

Rise of Financial Crime in the NFT Market Elicits New Scrutiny from Regulators

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With the enduring popularity of certain NFTs and the promise of their use in the Metaverse and beyond, the hype around the new technology has been accompanied by rising concerns over NFTs being the centerpiece of traditional financial crimes like money laundering and wire fraud. For example, on June 30th, 2022 the [Justice Department indicted six individuals](#) in four separate cryptocurrency fraud cases, which altogether involved over \$130 million of investors' funds. These indictments include allegations of a global Ponzi scheme selling unregistered crypto securities, a fraudulent initial coin offering involving phony associations with top companies, a fraudulent investment fund that purportedly traded on cryptocurrency exchanges, and the largest-known Non-Fungible Token (NFT) money laundering scheme to date.

In one of these cases, the defendant, Le Anh Tuan, a 26 year-old Vietnamese national, was [charged](#) in California with one count of conspiracy to commit wire fraud and one count of conspiracy to commit international money laundering involving "Baller Ape" NFTs. ([U.S. v. Tuan](#), No. 22-cr-273 (C.D. Cal. Indictment June 28, 2022)). Seeking to capitalize on the popular Bored Ape Yacht Club, the defendant launched the Baller Ape Club, comprised of "Baller Ape" NFTs featuring figures in various attires decorated with colorful accoutrements. According to the indictment, Tuan and unnamed co-conspirators first gained access to investors' digital wallets and processed token transactions and then "rug-pulled" investors shortly after Baller Ape Club's public sales began by terminating the purported project without notice and closing its website. In all, approximately \$2.6 million was alleged to be stolen. To hide the stolen funds, the defendant purportedly laundered the money through "chain-hopping," a money-laundering scheme where funds are moved across multiple cryptocurrency blockchains and decentralized cryptocurrency swap services are used to obscure the trail of the stolen funds.

U.S. v. Tuan is only the most recent case of crime to rock the NFT world. Earlier in June, Nathaniel Chastain, a former product manager at OpenSea, was [indicted](#) in New York in the first ever digital asset NFT “insider trading” scheme. ([U.S. v. Chastain](#), No. 22-cr-305 (S.D.N.Y. Sealed Indictment May 31, 2022)). OpenSea is the largest online marketplace for the purchase and sale of NFTs. Chastain allegedly launched a scheme by abusing his knowledge of confidential information to secretly purchase dozens of NFTs in advance of them being prominently featured on OpenSea. As part of the management team, Chastain was responsible for selecting NFTs to be featured on OpenSea’s homepage; OpenSea kept these special NFT selections confidential until they went live, as a main page listing often translated to a jump in prices. After the NFTs were featured, Chastain would purportedly then sell them at profits of two-to-five times his initial purchase price. Running the alleged scheme from June 2021 to September 2021, some reports [stated](#) that Chastain appeared to make a total profit of 18.875 ETH or \$67,000 back in September 2021 (not a large figure given that news outlets reported at that time in August 2021 [OpenSea had a sales volume of \\$4 billion](#)). To conceal the fraud, he allegedly conducted these transactions using anonymous digital cryptocurrency wallets and OpenSea accounts. The DOJ fashioned the charges against Chastain as one count of wire fraud and one count of money laundering, seeking forfeiture of any criminal proceeds, among other relief.[\[1\]](#)

These recent offenses related to NFTs bring up numerous legal questions concerning the status of NFTs. Chief among these concerns is the legal uncertainty as to whether existing securities laws apply to the new world of digital assets. (Note: The uncertainty surrounding NFTs and intellectual property protection is another matter, which is the subject of a [related post](#).) Insider trading is traditionally the basis of charges associated with securities transactions. NFTs, however, are often considered to be digital collectibles and investment-quality digital artworks as opposed to securities, and to date, there has been a notable lack of legal precedent around digital assets in general that might offer some clarity. As such, it was unclear until Chastain's indictment whether prosecutors would even address Chastain's alleged trading behavior back in September 2021. Despite the headlines and the label of "insider trading," the Chastain indictment by the DOJ was not actually based on securities laws or insider trading regulations, and is in fact based on fraud claims as opposed to securities law violations. Considering the way the charges were drafted in the Chastain case - the word "security" does not appear in the indictment - the indictment falls more under the general category of alleged financial crimes than a securities law violation. Indeed, as U.S. Attorney for the Southern District of New York Damian Williams [noted](#), "NFTs might be new, but this type of criminal scheme is not." With new technological platforms and investment opportunities available, money laundering and deceptive trading practices are both age-old problems that invariably will occur in the modern day context.

