Podcast Transcript

Everything You Need to Know About NFTs in 10 Minutes or Less

Date: July 21, 2021

Host: Randall Rubenking **Guest:** Robert Musiala

Run Time: 12:26

For questions and comments contact:

Robert A. Musiala Jr.

Counsel
Chicago
T: 1.312.416.8192 | rmusiala@bakerlaw.com

Rubenking: NFTs. It seems no matter where you turn these days, people are talking about this emerging market. But what is a non-fungible token? What can you do with one? And what kind of regulatory risks can you expect if you join in?

I'm Randall Rubenking, and you are listening to BakerHosts.

On today's episode, Rob Musiala, a Counsel in the Digital Assets and Data Management group and the co-leader of our Blockchain Technologies and Digital Currencies team, discusses everything you need to know about NFTs… in 10 minutes or less.

Let's listen in.

Musiala: So my goal is to provide a brief introduction to some of the key concepts related to NFTs and the market, the technology, the legal issues. So I'll try to keep this to about 10 minutes and let's get right into it.

NFTs are really one of the newest markets that has emerged in the data management and digital asset space. The first thing you need to know about NFTs is that this market is here. This is not something that is coming in the future. This market has arrived. Just as a couple examples, you know, the market really started with the NBA Top Shot series. It was selling video clips of famous NBA plays and that market has generated somewhere in the neighborhood of $600 million to date. Time magazine has sold classic magazine covers as NFTs. Topps Baseball Cards, not to be outdone by NBA Top Shot, has now launched baseball cards issued as digital NFTs. Mick Jagger and Dave Grohl recently put out a single as an NFT, and that NFT is a song that's actually attached to piece of digital artwork along with the music file. The auction house Christie's has been auctioning off these CryptoPunks NFTs, as well as other NFTs. The CryptoPunks have gotten a lot of attention because they've been selling for very high values, $17 million at the time that I had finished this last week. But just last Friday evening, I found out another one of these CryptoPunk NFTs sold for about $11.7 million at Christie's. And even the AP and New York Times have sold NFTs related to historical photos and articles from their publications, so, and that's, this is just only in the past couple months and this market just continues to evolve very rapidly.

So what is an NFT? Well, NFT stands for non-fungible token, and it's essentially a blockchain based token that is attached to a digital media file. And by doing that, you effectively create a uniquely identifiable digital media file so that the owner of that ERC-721 token, that NFT, is able to prove that they own the original version of the digital media file. And that can be proved using blockchain data. I'll talk a little bit more about, kinda the technical aspects in just a second. But before I do, I just want to get into a little bit of a background on the Ethereum network which underpins a lot of this.

So Ethereum is what I call public blockchain 2.0. The Bitcoin network was the first ever blockchain network. It was launched around about late 2008, early 2009. For a couple years, developers were watching this and studying the code, which was open-source. And then in 2015, the Ethereum network was launched and the builders of the Ethereum network essentially copied a lot of the blockchain source code which was publicly available. And they tweaked it and they modified it to add some unique features to make it so that it could do things more than just facilitate payments. And this is the Ethereum network. And so some of the unique aspects of the Ethereum network are here on the slide. The first that you need know about is, are these things called smart contracts, which is basically the ability to imbed logic rules into the Ethereum blockchain. So that when one type of transaction happens, another type of transaction automatically happens. The Ethereum also allows you, in addition to transferring Ether, which is the cryptocurrency on Ethereum, it also you to create your own cryptocurrency. These are called ERC-20 tokens, and these have created a lot of very complex legal issues. We're not gonna get too much into ERC-20 tokens today.

You may have heard of these terms called DAOs and DeFi. DAO stands for distributed autonomous organizations. DeFi stands for decentralized finance. These are essentially applications that are created through a combination of smart contracts to effectively run automated applications without the need for human involvement, both in the financial sector and other sectors. And then, the latest development from Ethereum are NFTs, non-fungible tokens. Similar to ERC-20 tokens, these are tokens that you can create and that reside on the Ethereum blockchain. Except, what's different about them is that while ERC-20 tokens are essentially fungible, where you can't tell one from the other, ERC-721 tokens are uniquely identifiable. And so it's by creating these uniquely identifiable tokens on the Ethereum network or other blockchains, you are able to create a digital asset where only one person can hold and own that asset, that digital asset at any given point time. And you can prove through the underlying blockchain that that holder is actually holding the original and not copy.

With that technical background, an NFT is created by first creating an ERC-721 token on Ethereum or another blockchain, usually Ethereum, and that 721 token is uniquely identifiable itself on the blockchain. The ERC-721 token does not store the image. Instead it points to the image. So it's embedded with code that will point to another location where the media file resides. And that media file can reside in a centralized database. It can also reside in a decentralized database like IPFS. And the decision where to store your media file for your NFT is an important one. And then, you know, the owner of an NFT is actually, from a technical perspective, holding that ERC-721 token in a blockchain-based digital wallet, and middleware effectively allows the holder of that token to connect to where the media file resides, such that the holder of that token is the only one that is able to access the "official" version of the media file. And again, the owner of that token can prove indisputably on the blockchain that they are in fact the owner of that official version of the media file.

