The uncertain regulatory status of NFTs

Authors:
Zeina Zoghbi, Regulatory Expert at The Tokenizer
Michael Juul Rugaard, CEO & Co-Founder of The Tokenizer

Published by The Tokenizer, April 2023

Contents

NFTS and Securities **3**

Possible legal implications 4

What is a security token - and a security? 4

A European perspective 5

The US approach to securities 6

The Howey Test on NFTs 7

US law firm's opinions 10

Some common understanding 11

MiFID II and NFTs 12

A tangible NFT example: Damien Hirst's The Currency 14

NFTs and Delinquency **18**

How susceptible are NFTs to crime? 18

A - Infringements specific to the digital world 19

Phishing scams 19

Rug pulls 20

Ponzi schemes in the NFT space 20

B - Common offences that apply in the NFT ecosystem 20

Intellectual property infringements 20

Tax evasion 20

Money laundering 21

Regulatory treatment of NFTs **23**

A - Potential leads to follow in terms of regulation 23

B - How to manage money laundering and illicit activities risks? 24

Conclusions **26**

Seen from a legal perspective, when is a non-fungible token just a harmless representation of an asset, and when is it about to become something else that might catch the attention of regulatory authorities and put demands and restrictions on the parties involved in the NFT?

This is a question that more token issuers in the NFT space should pay attention to - even though it's currently not easy to find a straightforward answer. This is all about NFT and securities legislation, and we will cover that in the first part of this report.

The second part takes a closer look both from an issuer and an investor perspective at NFTs and delinquency in terms of fraudulent activities, money laundering (AML/KYC), and taxation issues.

These are all topics that need to be taken into consideration when looking at regulation of NFTs.

NFTS and Securities

What is an NFT? This simple question has been asked in dozens of articles recently, and mostly the answer is something like this:

A non-fungible token (NFT) is a unique, *not* interchangeable (*not* fungible!) token most often designed according to the ERC-721 token standard for non-fungible tokens.

Non-fungible means that each token is unique in the same way as a particular oil painting by Picasso is unique and cannot be exchanged with or replaced by any other oil painting in the world - or a handbuilt Stradivari cannot be exchanged with any other violin in existence. The Picasso and the Stradivari are unique assets, and so are millions of other, less spectacular assets in the world.

Contrary to NFTs, we have the category of fungible assets which are *not* unique and *can* be exchanged. For instance, five litres of gasoline can be exchanged with any other five litres of gasoline as long as the quality, like the level of octane, is the same. Or one particular euro is not unique but can be replaced with any other euro since the two euros have the exact same qualities and value.

When speaking of tokenized fungible assets, the token standard used is typically the ERC-20 standard. The same standard is used whether the fungible token represents a cryptocurrency or a fungible real-world asset like gold, oil, or electricity.

Now, what happens if we start mixing these categories?

First: A unique asset is tokenized using the ERC-721 standard and represented by a non-fungible token (NFT) in the ratio: 1 asset = 1 NFT. And it doesn't matter if it's a native digital asset like a digital picture (like a CryptoPunk character) or a real-world Stradivari.

Second: The already tokenized asset, now represented by the NFT, is tokenized once again in the sense that it is being divided - or fractionalized - into, for instance, 2000 smaller pieces, each represented by a new token created according to the ERC-20 standard which makes each of the 2000 new tokens fungible, meaning

that each of them represents the same qualities - like rights and value.

So what do we have now? Is it a fungible non-fungible token? Well, a fractionalized NFT is perfectly possible, and it already got a name: F-NFT. In this case, you could think of the NFT - the non-fungible token - as a kind of blockchain-based digital deed representing the entire asset and the ERC-20 fungible tokens as small pieces of the asset, each representing certain rights over a part of the asset, which will typically be an ownership right - very much like a stock.

Very much like a stock! But whoops! Did we just create securities out of an NFT? What are the implications of that? Are we still in the realm of pure technology, or did we cross a line here? Did we step into a regulated space with the risk of catching the attention of a regulatory authority?

Possible legal implications

The NFT space is emerging worldwide, and creative ideas, projects, and companies see the NFT light of day as we speak. However, technological possibilities and brilliantly creative ideas cannot form a foundation on their own in the realm of the token economy. A straightforward rule of thumb should be: Never spend your time and resources executing on a token project before it has been tested from a regulatory perspective, and you have obtained at least some level of certainty about the possible regulatory risks involved.

If somebody issues, fractionalizes and trades NFTs in the belief that the NFTs are, for instance, simple commodities - just like creating and selling cupcakes or bicycles - and it turns out that the NFTs were securities, that the tokens were security tokens, the issuer could get into problems. We saw that not least in the US, where the Securities and Exchange Commission (SEC) in the aftermath of the ICO craze ended up filing lots of cases against illegal ICOs.

What is a security token - and a security?

Now, before continuing the analysis of NFTs in terms of legal status and regulation, we need to define what we actually mean when we talk about security tokens.

The term Security Token is unique in the token space in the sense that for the first time, the crypto community - for lack of a better word - faced the regulatory music by entering 'security' into a token name and thereby acknowledging that this token because of its securities-like characteristics was something more than just a piece of technology and crossed the line into the realm of regulation. So, to put it simply: A security token is a token that, from a legal perspective, has the characteristics of a security. But that only leads us to the following question: What is a security?

This question can be answered in different ways, and often the dividing nuances of the answer have a geographical attachment. In Europe, for instance, a definition of securities can be found in the Markets in Financial Instruments Directive II (MiFID II)[1], and in the US, the SEC uses the Howey Test to decide when something should be deemed a security.

---

[1] https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32014L0065

A European perspective

Not surprisingly, a key term in the Markets in Financial Instruments Directive II (MiFID II)[2] is 'Financial instruments', and among those are securities - or more specifically, Transferable Securities. The MiFID II definition of Transferable Securities in its Article 4(1) (44) goes like this:

“(44) ‘transferable securities’ means those classes of securities which are negotiable on the capital market, with the exception of instruments of payment, such as:

(a) shares in companies and other securities equivalent to shares in companies, partnerships or other entities, and depositary receipts in respect of shares;

(b) bonds or other forms of securitised debt, including depositary receipts in respect of such securities;

(c) any other securities giving the right to acquire or sell any such transferable securities or giving rise to a cash settlement determined by reference to transferable securities, currencies, interest rates or yields, commodities or other indices or measures."[3]

So, according to the EU directive, transferable securities are financial instruments “like shares in companies” that “are negotiable on the capital market,” which means that they are designed with the purpose of being traded, bought and sold, on the market.

---

2 https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32014L0065

3 https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32014L0065

Now, what does MiFID II say about security tokens? Nothing. The concept of security tokens wasn't even born when MiFID II was first published in 2014 (it came into force in 2018).

However, even though a specific legal definition of security tokens is still missing, it is a common assumption among legal experts that the security definition of the MiFID II is applicable for tokens with the same characteristics as transferable securities, and therefore that MiFID II in practice acts as the legal framework for security tokens in Europe.

