NFTs – *Caveat Emptor*

By Alan Snyder

The technology is beguiling: the Non-Fungible Token (NFT) market has exploded, heading toward $3 billion in sales; the applications run from digital art to sports, gaming, other collectibles, real estate and more; is it all much ado about nothing, a passing fancy reminiscent of "Tulipmania"? While it may be the Wild West, we believe it has the power to evolve and be significant. Buyers should, however, carefully contemplate the current shortcomings despite the hype, arcane tech language and crypto froth. In this brief note, we will highlight issues surrounding art "NFTies" (also shortened to tokens).

Introduction

An NFT is a digital "asset," recorded and certified on blockchain, that represents ownership (a slippery term, as detailed below) of an item, but is not the item itself. For example, if you purchase a digital image via an NFT, the image remains separate and can still be copied, distributed, etc. but the NFT representing your ownership cannot. The "non-fungible" part of NFT means that it is unique. Unlike, say, fungible bitcoins (one bitcoin is indistinguishable from another), NFTs are one-of-kind and represent a specific item or share of an item.

Intellectual Property

You must ascertain from the beginning exactly what rights are conferred to the token owner. Generally, the copyrights are retained by the original copyright owner (usually, but not always, the author or creator of the work), limiting the image use. In the most ballyhooed NFT sale to date of the Beeple (Mike Winkelmann) titled "Everydays: The First 5000 Days" for $69 million, the artist retained the copyrights. Vignesh Sundaresan, the buyer, paid a bunch simply to have the bragging rights to claim ownership of the image, though Winkelmann can sell the individual images as he chooses. Last to consider, can the image be reproduced and/or limited to non-commercial (personal) use?

If the token holder undertakes a non-permitted use, can the token be burned, a.k.a. extinguished or cancelled? Exactly what constitutes proof of cost basis like a traditional old-world bill of sale, including for tax reporting given the opaqueness emanating from some token trading strategies, e.g., tumbling? Highlighting the tax issues is whether to pay taxes on the cryptocurrency sales that funded the purchase and/or to pay tax on the gain/loss upon sale of the NFT.

Securities Laws

Does the token purchaser become exposed to liability or loss of ownership if the token seller, platform (if indirect) or auction house has violated securities laws? Lately and with renewed vigor, the federal government has demonstrated that it is not keen on dirty money being used to make large value purchases. Witness new broader regulation being applied to real estate and dealers. The issues: was there a broker-dealer involved in the sales process, particularly if multiple tokens were issued against the same piece (fractionalization); and, did anyone in the process ask for "Know Your Customer" ("KYC") and other Anti-Money Laundering ("AML") information? Being swept into these issues can be expensive, painful from adverse publicity, and a colossal distraction.

Contract

Ethereum, the most commonly used cryptocurrency for NFTs, provides a "smart" contract that may define some of the operations and legal provisions. Ethereum is a blockchain network that manages smart contracts, which are software instruments that self-execute certain functions according to pre-programmed parameters and triggers. A popular smart contract is the ERC-721 token standard used for managing NFTs. By publishing an ERC-721 contract to Ethereum, network participants can mint new NFTs that operate according to the logic of their governing smart contract. Nothing in this new world is straightforward - examine the new phenomenon of "sleepminting," which is a new risk albeit an unlikely one. However, with case law limited, these smart contracts are not yet tested; and oftentimes, additional contract provisions are "off chain" with the token pointing to them in a more detailed file. We have been repeatedly told about the immutability of the blockchain, yet what about such subsidiary files?

To the predictable delight of all artists, many NFTs provide for the artist to participate in a royalty payment when, as, and if the token is sold to a new purchaser. There is a big BUT. Royalties are enforced on the level of the marketplace, not the blockchain. It is up to the marketplace to enforce the royalty schema. Hence, these payments may not be made if the sale were to occur on a new platform that does not recognize this payment obligation. Oops!

Can the token buyer be sure that additional tokens will not be sold, diluting the value of ownership? Maybe yes and maybe no. If the number is on the blockchain, the token holder is protected except in the event of fraud. If not on the chain or IPFS, the protection is less certain. IPFS stands for the modestly named Interplanetary File System, which offers third party verification of the data and notes any changes made.

If there are seller warranties, how are they represented, enforced, and claimed, if breached? Currently, there is limited clarity.

Determining who originally sold (minted) the token may not be obvious, but can be extremely important. Let's say an NFT platform minted the token. What happens if the platform goes bankrupt, which has happened? The link between the token and the digital image may be lost depending on how and where the image was stored. Ugly, and now the NFT owner may be S.O.L.

Insurance covenants add to the challenge. Where is the contract held, were the beneficiaries clearly defined, were any premiums paid, and lastly, is the coverage still in place?

Technology

NFTs are not cost-free. In fact, it takes some sleuthing to discover all of the costs. At the time of the original purchase was there a fee tacked on exogenously to the token purchase price, much like a commission or service fee? There may be imbedded fees in the "smart" contract or in an offline file to be paid on any future sale. The heralded costs of processing any blockchain transaction must be paid as well; these are the notorious "gas" fees. All of these costs add up and may make any potential trading gain illusory.

Some of the earlier comments have touched on tech issues. At a basic level, where information is stored becomes essential to ascertain, i.e., on the platform, on the blockchain (currently unusual for images given the large file sizes), IPFS, or on a platform server?

Future

While nascent, there are many positives surrounding the NFT ecosystem:

- Smart contracts can be tailored to pay artists, originators and other service providers
- Immutable recordkeeping for some of the data sets
- Fulsome descriptions of provenance, authenticity, exhibition history and artist information
- Multiple buyers tied to the underlying art, lowering the cost of entry
- Detailed sales records and prices
- Access to heretofore unavailable or hard to access art

To date, the focus has been on digital art, a rapidly growing genre appealing to tech savvy millennials. What if the NFT benefits could be applied to physical art? The addressable market is $1.7 trillion with annual sales turnover approximating $60 billion. Sadly, most physical art is stored in climate-controlled warehouses or vaults by collectors and museums without enough wall space. Images travel easily - people, not so much. Buying a fractional interest in a Picasso or Basquiat creates a more approachable investment that can also be tradeable. A diversified hard asset portfolio could be created using NFTs. The list of potential use cases is long and varied.

Conclusion*

OK, the above was a quick traipse through the tulips and outlines several issues that should be researched. Every investment takes work, new ones particularly. *However*, we believe NFTs and their technology underpinnings, while rough today, will become more polished over time and we aim to be a polisher.

Years ago, as a young punk, I hit Wall Street after securing the obligatory, at the time, MBA (Much Better At last). The listed options market was just beginning, supplanting the OTC (over the counter puts and calls) market. Without any gray hair, and having analyzed the inherent profitability, my bona fides were similar to all others. Believing that this toolkit would exponentially grow, I jumped in. Even this leaky ship was raised as the tide came in.

We believe NFTies offer a similar upside with the right admixture of intense hard work, out of the box creativity, commitment to high-level security protocols, and regulatory compliance. Shinnecock Partners plans to embrace all of these.

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