And so how does, you know, to bring of all these technical concepts together, you have to work with vendors. And there are dozens of vendors that have arisen in this space, all with different business models and subtly different and unique aspects. And so it's critical, you know, if you're looking to potentially launch an NFT initiative, to evaluate those vendors, understand what they can and can't do, understand who has the ability to best fit your specific needs. One concept that I want to highlight that the vendors are able to do is you can attach more than just a media file to your NFT. So, for example, and one thing I like to highlight for clients is that you can attach clickwrap terms and conditions to your NFT. In the same way that the blockchain token points to the media file, it would also point to the terms and conditions that govern the ownership and secondary transfers of that media file. So just one example of some of the options that some of these vendors can assist with.

I also want to note that, you know, if you're looking to launch an NFT initiative, you may want to consider enabling the ability to accept cryptocurrency as payment for selling NFTs because this is very much a cryptocurrency and blockchain focused market. And while you don't necessarily have to sell NFTs for cryptocurrencies, the ability to accept cryptocurrencies as payment I think can really help in building out your NFT marketplace and model. And so you have to consider other vendors that can help you to accept, hold, store, and eventually convert cryptocurrencies into U.S. dollars in a way that's compliant with regulations, especially with the U.S. Bank Secrecy Act.

And lastly, from market perspective, I just want to highlight that NFTs, because of the blockchains that underpin them, are enabling a lot of new models related to digital assets. One of which is the potential to create, what I'm calling and what other have called, perpetual royalty payments. This is something that a lot of folks in the technical community are working on right now, as we speak. Conceptually, it is very much doable, based on sort of the functionality of the Ethereum network. And the idea is that through a clever combination of smart contracts, you can embed and program into your NFTs, restrictions that would restrict the transfer of the NFT on the secondary marketplace until and unless that that transferee pays a perpetual royalty payment in the form of a cryptocurrency that would be sent directly to the wallet of the original seller and creator of the NFT. And so you can imagine how this ability to collect perpetual royalty payments in the secondary marketplace can really be transformative in the world of art and digital media.

So, I'll talk about just a little bit of the legal and regulatory risks related to NFTs. The 30,000-foot view is that in the United States, the cryptocurrency and blockchain market is in a highly complex regulatory area. And, you know, in general, you have four different regulatory agencies here in the U.S. that define cryptocurrencies in four different ways. You have FinCEN; the Financial Crimes Enforcement Network defines cryptocurrencies as money subject to the Bank Secrecy Act and FinCEN regulations. The IRS defines cryptocurrencies as property and so they'll be taxed just like property where you have to keep track of your gain and loss and basis. The CFTC defines cryptocurrencies as commodities and the SEC with some very limited exceptions defines cryptocurrencies as securities.

So, this is the complex environment that you have to navigate if you're looking to launch an NFT initiative. In general, those top two regulators FinCEN and IRS are almost certain to apply to NFTs. The two at the bottom, CFTC and SEC have been relatively silent so far and so the application of the regulations is unclear. But all four of these regulatory regimes needs to be considered in order to launch an NFT in a responsible way. And lastly in addition to the regulators, you know, the legal environment is also evolving in the private marketplace. Most recently just about a month ago Dapper Labs, which was the platform that helped launch the NBA Top Shot NFTs, was hit with a private civil class-action lawsuit alleging that those NFTs were unregistered securities.

And so, what this shows us is that while the SEC hasn't to date had an enforcement action in the NFT market. We already have private class-action litigants that are using SEC regulations as the basis to form private lawsuits. And one thing that I found interesting about this particular complaint is that the allegations in the complaint included allegations that Dapper Labs "used their control over the platform to prevent investors from cashing out their NFT purchases." So there seems to have been some kind of, you know, failures of that platform that may have, in my opinion, you know, really kind of underpinned a lot of emphasis behind this lawsuit. And so, this just goes to show that in addition to regulatory risks there are also risks that you have to consider with respect to sort of the private marketplace and potential litigation.

So that is your ten-minute introduction to NFTs.

Rubenking: Thank you, Rob. If you have any questions for Rob, his contact information is in the show notes. As always, thanks for listening to BakerHosts.

Comments heard on BakerHosts are for informational purposes and should not be construed as legal advice regarding any specific facts or circumstances. Listeners should not act upon the information provided on BakerHosts without first consulting with a lawyer directly. The opinions expressed on BakerHosts are those of participants appearing on the program and do not necessarily reflect those of the firm. For more information about our practices and experience please visit Bakerlaw.com