



Non-fungible Tokens

Legal and Economic considerations – A European Perspective
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Agenda

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- Intellectual property rights
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Introduction

- NFTs are tokens that represent a unique asset on a distributed ledger (e.g. a blockchain)
- The underlying type of asset can be both, natively digital (images, videos, digital authenticity information of a particular good – e.g. of a luxury watch – other type of digital content) or physical (paintings, cars or other tangible, real world assets)
- Tokens are technically a set of information recorded on a blockchain that represent the digital or physical asset
- Once the NFT has been minted, it can become a proof of entitlement to the underlying asset (which however cannot be per se equated to the legal ownership over this asset) via the private key linked to the token

The following legal and economic assessment provides an extensive but not exhaustive overview and focusses on current EU and German legal frameworks in force which are however subject to ongoing regulatory changes. This assessment shall therefore by no means be construed as an anywhere near final (legal or economic) assessment of NFTs!

Characteristics of NFTs

- Non-fungibility and non-interchangeability of the unique, originally indivisible underlying asset (whether tangible or not). Token itself is (in most cases) transferable
- Concept of fungibility: ability of a good or asset to be interchanged with other individual goods or assets of the same type
 - An asset will likely be considered "fungible" if it is - quantitatively and qualitatively – replaceable, i.e. can be substituted with an identical asset (e.g. fiat money, Bitcoin, etc.)
- An asset can be therefore considered to be “non-fungible” if it cannot be exchanged for precisely the same amount of the same type because its uniqueness and different characteristics
 - A physical painting on canvas is a unique piece as there exists no other identical painting (every duplication or copy will likely be considered as a new (unique) asset)
- Fractional parts of an NFT could be considered not to be unique if they do not represent a particular piece of that asset and thus "fungible" (however to a limited extent)

Intellectual property rights

- Intellectual property rights bestow the owner of an intellectual work with rights to protect such work i.e. from use and commercialization by third parties
- An NFT is rather a certificate of authenticity such that it verifies – designed and intended to be tamper-proof – that the owner of the NFT is the owner of and has access to a unique digital piece of work written on the NFT which might be protected by intellectual property as well as the transaction history of such ownership and the NFT does not convey security-like rights
- It remains open whether and what type of rights of use the parties may have intended to agree upon with the sale of an NFT even if no specific agreement was concluded and how the process of creating an NFT is characterized legally

European legislation and taxonomic considerations (1/2)

MiFID II (Directive 2014/65/EU)

- MiFID II is not only in itself a complex regulatory framework for certain types of financial instruments and services/activities but serves also as a linking point for other EU financial directives and regulations
- Most forced and discussed questions: *Are NFTs “securities” within the ambit of MiFID II?*
- A NFT which merely serves as a pure digital representation of one underlying asset will likely not meet the definition of “transferable security” because it is not fungible and changeable due the uniqueness of the underlying asset
- In contrast: Fractionalized NFTs may already qualify as transferable securities within the ambit of MiFID II as they may be regarded as fungible (depending on the right linked to this fractionalized NFT)

European legislation and taxonomic considerations (2/2)

Markets in Crypto Assets Regulation (MiCAR)

- MiCAR introduces a new, independent definition of "crypto-assets":
“a digital representation of value or rights which may be transferred and stored electronically, using distributed ledger technology or similar technology”
- (Current draft) MiCAR provides for an exemption as regards the requirements to draw up and publish a crypto-asset white paper for those crypto assets that are unique and not fungible with other crypto-assets
 - This exemption applies however to crypto assets as defined by Art. 3 (1) no. 2 MiCAR and can therefore not be taken as an ultimate answer to the initial question whether NFTs can be classified as crypto assets under MiCAR
- It is currently not entirely clear whether NFTs fall in scope of the current draft MiCAR given the broad definition of crypto assets

Economic considerations and valuation (1/2)

ECB's approach on crypto assets

- ECB defines crypto assets as *“a new type of asset recorded in digital form and enabled by the use of cryptography that is not and does not represent a financial claim on, or a liability of, any identifiable entity”*
- Crypto-assets are not to be considered as virtual currencies or digital currencies and shall not qualify as a financial instrument under MiFID II
- ECB (2019) concludes: crypto-assets risks/implications for financial stability, monetary policy, and payments and market infrastructures are limited and/or manageable within the current framework. However, risks re laundering/terrorism financing and consumer protection
- Given that the definition of crypto asset is quite broad, it could arguably also include NFTs
- ECB however clarifies that the mere digital representations of existing assets referred to as "tokens", which allow recording these assets by means of a different technology are not in scope of ECB's definition of crypto assets and that the same technology-neutral rules and legal provisions shall therefore apply

Economic considerations and valuation (2/2)

Developments and valuation

- At the current stage, NFTs do not have the same liquidity as other types of investment products
- Challenges in valuation of NFTs result from persistent uncertainty about their economic and legal nature
- Rarity, utility and tangibility may serve as evaluation criteria
- Another approach may be a valuation of an NFT according to the so-called „valuation theory“

German supervisory law implications (1/2)

Crypto Assets

- Germany is one of the first EU jurisdictions that introduced a definition of "crypto assets" under its financial regulatory law
- Pursuant to Sec. 1 (11) sent. 4 of the German Banking Act (KWG), a crypto asset is defined as *“a digital representation of value which has neither been issued nor guaranteed by a central bank or public body, does not have the legal status of currency or money but, on the basis of an agreement or actual practice, is accepted by natural or legal persons, as a means of exchange or payment or serves investment purposes and that can be transferred, stored and traded by electronic means”*
- Fungibility is not explicitly mentioned as a prerequisite for the definition of crypto assets
- Uncertain when a pure digital representation (e.g. of a sneaker) "tips over" to an asset with an investment purpose in a legal sense
- Whether NFTs qualify as a crypto asset under the KWG depends, amongst others, on the specific nature of the NFT in question and its particular features linked to it

German supervisory law implications (2/2)

Investment Product

- Certain financial instruments which do not fall within the ambit of MiFID II or the German Capital Investment Code (KAGB) may however be covered by the German Capital Investment Act (VermAnlG)
- Investment products are financial instruments pursuant to the KWG and commercial dealings which such products may therefore trigger authorization obligations and prospectus requirements
- Depending on the specific features in the individual case certain NFTs may (already) fall within the ambit of the VermAnlG
- However, from a German supervisory law perspective no definite regulatory classification can be made at present due to the different types of NFTs and the lack of further guidance given by the German legislator and BaFin

Conclusions

- Some fractionalized NFTs may qualify as “securities” and may accordingly be within the ambit of MiFID II
- It is currently not entirely clear whether NFTs fall in the scope of the current draft MiCAR given the broad definition of crypto assets
- Risks are related to valuation and related to intellectual property rights
 - The current legal framework does not address all intellectual property issues in regard to NFTs, their issuance and their trade
- German perspective as example jurisdiction:
 - While it is still not entirely clear whether NFTs qualify as a “crypto asset” under the KWG, some NFTs may already be classified as an investment product under the VermAnlG

Thank you