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NON-FUNGIBLE TOKENS: THE GLOBAL LEGAL IMPACT

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NON-FUNGIBLE TOKENS: THE GLOBAL LEGAL IMPACT

The market for non-fungible tokens (NFTs), or cryptoassets representing proof of title to a unique digital version of an underlying asset, has soared. In the sports and digital arts sectors, recent NFT issuances have sold out in seconds, netting their creators millions.

Subject to limitations in any relevant jurisdiction, NFTs have the potential to facilitate new revenue streams by establishing new forms of digital property, act as new channels for businesses and digital creators to reach customers, fans, and audiences and/or enable the monetisation of physical assets.

While NFT issuance is growing rapidly globally, the legal and regulatory treatment of NFTs continues to evolve. We have been advising clients on NFTs in various jurisdictions. In this briefing, we share our experience to demystify NFTs and consider some of the key risks, and how the tokens are regulated across some key financial centres.

NBA Top Shot

The National Basketball Association's (NBA) Top Shot, is a blockchain-based online platform hosted by Dapper Labs for basketball fans to purchase and trade highlights of NBA sporting history (or "Moments") through NFTs intended to act as virtual trading cards. Moments are minted (i.e. created) on the underlying blockchain platform, but are graphically displayed as digital cubes containing the video highlight in the online marketplace.

What are NFTs?

An NFT is a digital asset whose uniqueness and ownership can be demonstrated and verified using distributed ledger technology (DLT). NFTs can be used to create a tokenised proof of title to a unique digital version of an underlying digital asset (such as images, videos or other digital content) or physical asset (such as paintings, sculptures or other tangible assets).

When someone “mints” an NFT, they create a unique digital version of the work as a data file using blockchain, or another type of DLT. Once minted, NFTs cannot be edited or deleted, and can be viewed publicly and freely traded with verifiable security of exclusive ownership and transaction traceability. An NFT issuance may consist of a single NFT, or may involve thousands or millions of tokens.

Each NFT is unique. In contrast, most other cryptoassets, are fungible, i.e. each token is interchangeable with and indistinguishable from another

Some NFTs incorporate smart contracts which specify and automate certain rights and obligations of the buyer and seller, for example, to provide that the NFT creator receives a percentage of the transaction proceeds every time the NFT is sold on.

NFTs have gained traction to date in the digital space but also have the potential to digitise unique physical assets, such as physical artwork, in theory allowing these assets to be bought, sold and traded more efficiently. In principle, all physical assets could be tokenised either as fungible or non-fungible tokens. Many businesses have successfully tokenised a range of assets including iconic images, athletic highlights, entertainment and sports memorabilia, event tickets, music albums, artwork, famous Tweets, internet memes, gaming and e-sports digital content, unique sportswear and other collectibles using NFTs.

How do NFTs generate revenue?

NFTs can enable the efficient commercialisation of unique assets that are otherwise difficult to sell or prove ownership of, as well as the creation of entirely new digital product lines and revenue streams.

As with many other digital assets, some NFTs offer the ability to "fractionalise" ownership of the underlying asset, i.e. to split ownership so that each purchaser of an NFT benefits from the underlying asset in proportion to the fraction they own, which can enable new ownership structures that proponents assert have

the potential to democratise ownership of assets that have traditionally been viewed as inaccessible. However, other NFTs are indivisible.

Transaction structures for minting and selling NFTs vary. Many NFT creators are "crypto natives" with DLT expertise who issue the NFT themselves and also create or own the underlying artwork or other asset to which the NFT is linked. Where the content creator/owner is not native to the crypto space (e.g. a celebrity, musician, athlete or sports club or other business), a third party may issue the NFT on behalf of the content creator/owner. The third party may also provide the underlying technology platform for minting and selling the NFTs, or another platform provider may be involved. Revenue sharing models between the various participants differ considerably and should be carefully considered.

Commercialisation of digital assets

A digital asset, such as a significant tweet, a video file or digital photograph, can be linked to a finite number of NFTs. The sale of those NFTs creates a whole new revenue stream. The provenance of the underlying digital asset is assured by the NFT.

An artist could also sell an NFT linked to a digital version of a physical asset (e.g. an image or video of a painting or sculpture) to one buyer, while selling the physical work itself to another buyer as an additional opportunity to profit. NFTs have opened the door to artists and content producers further commercialising their work in a digital environment, by providing an infrastructure in which value can be ascribed to a digital 'copy' of a work due to the uniqueness of that copy.

