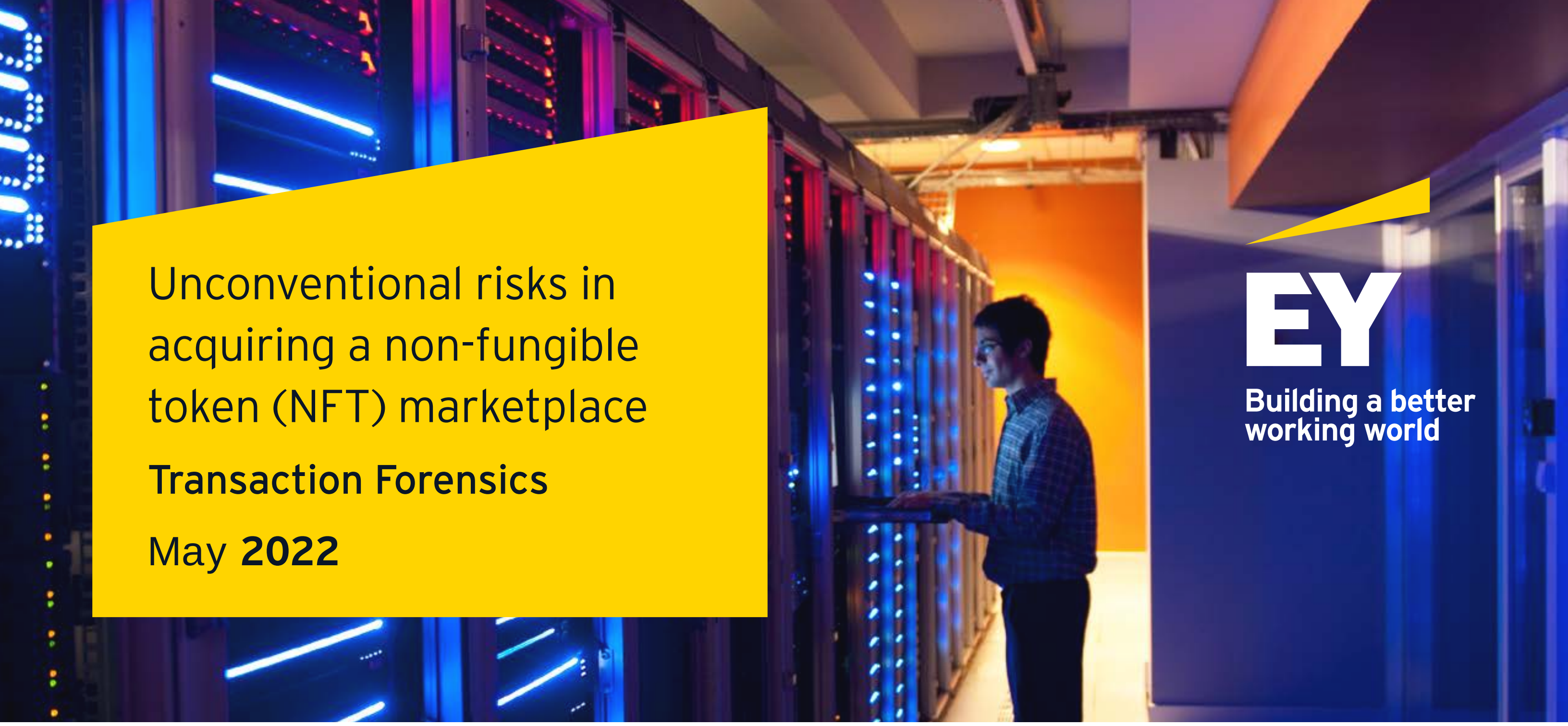

Unconventional risks in acquiring a non-fungible token (NFT) marketplace

Transaction Forensics

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Blockchain technology, made famous in the mid-2000s by developers and peer-to-peer network technologies, has grown steadily in the traditional business space since its advent. Despite the initial hesitancy of investors and business owners, activity hosted on blockchain, including the maintenance and sale of NFTs, shows no signs of stopping, evidenced by $17.6 billion in trading in 2021, an increase of 21,000% from 2020.[1] NFTs present new opportunities and markets coupled with previously unforeseen risks. The NFT space is dominated by digital startups operating globally, largely remotely and under insufficient or outdated laws. Entities looking to acquire an NFT marketplace would benefit from performing integrity diligence ahead of acquisition to gain an understanding of the potential financial, legal and reputational risks.

Integrity of financials may be unreliable

Entities involved in the hosting and sale of NFTs may suffer from a lack of robust and consistent financial reporting due to management's gross negligence or breaches of the duty of care. This is rooted in a lack of dependable financial reporting regulations in a space where an entity can boast a "launch first, account later" work ethic. With this in mind, it is beneficial for the buyer to consider a thorough assessment of the seller's financial accounts subject to higher risk of manipulation, bribery and corruption. This assessment may uncover inconsistent, incomplete and potentially fraudulent records resulting in inadequate reserves and/or disclosures.[2]

Domestic and international regulation

Within the United States, cryptocurrency is regulated under the purview of the Financial Crimes Enforcement Network (FinCEN). However, many NFT marketplaces operate globally, which means they are subject to numerous regulations in varying jurisdictions where there is an underwhelming number of existing laws.[3] NFT marketplaces are vulnerable to money laundering and terrorist financing activities, particularly if there is a lack of know-your-customer (KYC) procedures. This could result in the same individual registering multiple trading accounts in order to purchase assets from themselves while "washing" the funds.[4] Other users may leverage an entity's platform to sell fake NFTs or NFTs for which they do not own the rights, violating intellectual property laws.[5] Integrity diligence involves an understanding of ethics and compliance policies and procedures to identify existing regulatory controls and where potential gaps exist and to discover and quantify the impact of violations to both.

Environmental, social and governance (ESG) risk

NFTs have become known for their part in the creation of excessive carbon dioxide emissions, which are generated by the cryptocurrencies used to purchase them.[6] Specifically, the process of mining and adding a new "block" of transactions uses a substantial volume of electricity.[7] The more mining, the greater the environmental impact. With a renewed focus on ESG investment metrics and climate-related disclosures proposed by the US Securities and Exchange Commission (SEC), NFT marketplaces, which fall into the SEC disclosure purview as a producer of greenhouse gas emissions, may face substantial required changes ahead.[8]

For the acquisition of NFT marketplaces, integrity diligence allows a buyer to stay on top of inconsistent financial reports, changing domestic/international regulations, evolving environmental requirements and other risks posed by the Target.

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7 Ibid

8 Will Rigali, "ESG and Cryptocurrency: Considerations for Market Participants," *theracetothebottom.org*, August 31, 2021; "The Enhancement and Standardization of Climate-Related Disclosures for Investors," SEC proposed rule, File Number S7-10-22, March 21, 2022 (link)