What Do You Actually Own When You Own a Non-Fungible Token?

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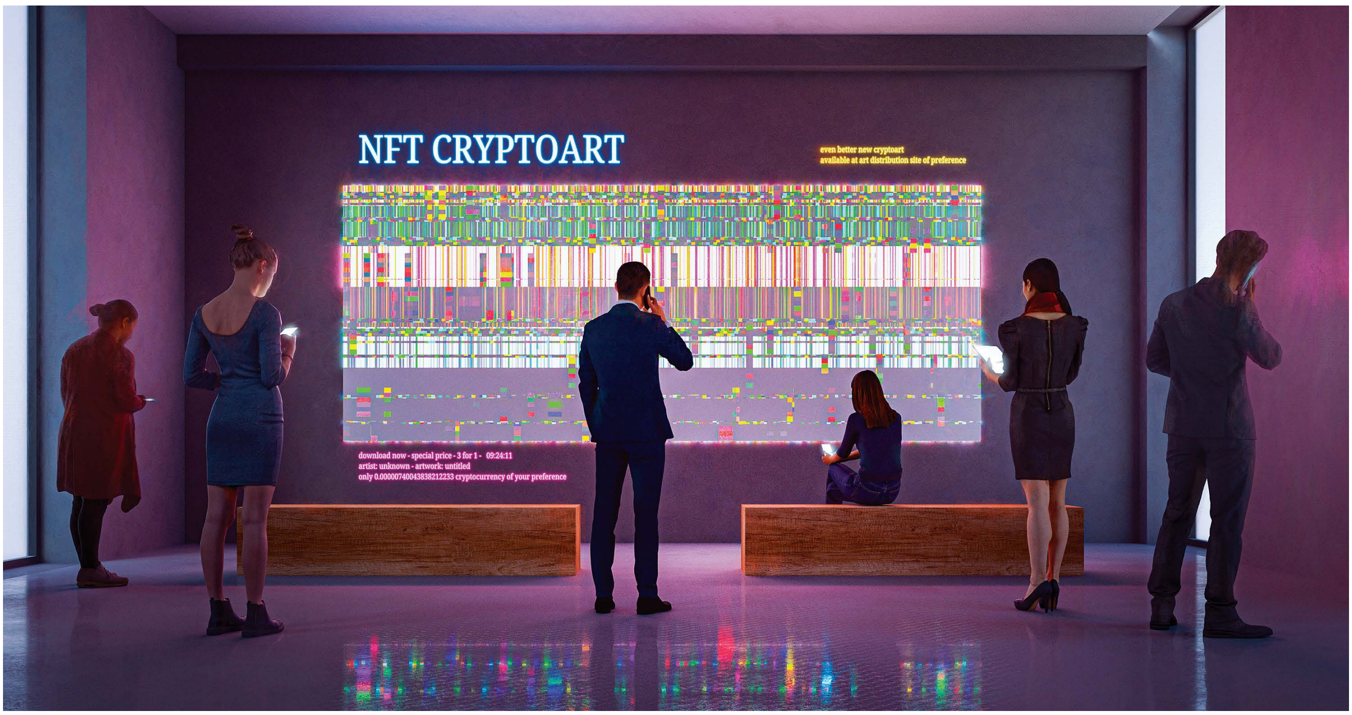

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"Charlie Bit My Finger," a 56-second home video of British toddler Harry Davies-Carr and his infant bher Charlie, was one of YouTube's earliest viral sensations. The 2007 video returned to the headlines in May 2021, when the boys' family sold it as a "non-fungible token" (NFT) for more than $760,000. It commanded the exorbitant price because the buyer could be sure the video was the family's original clip, not one of the many thousands (if not millions) of identical copies available on the internet.

Before the advent of NFTs, creators of digital art and other electronic media faced severe limitations on their ability to monetize their work given the ease with which anything digital can be replicated and shared. NFTs solved this problem by allowing artists to place a digital authentication on their original work, akin to a signature on an oil painting. The results have been extraordinary. One month before the sale of "Charlie Bit My Finger," Christie's sold an NFT collage by digital artist Beeple for $69 million, the third-highest sale price ever for a work by a living artist.

But the dramatic rise of NFTs has not gone without controversy. Skeptics compare their emergence to the dot-com bubble of the 1990s and call into question what, if anything, the owner of an NFT actually owns. There is no official agency guidance regarding NFTs' asset class, nor is it clear which, if any, agency has authority to regulate NFT transactions.

What Is an NFT?