Commercialisation of physical assets

While NFTs have been mostly linked to digital assets to date, fine art, luxury goods and other physical assets have the potential to be linked to NFTs. This ensures the provenance of the underlying asset but can also assist with increasing liquidity. Considering the collectible wine investment market for example, NFTs may

Buying Myself Back: A Model for Redistribution

Model Emily Ratajkowski recently sold an NFT called "Buying Myself Back: A Model for Redistribution" for US$140,000. Her NFT is linked to a photograph of herself standing in front of a painting by artist Richard Prince of a photo of herself – for which she was paid US$150 at the time. Her NFT served two purposes – (1) to take back control of her own image, which she believes Prince had exploited; and (2) to generate revenue. The purchasers of her NFT will not receive a physical copy of the photograph.

Glossary

- **Blockchain** is one type of DLT in which the data is set out and built up in successive blocks, where each new block of data verifies the content of the previous block. It is known for being the technology underlying Bitcoin, but has been integrated into many other transaction and asset types. Most NFTs are minted on the Ethereum blockchain.
- **Cryptoasset**
  A digital asset created using cryptography. Cryptocurrencies are a subset of cryptoassets with money-like functionality. The term token is often used synonymously with cryptoasset.
- **Distributed ledger technology (DLT)**
  DLT is a decentralised peer-to-peer data storage system where participating computers (known as **nodes**) hold and maintain identical copies of the ledger. Data integrity is achieved through public-private key cryptography, so that an individual node cannot tamper with the information recorded in the ledger by rewriting the transaction.
- **Non-fungible token (NFT)**
  An NFT is a unique cryptoasset that represents rights to an underlying 'tokenised', often digital asset, which is created and transferred using DLT. This contrasts with many existing cryptoassets, including cryptocurrencies like Bitcoin, which are fungible or interchangeable.
- **Smart contract**
  A smart contract is commonly defined as an agreement written in computer code with automated performance. Smart contracts are automatable and enforceable either by legal enforcement of rights and obligations (though they may not always amount to legal contracts) or via tamper-proof execution of computer code.
- **Token**
  A token is a digital entry on a DLT register or other digital infrastructure where a person is recorded as owning a unit or other entitlement. Tokens may represent a permission to control a resource native to the DLT platform, rights granted to the holder, or a "real world" asset. The latter is commonly referred to as the "tokenisation" of underlying assets.

reduce the risk of counterfeiting and substitution by linking individual bottles of wine to a unique NFT (e.g. by way of a QR code) that proves provenance, history of ownership and provides a record of how and where the wine has been stored. A secure physical storage facility is likely to be a key component of any structure. As such, collectible wines can be virtually traded more easily while showing proof-of-ownership and proof-of-value. However, in the short term, liquidity may be more limited as investors will need to be comfortable with the technology and the operator of the platform, as well as the issues around secure and effective storage that typically accompany collectible wine.

Royalty collection as a payment model

Some NFTs are coded to incorporate smart contracts that can be programmed to include the automatic allocation of a portion of the amount paid by an NFT purchaser to the original owner/issuer of the NFT, thus giving the original owner an ability to realise the benefits of the secondary marketplace by way of "royalty" payments. Ratajkowski's NFT, for example, is understood to generate a payment for her every time that it is resold.

Who is interested?

- Potential issuers: as NFTs may represent either digital or physical underlying assets, they open up huge opportunities for monetisation in the creative sector. Although most NFT activity has been seen in the creative, sports, gaming and fashion sectors, we anticipate issuances across the broader retail sector.

- Investors: NFTs make establishing provenance and traceability of assets much easier, making assets such as digital works of art easier to buy, sell and trade and broadening access to new asset classes.

- Financial institutions: Trading in NFTs could one day be facilitated or engaged in by financial firms (acting as intermediaries or on their own behalf), mirroring the role they play in markets for more conventional forms of investments or property. As the market for NFTs develops and regulation evolves, regulated firms may seek to offer specialist intermediary services to help the market develop.

Asking the right questions

Understanding the legal and regulatory issues is critical before deciding whether to issue, purchase or deal in NFTs. Here are some questions to consider:

Are there any licensing requirements?

Most jurisdictions do not yet have legislation or regulations specifically applicable to NFTs, but a host of existing regulations may still apply. This will depend on:

- the token's characteristics and features;
- the activities performed in respect of such token; and
- the territorial scope of the particular regulatory framework.

For example, in the UK, the Money Laundering Regulations 2017 define cryptoassets as "*a cryptographically secured digital representation of value or contractual rights that uses a form of DLT and can be transferred, stored or traded electronically*", and set out activities that, when performed in respect of cryptoassets, trigger a registration requirement. Where NFTs meet this definition, exchanging them for cash or other cryptoassets or making arrangements for others to do so, would trigger a registration requirement. Where an NFT does not qualify as a cryptoasset, for example because it does not represent value or contractual rights, the regime does not apply to it.

