Non-fungible tokens: What are the legal risks?

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Introduction

The market for Non-Fungible Tokens (NFTs) has boomed over the past year. Businesses and asset owners have been creating and selling NFTs representing a range of assets, whether digital or physical, including internet memes, digital images, event tickets and memorabilia.

Notable examples include the sale of an NFT representing the original source code for the World Wide Web, written by the Web’s inventor, Tim Berners-Lee, for USD5.4 million, and the first tweet of Twitter’s CEO, Jack Dorsey, for USD2.9 million.

This article sets out some of the key legal risks to be aware of for those thinking of investing in NFTs.

What is an NFT?

An NFT is a cryptographic tool which is capable of proving ownership and authenticity of an underlying asset, typically in digital form. Similarly to their cryptocurrency counterparts, such as Bitcoin, NFTs are created (or ‘minted’) and recorded using blockchain technology. Digital asset and blockchain platforms, such as DLA Piper’s digital asset creation platform, TOKO, can be used to create NFTs. Those NFTs can then be bought and sold on marketplaces that are linked to the underlying blockchain technology.

A fundamental distinction between NFTs and cryptocurrency lies in the fact that NFTs are (as their name states) not
“fungible”, meaning each NFT is unique and therefore not interchangeable with any other NFT. Each NFT contains a unique identification and metadata that makes it a one-of-a-kind asset.

The growing interest in NFTs is further driven by the potential for creating new revenue streams. NFTs, and the blockchain technology on which they are founded, offer asset owners the opportunity to generate significant revenues in a new and innovative way, for example, by creating and selling fractions of assets as digital representations. Assets which would have previously proved difficult, if not impossible, to sell, such as the tweets or the source code referred to above, can be monetised through issuing NFTs. Asset owners can even sell an NFT in respect of the digital representation of a physical asset, while still owning (or separately selling) the underlying asset at the same time.

However, as with any asset class, it is important that investors consider the risks as well as the potential rewards.

Key legal risks of NFTs

Defining ownership rights

As with any other contract of sale, it is crucial that a purchaser of an NFT carefully considers the terms governing the relevant token prior to purchase, including what rights are being acquired and what rights will remain with the seller. While the purchaser of an NFT buys, and then owns, the token, owning an NFT does not equate to owning the underlying asset itself. As such, the purchaser of an NFT will not necessarily enjoy rights such as copyright of the underlying asset, which often remains with the creator of the NFT.

Smart contract technology can be embedded into NFTs, for example, to prohibit the transfer of the NFT until certain conditions are met or to protect the minter’s rights to royalties such that, each time the NFT is resold, the minter automatically receives a royalty fee. It is therefore crucial for investors to understand the mechanics of the NFT(s) in which they are interested in investing in advance of purchase.

Equally, sellers of NFTs should remain alive to the risk of being accused of misrepresentation when selling NFTs. Sellers should therefore make the terms of a sale clear, paying particular attention where matters such as the history of ownership or storage of the physical asset are of vital importance (for instance, in respect of a luxury good or work of art).

NFT owners also need to heed the usual warnings regarding market volatility, particularly given that NFTs are a relatively new asset class without a proven track record. It is important for investors not to get carried away by temporary market sentiments, to be aware of their own investment objectives, and to consider carefully the true value of any NFT they intend to purchase. In August 2021, for example, an NFT representing the clip art of a rock sold for 400 Ether which equates to approximately USD1.3 million. This NFT was issued by EtherRock on the Ethereum blockchain. According to the EtherRock’s own website, “these virtual rocks serve NO PURPOSE beyond being able to be bought and sold, and giving you a strong sense of pride in being an owner of 1 of the only 100 rocks in the game :)."

Loss of or damage to the physical asset

An NFT and the underlying asset it represents are separate assets. While the NFT will contain information about its link to the underlying asset and the NFT holder’s title to the NFT, should the underlying asset be destroyed, lost or stolen, the NFT could be rendered worthless. That said, an NFT representing artwork by the UK artist Banksy was marketed on the basis that the underlying artwork had been deliberately destroyed, leaving only the digital representation sold through the NFT. Therefore, in some instances, the destruction of the underlying physical asset, leaving only the NFT as evidence of its former existence, may serve to increase the value of the NFT.

It is nevertheless important to ensure (in some cases) that there is some guarantee as to the safety of the underlying physical asset and allocation of risk in the contractual documentation before purchasing an NFT.

Risk of fraud

While NFTs exist to authenticate provenance and title, and although they benefit from the blockchain technology, which creates clear, timestamped audit trails of ownership, the risk of fraud persists, particularly in light of the anonymity of blockchain.

Fraudsters could mint an NFT relating to a work that is not their own and without the creator’s permission. For example, an online auction of an NFT purportedly by Banksy (a different Banksy NFT to the one referred to above) was
subsequently found to be fraudulent and not in any way affiliated with the artist, despite there being a link to the NFT auction on the artist’s website (which was added by the fraudster). Likewise, with respect to copyright, minters of NFTs could falsely claim to own copyright in respect of the underlying asset.

These risks can be mitigated by purchasing NFTs from reputable creators, or by undertaking proper due diligence as to its provenance if buying on a secondary market. For instance, DLA Piper’s TOKO platform combines innovative blockchain technology with the compliance and regulatory rigor of a global law firm to tackle and eliminate such risks of fraud and enhance auditing capabilities.

Uncertain regulatory framework

Where NFTs are traded across global platforms, issuers and buyers must be aware of the legal and regulatory treatments across different jurisdictions. However, since NFTs are a relatively new asset class, much of the legal and regulatory framework surrounding NFTs is still under development both in the UK and across the globe.

Based on current guidance published by the UK FCA in 2019, it is likely that many NFTs would be considered as “unregulated tokens” since they do not meet the definition of either electronic money or security tokens. However, it is possible that certain types of NFT could constitute a type of regulated financial instrument such that it falls within the UK’s regulatory perimeter. Careful analysis of the classification and regulation of each NFT transaction is therefore required.

The considerable sums that are often spent on NFTs, coupled with the fact that sellers and buyers of NFTs often remain anonymous, can make NFTs attractive to those interested in laundering money. Operators of NFT platforms need to be alive to such risks, and ensure they comply with their applicable regulatory duties.

The UK has transposed the EU’s Fifth Anti-Money Laundering Directive 2018/843 into the Money Laundering, Terrorist Financing and Transfer of Funds (Information on the Payer) Regulations 2017 (MLRs). This new regime came into force in January 2020. The MLRs now require cryptoasset exchange providers and custodian wallet providers to register with the Financial Conduct Authority prior to undertaking any cryptoasset business. Given the broad definition of “cryptoassets” under the MLRs, it is possible that businesses dealing with certain NFTs will fall within its scope.

As the popularity of NFTs continues to rise, so too does the likelihood of further regulation of the sale, distribution and marketing of NFTs.

Conclusion

NFTs offer exciting opportunities for digital creators, sellers, and buyers alike. Nevertheless, as the market continues to evolve, it is crucial that buyers are aware of and understand the risks inherent in these products. To minimise these risks, buyers should carefully consider what they are purchasing, ensure that any embedded smart contract accurately reflects the rights they anticipate receiving, and only purchase and deal in NFTs on reputable marketplaces.

Access the Guidance on Cryptoassets

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