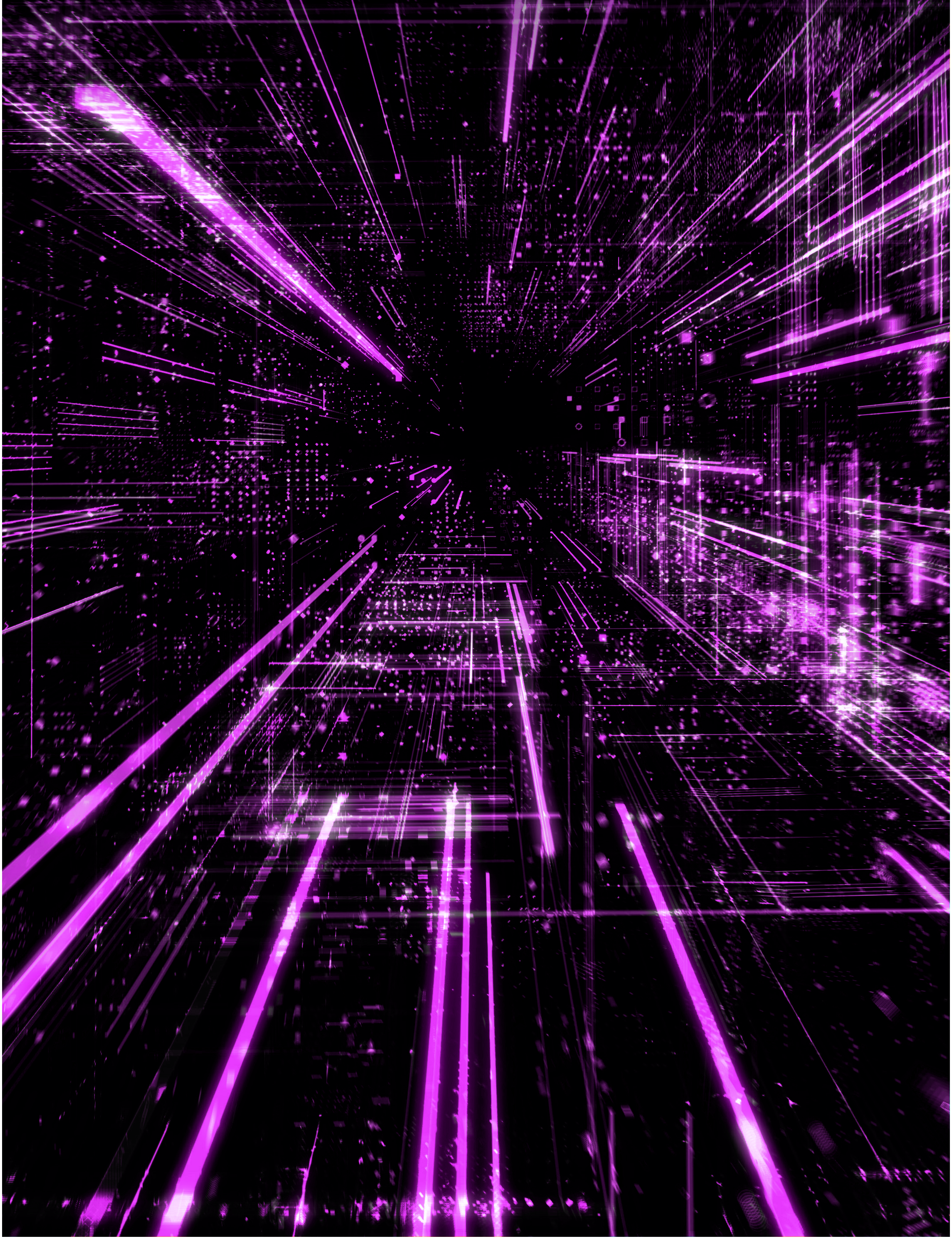
“Possessing runs the world, and the metaverse will have a hard time changing that. But here come the NFTs.”



Ownership in the metaverse – the great illusion of NFTs

By removing the physicality of the real world, the metaverse is poised to shift our human society away from several long-held legal concepts, including the concept of ownership. Because "owning" has a completely different meaning in the virtual world than it has in the real world, what one owns or may own in the metaverse will likely be a question that is only relevant to a happy few and will also likely be the subject of films, books, heated societal debate, and of many more lawsuits before the notion settles. Could NFTs offer a solution?

This tension results from a very simple stance. The Internet is made of code and content, yet there are no ownership rights in code and content but for those who wrote the code and created the content. Do you think you own your software, a piece of music, an audio book, a game character, a game asset, a virtual car? Think again. At best, you received a license to use the items; at worst, you may be infringing upon someone else's rights.

Yet, paradoxically, one has never bought and sold more than on the Internet; and in a society where capitalism is alive and well, study after study shows that owning continues to be far more valued than licensing. This "endowment effect" explains why marketers and advertisers are so reluctant to use expressions such as "limited license" or "permission to use." Possessing runs the world, and the metaverse will have a hard time changing that. But here come the NFTs.

What is the endowment effect?