Regulatory regimes vary significantly globally, so it will be necessary to analyse the regulatory position in each jurisdiction where the NFT is issued, marketed and where key participants are based.

Are there any tax implications?

Whilst tax authorities globally have made progress in considering and issuing guidance on the taxation of cryptocurrencies, the tax treatment of other cryptoassets, including NFTs, remains unclear. Most jurisdictions consider cryptoassets to be property for

tax purposes, but, without detailed legislation or guidance, their precise tax treatment requires consideration of existing tax rules and an attempt to fit a given cryptoasset within the most appropriate regime. This means looking at a variety of factors including the nature of the cryptoasset, what it represents, its intended use and whether any analogies can be drawn from the relevant jurisdiction's existing approach (if any) to taxation of cryptocurrencies. This can give rise to considerable complexity and uncertainty.

The exercise becomes particularly challenging when considering NFTs. By way of example, if I sell my NFT to you, questions will need to be asked to ascertain the tax treatment, such as:

- What exactly is being sold and why? Is it the underlying asset (and if so, is that underlying asset an intangible asset, a financial instrument, a physical asset, or something else), is it certain limited rights in the underlying asset, or are such rights so limited that the asset being sold amounts to no more than the NFT itself? Capital gains taxes, income taxes, VAT/sales taxes and/or transfer taxes may be relevant depending on the answers.

- If the sale falls within deemed market value rules, how do we go about valuing the NFT in a potentially illiquid market when it is supposed to represent something unique, and may in fact merely confer the status of owning the NFT itself without any meaningful rights in an underlying asset?

- Which jurisdiction(s) get to claim taxing rights? Are NFTs located where the beneficial owner of the NFT is resident, as is generally the approach taken with respect to cryptocurrencies, or might they be located in the jurisdiction of the underlying asset (and is it straightforward to work out where that is if the underlying asset itself is digital)?

- What happens if the underlying asset is later hacked, duplicated, counterfeited, destroyed or deleted, or the link between the NFT and the underlying asset is broken? Will the purchaser be able to claim a loss for tax purposes?

Given all of this complexity, coupled with the decentralised and anonymous nature of cryptoassets, we expect that a significant proportion of transactions involving NFTs and other cryptoassets remain unreported and untaxed. Tax compliance and evasion risks with respect to NFTs and other cryptoassets have largely remained unexplored to date.

However, cryptoassets in general are becoming more mainstream, and NFTs in particular are very much in the public eye by virtue of being associated with celebrities, sports teams and eye-watering sale prices. The OECD is developing proposals around effective reporting and information exchange for cryptoassets, potentially making exchange platforms responsible for compliance in addition to taxpayers. Tax, and tax compliance, is therefore likely to become more complex for those issuing and arranging NFTs.

Are there any resale rights implications?

In the UK and the EU, the Artist's Resale Right (ARR) ensures that creators of original pieces of physical artwork receive a small percentage of the sale price whenever their work is resold by qualifying intermediaries, for example by way of auction or dealership. ARR is unlikely to apply to artwork sold by way of NFTs and so creators may be concerned that NFTs offer a way to avoid ARR.

One of the benefits of NFTs issued on DLT platforms that utilise smart contracts is that the commission process can be automated. By incorporating royalty obligations in the smart contract that accompanies the NFT, artists can ensure that they have similar protection to that provided by ARR.

In jurisdictions where the law does not recognise resale rights relating to creative works and contractual provisions have traditionally given an alternative recourse, smart contracts that automate royalty payments could help bypass such limitations.

However, some NFT marketplaces only function on specific types of DLT, which means that automated royalty payments might only take place when the NFT is

The Nyan Cat meme

The minting of an NFT linked to the Nyan Cat meme provides an example of a content producer commercialising their work via an NFT drop (the act of offering the NFT for purchase).
The author of the original Nyan Cat meme minted a single NFT of a remastered version of the Nyan Cat meme. This NFT was purchased for around US$590,000 following a bidding war on the crypto art platform, Foundation. The purchaser of the NFT acquired the token, which is a record of ownership of the unique digital version of the meme. However, the copyright in the original meme was retained by its creator.

traded through the same platform it was issued on. Selecting the right platform is therefore a key commercial decision for the issuer to ensure it can enforce its royalties, together with inclusion of appropriate restrictions around resale. Similarly, analysis of the legal recognition and enforceability of smart contracts in each relevant jurisdiction is a crucial step.

What is the ownership status?

