

Podcast – NFTs: a global view on what they are, how they're regulated, and more

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Ben: Hello and welcome to this Allen & Overy podcast on non-fungible tokens, or NFTs. NFTs have become a global phenomenon over the past 12 months, emerging everywhere from fine arts to professional sports and music to social media and even to politics. My name is Ben Regnard-Weinrabe and I help lead A&O's global Fintech and Crypto Practice. In this podcast I am joined by Bella Karlsson in our Silicon Valley office, Andre Da Roza in Hong Kong and Louise Utting in London to talk about what NFTs are, why they are generating so much interest, and some of the things to watch out for.

So Bella, can you start by telling us what a non-fungible token really is?

Bella: Sure Ben, the short and technical answer is that an NFT is a unique cryptographic token that has attached metadata issued on a blockchain. The metadata often contains a hyperlink to digital content. To explain further we can think of an NFT as typically having four basic components. The first component is the token itself, think of it as a verifiable signature. The token is recorded or "issued" on a blockchain. Anyone can view what address minted the token and who else owned the token previously.

The second component is the associated metadata. This can be a piece of computer code that can create an image or a hyperlink to content hosted online such as an MP3 audio recording, a graphic or image or text. For example Jack Dorsey's first tweet which he sold as an NFT.

The most common type of metadata is a hyperlink to the digital content. However there are notable pixel art projects and generative art projects that contain the code for the content within the token's metadata itself. This is so-called "on-chain" art.

The third component of an NFT is the smart contract, which is not a contract at all, but rather a series of automatically executable instructions associated with the NFT, or to put it another way, a set of rules that govern how the token can behave or interact with the blockchain. For example, a smart contract can instruct that upon the sale of the NFT, a royalty of 5% of the sale price automatically goes to the creator of the NFT.

The fourth component is the contract or promise that comes with an NFT's issuance, commonly found in the terms of use for the platform through which the NFT is issued or sold. This is not a technology element, rather we're talking about a promise by the issuer of the NFT which gives the token its value. It might be, for example that the issuer undertakes not to issue another NFT with the same content or promises that the token holder can enjoy, perform, exploit or sell the content. Arguably this layer is the most important but the least understood.

Ben: Thanks Bella. That's clear as to the typical nature of an NFT. May I now turn to you, Andre, to describe the players within the burgeoning NFT ecosystem?

Andre: Thanks Ben. The NFT ecosystem is a global one that's developing rapidly but nonetheless, has some identifiable key features.

Firstly we have content creators, be they musicians, artists, influencers, gamers or related companies in those sectors - these are the people who produce content which goes into the NFTs.

Then there are issuers and marketplaces. In principle anyone can use open source software to issue an NFT to, for example, their Ethereum wallet and then sell it, but often creators use platforms like OpenSea or Rarible to issue and then market their token, as these are the venues where most trading activity occurs.

NFTs are of course issued on a blockchain, so at the core of the market are blockchains like Ethereum, Solana and Flow.

Finally, on the buy side there are individuals like you and me, who just want to own NFTs as well as institutional buyers who want to resell NFTs or fractionalise them.

Ben: Thanks Andre. We'll come back to fractionalisation but first it would be helpful to understand how NFTs are regulated. Louise - the broader crypto ecosystem has for some time been attracting considerable attention from regulators. Is that also the case for NFTs specifically, perhaps you can start with the regulatory environment in the UK and Europe?

Louise: Thanks Ben. I'll give some thoughts on the applicability of the UK and EU level anti-money laundering and financial services regulatory regimes.

The UK and EU money laundering regimes apply to certain cryptoassets service providers, notably certain exchanges and custodians.

In the UK a crypto asset is defined as a cryptographic re-secured digital representation of value or contractual rights that uses a form of distributed ledger technology and can be transferred, stored or traded electronically.

Where an NFT satisfies this definition, it is likely to turn on whether it's a representation of contractual rights. On the one hand, as Bella explained, an NFT tends to come with contractual rights but on the other hand, such contractual rights may arguably be collateral to, rather than part of, the NFT and it seems unlikely that the UK legislation would, at the time it was drafted, have had NFTs in mind.

It's therefore debateable as to whether an NFT would constitute a representation of contractual rights so as to fall within the scope of the UK money laundering regime. In our view given the UK regime appears to have been deliberately widely drafted, there is a real possibility that an NFT would be deemed to fall within scope.

As regards the EU level regime, although the UK implemented the EU cryptoasset money laundering regime, the UK went beyond the EU Money Laundering Directive which is limited to virtual currencies and so we think it unlikely to cover NFTs.

As regards the application of the financial services regulation, a basic NFT that simply grants an individual licence to enjoy content is unlikely to be regulated at present in the UK or the EU.

However, if other types of right attach to an NFT, they would need to be reviewed to identify whether they might give rise to, for example, securities regulation.

Furthermore, certain EU countries such as France, have purely domestic cryptoasset regimes not deriving from EU legislation which would need to be considered or, as the UK has done for money laundering, their regimes may more expansively implement or interpret EU legislation.

