

NOTES AND REFLECTIONS

LEGAL FRAMEWORK OF NON-FUNGIBLE TOKENS LEGAL REPERCUSSIONS & CHALLENGES AHEAD

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Introduction

Non-fungible tokens (NFTs) are often regarded as the cryptocurrency of the future. The ownership and value of an original digital asset like a picture, video, or audio file may be established with the use of a digital asset called a Non-Fungible Token (NFT). Blockchain technology and smart contracts are used to issue them on these assets, creating one-of-a-kind digital signatures and guaranteeing their safety. As a result of their speculative nature, sudden price drops or rises, and susceptibility to cyber security attacks, they are very risky investments. NFTs aim to alleviate the burden of proof-of-ownership verification.

Due to the ease with which digital material may be duplicated and circulated, the value of the original work has decreased as a consequence of the proliferation of copied and redistributed versions. NFTs are an effort to institutionalize decentralization, ownership tracking, and value storage, and to publicize the legitimate owner's right to the original work in the case of a copy. Its stated purpose is to function as a verifiable evidence of ownership and to bestow "*digital bragging rights*" onto the inventor by way of a record of such possession. Moreover, Proponents of NFT argue that the tokenization of assets will fundamentally alter the ways in which digital (and eventually physical) assets are bought, sold, and utilized in other transactions.

Hence, the practice of tokenizing actual goods is not new in the eyes of the law. Bills of lading, deeds of title, and security certificates are all examples of documents that may be used to represent assets and the rights and interests in them. Tokens is a suitable term for them. The challenges of securely transferring assets inspired the development of tokenization. The law, which had evolved in tandem with market norms, offered the



critical conceptual foundation for addressing rights and responsibilities concerns brought about by these novel types of property.

Blockchain and Cryptocurrency

In certain circumstances, the transfer of tokens constitutes a full transfer of ownership of the asset representing which the tokens are exchanged. Any participant who follows the rules may add data to the distributed ledger known as a blockchain. A block may include a new transaction or record. Each time a block is mined, a new one is generated. (or minting). When a transaction is finalized, it is "closed" in a block. Each subsequent block is connected to the one before it. Each block in the chain is encrypted using a "hash," a mathematical representation that incorporates data from the previous block in the chain. Each time an input is modified, a new hash is generated, making each one of them truly one-of-a-kind. Therefore, the "hash" will change if even a single link in the chain is altered¹.

The "hash" is updated and the new transaction is broadcast to the network every time a new one is processed. As a result, a sham transaction is very difficult to pull off. This makes the token unchangeable and non-transferable. Digital assets pertinent to NFT may be archived either on-chain or off-chain therefore the token stores the digital asset's hash on the blockchain². When digital assets are kept off-chain, they are kept on a separate server and are only accessible via the token's associated URL. Metadata for NFTs are kept in digital wallets on the blockchain and Each NFT wallet consists of two keys: a public key that functions like an address or account number to provide a destination and authorizes the key holder to access the data within a wallet, and a private key that authenticates the key holder and grants access to the data within a wallet. This system relies on public-key cryptography to validate authenticity³.

Legality surrounding the Conundrum of NFT and Cryptocurrency

Despite claims to the contrary on a number of websites (e.g., "having a Token is the same as owning a physical artwork"), there is frequently no correlation between Token ownership and any actual asset. The token does not correspond to its fundamental asset. Legal or copyright proprietorship of the associated digital or physical asset is unrelated to token possession. Clearly, the Terms of Service for NFT marketplaces stipulate that no ownership information is disclosed upon the purchase or sale of NFTs or Collectibles.

Despite the fact that cryptocurrencies have existed since the beginning of the previous decade, the primary debate over their legality began after a June 2018 RBI Circular prohibited banks from engaging in cryptocurrency transactions. Internet and Mobile Association of India v. Reserve Bank of India⁴ was lodged with the Supreme Court to

¹ Prashant Kataria, "Non-Fungible Tokens in India Buyer should consider – Legal Implications", *King Stubb and Kasiva*, Jun. 01, 2022.

² Vaibhav Pareek and Jaideep Reddy, "Cryptocurrency and Blockchain" *Nishith Desai and Associates*, Jul. 15, 2022.

³ Ibid.

⁴ Internet and Mobile Association of India v. R.B.I, (2020 SCC online SC 275).



contest this Central Bank decision. Article 19(1)(f) of the Indian Constitution stipulates that the freedom to engage in commerce is a fundamental right.

Even if reasonable restrictions could be imposed on this right, it was determined that the actions taken to regulate cryptocurrencies were not proportional to the dangers posed. This indicates that the Court did not consider bitcoin trading to be subject to the trading restriction. Since NFTs are exchanged for cryptocurrencies, the legitimacy of cryptocurrencies must be maintained for NFTs to be legitimate.

The court ruled that cryptocurrencies do not satisfy the definition of currency and that it would be a reach to state that they are not money in "*some special circumstance.*" Furthermore, The court rejected the respondent's argument that cryptocurrencies should be treated as commodities. Currently, it is uncertain whether NFTs are commodities, currencies, or securities. Since they cannot be exchanged for currency, it is fair to state that they are not money. It is unclear whether these items constitute commodities or security.