The purchaser of an NFT owns the token itself, which is a record of ownership of the unique digital version of the underlying work, so that when the NFT is transferred to someone else, the underlying digital version of the work is transferred with it. An NFT does not (unless stated otherwise) represent copyright ownership of the underlying asset. Copyright to the underlying work, or property rights in respect of a physical underlying asset, would only be transferred where specifically agreed (and validly assigned). In most of the NFT issuances to date, there has been a clear intention not to create ownership interests in the underlying asset. In this respect, purchasing an NFT is the same as purchasing a physical work of art, which rarely involves an assignment of copyright in the artwork.

By virtue of retaining the copyright in an underlying work, the original creator of an NFT retains the exclusive right to do certain acts in relation to the underlying work which are restricted by copyright, namely the right to make additional copies, distribute, display or sell the work to someone else. The purchaser of the NFT receives the token and, typically, the rights to use the unique digital version of the work for personal use and resell that copy of the work.

The scope of a purchaser's usage rights with respect to an NFT are determined by the conditions or licence terms attached to the acquisition of the applicable NFT, which will vary from token to token. The creator of the NFT or marketplace where it is acquired could therefore implement more permissive licence terms enabling the buyer of an NFT broader rights to exploit the unique digital version of the work acquired in connection with the respective NFT. Equally, creators should be mindful of the licence terms that any marketplace or platform offers to ensure that the creator is not ceding more rights to purchasers than expected.

While certain cryptoassets have been recognised as qualifying as "property" (rights "*in rem*") in some jurisdictions, the question of whether an NFT would be recognised by the courts as proof of legal title to a digital version of the asset to which it is linked remains open. Technically, the holder of an NFT simply has a unique set of numbers which amount to a token in their wallet, thereby granting the holder the ability to decide where or to whom the NFT should be transferred. Arguably, this creates factual control of the linked asset in a way akin to property rights. The logic is that when something like a picture, sound or text is attached to the NFT, the token proves that the digital copy of the underlying work is an authentic copy of the original work.

However, as discussed above, the NFT does not necessarily transfer copyright and therefore the scope of an NFT buyer's enforcement rights is unclear. This poses the question of whether the NFT owner can require the original creator to take steps against someone who has created unauthorised versions of the underlying content, and, if that counterfeiter in turn created a counterfeit NFT, who would or could take action. It also raises the question of what action can be taken by the purchaser of an NFT where the creator subsequently issues more versions of the NFT, thus increasing the availability of the asset (and therefore, in principle, reducing its market value).

Are there anti-money laundering (AML) concerns?

Physical artwork has been used as a tool for money laundering, given the potential for anonymous purchases of high value artworks to be made. However, its effectiveness is limited as physical art can be hard and expensive to transport and store. To the extent that NFTs are developed that provide an actual ownership interest in artwork, they would offer the benefits of purchasing physical art while resolving the problems of physical transportation and storage and therefore could represent serious AML concerns.

The Financial Action Task Force (FATF), the global standard setter in relation to AML, has recognised that NFTs may create opportunities for money laundering or terrorist financing and has called for further regulation, so we are likely to see international developments in this space in the coming months.

Whether NFTs fall within the scope of existing AML regulation will depend on local implementations of FATF guidance in relevant jurisdictions and the specific characteristics of the NFT in question. See page 8 onwards for highlights of the considerations across key global financial centres.

What are the practical considerations?

Data and storage

NFTs are hosted on a DLT platform, which typically does not enable storage of large files, such as digital assets. As a result, the NFT and its underlying digital asset are typically connected to each other via a link. If the digital asset is stored on a conventional server, there is a risk that the file could be changed or deleted, or the server could shut down, hence breaking the link between the asset and its corresponding NFT. Certainty of the reliability and security of the link and the server hosting the digital asset is essential. A more robust alternative is a distributed, decentralised storage system, but these are yet to be widely adopted.

Litigation risk

The usual risk of misrepresentation when selling digital assets will apply to NFTs. NFT issuers need to be clear with purchasers about the risk of market volatility leading to a complete loss in value for them. Whether NFT owners have any rights in relation to the underlying asset in such a case remains to be seen.

Environmental cost

The execution and validation of NFT transactions on a blockchain, particularly under the Ethereum blockchain which relies on proof-of-work validation, is computationally intensive and requires a large amount of energy. This type of validation is similar to the mining or creation of new Bitcoins, which Cambridge University recently found consumed more energy than the entire country of Argentina on an annual basis. Validating NFT transactions will continue to consume significant amounts of energy until more sustainable data centres and validation techniques are created at large scale. There is ongoing work around migrating Ethereum from "proof-of-work" to "proof- of-stake" validation, which is anticipated to considerably decrease the amount of energy required for validation. However, proof-of-stake validation raises separate network operation concerns, which may impact the overall anticipated reduction in energy consumption, including in relation to security, fairness, and transaction redundancy. Alternative platforms may offer issuers more sustainable solutions today. This will be a key consideration for potential issuers, advisers and purchasers who are focussed on reducing their environmental impact.

