NON-FUNGIBLE TOKENS AND THEIR LEGAL IMPLICATIONS

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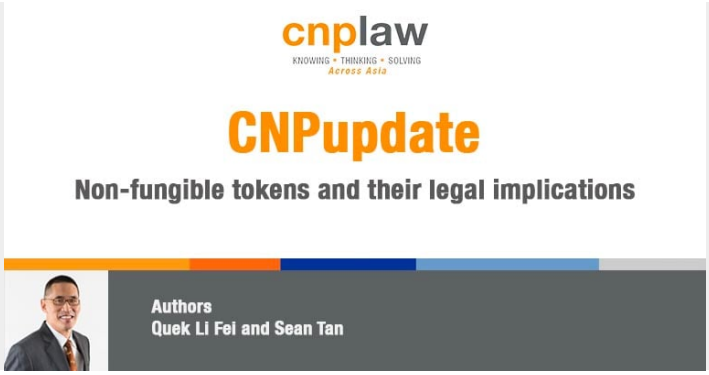

Category: CNPupdates

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What are Non-fungible tokens?

Non-fungible tokens ("NFTs") are unique digital tokens backed by blockchain technology, the same distributed ledger technology supporting well known cryptocurrencies such as Ethereum and Bitcoin. Despite having been around for a while, NFTs have become quite the rage recently largely due to the popularity of cryptocurrency as well as the infrastructure supporting cryptocurrency, *viz.* blockchain. Unlike traditional fiat currency, cryptocurrency and other digital payment tokens, where fungibility is a key characteristic, an NFT creates value due to its non-fungible nature, which is intended to create scarcity.

A short explanation on what "fungible" means may be helpful. A fungible is an item which does not bear unique characteristics and any one of which is replaceable by another identical item and mutually interchangeable. A good example of a fungible is any fiat currency like the US dollar. Each dollar note is considered alike. Likewise, fungible tokens are completely interchangeable with each other. Contrary to "fungible tokens", NFTs have a unique value proposition. NFTs are unique instances, and every token has a unique ID for easily differentiating from other tokens in the same smart contract for that token. The non-fungible token will have a particular owner, and each NFT's value may differ because of the separate treatment of each token. Certain NFTs can represent unique tributes having provable scarcity.

Traditional works of art such as paintings and sculptures are valued due to their uniqueness, which in turns creates scarcity. In contrast, digital files (i.e. digital art) can be easily and infinitely reproduced. An NFT can therefore be used to "tokenise" a digital file to produce a digital certificate of ownership that is stored on the distributed ledger which can subsequently be bought and sold. This enables the creator to make the digital file unique and attach the element of scarcity to the digital file, thereby creating value.

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Understandably, this phenomenon may create a host of novel legal issues and implications.

Regulation of NFTs in Singapore

The Payment Services Act of 2019 ("PS Act") defines "digital payment token" to mean:
"*any digital representation of value (other than an excluded digital representation of value) that – (a) is expressed as a unit; (b) is not denominated in any currency, and is not pegged by its issuer to any currency; (c) is, or is intended to be, a medium of exchange accepted by the public, or a section of the public, as payment for goods or services or for the discharge of a debt; (d) can be transferred, stored or traded electronically; and (e) satisfies such other characteristics as the Authority may prescribe*".

Based on the above, although it appears that the definition of a "digital payment token" mainly applies to fungible tokens, it may be possible for certain types of NFTs, depending on the relevant factual circumstances (such as its usage and attributes) and underlying digital file, to fall within the definition of a "digital payment token". Correspondingly, the relevant provisions within the PS Act may be applicable to NFTs which constitute digital payment tokens.

Other potential legal issues

A potential legal issue will be the establishment and enforcement of intellectual property rights as well as contract issues relating to NFTs, given that the sale and purchase of NFTs have been proposed to be governed by smart contracts.

Innovators behind NFTs have also been exploring other methods to further fractionalise the NFTs in order to create a bigger market and generate more interest amongst potential buyers, and the rapid pace of these developments will require close regulatory scrutiny as to whether NFTs could fall within the definition of a security or a collective investment scheme and be subject to requirements under securities laws and regulations, such as prospectus and licensing requirements.

It should be noted that, generally, intellectual property ("IP") rights are jurisdictional whereas an NFT may change hands through the blockchain, which is available to the users of the internet across jurisdictions. Therefore, an artist selling a tokenised digital work of art may not be able to enforce his or her rights against an imitation made by a buyer of the NFT in a separate jurisdiction. While this risk may be similar to the export of a copyrighted product to a foreign country, the anonymity behind blockchain technology makes it even harder for the creator of the NFT, the artist, to enforce any form of IP or contractual rights against the imitator buyer.

Given that the underlying digital file of an NFT can vary across different types of digital content, legal issues and implications may vary across NFTs. While the NFT phenomenon has seen the tokenisation of digital files representing digital artwork, it is unlikely to be long before a new form of digital file or asset is introduced and tokenised by an NFT.

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