In the absence of clear guidance of the regulatory status of NFTs, a bipartisan group in Congress has attempted to provide clarity through the recently proposed [Responsible Financial Innovation Act \(RFIA\)](#), sweeping bipartisan legislation which seeks to create a complete regulatory framework for governing digital assets. The RFIA seeks to clarify the respective jurisdictions of the Securities and Exchange Commission (SEC) and Commodity Futures Trading Commission (CFTC) over digital assets. If passed, the bill would offer more regulatory clarity in determining whether a digital token is a commodity or a security, and among other things, by proposing that the majority of digital assets (subject to exceptions) be classified as commodities subject to oversight from the CFTC. As a [report](#) on the bill to Congress noted: "The RFIA would narrow the SEC's jurisdiction over digital assets as the agency currently conceives it."

Despite the potential passage of the RFIA, it is important to note that [the SEC has previously stated that NFTs can still be considered securities if they pass the 'Howey Test.'](#) which stipulates that an “investment contract” exists when there is the investment of money in a common enterprise with a reasonable expectation of profits to be derived from the efforts of others. *SEC v. W.J. Howey Co.*, 328 U.S. 293 (1946). The SEC generally looks to the ‘Howey Test’ along with the nature of the transaction rather than the good being sold in order to determine whether an investment contract exists. Thus, even if certain digital assets were treated as commodities under a new legal regime that features an expanded CFTC role, the SEC would presumably still seek to regulate digital assets that it believes are being used to raise money in the manner of a traditional security or are bundled and fractionalized into securities over digital assets. As such, we are left to wonder how digital assets and NFTs might be regulated and how the roles of the CFTC and SEC would be balanced under a comprehensive digital assets law. Though, as [Chair Gensler commented recently about the RFIA bill](#), he is concerned that deregulating certain digital assets or removing them from the SEC’s jurisdiction might create loopholes or “undermine” the overall regulation of the markets.

As revealed by the OpenSea and “Baller Ape” NFT indictments, blockchain’s decentralized nature and the transparent ledger can at times facilitate criminal activity and also expose it. Taking advantage of these innate qualities of blockchain technology while increasing responsible regulation from the SEC or the CFTC may help promote a more robust, but safer crypto space. At the same time, however, the increased regulation may also counter the spirit of the crypto world, where many investors have turned precisely due to the lack of regulation in hopes of making their fortunes.

[1] Within the uncertain legal climate regarding digital asset regulation, several news sources have pointed out that this type of conduct may be much more common than expected. Some traders, unlike Chastain, may simply be more careful and better at hiding their traces. One NFT trader and creator, Fedor Linnik, confided that [insider trading can happen in popular projects with 10,000 profile picture-style NFTs](#). Initial buyers of a newly minted NFT collection cannot discern the traits or valuable rarities unique to their own NFT until the reveal, allowing a gap in time for creators who know which unrevealed NFTs will be more rare and valuable and time to furtively buy them off the market with the goal of reselling them at a higher price at a later time. While certain traders may be capitalizing on the lack of regulation, many others might avoid certain projects for this reason and have even documented potential crimes. This is exemplified by the fact that traders themselves [first exposed Chastian's alleged criminal activity](#) using blockchain records to link his trades to his publicly-known Ethereum address. It is possible that if scrutiny continues from either the crypto community or the Government, more indictments will arise in the future.

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