This assumption is strongly supported by the 2020 EU regulation MiCA (Markets in Crypto-assets Regulation), which does NOT regulate security tokens or even mentions the term 'security token', but refers to MiFID II as the directive which covers "crypto-assets that qualify as: (a) financial instruments as defined in Article 4(1), point (15), of Directive 2014/65/EU."[4]

The US approach to securities

If we look at the US laws and the Securities and Exchange Commission's (SEC) definition of both 'traditional' securities and digital assets deemed securities, the term 'investment contract' and the Howey Test, are vital in determining whether something is or is not a security.

The Howey test has been used for decades, and the SEC decided to also apply it to the cases following the massive ICO wave during 2017 and 2018, where a large number of presumably utility tokens came under suspicion for being unregistered securities.

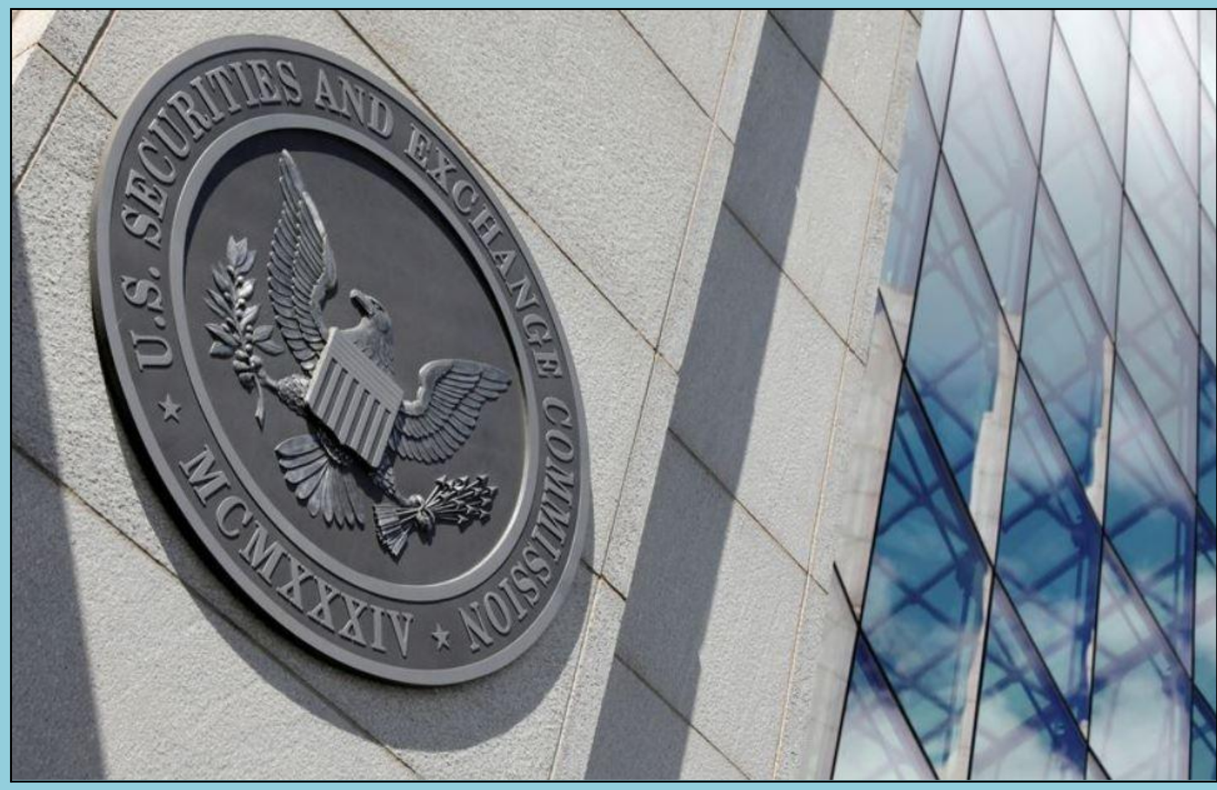
In 2019, the SEC even published a *Framework for "Investment Contract" Analysis of Digital Assets* aiming at ICOs to provide "a framework for analyzing whether a digital asset is an investment contract and whether offers and sales of a digital asset are securities transactions." The legal basis for this framework is, once again, the Howey Test.

Under the Howey Test, "an 'investment contract' exists when there is the investment of money in a common enterprise with a reasonable expectation of profits to be derived from the efforts of others." This sentence covers four prongs that all need to be met for a token to be considered an investment contract and deemed a security token:

1) Investment of money
2) in a common enterprise
3) expectation of profits
4) derived from the efforts of others.

Prong number one is relatively straightforward. The investor needs to put some money into the venture. However, the second prong is more tricky since the term 'common enterprise' is being defined in three different ways by different US federal circuit courts. For those who want to deep-dive into the discussion on whether 'common enterprise' should be approached as a 'horizontal commonality', a 'narrow vertical commonality' or a 'broad vertical commonality', we can recommend this article by Ryan Borneman.

[4] https://www.eesc.europa.eu/sites/default/files/files/presentation_-_mr_levin_0_0.pdf



However, for now, we will settle with the US Legal's definition of the term, saying that: "In the context of an investment contract, a 'common enterprise' is defined as an enterprise in which the fortunes of the investor are interwoven with and dependent upon the efforts and success of those offering or selling the investment of third parties."[5] Or as Nick Grossman says in his article "A Visual Guide to the Howey Test"[6], a 'common enterprise' roughly means that "investors and the company rise and fall together."

Prong three and four are relatively straightforward too. An 'investment contract' involves some expectation of profits to the investor, and the investor's role is only to invest and not to, for example, help run the company or develop the company's products. It's a passive investment that - hopefully - results in a return (could be in the form of a dividend as well as an increase of the value of the asset) due to the work/efforts of others.

The Howey Test fits perfectly for traditional securities like, for instance, stocks: An investor buys a stock in a company to get a profit out of the company's success on the market.

The Howey Test on NFTs

But what does the Howey Test have to say about NFTs? Does any NFT meet all the prongs? And does any NFT qualify as a

[5] https://definitions.uslegal.com/c/common-enterprise/

[6] https://www.nickgrossman.xyz/2018/a-visual-guide-to-the-howey-test/

'transferable security' as defined by MiFID II? That is the core questions of this article, and we are still a bit away from the answer.

Obviously, neither the Howey case (resembling investments in citrus trees in 1946) nor the Howey Test says anything about a modern phenomenon like NFT. And up until now[7], the SEC hasn't published any official guidelines or statements on how to evaluate the legal status of NFTs[8].

However, SEC Commissioner Hester M. Peirce, in a video interview already in March 2021, said that NFT creators should be aware that they might, in some instances, end up creating securities[9]:

"We [the SEC] have an interest in anything that could be a security...but the whole concept of an NFT is that it's supposed to be non-fungible, so it is supposed to be unlike anything else, which, in general, makes it less likely to be a security.

But people are being very creative in the types of NFT they are putting out there - it's a wonder what some people will pay for! And so I think, given that creativity, as with anything else, you should be asking questions, if you are doing something where you are saying: 'I am selling you this thing, and I am gonna put a lot of effort into it...building something so that the thing you are buying has a lot of value.' I mean, that is going to raise the same kinds of questions that these ICOs have raised. So you got to be very careful when you do something like that.