Reputational risks

Brand reputation is key for entities who have worked hard to build close ties with their fans, followers and supporters. The reputational benefits of being associated with a nascent technology need to be balanced against the risks such technologies inherently bring. If an issuer's NFTs or tokens significantly reduce in value, there is a great risk of brand devaluation. Equally, the issuer's brand could be affected by issues with the platform used to sell and trade the NFT, which may, in extreme circumstances, render the NFT worthless.

NFT issuers should also consider the risk of reputational damage by issuing NFTs on platforms that have a negative environmental impact, as set out above.

A GLOBAL ISSUE: WHAT ARE THE REGULATORS DOING?

NFTs are available and traded globally because DLT platforms operate beyond borders. Therefore, issuers, advisers and purchasers of NFTs will need to consider the legal status and regulatory frameworks across multiple jurisdictions.

There is very little global regulatory guidance as to whether NFTs fall within the perimeter of existing regulation applicable to cryptoassets.
Most jurisdictions have not yet developed regulatory frameworks specifically applicable to NFTs, although several have implemented or published plans to regulate DLT or cryptoassets more broadly. Liechtenstein is an exception, having established a law regarding the civil and supervisory framework for the tokenisation of rights in physical assets, which would cover certain NFTs.

Some highlights of international regulatory developments across key global financial centres are set out below.

European Union (EU)

- NFTs are not currently specifically regulated in the EU. However, the features of any proposed NFT issuance would need to be considered alongside various existing regimes, including in relation to securities, electronic money and crowdfunding, to ensure that these are not triggered.
- On 24 September 2020, the European Commission published the Markets in Crypto-assets Regulation (MiCA), which proposes to regulate currently out-of- scope cryptoassets and their service providers under a single licensing regime. MiCA is anticipated to take effect by 2024 and will apply to any person issuing or providing cryptoasset services across all Member States, as well as any non-EU firm seeking to trade in EU member states. One of the proposed obligations is that cryptoasset issuers would need to issue a prospectus-like "crypto-asset white paper". MiCA's definition of 'crypto-assets' includes NFTs – although, as currently drafted, issuers of non-fungible cryptoassets will not be required to publish a white paper.

Germany

- The German implementation of the 5th AML Directive (AMLD5) defined "crypto assets" as financial instruments within the meaning of the German Banking Act (KWG). Under the KWG, crypto asset means "*a digital representation of value that is not issued or guaranteed by a central bank or a public authority and does not possess a legal status of currency or money, but is accepted by natural or legal persons as a means of exchange or payment or which can be used for investment purposes and which can be transferred, stored and traded electronically*". The reference to being used for investment purposes is an expansion of AMLD5. As NFTs can, in principle, be used for investment purposes given their unique (value-creating) character, there are good arguments that NFTs may qualify as crypto assets and therefore as financial instruments under the KWG. In this respect, the underlying service in relation to an NFT (i.e. brokerage or trading-related activities) may trigger a licence requirement.
- Some NFTs may qualify as investment products under the German Capital Investment Act, which governs the public offerings of investment products that promise an interest payment, repayment of invested capital or a cash settlement in exchange for an investment of capital. Whether NFTs fall within this definition is a question of fact, subject to the characteristics of the particular token.

Italy

- Under the Italian implementation of AMLD5, the definition of "virtual currency" also encompasses digital representations of value which are not used as means of exchange but are held for investment purposes, as long as they are transferred, stored and traded electronically. In principle, NFTs could fall within the scope of such definition and trigger AML obligations.

- Some NFTs may also qualify as investment products under the Italian Consolidated Financial Act triggering additional licensing and other obligations. "Investment products" encompass MiFID instruments as well as "any other form of investment of a financial nature". The Italian regulator has clarified that an 'investment of a financial nature' is one entailing all of the following: (i) a capital disbursement; (ii) the expectation of a financial gain; and (iii) the assumption of a risk directly linked and correlated to the capital disbursement. An NFT's features would need to be carefully considered to see if it would meet these conditions.

Japan

- In Japan, while fungible tokens are regulated as security tokens or cryptoassets under the financial regulations, and dealing with them triggers certain licensing requirements, the non-fungible nature of NFTs means that they usually do not have a settlement function and therefore will not qualify as regulated cryptoassets.
- As a result, many NFTs are not specifically regulated, and dealing with them does not trigger any licensing requirements. NFTs linked to trading cards or in-game items recorded on the blockchain are most common in Japan, primarily because the Japanese online gaming market is one of the biggest and most mature globally.
- Despite not being caught by specific financial regulations, NFTs issued as in-game items do raise issues in relation to the Act Against Unjustifiable Premiums and Misleading Representations and gambling crime under the Criminal Code. Therefore, recently the Blockchain Contents Association and the Japan Cryptocurrency Business Association have each formulated guidelines concerning NFTs.

