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What Cos. Need To Know Before Entering Nascent NFT Market

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On March 11, the artist known as Beeple sold for $69.3 million a digital collage work, "Everydays: The First 5000 Days," and its associated nonfungible token, or NFT. The auction was conducted by Christie's International PLC and "Everydays" became the third most expensive work ever sold by a living artist.

A few days later, an image of The New York Times column, "Buy This Column on the Blockchain!" was turned into an NFT and sold for $560,000.

The musician and artist Claire Boucher, known as Grimes, sold nearly $6 million worth of digital artworks as NFTs in under 20 minutes.

These transactions represent some of the highest profile sales of an NFT to date and have rapidly propelled NFTs to the forefront of public consideration. Individuals and businesses participating and operating in this space should carefully consider the legal implications of doing so, as the laws surrounding NFTs are not yet well developed and there is a good degree of regulatory uncertainty in the industry.

NFTs are digital assets that represent anything unique — such as artwork, videos, GIFs, songs or even tweets — as an Ethereum-based smart contract, which does not contain the associated image, but instead contains a link to the image file.[1]

NFT Sales

While design flexibility and diverse functionality make NFTs useful to business and brand owners, they also expose NFT handlers to possible government regulation depending on how regulators choose to view a particular NFT or sale

As NFT sales proliferate, regulators are poised to step in to address the question of how to classify these novel assets. Determining the regulatory regimes that apply to NFTs requires a detailed inquiry. We discuss key regulatory issues below.

First, NFTs are virtual currencies and, therefore, commodities, subject to regulation by the Commodity

Futures Trading Commission if there is any fraud, misrepresentation, or manipulation involving the NFT.[2] While the CFTC has not yet publicly shared a specific position on NFTs, the agency has promised a holistic framework for digital assets by 2024 and has referred to digital assets as "21st century commodities."[3]

Second, NFTs could be viewed by regulators as securities. The term "security" includes an investment contract, which, under precedent from the U.S. Supreme Court's 1946 decision in U.S. Securities and Exchange Commission v. W.J. Howey Co., exists when there is (1) an investment of money (2) in a common enterprise (3) with a reasonable expectation of profits (4) derived from the efforts of others.[4]

The Howey test applies regardless of whether an instrument has the traditional characteristics of a security, and considers not only the instrument itself but also the manner in which it is offered, sold or resold.

In the case of an NFT sale, an investment contract could exist. The purchase of an NFT involves the investment of money or the like (e.g., virtual currency) and likely an expectation of profit by the purchaser.

What is unclear, however, is (1) whether a common enterprise exists, and (2) whether the anticipated profit was derived from the efforts of others. Perhaps a common enterprise could be found where the purchaser of an NFT already owns other works by a particular artist and divides ownership of those works into blockchain-based tokens that he sells to the public.[5]

However, if all profit-generating efforts belong to the purchaser, the particular NFT may fail the "efforts of others" prong of the Howey test. Of course, this does not mean other NFT sales might not satisfy the Howey test and therefore be regulated as sales of securities.

Third, NFTs may be viewed by regulators as substitutes for value under the Bank Secrecy Act, implicating money transmission legal compliance. If an NFT marketplace receives fiat or cryptocurrency from a purchaser in exchange for delivery of an NFT from a seller or artist, and then passes the purchaser's payment to the seller, this is likely money transmission.

This is because the marketplace would appear to have engaged in the "acceptance of currency, funds, or other value that substitutes for currency from one person and the transmission of currency, funds, or other value that substitutes for currency to another location or person by any means."[6]

On March 9, the U.S. Department of the Treasury's Financial Crimes Enforcement Network published its first notice related to the Anti-Money Laundering Act of 2020.[7]

The agency underscored that illicit activity related to antiquities and art may involve financial institutions and trigger reporting requirements. It also provides specific instructions for filing suspicious activity reports related to antiquities and art, which present a heavy regulatory burden.