You also have to be careful if you decide that you are going to take a bunch of these NFTs and put them in a basket and then break them up and sell fractional interest. Or even if you take one NFT and sell fractions - I mean, if they are selling for 69 million dollars, you might want to break them up and sell fractional interest, and then you've got to be careful that you are not creating something that's an investment product - that's a security. So you always have got to ask those questions. I think, as we have seen, the definition of security can be pretty broad."

---

[7] The SEC is still determining whether NFTs are being treated like securities under a different name. In addition, in varying jurisdictions, NFTs fit different asset classes, and could therefore fall under certain pre-existing regulations.
With the recent SEC actions regarding Yuga Labs, it seems clear that "punitive measures have remained one of the only points of contact between the SEC and the NFT space, since bad actors continue to flourish."
https://www.ft.com/content/e8df6ea4-e9fb-4058-9a36-cef9c12f4726
https://www.coindesk.com/consensus-magazine/2022/12/28/nfts-are-securities-and-its-great/

[8] SEC commissioner Hester M Peirce talked about doing so in a Financial Times interview in October 2022: https://www.ft.com/content/e8df6ea4-e9fb-4058-9a36-cef9c12f4726

[9] https://www.youtube.com/watch?v=dkunmN8wbKE - interview starting at 23:10.

The Howey Test is named after William J. Howey. "Born in Odin, IL, in 1876, William John Howey was a larger-than-life character whose rise and fall was deeply tied to the boom and bust days of 1920s Florida. Raised on a farm and armed with only a limited formal education, Howey became one of the state's most successful citrus developers, opening the first Florida citrus juice plant and building his unique sales program for selling the cultivated citrus groves as asset-backed securities investments. [...] By 1920, Howey had amassed 60,000 acres of highly profitable citrus groves, according to the Supreme Court ruling. He would plant about 500 acres annually and keep half of it for himself. The other half, he would sell to the public as "narrow strips of land," each acre planted with 48 trees, later doubled to 96 trees per acre, the ruling says. Howey also owned a service company called Howey-in-the-Hills Service Inc., which took care of the crops, and the two corporations jointly were listed in the investment contracts."[10]

---

10 https://www.forbes.com/sites/chitraragavan/2017/11/14/how-a-1920s-florida-citrus-land-baron-created-the-acid-test-for-crypto-tokens/?sh=7e1c39904a3c

US law firm's opinions

Besides Hester M. Peirce's relatively vague warning, which is not an official SEC statement or guideline, all we currently have to lean against are private lawyers' interpretations of the possible regulatory implications of NFTs in the US.

However, two things are interesting when looking at the lawyers' approach to NFTs. The first one is that a surprisingly large number of law firms, mainly from the US, were very quick to put out introductions and opinion pieces on the possible legal implications of NFT, and since law firms tend to have a well-developed sense of business opportunities this could indicate that NFTs may indeed start to take hold as a lawyer's business area. Bear in mind that the uncertainty in terms of NFTs as securities are only one relevant legal aspect of NFTs. In addition, issuers of NFTs will have to consider questions like AML, copyright implications, tax law implications, and more - as we will come back to later in this paper.

The other interesting thing is that so far, most law firms seem to have a somewhat common understanding of NFTs which very much follows the lines of what Hester M. Peirce said in the quote above.

Let's look at a few examples of US law firm statements. Norton Rose Fulbright writes:

"If an NFT merely represents the ownership of an item such as a digital kitten, highlight reel, or videogame collectable - then it is arguably not a security. If, however, an NFT is promoted as a speculative investment, accompanied by the suggestion of a promoter that the NFT will increase in value as a result of the actions of the issuer or the promoter—then the NFT might very well be considered an investment contract and thus a security. For example, if a real estate developer decided to issue an NFT that represented an interest in a building yet to be built and the proceeds are used for development of the building, it would be hard to imagine this wouldn't fall under the jurisdiction of the SEC. It is also conceivable that an ostensibly non-security NFT could be sold or marketed in a manner that it may be deemed to be 'wrapped' in an investment contract, thus making the whole package a security."

Tater Krinsky & Drogin writes:

"If the NFT relates to an already existing asset, like a photograph or piece of digital art, and is marketed as a collectable with a public assurance of authenticity on the blockchain it is unlikely that such an NFT would be deemed a security. However, if the NFT is being created and sold as a way for members of the public to earn investment returns then that type of NFT will be more likely to be considered a security."

Dilendorf Law Firm writes:

"The answer to whether NFTs may be treated as securities under US law is maybe – perhaps, not all NFTs will be viewed by the US regulators as securities, but quite possibly certain NFTs indeed will be. If an NFT is connected to a unique piece of digital art/collectable/gaming prop, effectively serving as a blockchain certificate of authenticity, such NFT is unlikely to be a security. If, however, NFTs

are offered to the General Public with a promise of liquidity and continued services of the issuer, increasing the NFT's value, such NFT may be wrapped in an investment contract and, thus, a security itself."

Some common understanding

Now, the current common understanding when it comes to the US seems to be that NFTs will not be deemed securities according to the Howey Test in cases such as the following:

- If an NFT is used as a digital, blockchain-based deed to prove the originality and provenance of a digital or a physical asset such as an artwork.
- If NFTs represent collectables - in the ratio 1 asset = 1 NFT - like CryptoPunks or digital in-game items such as skins or digital weapons.
- If NFTs are used, for instance, to represent concert tickets, because the NFT may be a highly efficient and secure way of transferring tickets, keeping track of them, and fighting attempts of fraud and scams.
- If NFTs are used for registration of all kinds of physical assets and by doing so replacing cumbersome paper-based deeds with more secure and efficient digital, blockchain-based deeds that potentially enables the owner of the asset to easier make the asset tradeable and liquid or to use it as collateral for loans on DeFi platforms.

That said, when it comes to breaking up or fractionalizing NFTs, making them into F-NFTs, most law firms - as well as SEC's Hester M. Peirce - raise a warning flag. An NFT by definition is non-fungible, but by fractionalizing the NFT, the new fractions most likely become fungible and get the same characteristics very much as traditional financial instruments deemed securities.

Again, according to the Howey Test, an investment contract, which is a security, exists "when there is the investment of money in a common enterprise with a reasonable expectation of profits to be derived from the efforts of others." If some legal entity that owns an asset represented by an NFT breaks it up with the purpose of offering/promoting the fractions to investors as investment products with no utilities left (like proving originality and provenance), these tokens might be deemed securities in the form of investment contracts.

Now, when it comes to the case of F-NFTs, the best advice to token issuers, until further notice, is probably not to go down that road at all, unless they are prepared to register their tokens as securities, which is of course also an option.

MiFID II and NFTs

Now, let's go back to Europe. As described earlier, MiFID II talks about financial instruments as 'transferable securities', meaning that the attribute of transferability is vital when analysing whether an asset is to be deemed a security or not.

In the whitepaper *ICOs, Cryptoassets and MiFID II: Are Tokens Transferable Securities? (2020),* the author Martin Hobza adds to his description of the MiFID II's definition of transferable securities, that: "Such instrument does not have to be actually traded on the capital market at a certain moment in order to qualify as transferable security."[11]

This point from Hobza is interesting because it *might* raise a questionwhen talking about NFTs. If NFTs sometimes become securities, is that only because they are handled in specific ways - like being traded on an exchange? Or do they become securities by design, regardless of what happens to them after their creation?

