution in Digital Assets and how these are traded. NFTs embody immutable rights to unique digital assets like for example digital art and collectibles that are represented as digital tokens that can be traded in various marketplaces, they use blockchain technologies, encoded into the blockchain with smart contracts, and traded with cryptocurrency such as USDT (Tether) and ETH (Ethereum). Through NFTs a unit of data is stored on a blockchain that certifies a digital asset that is unique, not interchangeable as fungible tokens such as Bitcoin. The difference between NFTS and other digital assets is that they have a unique certification of ownership. (Sharma, 2022)

Fig. 2. A virtual NFT gallery in Decentraland, owned by P5. Galleries are interactive media in the game, designed for people to sell and buy NFTs. Each user has her own avatar/character in the virtual world. (Sharma, 2022)

NFTs represent a new way to organize, move, program, consume and store digital information. They have experienced a fast rise across art, sports, content creation and tech-crypto businesses, because of the risks and importance of this rising market is that regulators have started to worry and consider the risk they present as a platform for money laundering. In this sense the present research paper has the following research question: How do NFTs as part of digital assets affect Money Laundering? This is a current topic that has no clear solution or answer, the real extent of the use of NFTs for money laundering is not yet known.

Researchers agree that the the anonymity and decentralisation capabilities of blockchains are being exploited by criminals. (Ibanez, 2018)

There are still many unanswered questions around NFTs, the only thing that is more understood is the technology behind them.

2.- General and Theoretical Background of NFT's. –

NFT, a non-fungible token is a type of digital token and crypto asset associated with the blockchain that acts as a digital certificate of authenticity. A series or digital objects like for example images, videos, music, books, tweets and virtual land can be bought and sold as NFT's.

An NFT, being a non-fungible token is not replaceable and is unique it can not be substituted by anything else. It has a unique series of numbers stored on the blockchain. These non-fungible tokens have changed the digital asset market.

At the present NFT's are not subject to regulation, this means that there is no legal protection for those who create, trade and invest in them. Because they are not regulated it is very difficult to track funds.

Although NfT's are basically a new concept, they are a vessel to carry out different types of fraud one being Money Laundering. A concrete example of this can be because the pricing of these tokes is so subjective, this is a great opportunity for criminals to lauder their money through NFT trading without arousing much suspicion as they would with trading traditional assets.

The present paper is a literature review that includes mostly current sources due to the current actual topic of NFTs. The main Hypothesis of this present research is: NFTs are a platform that allow criminals to easily launder money.

This hypothesis can be sustained on one of the facts that the high amounts that are being used in these transactions have no offer no limits or clear controls, this is the perfect scenario for criminals, inviting them to launder huge amounts of money with almost no control. This is obviously a very negative effect of NFTs; however, this paper will also consider some positive effects they can have.

It is known that Fraudulent behavior inside the art sector has been around for very long, mainly because of the difficulty of proving provenance and authenticity. NFTs can possibly offer the solution for this with their underlying blockchain technology when applied to artworks. (Liden, 2022).

Blockchain technology provides a bonded registry of previous ownership, although, the validity is dependent on the starting point of the blockchain registry. (Whitaker, 2019)

3.-Analysis/ Methodology,

As we mentioned before the chosen methodology is a literature review. This is probably the best methodology for this paper due to the novelty of the subject and not having much clear information relating to it.

There is a lack of understanding and study on how NFTs are evolving and affecting different spheres. Due to this we think a literature review is an incomplete analysis for this phenomenon offering just an introduction to conduct a more in-depth research on the subject. NFTs need innovation and creativity to tackle its evolution so this obligates us to create new ideas and analisis parting from the ones we learned in the past.