Luxembourg

- NFTs are not currently specifically regulated in Luxembourg. However, depending on the features and purpose of an NFT, certain activities in respect of such NFT could fall within one or more of the existing regulatory frameworks:

  1. Where an NFT qualifies as a financial instrument, a number of activities including the buying, selling, intermediation as well as certain ancillary services in respect of such financial instrument may trigger a licensing requirement as an investment firm. Additionally, any other related financial sector activity performed in Luxembourg (e.g. custody or lending of financial instruments) may trigger licensing requirements and create certain regulatory and prudential obligations.
  2. Where an NFT qualifies as electronic money, the issuer may trigger a licensing requirement as an electronic money institution and be subject to ongoing obligations, including conduct of business rules.
  3. The issuance of NFTs which qualify as units of a collective investment undertaking could trigger a licence requirement as an undertaking for collective investment for the issuer or its management company under the relevant Luxembourg investment funds and AIFM laws and regulations.

- Pursuant to Luxembourg's AML legislation as adapted following AMLD5 and relevant FATF guidance on virtual assets, a virtual asset means "*a digital representation of value (including a virtual currency), that can be digitally exchanged, or transferred, and can be used for payment or investment purposes*" with the exception of virtual assets which constitute electronic money or financial instruments. It is possible that certain NFTs may fall within this definition.
- Firms who are established or provide services in relation to virtual assets in Luxembourg, including exchange, transfer, safekeeping and administration and the participation in and provision of financial services related to an offer of virtual assets, are subject to a registration requirement as a virtual asset service provider with the Commission de Surveillance du Secteur Financier and must comply with relevant AML obligations.

- Commercial activities not subject to a sector-specific regime and carried out with a profit-making aim in Luxembourg may trigger a general business licence requirement.

The Netherlands

- NFTs are not currently specifically regulated in the Netherlands. However, certain activities in respect of certain cryptoassets (depending on their features) could fall within one or more of the existing regulatory frameworks:

  4. where an NFT qualifies as a financial instrument (e.g. as shares, bonds, units in collective investment schemes, or derivatives), the buying, selling, intermediation and certain ancillary services in respect of such financial instruments may trigger a licensing requirement as an investment firm (*beleggingsonderneming*);

  5. where an NFT qualifies as electronic money (*electronisch geld*) in circumstances where it represents a claim on the issuer for pre-paid electronic spending power, the issuer may trigger licensing requirements as an electronic money institution (*elektronischgeldinstelling*);

  6. where an NFT qualifies as an investment object (*beleggingsobject*), which is defined as "*an item or object, a right to an item or object or a right to the full or partial return in cash or part of the proceeds of an item or object, (…) that is acquired other than for no consideration (e.g. for payment in kind), with the prospect of a return in cash and where the management of the object is mainly carried out by someone other than the acquirer*", the offering and intermediation in respect of such investment object may trigger a licensing requirement as a financial service provider (*financiëledienstverlener*); and

  7. where an NFT qualifies as a "virtual currency", which is defined in the Dutch implementation of the AMLD5 as "*a digital representation of value that is not issued or guaranteed by a central bank or a public authority, is not necessarily attached to a legally established currency and does not possess a legal status of currency or money, but is accepted by natural or legal persons as a means of exchange and which can be transferred, stored and traded electronically*", the activities that amount to (i) exchanging virtual currencies into cash, or vice versa, or (ii) safeguarding private cryptographic keys on behalf of its customers to hold, store and transfer virtual currencies may trigger registration requirements in the Netherlands.

People's Republic of China (PRC)

- Activities relating to cryptocurrencies and cryptoassets are strictly regulated and scrutinised in the PRC. Despite the absence of a unified regulatory framework, rules in respect of cryptoassets are scattered in ad hoc notices and circulars issued by the PRC financial regulators, as well as self-discipline organisations. The milestone regulation in this area is the Circular on Preventing Risks related to Initial Coin Offerings (ICO) (2017) issued by seven Chinese governmental agencies (including the PRC's central bank, the People's Bank of China) in September 2017 (the ICO Circular). The ICO Circular marked an unprecedented regulatory clampdown on cryptoassets which has been sustained in practice; since 2017 we have seen supervisory and enforcement actions taken in respect of crypto-related activities.

- In May 2021, the National Internet Finance Association of China, the China Banking Association and the Payment and Clearing Association of China issued a joint statement reiterating the position in the ICO Circular that their member institutions (including banks and payment firms) should not offer any crypto-related services in the PRC. The statement also set out further specific restrictions and risk alerts, including around cryptocurrency exchange, investment and trading.