For example: If my sole intention of minting an NFT is to prove that my digital work of art is in fact created by me and not by someone else, does that in any way ensure that my non-fungible token is not a financial instrument? Or does the fact that

[11] https://www.researchgate.net/publication/345807153_ICOs_Cryptoassets_and_MiFID_II_Are_Tokens_Transferable_Securities

the NFT by design *also* increases my chances of selling the digital artwork - just like I would be able to sell a physical piece of artwork - mean that I am in danger of violating the securities law?

The answer would probably be that as long as I maintain the 1 asset = 1 NFT relation as described earlier, such an NFT would have too few attributes in common with transferable securities like stocks to become a transferable security itself. Even though the digital piece of art is represented by an NFT that makes it possible to prove originality and provenance, which is a prerequisite for a sale, it still doesn't make one NFT representing one piece of art into a stock. It rather assembles a unique physical piece of art like a signed and dated oil painting which would also be genuinely non-fungible.

This interpretation of the legal status of NFTs in an EU context is supported, for instance, by the law firm McCann FitzGerald:

“Of the various types of financial instruments listed in MiFID, ‘transferable securities’ appear most relevant to NFTs. It is, however, unlikely that an NFT will constitute a ‘transferable security’. To fall within that definition, an NFT must belong to a class of securities and to form such a class, the tokens in the class must be fungible with each other.”

Once again, it’s stressed that the attribute of truly non-fungibility makes the difference in the legal assessments. However, McCann FitzGerald underlines that it may rely on a closer analysis to decide whether or not a token really is non-fungible.

“In any particular case, however, it may be necessary to carry out an analysis of the relevant token to determine whether it is, in fact, non-fungible for the purposes of MiFID.”[12]

Yet another law firm specialising in crypto and the token economy is Copenhagen-based Samar Law. Founder Payam Samarghandi agrees that NFTs in a 1:1-relation are unlikely to be deemed 'transferable securities', but he points out that even if the securities laws do not regulate an NFT, it could potentially still be subject to other rules and regulations such as anti-money laundering regulations and KYC. Payam Samarghandi says:

"The jury is still out when it comes to other regulatory aspects of NFTs. None of the current financial regulations specifically regulates entities performing activities with NFTs, and the most recent guidance from FATF indicates that NFTs might not even fall under the EU definition of virtual currencies as set forth in the AML Directive. One could therefore argue that NFTs currently find themselves in a regulatory no man's land, but that would, in my opinion, be a precipitate stand. Variations of NFTs, such as fractionalized NFTs, would most likely fall under the legal definition of virtual currencies and thus financial regulation. In other cases, it would depend on the tokenized asset and/or the characteristics of the NFT in plan if the NFT falls under the definition or not.

However, at some point, the regulators will start looking closer into all possible aspects of NFTs, and my best advice to issuers and providers of NFTs would be to start keeping some kind of track record of your sales and, if possible, voluntarily

[12] https://www.mccannfitzgerald.com/knowledge/fintech/crypto-assets-the-meteoric-rise-of-non-fungible-tokens

implement some simple KYC procedure. If or when the FSA knocks on your door, you can show them that you have already done your best to self-regulate, which will probably make the dialogue easier and more positive."

A tangible NFT example: Damien Hirst's The Currency

The focus of this concrete case is - again - the securities regulations, and from what we have seen so far, the main problems seem to occur in cases of F-NFTs. But before settling on that conclusion, let's deep-dive into a concrete example, which shows how ambiguous this whole area still is and how many puzzling questions it raises.

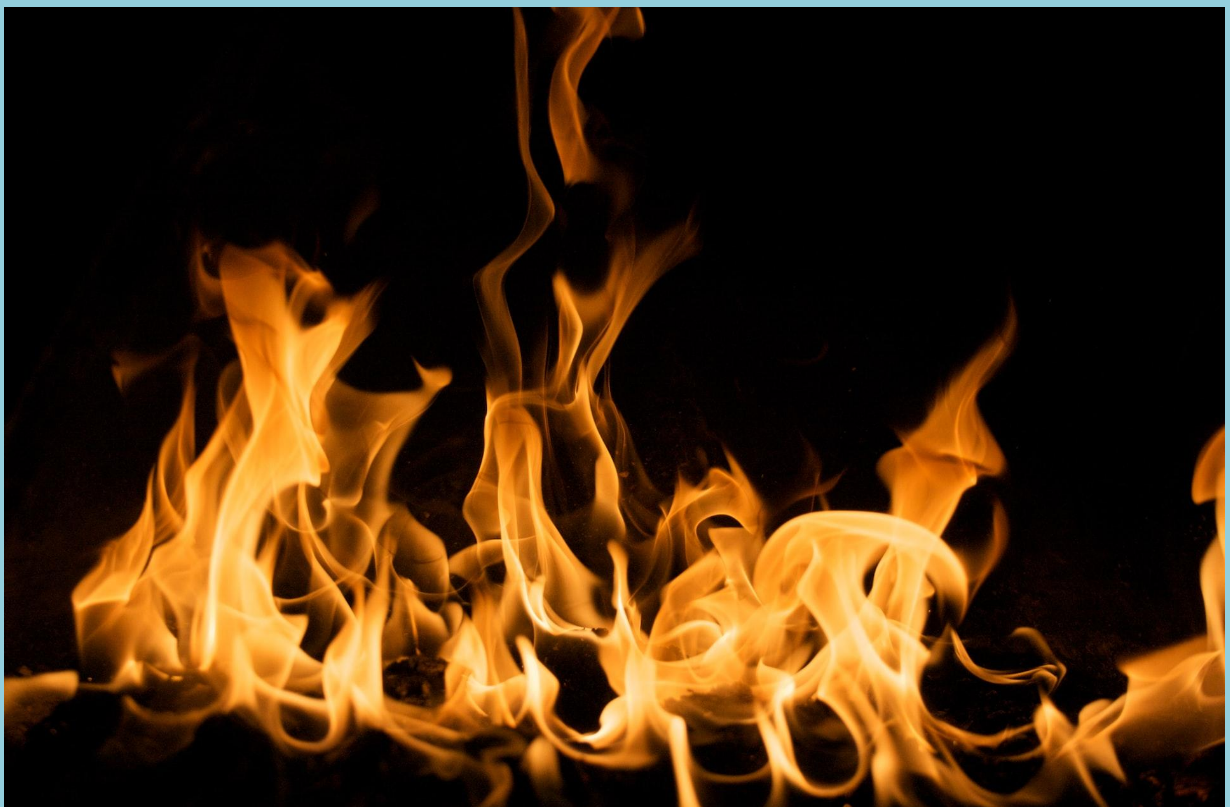
But first, let's recapitulate: We have this seemingly simple case where an artist creates a digital artwork and decides to have it represented by an NFT. And because the NFT makes it possible for the artist to prove the uniqueness and the provenance of the digital work (which was not possible before NFTs), the artist is now able to sell his or her digital artwork to an art-loving collector just as if it was an oil on canvas painting.

