



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

Transaction Forensics

May 2022



Building a better working world

Forensic & Integrity Services | Part 6 of our M&A Integrity Diligence Services

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 The NFT space is dominated by digital startups operating globally, largely remotely and under insufficient or outdated laws.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.



Ernst & Young LLP contacts



Amanda Massucci

EY Americas Transaction Forensic Leader
Forensics & Integrity Services
+1 213 977 8380
amanda.massucci@ey.com



Katie Kyle

Partner
Forensic & Integrity Services
+1 732 516 4091
katie.kyle@ey.com



Olivia Sondler

Senior
Forensic & Integrity Services
+1 212 773 2090
olivia.l.sondler@ey.com

- ¹ Ryan Browne, "Trading in NFTs spiked 21,000% to more than \$17 billion in 2021, report says," *CNBC.com*, March 10, 2022
- ² Tobias Adrien, Dong He and Aditya Narain, "Global Crypto Regulation Should be Comprehensive, Consistent, and Coordinated," *blogs.IMF.org*, December 9, 2021
- ³ Ibid
- ⁴ "Building AML Compliance for NFT Marketplaces," *sumsub.com*, August 6, 2021
- ⁵ Ibid
- ⁶ Justine Calma, "The Climate Controversy Swirling Around NFTs," *theverge.com*, March 15, 2021
- ⁷ Ibid
- ⁸ Will Rigali, "ESG and Cryptocurrency: Considerations for Market Participants," *theracetothetbottom.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](#))

EY | Building a better working world

EY exists to build a better working world, helping to create long-term value for clients, people and society and build trust in the capital markets.

Enabled by data and technology, diverse EY teams in over 150 countries provide trust through assurance and help clients grow, transform and operate.

Working across assurance, consulting, law, strategy, tax and transactions, EY teams ask better questions to find new answers for the complex issues facing our world today.

About EY Forensic & Integrity Services

Embedding integrity into an organization's strategic vision and day to day operations is critical when managing complex issues of fraud, regulatory compliance, investigations and business disputes. Our international team of more than 4,000 forensic and technology professionals helps leaders balance business objectives and risks, build data centric ethics and compliance programs, and ultimately develop a culture of integrity. We consider your distinct circumstances and needs to assemble the right multidisciplinary and culturally aligned team for you and your legal advisors. We strive to bring you the benefits of our leading technology, deep subject matter knowledge and broad global sector experience.

EY refers to the global organization, and may refer to one or more, of the member firms of Ernst & Young Global Limited, each of which is a separate legal entity. Ernst & Young Global Limited, a UK company limited by guarantee, does not provide services to clients. Information about how EY collects and uses personal data and a description of the rights individuals have under data protection legislation are available via ey.com/privacy. EY member firms do not practice law where prohibited by local laws. For more information about our organization, please visit ey.com.

Ernst & Young LLP is a client-serving member firm of Ernst & Young Global Limited operating in the US.

© 2022 Ernst & Young LLP
All Rights Reserved.

US SCORE no. 15847-221US
2203-4003964
ED None

This material has been prepared for general informational purposes only and is not intended to be relied upon as accounting, tax, legal or other professional advice. Please refer to your advisors for specific advice.

ey.com/us/transactionforensics