NFTs are a newfound application of blockchain, the digital-ledger software that allows users to record data in permanent and unalterable form across a widely distributed and decentralized network. Although blockchain is known primarily as the technological foundation for cryptocurrencies, the "coins" of which are intentionally uniform and interchangeable, there is nothing inherent in the design or concept of blockchain that requires data units to be fungible.

Like the coins of a cryptocurrency, NFTs are "tokens," i.e., units of data transferrable between parties and then recorded in the blockchain. But unlike cryptocurrency, NFTs derive value from the fact that they are intentionally and inherently one-of-a-kind items; by definition, they are "non-fungible." Once an NFT is recorded in the blockchain, it becomes an unalterable and externally verifiable record of the authenticity of a particular thing, supplying the critical elements of scarcity and integrity to assets that are otherwise difficult to commodify.

Although originally designed to authenticate digital art, NFTs have since been adapted to nearly every form of media. Earlier this year, the rock band Kings of Leon sold their new album in NFT form, generating a reported $2 million. Twitter founder Jack Dorsey made nearly $3 million for charity by selling an NFT of his first tweet. And the University of California-Berkeley made headlines when it announced it would auction, in NFT form, the patent disclosures of two Nobel Prize–winning inventions.

Notably, an NFT does not itself contain the image, film clip, invention, or other item it authenticates; the original media normally cannot be stored in the blockchain because of its file size. Instead, the NFT functions merely as certification of ownership and authenticity, making the blockchain analogous to a title registry for non-physical assets. Like a title registry, the NFT usually directs visitors to the location of the property in question, often through a link to the domain and IP address of the original item. But because electronic data at any particular domain can change over time, NFT-based links are subject to "link rot," like all other links, and hence the passage of time can leave an NFT pointing to nothing at all.

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What Rights Does an NFT Convey?

While an NFT is nigh-unimpeachable as a record of authenticity, it conveys fewer rights than other types of property. In the case of physical art, a purchaser ordinarily has the right to remove a work to the location of his or her choice. Although reprints and posters may be available, the original work itself is subject to the owner's exclusive right of access.

Not so for NFTs. The owner of an NFT generally has no right or ability to prevent others' access to the original work, let alone the many readily available and indistinguishable copies that may exist. Jack Dorsey's first tweet, for example, remains on Twitter where it has always been, and the purchaser of the NFT merely owns the blockchain marker certifying his ownership of it. Given this reality, skeptics analogize the purchase of an NFT to buying only the deed to a house, rather than the house itself, with the deed as the proof of purchase.

Nor does ownership of an NFT carry with it the copyright to the underlying work. Unless separately conveyed via contract, the copyright ordinarily remains with the creator of the work, who is free to continue exploiting it commercially. In other words, the purchaser of an NFT cannot prevent its seller from making multiple, identical copies of the same digital work and then selling them individually as unique "originals," each with its own NFT. According to the *New York Times*, a popular digital artist known as Pak has done exactly that, selling a series of NFTs representing the same exact image, each with a different title, at prices ranging from $1 to $1 million.

Given the limited rights that NFTs convey, commentators have wondered how they can fetch such extraordinary prices. But NFT buyers are primarily blockchain and cryptocurrency sophisticates who are comfortable with transactions premised entirely on ascribed rather than intrinsic value. And it may be no coincidence that the dramatic rise in NFT popularity overlaps neatly with the COVID-19 pandemic. As Harvard Law Professor Rebecca Tushnet observed in a recent interview, some amount of enthusiasm for NFTs may be attributable to the fact that buyers, unable to enjoy their ordinary activities, were simply looking for a new hobby.

What Is Next for NFTs as an Asset Class?

Thus far, 2021 is on pace to eclipse 2020 in NFT trading volume, with more than $200 million in total NFT sales in the first quarter alone. U.S. regulatory agencies have yet to provide official guidance as to NFTs' proper treatment as an asset class, focusing to date on cryptocurrencies. However, it is unlikely that the current lack of oversight will persist if the NFT market continues to grow. This raises the question of which, if any, regulatory scheme presently covers NFTs.

Unlike cryptocurrencies, which are routinely traded on exchanges for their potential appreciation in value or simply as a hedge against inflation, NFTs are not as readily characterized as financial instruments or securities subject to oversight by the Securities and Exchange Commission. Indeed, one might question whether any federal regulatory interest exists for an NFT transaction that, as some law firms have noted, more closely resembles a fan buying a collectible than an investor buying a stock. That said, the definition of "commodity" under the federal Commodity Exchange Act is extremely broad, and the Commodity Futures Trading Commission has already claimed regulatory jurisdiction over market-traded intangibles like renewable energy credits. Only time will tell whether it—or another agency—will decide that NFTs are sufficiently important as an asset class to warrant its oversight. LN

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