The collector buys the work, adds it to his or her collection, perhaps hangs it on a living room wall in a digital NFT frame, and maybe holds it for years. This is similar to the way physical art has been sold for many decades (except for the fact that the gallery now may be replaced by NFT platforms like Opensea). Artworks sold this way have usually been categorised as commodities, even though the monetary value of the work may increase over the years, and the holder of the artwork may earn a profit by selling it at some point.

Now, how much different does this setup need to be before a clear case slides into a more diffuse borderline territory? Let's take a look at a specific example:

The famous British artist Damien Hirst launched his NFT project *The Currency* in 2021. Hirst has been known for, among many other things, his spot paintings for a long time, and in this project, he produced 10,000 physical spot paintings called Tenders, all in the same format, all consisting of coloured spots on paper, but all different, all unique artworks. Each spot painting was represented by an NFT, and all 10,000 paintings/NFTs were offered for sale to the public for a price of 2,000 $ each. From 14-21 July 2021, it was possible for buyers/investors to sign up for an artwork/NFT on the project's website on a first-come, first-served basis.

An interesting twist, typical for Damien Hirst's approach, is that the buyers/investors who acquired a spot painting/NFT, at some point, had to make a delicate choice: Would they want to keep the physical artwork or the digital NFT? They could only have one of them, and the counterpart would be burned.



Of 10,000 artworks, 5,149 were retained as paintings and 4,851 as NFTs. The burnings took place in the gallery room, as you can see in this recording published on Instagram: https://www.instagram.com/reel/CkY2yO3gn7o/?igshid=OGRjNzg3M2Y=

Now, let's have a closer look at some of the questions from a legal assessment perspective that Damien Hirst's The Currency raises:

- Is Damien Hirst in this case just an individual, or is he more like a company? Does it make any difference that Damien Hirst is known worldwide almost as a market brand and has a large team of people working for him? A few years ago, when Hirst decided to focus more on oil paintings produced by himself instead of his assistants, he reportedly dismissed 50 people, meaning that he 'only' had 200 employees left. Now, does this make 'Damien Hirst' more like a company - a 'common enterprise' perhaps - than an individual, a person?

- Does it matter that Damien Hirst's name and work is a market in itself that some art investors and galleries may have an interest in protecting - as is the case, for example, with the Andy Warhol market?

- Does it make any difference that some people may be likely to view a work by Damien Hirst as, first of all, an investment?

- Does it matter that people should apply on The Currency's website to acquire one of the 10,000 artworks and that the application site was open for only one week? Could this

have contributed to a kind of FOMO? In this case, no less than 32,472 people tried to get hold of the 10,000 artworks/NFTs during the week in July 2021.

- Does the fact that The Currency is not only about one NFT but 10,0000 NFTs all looking *almost* alike and all part of the same project make any difference in how the NFTs are legally assessed? Would it perhaps be possible to argue that, in this case, the actual artwork is something bigger than each of the 10,000 spot paintings/NFTs/Tenders? That the The Currency is a conceptual piece of art, and the 10,000 spot paintings/NFTs/Tenders are just fractions of The Currency. And could that point atthe 10,000 fractions as fungible tokens rather than non-fungible because their individual differences would be nothing more than the difference between two 1-dollars bills, each equipped with a unique combination of 11 numbers and letters revealing information on the note series from the issuing Federal Reserve bank. This unique number doesn't make the dollar bills non-fungible. In fact, what Damien Hirst apparently was trying to achieve with this project - The Currency - was to create a currency. And apparently, that was the reason for making as many as 10,000 pieces (perhaps besides the simple fact that 10,000 pieces times 2,000 $ = 20,000,000 $, which is quite a lot of money).

- Does it matter that the project of which the NFTs are the core elements was promoted rather intensively for a period leading up to the sale of the 10,000 NFTs?

- Does it matter that the platform/website supporting The Currency called The HENI Marketplace (the place that offered information about the project and from which the order applications for the artwork should be sent) even provided detailed instructions on how to resell the purchased artworks on the secondary market:

  “The first option is to directly list an NFT for sale. From the Sell section you are able to list an NFT that you own for sale. Select the artwork you wish to sell, and set the price in DAI that you want to list your artwork at. Your item will be listed for a maximum of 90 days, or until you remove it from sale. You are able to cancel your listing at any time. If your NFT has been sold on the HENI Marketplace, the funds (minus commission) will be transferred directly to your connected MetaMask wallet. The NFT will be transferred directly to the buyer’s MetaMask wallet.”[13]

- Did the below report from the sales of the Damien Hirst's spot painting/NFT on the secondary market, which was opened immediately - apparently with no holding period - make any difference in the legal assessment of these NFTs?

  “The secondary marketplace for buying and selling Tenders has

13 https://heni-support.zendesk.com/hc/en-gb/articles/4404794352657-How-can-I-sell-an-NFT-on-the-HENI-Marketplace-

been open since 29 July. The first day of trading on the secondary market saw trading volumes of more than $1.3 million. The average sales price on this day was $7,128. Over the next 10 days (until 9 August), the volume of tenders traded averaged $395,173 per day with an average price of $8,379.

Saturday 14 August saw an increase in volume to $2.8 million in 24 hours. The average price on the day was $14,582, having opened at $11,302 and closed at $19,032.

Sunday 15 August saw the trading volume increase to $9.6 million in 24 hours. The price opened at $21,224 and closed at the end of the day at $36,027. The overall average price on the day from 351 sales was $27,417.

Tuesday 31 August saw trading volume of $6 million in 24 hours. The price opened at $52,107 and closed at the end of the day at $63,114. The overall average on the day from 98 sales was $61,224."[14]

Damien Hirst's The Currency is one of the more interesting artworks in the NFT space. And we do not in any way claim that the questions raised above matters from a legal and regulatory token assessment perspective. But they do show that some cases tend to get very complex if you take a closer look.

And if you know Damien Hirst, this is no surprise. He has been a true master of raising questions throughout his artistic career. Just to give an example, which somehow resonates with the above discussion: Damien Hirst was the first artist ever to skip the primary market entirely and - on September 15 2008 - sell a series of 223 brand new artworks directly through an auction at Sotheby's. The auction, which took place literally seconds before the outburst of the global financial crisis, reached more than 200 million US dollars.

14 https://fadmagazine.com/2021/09/13/damien-hirst-the-currency-the-total-market-value-of-the-project-is-approximately-500million/#:~:text=The%20Currency%20by%20Damien%20Hirst,each%20of%20the%2010%2C000%20artworks.

NFTs and Delinquency

While some people see NFTs as an innovative solution to various problems, especially for the art industry, others see them as an ordinary digital representation devoid of any value.

NFTs use cases vary from one sector to another. Digital artwork, fundraising, metaverse functionality, exclusive membership/ticketing and gaming, to name a few. But the main use case we will focus on in this part of the paper is NFT use in malicious activity.

How susceptible are NFTs to crime?