In psychology and behavioral economics, the endowment effect is the finding that people are more likely to retain and value an object they own rather than acquire that same object when they do not own it. This is typically illustrated in two ways. In a valuation paradigm, people's maximum willingness to pay to acquire an object is typically lower than the least amount they are willing to accept to give up that same object when they own it – even when there is no cause for attachment, or even if the item was only obtained minutes ago.

Used in experiments in psychology, marketing, and organizational behavior, the endowment effect also materializes when people who are randomly assigned to receive a good ("owners") evaluate it more positively than people who are randomly assigned to receive rights to do certain things with the good ("controls"), and that is the gigantic paradox that the metaverse will need to confront. While they are posed to solve the ownership problem of the virtual world, without some drastic intervention from legislators, NFTs may turn into nothing more than a collective illusion of ownership.

What is an NFT?

In short, an NFT, or "non-fungible token," is a unit of information recorded on a blockchain about a good or service that is not interchangeable.

Blockchain? A blockchain records information in a distributed database that seals the information with a collaborative cryptographic procedure. The information comprises transaction data and a time stamp and is organized in linked "blocks" as it is recorded. One transaction is recorded in a block, and the subsequent related transaction is recorded in another block that is linked to the first one, using cryptography. By design, a blockchain is resistant to modification because altering one block retroactively cannot be done without altering all other linked blocks. This feature and its functioning in a decentralized peer-to-peer network give it its reliability. Arguably unfalsifiable and incorruptible, blockchain technology is new, enigmatic, and terribly appealing as a concept.

“A key feature of NFTs is that they are (or ought to be) liquid and thus easily tradable.”

Fungible? Blockchain is the technology that enables the existence of cryptocurrencies, such as Bitcoin.

Cryptocurrency works like any other currency in the sense that its units are fungible and can be traded or exchanged equally. One Bitcoin has the same value as another Bitcoin, just as one dollar bill has the same value as another dollar bill. An NFT, much like a cryptocurrency, uses blockchain to record the transactions related to it. But unlike cryptocurrencies, NFTs are non-fungible. NFTs represent a particular good or a particular service, and they uniquely relate to what they represent. That means they are not equally exchangeable and are, in theory, unique.

What is the point of NFTs? Blockchain technology can be used to deliver a variety of services. For example, the ethereum blockchain has been used from a very early stage to authenticate rare or valuable objects including diamonds or tangible work of arts. What NFTs bring into the picture is the “tokenization” of the asset that the information relates to, to make that asset “tradable.” A transaction layer is added to the information layer, with the aim of creating a market for the underlying asset. In essence, NFTs are tools for turning previously non-liquid assets into “quasi-liquid” assets.

Early use of NFTs: the example of the ‘art’ NFTs

While the scope of application for NFTs is significant and it is fair to assume that NFTs will, one way or another, play a much greater role in our lives than they do now, the hype and publicity surrounding NFTs has largely been focused on the use of NFTs to trade artworks. Other assets have started to be tokenized and traded as NFTs (such as music, video games skins, etc.), but the wave of enthusiasm triggered by the sale of a Beeple NFT by Christie’s for $69 million in March 2021 means that a vast amount of NFTs currently being minted and sold through marketplaces are artworks.

In its blog post about the sale, Christie’s mentions that it “is the first major auction house to offer a purely digital work with a unique NFT (Non-fungible token) – effectively a guarantee of its authenticity – and to accept cryptocurrency, in this case Ether, in addition to standard forms of payment for the singular lot.”

But what exactly did Christie’s sell here? Did the acquirer – a crypto investor who goes by the name of “Metakovan” – really pay $69 million for a certificate of authenticity?

“Owning” art. Ownership is a legal concept as old as human civilization. It is surprisingly simple and complex at the same time and a concept that has had to adapt quite dramatically to the advent of the digital era. As discussed in an earlier blog post, in law, property is “the right to enjoy and dispose of things in the most absolute manner.” This is clear when it comes to, for instance, your house. You bought it; it is your property in absolute.

By contrast, intellectual property is a far younger concept. intellectual property is a branch of law that comprises the rules applicable to “intellectual” or “immaterial” creations, which are elevated to the rank of “intangible property” by the law. For instance, the law designates patentable inventions, trademarks, and creative content as intangible assets that may be appropriated and “owned.” By contrast, the law does not designate mere data or mere information as being protectable by intellectual property rules and therefore capable of being “owned” – and for good reasons. In democratic societies, information and data, just like ideas, are free-flowing. Data, in itself, is not something that can be appropriated or “owned.” It is not possible to own the information that Joe Biden was elected president of the United States in the 2020 elections, just as you cannot own the idea of painting flowers.

So now, if you apply this logic to the world of art, you end up with the following situation. Two kinds of property exist in physical artworks: the tangible property and the intellectual property. Whereas only one kind of property exists in digital artworks: the intellectual property. What this means is that unlike a physical work, a digital artwork cannot be owned by two persons or entities at the same time. Only one property exists, and that is the intellectual property of the creator.

