THE COMING BLOCKCHAIN REVOLUTION IN CONSUMPTION OF DIGITAL ART AND MUSIC: THE THINKING LAWYER'S GUIDE TO NON-FUNGIBLE TOKENS (NFTS)

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First there were CryptoKitties. Then came digital art, CryptoPunks and NBA Top Shot. But when Beeple's digital art piece “Everydays: The First 5000 Days” sold at Christie's for US$69 million, the NFT mania truly began. And as with any wave of media mania, there also came the groundswell of negative media and hand-wringing about NFTs.

We believe it is time to address the pros and cons of NFTs from a thoughtful, legal perspective. NFTs are not all evil nor are they a panacea for artists and musicians. Here are our thoughts on the most common questions we have received from our clients about NFTs.

WHAT ARE NFTS?

NFTs are non-fungible tokens issued on a distributed ledger such as a blockchain. They are similar to cryptocurrencies like bitcoin in that they can be identified individually and are authenticated through a decentralized system of nodes via a consensus protocol. However, they differ from cryptocurrencies in that they are each unique, indivisible, and “non-fungible.”[1] NFTs are stored in “smart contracts,” which are automatically executable code that run on top of the distributed ledger on which the NFT is recorded. They provide a method of “provable uniqueness” and ownership for pieces of digital art, images, music and other content. NFTs are provably unique because each image and piece of content is linked to a single token stored in a smart contract on the distributed ledger and its ownership can be irrefutably established. While others may have copies of the same content, only one person can own the specific token authenticating ownership of the content. Currently, most, but not all, NFTs operate on the Ethereum blockchain. NFTs may help realize the long-touted but practically elusive goal of making blockchain technology a powerful tool to protect artists' rights to benefit from their creations without the need of intermediaries and to protect investors by helping establish provenance of art works.

WHY ARE PEOPLE SPENDING MASSIVE SUMS ON NFTS?

NFT purchasers often are collectors who view NFTs as a way to support their favorite artists, actors, musicians, and athletes. While there have been some recent high profile large dollar sales, most NFT sales are at a reasonable price that provides a much-needed way for artists, collectors, and musicians to monetize their work. As with collectors of many items (antiques, baseball cards, art) many collectors purchase NFTs because they hope they will increase in value and will be a good investment. The legal and regulatory analysis of an NFT will be heavily influenced by how it is intended to be used and how it is marketed. Whenever there are high-profile stories of ordinary people getting rich from new technology, some bad actors will try to take advantage of the situation.

WHAT ADVICE WOULD YOU PROVIDE TO ARTISTS OR MUSICIANS WHO WANT TO ISSUE THEIR OWN NFT?

Given recent high-profile stories of people getting rich from new technology, there have been media reports of bad actors who will try to take advantage of the situation.[2] If you are an artist or musician who is interested in issuing NFTs as a way to monetize your creative content, you need to be careful on how you proceed. For instance:

- Ensure that the piece of art/image, digital music or other creative work associated with the NFT is unique and authenticated. Ensure that you have all of the rights necessary to reproduce and distribute the work.
- Work only with a reputable technology company that will issue the token on your behalf in a manner that is transparent and secure.
- Inquire about the technology company's position on payment of royalties. While certain token standards prohibit royalties (because they are viewed as stifling the ability to freely transfer tokens) there have been discussions in the Ethereum community about the creation of a royalty standard.[3] At present, artists generally receive a payment when their NFTs are initially sold, but often not if they are resold in the future.
- Work only with a reputable marketplace that does not over-promise or hype the NFTs, and that does not require you to make significant up-front payments in order to issue and sell your NFTs. Find out which blockchain platform the technology company is using. Jodee Rich, founder of NFT issuer Kred and the NFT conference “NFT/NYC”, told us:
    - NFTs are minted on different blockchain platforms. Ethereum is the standard (called ERC721). Minting and transacting on the Ethereum blockchain is really expensive. We recommend minting on Ethereum compatible blockchains (such as Matic) which are just as effective and much less expensive.
- Make sure disclosures are clear regarding the purpose of the NFTs as a royalty vehicle, whether there is expected to be an established trading market for them, risk factors or other special considerations, and whether they are or are not investment contracts or other types of securities.

WHAT ADVICE WOULD YOU PROVIDE TO COLLECTORS WHO WANT TO PURCHASE NFTS?