There is no direct link between NFTs and delinquency. However, like any other valuable asset, NFTs can be used for illicit activities. In fact, perception of NFTs, their value (the popularity of an NFT collection across social media, the involvement of influencers and/or celebrities, speculative trading, the rarity of an NFT and its utility in crypto-based projects), how that value is derived, have proven unique compared to other emerging technologies, and have motivated reflections about the often tenuous line between NFTs and delinquency.

Every new technology has its drawbacks and NFTs are constantly questioning the legal world in relation to financial delinquency. When talking about blockchain technology, and specially NFTs, two core characteristics attract our attention, namely, anonymity and decentralisation.

Despite the transparency of the blockchain - making it easy for investigators to trace fraudulent NFT projects - the anonymity feature continues to pose risks of potential abuse.

It appears, given the various cases of abuse observed, that certain offences are specific to the digital world (A), while others are considered traditional offences (such as money laundering and fraud) impregnated by an immaterial aspect that the NFTs may offer (B).

A - Infringements specific to the digital world

NFT creators and investors need to be aware of certain risks related to the space. The most frequent concern across the NFT ecosystem is the theft of assets through various scams. Such deceiving behaviour is intended to incite the victim to provide access to their assets. Predominantly constituting infringements specific to the digital world, scams may range from deploying phishing links to impersonating NFT marketplaces.

Phishing scams

Scammers do not lack ingenuity. A wide range of means is revealed and favours the development of deceptive methods to the great benefit of cyber delinquents. Phishing consists of fraudulent cyber-manoeuvres based on 'social engineering': the hacker tries to obtain information about the victim to, later on, defraud him, usurp his identity or use the information to carry out a targeted computer attack against a company or an administration.

In the NFT ecosystem, phishing scams involve mimicking or impersonating the site of a well-known NFT platform. The scammer claims to represent a legitimate project, incites the victims to sign malicious transactions, compromises their crypto assets and steals their NFTs.

In a recent 2022 case, over 300 NFTs (worth approximately $400,000) were stolen. The Dobies NFT was an Ethereum-based NFT project launched in April 2022. In a careless mistake by the project's admins, the server's invitation link was kept on its social media account bio even after expiration. Scammers seized the opportunity and established a fake Discord server, mimicking the same link. The scammers, posing as Dobies NFT admins, then posted a phishing link for a fake giveaway. Consequently, many victims were tricked into believing in the link's legitimacy and unwittingly signed transactions that transferred their NFTs to the scammers.

This phishing behaviour is the first step before the main offence: fraud.
A diversification in NFT use cases is accompanied by the development of increasingly complex delinquency patterns. With airdrop phishing scams, impersonation scams, NFT swap scams, marketplace invite scams, and many more elaborated techniques on the rise, it is undoubtedly that the NFT ecosystem is tainted with a sulfurous reputation. This was seen, for instance, in OpenSea and BAYC (Bored Ape Yacht Club) support scams. Victims seeking support to solve a royalty issue agreed to share their screen with the scammers imitating typical customer support processes (for example, providing support tickets). Now, the scammers could view the victims' QR code, unlock their OpenSea wallet, and transfer their NFTs while assuring them that their issues were being solved.

Sometimes, scammers initiate a 'friendly' conversation with their victims and invite

them to share account information in order to solve a non-existent problem. Afterwards, the victims find their accounts drained.

Rug pulls

Rug pulls are the latest form of fraud. Like the pump-and-dump scheme, a rug pull consists of a malicious act in which the creators of a project - such as an NFT collection or a decentralised application - lure in early investors and then abruptly abandon the project. These scammers exit a project by selling their tokens, leaving their victims with worthless or significantly devalued tokens.

When venturing into an NFT project, developers detail their plans in a roadmap. Developers arrange auctions, resales, mints or airdrop campaigns to raise funds for the following stages of their main project. However, scammers capitalise on this suspenseful roadmap to encourage investors to buy into their new projects. Shortly after, to the great surprise of deceived investors, social media accounts related to the developers and any additional information are gone with the wind!

Rug pulls can damage the reputation of NFT marketplaces in particular and the blockchain ecosystem in general. They can erode trust in the underlying technology and discourage legitimate investors from actively participating in the NFT space.

Consequently, before engaging in any NFT project, investors must do their due diligence. They should research the project's creators and team, the NFT's value proposition, and the market demand for similar NFTs. They should also be wary of projects that promise guaranteed returns or unrealistic price appreciation. Primarily, investors should only invest in proportions they can afford to lose.

Ponzi schemes in the NFT space

Scammers can create NFT-based Ponzi schemes that promise high returns on investments for buying and holding NFTs. They use the funds from new investors to pay earlier investors. Eventually, the scheme collapses, and everyone loses their money.

B - Common offences that apply in the NFT ecosystem

As the use of NFTs becomes widespread, several common offences have been observed. By way of example, illicit activities include the following areas:

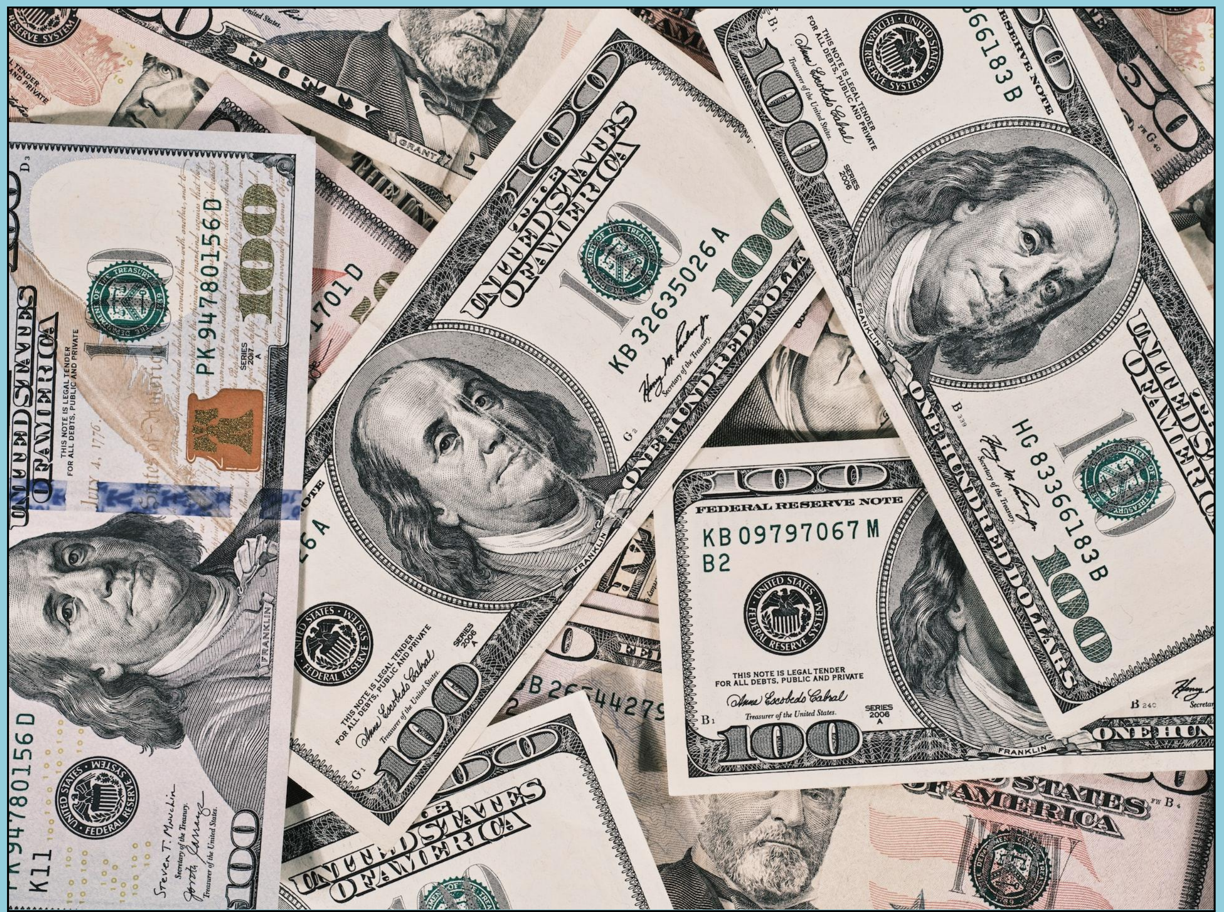
Intellectual property infringements

As NFTs are used to represent digital assets, the risk of intellectual property infringement is omnipresent. This can occur when someone creates or sells an NFT that represents a digital asset without obtaining the proper permissions or licensing from the original creator or owner of the asset.

Tax evasion

Depending on the jurisdiction, buying and selling NFTs may be subject to taxes. Therefore, individuals who fail to report their NFT transactions as taxable income or capital gains could be charged with tax evasion. In the United States, NFT transactions are generally treated as 'capital assets' and are subject to capital gains tax if sold for a profit. The amount of capital gains tax owed is based on the difference between the sale price of the

NFT and the original purchase price minus any allowable deductions or expenses. To avoid possible tax evasion charges, individuals must keep accurate records of their transactions (date of purchase, purchase price, sale price). In addition, constant professional support and guidance are crucial for individuals to understand their tax obligations and ensure they report their NFT transactions correctly.



Money laundering

Money laundering has long been a problematic infraction in the 'traditional' centralised financial system. For example, art pieces, like paintings, are easy to move, have relatively subjective prices, and may provide certain tax advantages.

Traditional money laundering typologies may also find application in the NFT space: NFTs may be bought and sold by criminal groups via third parties, including through shell companies. In addition, the three basic money laundering operations - placement, layering and integration - apply to NFTs.

To simplify it, criminals' primary purpose is to disassociate themselves from their original profit and generate rupture in their transaction trail.

A February 2022 US Treasury report concluded that NFTs are susceptible to money laundering. Accordingly, "no single platform operates the same way or has the same standards or due diligence protocols", and "art auction houses or galleries may not have the technical understanding of distributed ledger technology required to practise effective customer identification and verification" in the NFT space.

Typically, we see the following money laundering techniques:

1 - The creation of shell companies: Shell companies are legitimate legal entities that do not possess actual assets or run business operations. They exist only on paper and have no office or employees. Shell companies only become 'criminal' when used for such purposes. Setting up a shell company only requires a little identification, and the company will not expose the customers' identity. Consequently, shell companies may include multiple layers of companies created to divert money. Shell companies are non-traded corporations; they are not listed on any stock exchanges for buying and selling by investors.

To resume the NFT framework, a person may create a shell company to purchase NFTs with illicitly acquired funds. The company can then sell the NFTs on the open market to make the funds appear legitimate.

2 - Obfuscation services: The use of centralised exchanges is considered the privileged method to launder illicit proceeds. Most commonly, the perpetrated acts consist of a combination of mixers - such as the now-sanctioned Tornado Cash, no-KYC coin swap exchanges, crypto assets ATMs or gambling services - and direct transfers to centralised exchanges.

3 - Market manipulation and insider trading: Market manipulation is an artificially engineered action that drastically affects the supply or demand of a security.

Wash trading is a form of market manipulation. The offence consists of executing a transaction in which the seller is on both sides of the trade to paint a misleading picture of an asset's value and liquidity.
In the case of NFTs, the goal would be to make one's NFT appear more valuable than it is by 'selling it' to a new wallet the original owner also controls. Notably, while wash trading is prohibited in conventional securities and futures, NFT-wash trading has yet to be the subject of an enforcement action.

In addition, misuse of confidential information is considered a form of market manipulation. Creators or collectors in the NFT markets may have access to confidential information (about upcoming releases or developments) that can affect the value of the NFT in question. Profiting from insider knowledge, insiders can misuse this 'confidentiality' to make trades before the information is made public.

Nathaniel Chastain, a former product manager at OpenSea, was indicted in the first-ever digital asset NFT insider trading scheme in New York. Chastain allegedly abused his knowledge of confidential information to secretly purchase dozens of NFTs before they were prominently featured on OpenSea.

Regulatory treatment of NFTs

Deciphering how offenders use digital means to commit crimes is essential for regulators. The modus operandi may differ, but the result is always the same: considerable losses.
Applying the regulations explicitly designed for operations in the physical world to the virtual world and NFTs is a challenging task. As we have seen, the NFT space attracts delinquency due to the large amounts of money allocated to these assets: Wherever there is a flow of value, there is a potential crime. The challenge for the law is to seize these virtual realities to fight delinquency without hindering innovation.

NFT marketplaces must be proactive in risk management to soften and/or prevent operational risks from occurring. Therefore, what are the measures used to achieve this? And what are the regulatory requirements indispensable to carry out a compliant task?

A - Potential leads to follow in terms of regulation

Establishing an appropriate regulatory framework for the NFT ecosystem requires the consideration of some potentially useful cues.

Rule 1: Categorising NFTs. To identify the appropriate regulatory regime, it is necessary to determine 1) the structure of the NFT and 2) the jurisdiction competent for disputes dealing with NFTs in which the NFT is offered, held or traded.

(The case where NFTs are financial instruments and the tokens are securities is described in the first part of this article)

Rule 2: Differentiate between decentralisation and centralization. It is equally important to differentiate between a completely decentralised activity and an activity which may operate through a centralised third-party intermediary. Decentralisation may hinder the implementation and application of AML/KYC programs. However, from the moment a central entity comes into play, regulators will likely seek to leverage their intermediation and control to prevent financial crimes.

Before the emergence of NFTs, crypto-assets and anti-money laundering enforcers had a strong relationship. The entire crypto ecosystem, designed specifically to break away from centralised authorities, has not failed to conflict with regulations primarily based on trusted third parties and traceability.

Public authorities quickly identified the crypto-asset sector as presenting AML/CFT risks. As early as 2016, the European Commission indicated that it wanted to subject trading and custody platforms to AML/CFT regulation. The FATF also took a position in 2018 by amending its recommendations regarding new technologies. In France, PSANs must comply with KYC obligations, reporting suspicions or freezing assets in case of international sanctions. However,

obstacles continue to limit the effectiveness of AML/CFT.

NFTs within the AML regime: no specific legislation

The status of NFTs is not explicitly addressed in the AML regulation. The key regulatory spotlight is on the nature of the crypto-asset activity. Because NFTs can represent different types of digital assets and can also be created and traded in various manners, an assessment on a case-by-case basis is required to determine if a particular NFT business model falls within the AML regime.