- However, there is no clear-cut definition of cryptocurrency or cryptoasset under the laws of the PRC and whether an NFT qualifies as such may require a "substance over form" analysis. If NFTs

are created for fundraising, the relevant regulatory risks would be high. Likely post-issuance activity may also be relevant when evaluating potential risks in relation to any NFT.

- Notwithstanding the above, neither the ICO Circular nor other regulations explicitly prohibit a PRC resident from trading or investing in NFTs, but only remind people of the relevant risks associated with cryptoassets.

Russia

- Russia has recently finalised its legal framework regulating cryptoassets. It does not currently specifically refer to NFTs, but distinguishes between:

  1. **digital utility rights**, defined as digital rights to request the: (i) transfer of tangible assets; (ii) transfer of intellectual property rights, or (iii) carrying out of works and/or provision of services;
  2. **digital financial assets,** defined as digital rights including monetary claims, the possibility of exercising rights under securities, the right to participate in the capital of a non-public joint-stock company, the right to demand the transfer of certain digital securities; and
  3. **digital currencies,** defined as a combination of electronic data: (i) contained in the information system; (ii) capable of being offered and/or accepted as a means of payment and/or an investment; and (iii) in respect of which there is no person obliged towards every holder of such electronic data, save for operators and users responsible for issuance and making entries to the information system in accordance with its rules.

- Depending on the characteristics of a particular NFT, it may fall within one of these categories, or be considered as an asset sui generis. In either case the specifics of issuance of or trading in the NFT and the related regulatory, legal and tax implications would need to be analysed on a case-by-case basis, depending on the characteristics of the NFT and the underlying asset to which it is linked.

Singapore

- NFTs are not currently specifically regulated in Singapore. The regulatory approach has been to look beyond a token's label and examine its characteristics. If such characteristics fall within an existing regulatory framework, the NFT will be subject to regulation under that existing framework.

- Generally speaking, there are three types of digital tokens – security tokens, payment tokens and utility tokens. If an NFT is determined to be a type of security token (i.e. it exhibits the characteristics of securities, such as conferring or representing a legal or beneficial ownership interest in a corporation, partnership or limited liability partnership), it may be subject to the regulatory regime governing securities. This may include complying with the offering regime for an offer of securities and the licensing requirements for dealing in securities.

- If an NFT is determined to be a type of payment token (i.e. it is structured to function as a medium of exchange as payment for goods or services), it may be regulated under the Payment Services Act 2019, which governs the provision of payment services (which includes a "digital payment token service"). Currently, the scope of regulation for "digital payment token service" extends to dealing in digital payment tokens or facilitating the exchange of digital payment tokens. A person who carries on business in such activities triggers the licensing requirements under the Payment Services Act 2019, unless a relevant exemption applies.

- If an NFT is determined to be a type of utility token (i.e. it is used to access a good or service and does not fall within the former two categories), it may be unregulated.

United Arab Emirates

- The recently introduced Crypto Asset Regulations in the UAE, issued by the Securities and Commodities Authority with the support of Clifford Chance, are designed to capture cryptoassets which are securities or are otherwise traded on an exchange (a "regulated

commodity token). "Crypto assets" expressly include a DLT record serving as a representation of ownership. Therefore these regulations will only apply to the extent NFTs become tradable through a digital assets exchange, and such NFTs are promoted or offered (or associated with other financial activities conducted) within the UAE. It is unlikely in the near term that NFTs listing on digital assets exchanges will be practical given their unique and non-fungible nature. Where an NFT is subject to a brokerage arrangement or peer to peer transfer (whether organised through an online platform or not) – this is unlikely to be an "exchange" to which the current UAE rules are intended to apply. Notwithstanding the above, it remains possible that activities in the UAE in respect of NFTs (including for example, brokerage) will be subject to AML compliance responsibilities, which would need to be assessed depending on the nature of the underlying asset and the size of the transaction.

- The Abu Dhabi Global Market (ADGM), a growing financial free zone in the UAE, has become a leading regional zone for virtual assets business. The ADGM has developed its own regulations on "virtual assets" and it licenses firms to conduct regulated activities in respect of virtual assets separately to other parts of the UAE. However, again, these rules are unlikely to apply in respect of NFTs. The definition of a "virtual asset" refers to a digital representation of value that can be digitally traded and functions as (1) a medium of exchange; and/or (2) a unit of account; and/or (3) a store of value. Unlike the UAE rules, this does not expressly include a "representation of ownership". Therefore NFTs are arguably not captured. However, to the extent a particular NFT is determined a constitute a virtual asset, the ADGM's Financial Services Regulatory Authority only permits firms to conduct activities in respect of "Accepted Virtual Assets" – which must satisfy a number of criteria (including maturity and market cap). These criteria are unlikely to be satisfied by NFTs.