Prospective purchasers of NFTs should keep in mind that, while the NFTs may have some similarities to other collectibles, such as artwork, comic books, music, or trading cards, they also differ from those traditional physical assets in important ways:

- You are purchasing a unique piece of code on a blockchain that is linked to the product. You will not have a piece of art that can be hung on a wall; rather, you will need to store your NFT in a digital asset wallet, whether a wallet you control or one provided by a third-party.
- Purchase an NFT that you personally like from an artist you admire as a collectible.
- While the value of an NFT may be influenced by the reputation of the artist and the provenance of the NFT and the art work that it represents, do not expect that your purchase will necessarily increase in value or maintain a stable value.
- Recognize that while you own the token with code linked to the provably unique image or other work, others may have copies of the underlying work. But only you can own that token.
- Ensure you understand where the underlying work referenced by your NFT is stored. In most cases, the work is not actually stored on the blockchain and the NFT will “point” to a traditional internet site where the work is housed.
- Understand whether the NFT sponsor is carefully addressing compliance with regulatory requirements, and understand the potential effect on liquidity if the NFT is marketed as a security or a commodity, and understand potential rescission rights if an NFT that is not marketed as a security is subsequently determined to be a security that was issued in violation of the registration requirements of the securities laws.

WHAT ADVICE WOULD YOU PROVIDE TO LAWYERS WHO HAVE CLIENTS INTERESTED IN NFTS?

As with any new product or service, there is some uncertainty about the regulatory landscape for NFTs. Nevertheless, there are some clear rules to follow. If you are a lawyer with clients in this space, here are some top areas of the law that you need to be familiar with. It is important to realize that plaintiffs, prosecutors or enforcement agencies have sought to hold lawyers responsible for advice in other areas of the fast-developing legal framework for digital tokens and cryptocurrencies where that advice was in hindsight considered to have been overly aggressive.

Are NFTs Securities?

As with other blockchain-based tokens, the question of whether a given NFT might be a security will be highly dependent on the facts and circumstances. Being categorized as a “security” could subject an NFT to detailed registration and disclosure requirements, or alternatively to suitability requirements and offering restrictions for transactions exempt from registration. Complying with the registration requirements of the Securities Act would be impracticably expensive, while offering restrictions could make NFTs unsuitable for certain anticipated use cases such as facilitating artists' rights and royalties. The sale of a one-off NFT that only confers ownership over a piece of art likely would not be considered an offering of securities. However, more complicated transactions related to NFTs could easily cross the line and become securities offerings. For example, projects where large numbers of NFTs are minted and sold and where the issuer creates a platform to support secondary trading of the NFTs could potentially be viewed as a securities offering. Similarly, NFTs that are “fractionalized” and sold to individual investors are also likely to be considered securities.[4] To do so, the NFT itself is held by the owner or a custodian and fungible digital tokens that collectively represent 100 percent of the ownership of the NFT are created and sold to third parties. For NFTs minted on Ethereum, the NFT would be created using the ERC-721 standard and "ownership" tokens would be created using the ERC-20 standard.

Finally, if the NFTs or ownership tokens being sold will entitle the holders to a royalty payment or dividend stream related to the underlying music or art, such digital tokens could be deemed securities if the tokens are considered to represent an investment in a common enterprise with an expectation of profits to be derived from the entrepreneurial or managerial efforts of others under the *Howey* test.[5]

The Security and Exchange Commission's (SEC) regulatory guidance and enforcement activities over blockchain-based tokens of all types have evolved rapidly in recent years and continue to evolve to keep pace with technological innovation. Issuers of NFTs and platforms supporting the sales and trading of NFTs should be mindful of the rapid evolution within the recent past of the SEC's view of digital tokens and the circumstances that could cause it to regard a token as a security even if the token has elements of utility tokens. Lawyers advising clients on NFTs should be familiar with no action letters, and regulatory guidance related to initial coin offerings (ICO), decentralized autonomous organizations, and "utility tokens" and "security tokens," including the "Framework for "Investment Contract" Analysis of Digital Assets." Lawyers should pay particular attention to the numerous SEC enforcement actions.[6] Lawyers should also be mindful of the SEC statements in the context of ICOs that articulate an expectation that securities lawyers, accountants and consultants as gatekeepers have a special responsibility to help prevent violations of securities law in the design and offering of digital tokens. Moreover, if an NFT (or ownership token) is a security, a transaction that does not prompt regulatory scrutiny could nonetheless result in private litigation, because state and federal anti-fraud statutes typically apply even to securities that are exempt from registration requirements.

Are NFTs Commodities?

Even if an NFT is not a security, if the NFT may reasonably be expected to have secondary market trading and liquidity, a lawyer should also consider whether the NFT is a "commodity" under the U.S. commodity laws. A commodity is typically defined as a reasonably interchangeable good or material, bought and sold freely as an article of commerce, which includes all services, rights, and interests in which contracts for future delivery are traded presently or in the future. In several enforcement actions, the Commodity Futures Trading Commission (CFTC) has taken the view that bitcoin and virtually all other primary digital currencies that are not securities are commodities subject to the anti-fraud and anti-manipulation jurisdiction of the CFTC. Because CFTC-registered trading venues now offer futures contracts and other derivatives with Bitcoin and Ether as the underlying assets, it is now established that those digital assets are in fact commodities under U.S. law.