Many commentators have tried to draw an analogy between purchasing a digital art NFT to buying the physical original of a painting; the analogy they would draw, for instance, is that buying an NFT of digital art is akin to purchasing the Mona Lisa. But, this analogy does not hold water. When a person buys a painting from a gallery, what they buy is the “tangible property,” that is, the canvas and the paint – not the intellectual property. NFTs do not replace canvas and paint because NFTs are nothing more than information, and information cannot be owned.

While there are respected legal commentators who have suggested that some common law systems (English law in particular) may well have sufficient flexibility to expand the application of property law to certain types of purely informational crypto-assets, reconciling this notion with the freedoms of expression and information enshrined in international conventions[1] seems a particularly difficult task. Without legislative intervention, the absence or existence of property rights in information will continue to provoke difficult questions for crypto stakeholders.

What our research shows is that most NFTs being minted today are far more akin to providing a service (the authentication of a work of art) or granting a license (a limited permission to use and enjoy the digital art), but very rare are the occurrences where true ownership is being passed to the acquirer. The key takeaway from this is that purchasers of NFTs should understand what they are “buying.” Equally important is for those tokenizing artwork to be careful in how they market and advertise their NFTs. Advertising the “sale” of artwork could be potentially misleading if all the NFT creator is offering is a digital certificate. As we learn from behavioral economics and the endowment effect, the temptation might be strong to advertise NFTs like nothing less than a “sale,” but the consequences of doing so might be fraught with serious legal issues.

The (smart) contract issue

A key feature of NFTs is that they are (or ought to be) liquid and thus easily tradable. This is what gives them their apparent value and why we are seeing digital assets being sold and bought for millions. But where the NFT is nothing more than a license, how liquid can a license really be? A typical license agreement invariably offers some form of warranty or indemnity from the licensor to the licensee, against anything disturbing the quiet enjoyment of the rights granted, but if the NFT changes hands 20 times, who will stand behind the content?

Another challenge of using NFTs to “sell” certain limited licenses or usage rights over digital artwork is knowing how to effectively “attach” the contract/terms and conditions to the NFT such that the purchaser (and future purchasers) of the NFT is bound by them. The related issue is how can a seller or marketplace easily enforce the terms of those contracts against the applicable purchaser. Sellers and marketplaces have to walk a fine line between ensuring they impose appropriate terms on purchasers of NFTs and ensuring those NFTs can be traded easily with little formality. The more sophisticated the usage rights are, the more critical it will be to ensure that the seller imposes robust contractual restrictions and remedies on purchasers. Sellers will need to bear this in mind when choosing which marketplace through which to sell NFTs.

1. Including art. 10 of the European Convention on Human Rights which states: “Everyone has the right to freedom of expression. This right shall include freedom to hold opinions and to receive and impart information and ideas without interference by public authority and regardless of frontiers.”

Regulation, regulation

There is no specific regulation yet regarding NFTs, but the carefree attitude of early adopters should not serve to elude the reality: NFTs are regulated exactly like any other type of asset you can buy online. As transaction volume grows, we suspect there will be greater scrutiny applied by regulators, authorities, and watchdogs. While the issues will be as numerous as there are NFTs, two compliance issues deserve a special mention.

a. Securities regulation. As described above, NFTs have been designed to carry a number of similar characteristics to a financial asset. Although they are not fungible, NFTs have been encouraging, and used as a tool for, speculation. Consequently, it is possible that they may come to be regulated within financial regulation, but the question is still open. One of the primary factors that will determine whether an NFT is a security is the purpose for which it is being created and sold. 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 is more likely to be considered a security. Those considering minting an NFT should take advice before doing so to avoid unintentionally breaching financial regulatory law. Even the way in which the NFT is described and marketed can influence the extent to which it may be considered falling within the scope of securities law, and we foresee some marketplaces and sellers coming unstuck if they do not consider this seriously.

b. Consumer law. NFTs are offered to the public; they are not restricted to professional buyers only. Accordingly, marketplaces and sellers are subject to local consumer law, which requires them to operate with a high level of transparency and brings them within the scope of consumer protection laws on unfair commercial practices, including the right for consumers to withdraw and to receive appropriate information about the NFT in their local language, subject the NFT sale to their local law, etc.

a. Tax law. The nature of the transaction will determine its tax status (is it a sale or a license, a national or an international transaction, B2C or B2B, etc.). The tax treatment will also be different for marketplaces, sellers, and purchasers. With the high fluctuation in prices, it will be critical to obtain proper tax advice to understand your exposure to VAT and other taxes.

In conclusion, NFTs may be fun experiences, giving people special access to something they personally value (like an unreleased track by your favorite band, or a digitally signed artwork), but those looking to make a solid investment should understand the risks and limitations attached to NFTs and not let the sirens of digital ownership replace a robust due diligence exercise.

Sophie Goossens
Partner
London
sgoossens@reedsmith.com

Nick Breen
Partner
London
nbreen@reedsmith.com

"There is no specific regulation yet regarding NFTs, but the carefree attitude of early adopters should not serve to elude the reality: NFTs are regulated exactly like any other type of asset you can buy online."