Though the definition of "financial institutions" does not yet extend to those engaged in the trade of art, the AML Act directs the Treasury secretary to perform a study of the facilitation of money laundering and the financing of terrorism through the trade in art, which could be the harbinger of additional changes ahead.

NFT Platforms

Separate from regulation of NFTs themselves, those who provide an online marketplace or platform for NFT sales may also be subject to consumer safety regulation specific to e-commerce. In general, sales on even the largest platforms like eBay Inc. pose particular risks to consumers because of factors such as platform owners' lack of obligation to screen transaction participants, the difficulty of enforcing promises or obligations against anonymous buyers and sellers, and so forth.

Ultimately, the obligations of platform owners, even outside the NFT context, remain surprisingly ill-defined — a fact that raises uncertainty costs of NFT platform development for interested clients.

A consumer safety risk of NFT platforms is counterfeiting. Buyers in online marketplaces are at greater risk of purchasing counterfeit goods, since it is difficult to identify the red flags in an online environment that would typically alert shoppers to danger or inauthenticity in a physical market.

This is a risk that also applies to NFTs, since a possibility exists that the link between the NFT and the associated digital image could be flawed. Thus, there is a counterfeiting risk that NFTs could intentionally misrepresent authenticity information, misleading consumers as to the nature and value of their purchases.

This possibility might present even greater risks of consumer harm if the practice of minting NFTs for physical products increases in popularity, since counterfeit physical goods pose significant health and safety risks.

As e-commerce, global counterfeiting and pandemic buying have reached new collective heights, government concern about online consumer safety has substantially increased.

Already, significant legislation — like the Stopping Harmful Offers on Platforms by Screening Against Fakes in E-Commerce, or SHOP SAFE, Act; the Information Needed for Financial Options Risk Mitigation, or INFORM, Act; and the European Commission's Digital Services Act — has been proposed or enacted that targets consumer safety in online platform settings.

Moreover, in 2014, the Consumer Financial Protection Bureau began accepting complaints on virtual currency products and services closely related to NFTs, suggesting a likelihood of eventual consumer safety regulation in this area that may add to the legal difficulty of establishing an NFT platform.

Clients seeking to develop NFT platforms should carefully consider the types of consumer protection notices required and other obligations to which they may be subject. They should further consider the likelihood of new regulation or legislation, whether or not specifically targeted to NFTs, that may affect these obligations and thus the business merits of owning such a platform.

NFT Portfolios

While NFTs have been regarded by some as a passing fad, substantial investment by major brands suggests some amount of real value in possessing an NFT asset portfolio — much in the same way one might hold a patent, trademark or copyright portfolio.

For example, Taco Bell recently debuted a collection of $1 taco-inspired NFT GIFs; resale prices rose as high as $3,600.[8] NBA Top Shot sold $230 million in NFT basketball trading cards from October to January.[9] Finally, at a recent fashion conference, the executive vice president of Gucci Group

NV stated that luxury brand NFTs, including for physical goods, are inevitable.[10]

Examples like these suggest the potential importance of NFT portfolio ownership and management for business clients.

In addition to the regulatory considerations already discussed, clients contemplating NFT portfolio development or other NFT market participation should evaluate each NFT for potential violations of intellectual property law. While NFTs may enable greater protection for digital art, they also facilitate a wealth of new infringement opportunities — particularly in the art-driven copyright space.

Current intellectual property law, or changes thereto, may further affect the value of NFT ownership and existence of related obligations.

First, anyone can create an NFT, even for an image they do not own. Thus, NFTs allow infringers to commodify art through the creation of tokens without the knowledge or permission of the original artist. This practice has produced a new wave of copyright theft, to which even Banksy works have fallen prey.[11]

The practice also seems to tarnish the benefit of NFTs as a digital provenance, tracking ownership and confirming authenticity, since these unauthorized NFTs actually cut the original creator out of the blockchain record.