Even though there is an element of trading involved, NFTs may still be owned and traded. Land is similar to currency in that it is frequently held but also traded for profit. Immediately after this ruling, the Indian government decided to convene a committee of cryptocurrency industry experts to draft regulations for the Indian cryptocurrency industry.

Recent panel updates indicate that the Indian government is contemplating launching a cryptocurrency governed by the Reserve Bank of India, rather than allowing international cryptocurrencies to operate within the country. (RBI). If this were the case, Bitcoin and other similar cryptocurrencies would not be able to be purchased or sold, severely limiting their utility. In conclusion, the legal status of cryptocurrencies in India is unclear to us. It is undetermined what the future position of the government will be despite the fact that it is being traded and taxes are being deducted. Also unknown is the precise status of NFTs in India.

Contemporary Perspective in Purview as well as Catering to United States

WazirX, a new online market for NFTs in India, debuted not too long ago and has been performing admirably so far. The Indian government, the Reserve Bank of India (RBI), and the Securities and Exchange Board of India will determine the NFTs' credibility⁵. (SEBI). The classification of non-fungible tokens (NFTs) in the United States⁶ depends on a variety of factors, including whether they are sold as collections or as investments with the assurance of returns. In the first scenario, NFTs may be classified as commodities under Section 1(a)(9) of the Commodities Exchange Act (CEA), which defines commodities as "*all services, rights, and interests (except motion picture box office receipts, or any index, measure, value, or data related to such receipts) in which contracts for future delivery are presently or will be dealt in.*"

⁵ Hemant Kashyap, "WazirX Shatters NFT Marketplace Amid Ongoing Crypto Winter", *Inc 42*, Feb. 22, 2023.

⁶ Robert J, "The regulatory considerations of NFTs in the United States", *Coin telegraph*, Mar. 17, 2023.



In *Securities and Exchange Commission v. Howey Co.*⁷, the Supreme Court of the United States ruled that a security must meet all four of the following criteria: *"The test is whether the scheme involves an investment of money in a common enterprise with profits derived solely from the efforts of others."* This criterion is based on the efforts of others.

In 2019, the Securities and Exchange Commission (SEC) released a framework analysing the impact of *Howey*⁸ and related case law on digital assets. Keeping in mind that the stated test is fact-based, this framework illustrates how the SEC may determine that the test's tenets have been met. Specifically, it concludes that the test is frequently satisfied when purchasers have a reasonable expectation of profiting from the labour of others, given that the first two components (an investment of money and a joint business) occur frequently.

If NFTs are offered with the expectation that the consumer will profit from the labour of others, they may be marketed as securities. Using NFTs as *"deeds"* for digital artwork is improbable at present. Complicating matters further is the possibility that purchasing an NFT would grant you additional rights in addition to the license we discussed previously. In accordance with the *Howey* test, a non-fungible token may resemble a security if the issuer possesses perpetual rights to a royalty as part of the underlying smart contract or as part of the transaction. On the other hand, the criteria is unlikely to be met if the value of an NFT fluctuates primarily due to market forces and not due to the efforts of others.

Conclusions reached as a result of the *Howey* case⁹, particularly those concerning Gary Plastic Packaging Corp. In addition, as stated in *re: Merrill Lynch, Pierce, Fenner & Smith Inc.*¹⁰, a non-security asset may be deemed a security if its marketing enables investors to earn a profit and the profit is generated through the efforts of third parties. Fungibility occurs when one f-NFT (shard: a fraction of an existing NFT) of a particular digital asset can be exchanged for another f-NFT of the same digital asset, as is the case with the increasingly widespread practice of permitting fractional ownership of NFTs on exchanges such as NIFTEX and NFTX. In this scenario, a group of modest investors have merged their funds to purchase an NFT of which they each own a portion.

On some exchanges, proprietors may divide NFTs and exchange the resulting parts separately. Investors anticipate a profit from the market trade of these fragments. Market transactions involving f-NFTs pose the question of whether they are securities under the *Howey* test established by the Supreme Court of the United States. If an f-NFT is offered to the public with the expectation of profit, if the issuer provides services that increase the value of the f-NFT, or if the issuer exerts control over the secondary market, then the f-NFT may be considered a security under the *Howey* test. Investors did not invent the f-NFT or the work for which it verifies ownership.

Therefore, f-NFTs sold on markets may be deemed securities, whereas complete NFTs acquired through auctions or other means are more comparable to real estate (collectibles). This is demonstrably true with regard to f-NFT trading, which suggests the possible application of SEC (Securities and Exchange Commission) regulations. Indeed,

⁷ *Securities and Exchange Commission v. W J Howey Co*, 1946 SCC OnLine US SC 95.

⁸ *Ibid.*

⁹ *Id.* At. 7.

¹⁰ *Merrill Lynch Pierce Fenner Smith Inc v. M McCollum*, 1985 SCC OnLine US SC 6.



