

Is my NFT a security?

As NFTs continue to surge in popularity, questions swirl around their legal and regulatory status. For some NFTs there is lingering uncertainty on issues such as the ownership rights they convey to the buyer, whether the NFT can qualify as “property” under applicable legal frameworks, and which consumer-protection principles should apply to the sale and purchase of the NFT.

With NFTs being structured in an increasingly complex manner, an additional question that now commonly arises is whether the NFT qualifies as a regulated financial product under the laws governing its issuance and distribution. In their purest form, NFTs represent unique items such as collectibles or pieces of art that are not intended to be a financial product, notwithstanding that they may represent an attractive investment opportunity (as is the case of many non-financial real-world items). But when NFTs give their holder the right to income streams or to a share in an underlying portfolio of investment assets, the NFT potentially transforms into a regulated financial product. With the increasingly exotic structuring of rights attaching to NFTs, the conventional industry perception that NFTs are unregulated products is gradually eroding.

Use cases for NFTs with complex tokenomics abound. Such NFTs are, for example, integrated into play-to-earn gaming platforms, where they may represent avatars or other in-game items that can be used to generate income for the holder. NFTs may also be minted as an on-chain representation of a unique real-world asset that a decentralized autonomous organization (DAO) wishes to invest in, thus giving the DAO participants collective exposure to the value of that asset. A further noteworthy development is the emergence of platforms that issue NFTs that give their holders rights to a share of royalties generated by underlying music catalogues. In some cases, payments made to holders of the NFT may be automated via smart contract, for example where the NFT is issued on the Ethereum blockchain using the ERC-721 or ERC-1155 standard, both of which have proven popular in the NFT space.

Financial regulatory frameworks around the world generally function in a technology-neutral manner – i.e., they apply to digital tokens that have features of financial products irrespective of how the token is labelled or presented, and regardless of whether the token is offered or supported by a company that does not otherwise operate in the financial sector. Accordingly, a token – whether fungible or non-fungible – that gives the holder ownership or control rights in a business or portfolio of assets, or which entitles the holder to certain income or revenue streams, may qualify as a regulated product such as a security or a unit in a collective investment scheme. In determining which regulatory frameworks to consider, the relevant jurisdictions are usually those where the NFT is issued and those where users are located.

Determining whether an NFT is a regulated product is important because the issuance, offering, marketing and distribution of such a product will typically give rise to a raft of requirements that apply in the financial services sector, and non-compliance with these is usually an offence. These may include, for example, a requirement for the issuer and distributors of the NFT to be licensed or approved by the relevant regulator(s) and to comply with ongoing conduct-of-business requirements (e.g., in relation to disclosure of information to purchasers of the NFT, fitness and properness of personnel involved in running the NFT offering, etc.). Establishing and maintaining frameworks to ensure compliance with these requirements typically requires a high degree of

specialism and significant human and financial resource. While an NFT offering may be run within the confines of exemptions and may thus avoid regulation, typically such exemptions will only allow the offering to be directed at sophisticated investors in the wholesale markets and will not enable any offering to the retail public.

Consequently, issuers and distributors of NFTs whose core operations are situated in sectors such as entertainment and media or gaming will typically not wish to upscale and retool to meet the onerous requirements of financial services regulation, and will instead collaborate with appropriately regulated industry partners or will seek to structure their offering in a manner that avoids the NFT becoming a regulated product to begin with. Factors that potentially help mitigate the risk of an NFT qualifying as a security or other regulated product include the following:

- **Tokenomics:** In some cases it may be possible to avoid an NFT qualifying as a security or other regulated product if returns accruing to the NFT holder need to be earned by the holder on the NFT's native platform, rather than the holder having a passive entitlement to such returns. In this case it may be possible to characterise payments received by the NFT holder as being part of a simple commercial quid pro quo because they represent consideration for the holder performing actions that are useful to the NFT's native platform (such as staking or exercising platform governance rights).
- **Decentralization:** If the NFT is issued by a DAO or other protocol that is fully decentralized (i.e., it is governed solely by the community of protocol participants, without centralized control being exercised by any particular person), it may be possible to argue that the NFT, even if it has features of a security, does not qualify as a security because decentralization prevents the relevant product definition from applying. For example, where an NFT has features of a debt note (i.e., periodic fixed-interest payments are made to the holder) but is issued entirely on-chain and is not booked as a debt liability on the balance sheet of any entity, it may be possible to argue that the NFT does not qualify as a debt security. However, legal arguments of this nature that rely on decentralization remain largely untested with the regulators and courts, and they may not be future-proof given that regulators are increasingly focused on how to approach the supervision of decentralized finance.
- **Offshoring:** Where the NFT does constitute a security or other regulated product, an option that some NFT issuers consider is to establish their issuer company in an offshore jurisdiction and launch a website for their platform that is generic and not directed at users in any particular location. The platform then refrains from conducting active marketing in any location and relies solely on users on-boarding themselves to the platform on a reverse-solicitation basis. However, this approach may not be aligned with what most NFT platforms wish to achieve, because it precludes any marketing. It is also not risk-free because some jurisdictions in which users are based may not recognize reverse solicitation as a means of avoiding regulation. Furthermore, it would always be advisable to use geo-fencing to exclude users in some high-risk jurisdictions (e.g., the United States), even if they approach the platform at their own initiative.

As the structuring options for NFTs multiply, developers, platforms and other stakeholders involved in the NFT issuance and distribution process need to remain alive to the financial regulatory implications. Navigating the relevant frameworks and confirming the regulatory position should be treated as a key part of the product development process, as the consequences of inadvertent non-compliance can be costly. Appropriate structuring is key to ensuring that the product remains on the right side of the regulatory perimeter.

Authors



Hagen Rooke

Partner
Singapore
hrooke@reedsmith.com



Nina Carlina Sugianto

Associate
Singapore
ncarlina@reedsmith.com