Likely, the Copyright Act is already robust enough to capture this kind of misconduct. However, NFT-based copyright infringement will certainly be something new to judges, which may produce problematic and expensive litigation uncertainty for clients.

Second, NFTs themselves may be entitled to copyright protection. Because NFTs are made up of bits of open source code and are one of a kind, they may be entitled to their own copyrights, separate from the copyright on the associated digital image.

This reality could further complicate infringement proceedings, as where a legitimate NFT owner is being sued for copyright infringement by the legitimate owner of the associated artwork. While existing copyright doctrines may be sufficient to address these types of claims, the risk of litigation uncertainty is likely increased and platform owner obligations may prove complex.

This said, the existence of separate copyrights may also increase the overall value of NFT ownership.

Conclusion

In light of the novel legal and regulatory issues presented by NFTs, individuals and businesses involved in the sale and purchase of these digital assets should conduct a risk assessment to evaluate any necessary legal and regulatory compliance requirements for operating in this space.

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[1] The NFT permits the owner to prove his ownership of the image; it is immutable, it can be sold or transferred on the blockchain, and the transaction history is publicly verifiable. In terms of provenance, the blockchain record is much easier, more efficient, and more secure than paper provenances for traditional, physical assets such as art.

[2] Commodity Futures Trading Comm'n v. Patrick K. McDonnell & Cabbagetech Corp. d/b/a Coin Drop Mkts., No. 1:18-cv-00361-JBW-RLM, slip op. (E.D.N.Y. Mar. 6, 2018) (mem.).

[3] CFTC Announces Finalization of 2020–2024 Strategic Plan, Commodity Futures Trading Comm'n (July 8, 2020), available at https://www.cftc.gov/PressRoom/PressReleases/8196-20.

[4] S.E.C. v. W.J. Howey Co., 328 U.S. 293, 298 (1946).

[5] Prior to Christie's auction of Beeple's "Everydays: The First 5000 Days," the purchaser, MetaKovan, bought other works by the artist, divided ownership into blockchain-based "tokens," and sold those tokens to the public. See Gerrit De Vynck & Douglas MacMillan, He Just Spent $69 Million on a Digital Piece of Art. It's Not His First Beeple, Wash. Post (Mar. 18, 2021), https://www.washingtonpost.com/technology/2021/03/17/nft-beeple-metakovan-christies/.

[6] 31 C.F.R. § 1010.100(ff)(5)(i).

[7] FinCEN Informs Financial Institutions of Efforts Related to Trade in Antiquities and Art, U.S. Treasury (Mar. 9, 2021), https://www.fincen.gov/sites/default/files/2021-03/FinCEN%20Notice%20on%20Antiquities%20and%20Art_508C.pdf; see also Carlton Greene et al., Congress Passes the Anti-Money Laundering Act of 2020, Significant Changes to the Bank Secrecy Act Ahead, Crowell & Moring (Jan. 19, 2021), https://www.crowell.com/NewsEvents/AlertsNewsletters/International-Trade-Bulletin/Congress-Passes-the-Anti-Money-Laundering-Act-of-2020-Significant-Changes-to-the-Bank-Secrecy-Act-Ahead.

[8] Kayleigh Barber, WTF is an NFT, Digiday (Mar. 11, 2021), https://digiday.com/media/wtf-is-an-nft/.

[9] Sam Dean, $69 Million for Digital Art? The NFT Craze, Explained, L.A. Times (Mar. 11, 2021), https://www.latimes.com/business/technology/story/2021-03-11/nft-explainer-crypto-trading-collectible.

[10] Marc Bain, NFTs for Fashion are Inevitable, Quartz (Mar. 19, 2021), https://qz.com/1986615/nfts-for-fashion-in-the-real-and-virtual-worlds-are-inevitable/.

[11] Marion Maneker, NFTs are Creating the Opposite of Everything They're Meant to Fix, Artnews (Mar. 15, 2021), https://www.artnews.com/art-news/market/nfts-create-opposite-of-everything-they-are-meant-to-fix-1234586769/