What are the Intellectual Property Considerations for NFTs?

With respect to intellectual property laws, we recommend that lawyers ensure that the NFT issuer controls all of the rights in the content that are necessary for the reproduction and distribution of the NFT. For example, the owner of rights in a sound recording also would need to control or have license rights to the underlying musical composition performed on the sound recording. The rights in the music composition that were granted to make and distribute the sound recording may not extend to the creation and distribution of one or more NFTs. Although fair use and first sale rights also would apply to the creation, reproduction and distribution of NFTs, no court decisions have yet addressed the application of those doctrines to NFTs. NFT creators and distributors should be quite careful in relying on those doctrines given the current lack of precedent with respect to their application.

Similarly, the distribution of images that utilize trademarks such as product logos generally will require a license from the trademark owner and typically would be outside the scope of any existing trademark license. Brand owners already have entered the NFT markets and are likely to vigorously object to unauthorized uses of their trademarks as part of an NFT.

The owner of an NFT, like the owner of a unique work of art, generally will own only the digital item itself, and not any underlying intellectual property rights, which typically remain with the creator of the work, or their designee. The owner of the NFT therefore will have limited rights to exploit ownership of the NFT, apart from resale of the NFT itself, unless additional license rights are included with the NFT.

What Other State and Federal Laws Should be Considered?

As with most all commercial transactions, transactions involving NFTs will need to consider state and federal consumer protection laws, especially restrictions on unfair, deceptive (and abusive) acts and practices. These broadly construed laws generally prohibit actions that cause unfair harm or mislead parties to transactions. Federal and state regulators have issued various warnings to consumers about the uncertainty of the cryptocurrency industry, and we expect those regulators would have equal concern about the NFT marketplace, especially given its novelty and lack of general consumer understanding. As a result, those involved in NFT transactions should pay particular attention to representations in marketing and other disclosures to ensure their accuracy and thoroughness.

NFTs may implicate other laws depending on their particular characteristics. For example, to the extent an NFT is linked to a cryptocurrency (such as ownership tokens) or other monetary value, state money transmitter laws might be implicated. Forty-nine states have money transmitter laws on their books, and some (but not all) of those laws apply to activities involving cryptocurrency, such as holding cryptocurrency on behalf of others, receiving it for transmission to a third party, or issuing it. If such laws are triggered, a license would be required (unless an exemption or partnership with a licensee applied) and various obligations would apply, such as minimum capital, recordkeeping, examinations, and disclosures.

At the federal level, the same activity that could trigger state money transmitter laws may also trigger an obligation to register with the Financial Crimes Enforcement Network (FinCEN) and implement an anti-money laundering program. FinCEN has issued guidance explaining that it regulates “administrators” and “exchangers” of cryptocurrency and has continued to expand its regulatory oversight of cryptocurrency transactions, including recent proposals to impose new reporting and recordkeeping requirements. Although FinCEN has issued little guidance on NFTs specifically, earlier this month the Financial Action Task Force (FATF), a global anti-money laundering body, proposed revisions to its virtual asset guidance that could subject certain NFTs—such as those that enable the transfer or exchange of value on secondary markets—to regulation. Although FATF has not finalized the proposed revisions, it is unlikely these attempts at regulation will fade, so NFT issuers and exchanges should proceed accordingly.

CONCLUSION

NFTs can be a true win-win for both the sellers and purchasers, as well as for the artists and musicians who use them. The close relationship of many NFTs to works of art, and their popularity with artists and musicians may provide a basis to hope that NFTs will not suffer the challenges faced by the ICO market. However, care should be taken to ensure that the NFT transactions are implemented with clear and transparent terms, and a full understanding from all as to the laws that apply, the underlying nature of the product and how it provides true provable uniqueness.

FOOTNOTES

[1] NFTs created using the ERC-721 standard are indivisible.

[2] *See* David Gerard, NFTs: crypto grifters try to scam artists, again (Mar.11, 2021).

[3] *See* James Beck, Can NFTs Crack Royalties and Give More Value to Artists?, CONSENSYS BLOG (Mar. 2, 2021).

[4] *See* here

[5] SEC v. W.J. Howey Co., 328 U.S. 293 (1946).

[6] *See* SEC v. Ripple Labs, Inc., et al., Case No. 20-cv-10832, Southern District of New York, complaint filed December 22, 2020.

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