UK

- NFTs are not currently specifically regulated in the UK. However, certain activities in respect of certain cryptoassets (which may include an NFT depending on its features) could fall within one or more of the existing regulatory frameworks:

  1. where cryptoassets qualify as regulated investments (such as shares, bonds, units in collective investment schemes, or derivatives), the buying, selling, intermediation and certain ancillary services in respect of such regulated investments would trigger a licensing requirement and ongoing conduct of business obligations;

  2. where the cryptoasset qualifies as electronic money in circumstances where it represents a claim on the issuer for pre-paid electronic spending power, the issuer will trigger licensing requirements and ongoing conduct of business obligations;

  3. under the UK's AML legislation, cryptoassets are defined as "*a cryptographically secured digital representation of value or contractual rights that uses a form of DLT and can be transferred, stored or traded electronically*", and activities that amount to converting cryptoassets to other cryptoassets or cash into cryptoassets would trigger registration requirements. Such regulatory requirement is also triggered by intermediating or arranging such exchanges.

- Whether an NFT qualifies as a cryptoasset under the UK's AML legislation requires careful consideration, particularly if, based on its characteristics, it amounts to a representation of value or contractual rights.

- There are various proposed regulatory changes currently being consulted on in the UK, including around the regulatory perimeter applicable to cryptoassets and stablecoins and extending the scope of the financial promotions regime to apply to currently out-of-scope cryptoassets which might impact NFTs.

US

NFTs are not currently specifically regulated in the US. Thus, the legal status and regulatory classification of NFTs under US law remains unclear. However, as with other cryptoassets, the features of an NFT and how it is marketed and purchased or sold could cause an NFT to fall under existing US federal regulatory frameworks. The following key points should be considered:

- From a US securities law perspective, pieces of memorabilia and collectibles are not ordinarily considered to be a "security" standing alone. However, an NFT marketed as a financial investment whose holders have been led to expect profits from an entrepreneurial venture involving the NFT, or the managerial skills of the NFT's promoter, is more likely to be deemed to be part of an "investment contract", which is a type of "security" that is subject to US securities law. While no US federal regulator has taken enforcement action against an NFT issuer to date, we have seen private litigants filing civil class actions against NFT issuers alleging that the issuance of their NFTs constituted an unregistered securities offering under US law. Class action suits can be expensive to defend even where claimants are ultimately unsuccessful.
- The Financial Crimes Enforcement Network (FinCEN) and the courts have yet to issue specific guidance on NFTs. From a US anti-money laundering standpoint, whether an NFT can be characterised as a "medium of exchange" and ultimately as a "convertible virtual currency" under US law is not entirely clear at present. NFTs that are truly non-fungible should not be considered a medium of exchange or convertible virtual currency because, unlike Bitcoin or other virtual currencies, most NFTs are not designed or intended to serve as a currency substitute or medium of exchange. However, the situation could change – for example, if certain NFTs are actively traded and come to have an established value at which they can readily be converted to currency. In the case of intermediaries who facilitate NFT trading but also engage in other activities that are subject to established regulation, this argument may have less force. Recent changes to the Bank Secrecy Act included in the Anti-Money Laundering Act of 2020 (the 2020 Act) amend certain definitions to include businesses engaged in the exchange or transmission of "currency, funds, or value that substitutes for currency" as financial institutions that are subject to AML regulatory requirements.
- US federal regulators could also interpret anti-money laundering regulations governing dealings in "antiquities" or "art" to cover NFTs. The 2020 Act amended the Bank Secrecy Act's definition of "financial institution" to include persons engaged in the trade of antiquities, and directs FinCEN to promulgate implementing regulations. The 2020 Act also instructs the Treasury and other agencies to perform a study of the facilitation of money laundering in the trade of works of art, and report to Congress in January 2022 to inform the debate over whether to extend AML regulatory requirements to art dealers. The impact such actions will ultimately have on NFTs, if any, is not known at present.
- US federal sanctions laws may also be relevant to the issuance, purchase, and sale of NFTs. NFT transactions can occur between counterparties located anywhere in the world. Thus, US and certain non-US persons transacting in NFTs, and NFT dealers in particular, should ensure compliance with regulations issued by the US Office of Foreign Assets Control prohibiting business dealings with certain persons, as NFTs of any value could be used to evade US sanctions.

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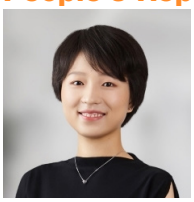

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