With increasing amounts of money being used to pay for NFTs, there are concerns that these tokens may be used to circumvent existing anti-money laundering rules. For example, under the 5th AML Directive, anyone purchasing or selling a work of art for more than 10,000 euros is accountable for customer due diligence processes. As the directive doesn't define a work of art or mention NFTs, it is unclear whether NFTs could be considered works of art.
Regardless of their current regulatory status, companies offering NFTs or facilitating NFT transactions should be cognisant of AML's potential risks in the sector.

B - How to manage money laundering and illicit activities risks?

Can criminals be brought to justice?

Criminal recovery may be considered ineffective in a pseudonymous space such as NFTs. However, the blockchain's transparency can effectively detect illicit circuits.
According to the 2022 Elliptic NFTs and financial crime report, it is essential to note that NFT communities have shown resilience when confronted with scams. The report highlights victims' ability to report, lock stolen NFTs, and elaborate reverse scam techniques while negotiating with scammers to return their stolen assets.

How should AML rules be applied to the NFT space?

Identity verification is an important matter in the NFT ecosystem. It ensures that the rightful owner of an NFT is the one who actually controls it. Verification, therefore, involves requesting legal documents that testify to the authenticity of the data. This procedure requires customers to provide documents like valid ID cards and utility bills.

In accordance, AML/KYC programs are built on five undertakings:
1 - Designation of a compliance officer
2 - Development of internal policies
3 - Creation of an employee training program
4 - Organization of third-party audits
5 - Deployment of risk-based procedures (Conducting Customer Due Diligence, Customer Identification Program, Transaction Monitoring).

Sanctions screening

Sanctions screening solutions are considered essential for NFT-based platforms. Sanctions screening is a measure used to detect and prevent financial crime, consequently helping companies to minimise financial risk exposure. More technically, it compares an organisation's records - such as customer data, business partner data, and payments data - against data lists to see any similarities. This process would indicate that if records include sanctioned parties, it would be advisable to avoid entering into a business relationship.

To conclude, the regulator's aim in the context of such technological development would be to adopt a preventive approach in regulating the NFT sector and the various use cases that may result from it. The traceability function of the blockchain should be coupled with traditional assistance. Prosecutors and investigators may be able to more readily obtain information from NFT platforms, crypto wallet custodians, or the parties to NFT transactions to identify possible suspects. Once individuals are identified, further investigations can be carried out, and charges brought appropriately.

Conclusions

NFTs first became a big deal in digital art almost overnight in 2021 - and there's a good reason for that.

Visual artists working with digital art had never been able to prove provenance over their works, had never been able to protect their works from being copied, had never been able to prove that a piece of art was created by them and not somebody else - and consequently had never really been able to sell digital art as original works of art. But all this became possible by tokenizing digital artworks and making them into unique, non-fungible tokens. This was and is an important step forward for serious artists working with digital art.

But along with the artists moving into the NFT space came a tsunami of copycats trying to make a quick buck on all sorts of visual expressions wrapped in NFTs and offered on the ever-growing number of marketplaces. The massive hype during 2021 made the NFT market one of history's fastest-growing bobble markets.

People invested in all sorts of 10K NFT projects that tried to copy what Yuga Labs had done with their Bored Ape series. But of course, the bobble had to burst, and it did so already during 2022, which was a necessary and good thing.

The current situation in the NFT space is that the clean-up from the 2021 craziness is still ongoing. Still, in parallel, lots of new NFT waters are being tested in various industries and business areas worldwide. NFTs represent music, in-game items, real estate, crop production, carbon credits, diplomas, medical records, IP rights, and personal identity.

The number of potential real-world use cases seems endless, and in the future, this is likely where NFTs will have a significant impact. However, with increasing diversification and expansion of the NFT space only comes even more complexity seen from a legal and regulatory perspective.

New use cases mean potentially new legal and regulatory challenges. The current categories of NFTs have already been operating in legally grey zones in many cases, and in the near future, this is likely to worsen.

Companies who want to build up a sound business based on or to involve NFTs must be aware of at least five fundamental rules:

1. Never believe that just because something is technically feasible, it's probably compliant too. This is far from always the case.
2. Always assume - until proven differently - that if something is illegal in the analogue world, it's also illegal in the digital world.
3. Never underestimate the regulator's intelligence and possible interest in your project or company. Trying to fly under the regulatory radar is riskier than ever before.
4. Always consider the option of being proactive and perhaps choose to self-regulate instead of waiting for the regulator to tell you to adjust.
5. Never let regulations bring you down - think of it instead as an opportunity to differentiate yourself

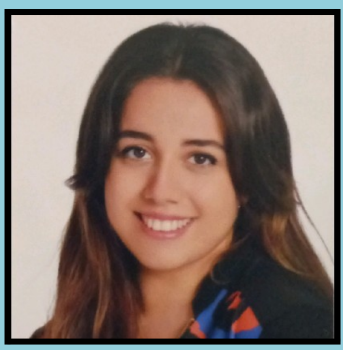
positively and increase your credibility.

The point here is that compliance is a must, and as we have shown in this article, projects/companies operating in the NFT space have to be aware of compliance within at least four main legal areas:

- Securities laws
- IP rights
- AML
- KYC
- Adopting an NFT insider trading policy in companies: These policies will ensure that employees cannot trade on material nonpublic information. They can also cover other things like market manipulation and wash trading.

Only by analysing your NFT token's status in the light of these four areas will you be able to secure full compliance for your project and company.

Regulation allows the securing of trade, the protection of the weak and the respect of fundamental rights. The construction of the NFT regulation is still a work in progress. It is crucial to determine what the 'new' forms of regulation will be. But in the meantime, it will be up to enterprises to take over. Here we discuss the notion of 'compliance', a construction born of the meeting between ethics and operational practices. Compliance emphasises procedural efficiency, practical implementation of certain rules, and regular actualization of these same rules. And a mapping method of the risks inherent to the NFT ecosystem can then be established. Such a method will allow the deployment of all necessary preventive and remedial measures.



Zeina Zoghbi, Regulatory Expert at The Tokenizer. PhD Candidate Blockchain-Délinquance financière, Aix-Marseille Université, Aix-en-Provence, Provence-Alpes-Côte d'Azur, France.

Michael Juul Rugaard, CEO & Co-Founder of The Tokenizer and Co-Founder of Norfico. Michael holds a master's degree in communication, language and literature from the Department of Scandinavian Studies and Linguistics, University of Copenhagen.

March 2023

This report was partly based on the article 'The uncertain regulatory status of NFTs' previously published on The Tokenizer's NFT subsite.

Disclaimer: *The authors of this article are not lawyers, and this article only expresses understandings of the legal implications of NFTs. Therefore the opinions are not intended as legal advice or a substitute for seeking legal counselling. The information is provided in order to help understand the legal implications of NFTs. All research leading to the redaction of this article has been conducted to ensure as much accuracy as possible. It is important to consider that legislative situations are likely to develop as the sector and its implications become clearer for the various parties involved.*