Considering Money Laundering in the information age the traditional process of: Placement, Layering and Integration, can be affected in some cases, for example in Ransomware were cash is not involved, “Placement” is skipped. Criminals trick or coerce their victims to wire transfer the demanded money to their account, so they can start directly with the “Layering” phase. (Villanyi, 2021)

It is also important when we speak about NFT's and how they facilitate Money Laundering to understand that: Because NFT'S can be transferred through digital wallets without moving the physical counterpart, makes it much easier to transfer ownership of high value items without physical movement of the item. In addition, as since the value of the NFT con be artificially increased through a practice known as "wash trading". Wash trading means that an NFT can move through several wallets of the same owner to make it appear more valuable and in high demand. Some have suspected this practice of "Wash Trading" has generated a profit of $8.9 million only in 2021. This facilitates Money Laundering. Some sustain that for the purpose of regulation against not only Money Laundering but also Financing of terror, the NFT can de regulated and treated as if they are cryptocurrencies. (Mooij, 2023)

We suggest that because of the new evolution of Digital Assets, Money Laundering studies should be conducted in new creative and innovative ways and not with our traditional procedures and understanding.

4.- Results

The US Treasury Department conducted a study on NFTs and they could be a target for criminals wanting to lauder money. According to their report, the NFT market generated $1.5bn in trading only in the first 3 months of 2021 and grew 2,627% over the previous quarter. But despite the possibility of money laundering in both blockchain based and traditional art markets, the Treasury came down against enacting new regulations on the art market and suggested focusing instead on root causes and vulnerabilities. NFTs present a problem for the regulators because of their ease in transfer of ownership, there are no geographical boundaries, the transfer is instant and can happen without the potential regulatory or financial cost of buying or selling a physical object.
The Treasury Department also flagged the possibility of criminals self-laundering money by purchasing an NFT, then passing it along to themselves with different digital accounts

to create a record of sales on the blockchain before selling it to an unsuspecting buyer and coming out clean on the other side. (Cassady, 2022)

The study only concludes regarding NFTs in the art sector, but as we explained before this is not the only sector where they are booming. On the other hand, the study recognized the regulatory difficulty in the digital market sector due in this case to the nature of NFT platforms, that they all can differ in structure, ownership models, operations, standards and due diligence protocols. The study also analyzed Smart contracts, that are used to generate revenue each time a transaction happens on the blockchain, this opens another vulnerability in NFTs, considering that the incentive to transact can be higher than the incentive to verify the identity of the buyer of the work, or even create the impossibility to follow the line of transactions due to them being conducted in a rapid successive manner. (Cassady, 2022)

One more concrete example that we can give on NFTs being used by criminals for unlawful purposes is that in February 2022, the UK tax authority (HMRC) seized three NFTs during a VAT fraud investigation of 250 alleged fake companies. Three people were arrested on suspicion of attempting to defraud HMRC of L1.4m, by hiding their identities using sophisticated methods. (Lydiate, 2022).

Perhaps it is also necessary to consider other risks beside Money Laundering that NFTs present, one of them is Financing of Terrorism, NFT's can potentially be used to fiancé terrorist activities, allowing terrorist to move and raise funds covertly. There are factors identified that allow the covert movement of funds. Like, anonymity and pseudonymity. Terrorist organizations can exploit this to conceal their true identities or objectives, raising and moving funds without detection. Also, the ease of transfer and global reach, this allows terrorist to access a wide range of buyers and supporters, increasing fundraising and movement of funds across different jurisdictions. Another factor, not enough regulation and monitoring, this creates opportunities for terrorists to exploit loopholes and engage in illicit activities. Let's not forget, value transfer and laundering, terrorists could potentially use NFT'S to transfer funds or assets between members of their networks

without attracting attention. By leveraging the perceive value, they can create a cover for their financial activities and use NFT transactions as a layer in the process of laundering illicit funds.
At present time, Financing of Terrorism through NFT's scale and prevalence is uncertain. But its important to recognize this risk and work towards implementing measures within the NFT ecosystem. (Packin, Geslevich, Volovelsky, 2023)

Cryptocurrencies are exploited for illicit means, such as hiding the source of criminal proceeds and beside transactions being traceable, more sophisticated criminal actors use a variety of techniques to disrupt investigations. Some researchers suggest a system of KYC (Know your customer) and ongoing monitoring, similar to the one used in the traditional art market and in compliant cryptocurrency exchanges, should be implemented.