Finally, looking into the future, based on current proposals, we don't anticipate basic NFTs being brought within the future regulation of the UK or EU levels. Of course, this would need to be monitored because the appetite for regulating NFTs may quickly evolve depending on their uptake and emerging risks.

Ben: Many thanks Louise for that overview on the regulatory landscape in the UK and EU. Andre, is there a clear and consistent approach to regulation of NFTs in the APAC region?

Andre: Unfortunately, the answer is no Ben. There are different approaches across APAC jurisdictions when it comes to regulating digital assets but so far the attention has been on the crypto exchanges and crypto trading. It's not even clear whether NFTs come within relevant definitions. For example in Hong Kong, part of the definition of "virtual asset" requires it to function as a "medium of exchange accepted by the public as payment for goods or services or for the discharge of the debt or for investment purposes". It's unclear whether NFTs satisfy this definition, in particular whether they could be viewed as a medium of exchange accepted by the public for investment purposes although we'd argue probably not.

It's also a bit of a grey area in mainland China. Whilst there is a general ban on crypto currencies, there's an active local NFT market but which, when marketed, tends to downplay the financial, investment and re-sale aspects of the NFTs. So for the moment it seems that NFTs are not in the regulatory spotlight in China just yet.

Ben: Many thanks Andre. Turning now to the US – Bella, what are your thoughts?

Bella: From a regulatory perspective, there hasn't been much action yet in terms of enforcement and there is uncertainty. What we can see is that an NFT in itself, without any promises of profit, does not necessarily follow squarely within the definition of a security. However with certain innovations in this space, such as for example, fractionalisation or platforms rewarding collectors aside from an eventual appreciation, these types of structures may be tending closer to what is considered a security.

Amongst other things that entities in this space need to have in mind is the trade sanctions aspects. Since geo-fencing may be difficult or even impossible depending on the set up of the platform.

Ben: So it sounds like regulatory compliance is potentially a tricky issue for anyone operating in the NFT space and particularly given that the eco system is so global in nature. Aside from regulation, what else should firms and individuals watch out for in the NFT space Bella?

Bella: The question of how intellectual property is bundled together to be tokenised deserves a podcast of its own.

If someone is buying from a major platform, an IP license will often be found in the terms of service of the platform, conveying for example a limited right to the buyer to display the NFT content on their social media and to be able to sell the token on a marketplace. Many projects in the space also utilize creative commons licenses, and at times creation of derivative works is directly encouraged.

What is important for the creators of NFTs to have in mind is that a creative commons license does not confer these rights only to the token holder, it allows anyone to use and redistribute the content as long as they follow the license.

We are also seeing NFT-specific open source licenses growing in popularity in the space, such as the NIFTY license, which conveys limited IP rights to the token holder, such as being able to commercialize the content of the NFT up to \$100,000.

With the rise in popularity of on-chain generative art, meaning that the art is generated from code on the blockchain, we will likely also see licenses that distinguish between the underlying code and the artwork itself in the future.

In the NFT space there is also an increasing trend of decentralization, meaning that artists and brands are, with the help of different blockchain services, deploying their own smart contracts. What is important to keep in mind for these players is that they need associated terms with the sale of the tokens, the smart contract not being sufficient in and of itself.

Additionally, depending on the type of content associated with the NFT, it can get more complex. For example, if I'm a music producer wanting to issue an NFT of a performance, I might need to engage with the artist's image, whoever produced the cover art, and of course the holder of the publishing rights and license to the music and its distribution, all of which might be held by different people and subject to existing prior contracts. And that's before we even consider how to collect royalties in the blockchain context! Are you seeing anything similar in the UK Louise?

Louise: Thanks, Bella. From a European perspective, that's part of an often broader uncertainty as to what rights attach to an NFT. There's little uniformity today, NFTs seem sometimes to create licences to IP, but sales frequently come as ownership without being clear as to what the token holder is in fact getting and whether the issuer is even entitled to give this. The nature of an NFT is important for buyers to understand and also for platforms and exchanges to consider.

These structuring points can also potentially have an impact on whether NFTs fall within financial services regulation. Following on from this theme, I think Andre was going to touch on fractionalisation.

Andre: Thanks Louise. Yes fractionalisation is the process of taking an NFT, which can't be split into smaller pieces, and sending it to a private key address called a smart contract which you've pre-programmed to issue a number of fungible tokens that give the holder a right to a portion of their NFT, locked in the smart contract. You've essentially securitised an NFT and the process has a lot of parallels with creating units in a collective investment scheme.

Ben: Thank you. This has been a helpful overview of NFTs and some of the big issues they raise. To conclude, it sounds like the NFT space is dynamic and potentially presents a number of

opportunities but with a variety of risks as well as legal and regulatory pitfalls to watch out for across numerous jurisdictions.

Thanks so much to Bella, Andre and Louise for speaking and to you for listening and as always, do contact us if you'd like to know more and please look out for our next podcast on NFTs.