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BLOG

NFT "Sells" for Over $500 Million Back to Original Owner in Apparent "WASH," Potentially Heightening Securities Concerns in This Emerging Market

NOVEMBER 15, 2021

Concerns regarding the application of securities laws, such as those banning "wash trading," are increasing given the popularity of Non-Fungible Tokens (NFTs) and cryptocurrency transactions, and Chairman Gensler's recent remarks on the regulation of these assets.

On October 28, 2021, a bot that tracks sales of CryptoPunks, a set of NFT avatars traded via the Ethereum cryptocurrency, reported that CryptoPunk 9998, an 8-bit figure with shaggy white hair, had sold for $532,414,877.01. As expected, the buyer, who used "flash loans" to acquire the funds to purchase the NFT, sent the Ethereum to the seller, who in turn sent the NFT memorializing the ownership of CryptoPunk 9998 to the buyer. However, as part of the same transaction, the seller then sent the Ethereum back to the buyer, who repaid his loans. Finally, the "Punk" was sent back to the original owner, who quickly listed it for sale again at nearly double the original price, 250,000 Ethereum (over $1 billion). So, what happened here?

In short, the buyer and seller likely colluded (or perhaps, were the same individual operating from different addresses) to artificially inflate the value of the NFT using a series of cryptocurrency-specific opportunities. Because of the instantaneous nature of digital transactions, cryptocurrency transactions frequently utilize "smart contracts," where no part of a series of transactions executes until all parts of the transaction do, similar to a traditional escrow closing. A subset of these smart contracts are called "flash loans," where uncollateralized loans are made to a buyer and re-paid in the same series of transactions. Flash loans represent essentially risk-free opportunities for arbitrage; for example, if a cryptocurrency is being traded for $1 on one exchange and for $2 on another, a savvy trader can use smart contracts to take out a flash loan of $100 worth of the cryptocurrency on the first exchange, sell it for $200 on the second exchange, repay the loan, and pocket the extra $100 as profit as part of a single instantaneous transaction. Flash loans are usually risk-free for lenders as well; if there is no contract executed to return the amount loaned, the initial loan will never be made. Another benefit of this setup is that since processing and validating fees (known as "gas" for Ethereum) are assessed on a per-transaction basis, accomplishing multiple steps in a single transaction minimizes costs.

These entirely legitimate smart contracts can also be used as a sort of digital "wash trading," where a buyer and seller collude to mislead the market and artificially inflate the value of a security without incurring any actual risk or changing the traders' positions. The buyer and seller essentially send the security and cash back and forth, but only the initial sale is publicly reported, with the second exchange where the security and money are returned to their

original owners happening surreptitiously. Wash trading was first banned by the federal government by the Commodity Exchange Act in 1936, but it has come under recent scrutiny again following the advent of high-frequency trading.

The purpose of the "fake" purchase of CryptoPunk 9998 was the same as it always is in wash trading: to mislead the market as to the value of a particular product, but here with an NFT rather than a traditional security. The buyer and seller of CryptoPunk 9998 accomplished their goal, with the bot's post noting the sale garnering nearly 6,000 retweets and a host of commentary. Larva Labs, the creator of the CryptoPunks and the associated bot, quickly clarified that it would add filtering to prevent notifications for these sorts of transactions in the future. What remains to be seen, however, is whether federal regulators will view NFT wash trading with the same scrutiny as traditional security trades. Wash trading in the digital sphere will be harder to track given the anonymized wallet addresses, requiring further research by regulators into the identity of traders when transactions like this happen. Given the uniqueness of NFTs in comparison to traditional securities with high share volumes, it is also possible regulators may not be as concerned, as wash trading can only mislead the market as to one particular NFT. Winston will continue to monitor the regulatory landscape as it relates to NFTs and the application of traditional securities law.

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