A criminal may attempt to replicate a famous piece of art and sell it as forgery. Similar to physical art, there are opportunities to forge NFTs.

Criminal hackers can hack into user accounts on NFT marketplace and transfer NFTs to their own accounts. After which he can sell the stolen tokens and attempt to launder the proceeds.

During the creation of an NFT, it is possible for creators to hide information within the NFT, this hidden information could for example be about a newly identified security vulnerability in a piece of software with the NFT used as a transfer mechanism to share this information between two criminals. (Owen, 2021)

To reduce the Money Laundering risk, cryptocurrencies are regulated at the point of exchange. Some researchers argue that the same regulatory framework can be applied to online auction houses for NFTs. (Owen, 2021)

Although at the present there is no specific regulation for NFT's, some sustain that Intellectual Property Law is sufficient and can be applied to them. (Mitchell, 2024)

The United States Securities Exchange Commission (SEC), has distributed some notices to business that trade NFT's alleging that some NFT's can qualify as unregistered securities. Some other businesses trading NFT's have also been fined by SEC. (Reguerra, 2024)

5.- Discussion and Conclusion

Perhaps more specific regulation will not mitigate the risks of Money Laundering in the NFTs market place but will certainly be a base from which to start. It is hard for participates in these markets to understand applicable laws and procedures before they decide to enter the digital asset market, considering these procedures are not clear or inexistent in the NFTs market. But this can become extremely complex when dealing with multiple international regulators and actors.

Researchers have studied traditional crime and cybercrime and found many similarities, regarding for example the spending of criminal proceeds (consumption and investment). But differences are identified when it comes to Money Laundering, financial innovation, such as the use of cryptocurrencies, seems to be limited to cases of IT (Information technology) related crime. One of the similarities between traditional crime and cybercrime is the offender's preference for cash. (Kruisbergen, 2019)

We disagree with the statement above, considering it only analyzed cases of malware, phishing and online drug traffickers. Maybe for these cases the statement is correct and "CASH IS KING" among this criminal. But when we speak about cryptocurrencies that are used to purchase NFTs, we need to consider that not much study has been conducted, to determine in a responsible way the extent of the use of this platform for Money Laundering purposes.

I think the lack of more understanding and research on this topic is the cause for not having yet clear answer about the real extent of the risks of Money Laundering in these types of blockchain technologies platforms.

We need to consider the hole picture of NFTs they are not just digital art, and perhaps have in mind that they are not being used very much now for money laundering but that can change in any minute, considering it can become one of the safe heaves for criminals to hide their illicit proceedings.

NFTs have not specially been contemplated in current AML (Anti Money Laundering) crypto assets. Marketplaces that complete transactions and exchange of NFTs for cryptocurrencies may be captured as crypto assets exchanges. Although NFTs can represent different types of digital assets and can also be created and traded in a variety of manners. The Discussion probably should first focus, whether the NFT amounts to “digital representation of value or contractual rights” and on the definition of crypto asset activities. (Jordanoska, 2021)

NFTs, are a trend that in our opinion will stay for a while, so more clarity and guidance is needed in order to see the full extent in their risk for Money Laundering. But the fact that they are an inviting platform for criminals can’t be denied.

The United Nations Office on Drugs and Crime estimates that annual Global Money laundering volumes in general range from 2% to 5% of global GDP. For 2024, this translates to between $2.22 trillion and $5.54 trillion. Money Laundering by NFT in 2021, reached $1.377 million. Although this sector is still small compared to the global impact of Money Laundering, this sector is lucrative for offenders due to the ease of anonymizing transactions. (Neopay UK, 2024)

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