SEC Commissioner Hester Pierce advised those involved in the creation and promotion of f-NFTs to proceed with caution so as not to inadvertently create a security. Moreover, a case (*Jeeun Friel v. Dapper Labs Inc*¹¹) is currently pending before the Supreme Court of the State of New York; its verdict is anticipated (at the time of writing) and may shed further light on the US position.

It becomes imperative to see the United States' approach which very is useful for considering how India may address NFTs, but it is not exhaustive. It is unlikely that the US mode of operation would align with the structural characteristics of the Indian legal and regulatory environment if it were to be implemented in its entirety in India. This is owing in no small part to the fact that India lacks an entity with the same level of authority and mandate as the SEC. Further, the American approach appears to be based on a case-by-case evaluation of the facts, which is not conducive to a robust and generalizable regulatory framework, which India requires in order to manage and utilize NFTs and related innovations in cryptographic assets. Numerous American investors have pointed out the vagueness of the US strategy, further diminishing its utility. This uncertainty is exacerbated by the fact that US institutions are uncertain as to whether or not *Howey* will apply to non-profit organizations.

Analysing the Indian Legal Conundrum vis a vis Cryptocurrency and NFT

In *Paramount Bio-Tech Industries Ltd. v. Union of India*¹², the Allahabad High Court determined that the *Howey* test would be applicable in India; however, *Howey* does not provide sufficient infrastructure for a framework on NFTs to be considered a starting point. Therefore, the American approach cannot be adapted to India's circumstances. Due to the novelty of NFTs and cryptocurrencies, as well as certain ambiguities associated with them, such as the negative environmental impact caused by massive energy consumption, and the skepticism of its validity or the fear among experts that it will be another bubble, there have been numerous difficulties in determining its legal aspects. Petitioners argued before the Supreme Court that the RBI lacked the authority to prohibit virtual currency transactions because virtual currencies are not legal tender. In *The Internet and Mobile Association of India v. R.B.I.*¹³, the Supreme Court invalidated the RBI's circular on virtual currencies and implementation recommendations.

In India, cryptocurrencies are now lawful, though they are not recognized as legal tender. Similarly, the purchase of NFTs is neither prohibited nor regulated by law in India. The majority of non-financial transactions (NFTs) occur in countries other than India, with all such international trade complying with the Foreign Exchange Management Act of 1999¹⁴. Currently, there is no general prohibition on NFTs, which could hinder their circulation in India. The NFTs could be regarded as intangible assets; however, laws are applied to intangible assets based on where they are located, and since NFTs are based on blockchain, which are global ledgers, determining jurisdiction in the event of disputes becomes difficult. The government has not commented on the legitimacy of non-fiat currencies, but its previous stance on cryptocurrencies casts doubt on the practice. Late

¹¹ *Jeeun Friel v. Dapper Labs Inc*, 21 Civ. 5837 (VM).

¹² *Paramount Bio-Tech Industries Ltd. v. Union of India*, [2004] 49 SCL 77.

¹³ *Id.* At. 4.

¹⁴ Million Dollar Meme: Non-Fungible Tokens and their Regulation, 2022 SCC OnLine Blog OpEd 5.



in January 2019, the Indian government enacted a law (the "Bill") prohibiting the use of private digital currency and regulating public or official digital currency within the country.

"No person shall mine, generate, hold, sell, deal in, issue, transfer, dispose of, or use Cryptocurrency in the territory of India" It is likely that NFT meets this criterion, as it is a crypto token that represents both value representations and a value store. Being transparent and non-fungible increases the likelihood that NFT will be exempt from the prohibition or punishment. Section 3(3) of the bill adds, *"Nothing in this Act shall apply to the use of Distributed Ledger Technology for creating a network for delivery of any financial or other services or for creating value, without involving any use of cryptocurrency, in any form, for making or receiving payment."* This paragraph outlines the exception to the law, allowing the use of ledger technology to establish a system for the transfer of financial or other services or the creation of value without involving the use of cryptocurrency in any form for making or receiving. However, this Bill is not wholly transparent.

Recently, however, government sentiment has become negative. India's finance minister, Nirmala Sitharaman, has stated unequivocally that cryptocurrencies and associated technologies will not be criminalized. She stated in her interview that there is a limited amount of time for people to experiment with blockchain and cryptocurrencies. Government officials have acknowledged inadequate bitcoin regulation. The new law will clarify the government's position on cryptocurrencies.

The question then becomes how future legislation prohibiting crypto transactions may impact NFT. Because the definition identifies it as a cryptocurrency, there is a possibility of restriction. Given the limited quantity of Indian NFT investors, it would be imprudent to ban the token. Since these tokens are frequently referred to as *"cryptocurrency,"* the government's stance on cryptocurrencies may have repercussions for NFT. As NFTs are more of an asset than a currency, a transition in perspective is necessary. There is one significant argument against considering NFTs to be currencies. This object is not interchangeable. In contrast to cryptocurrencies, non-fungible tokens do not pose an imminent risk of becoming an unregulated currency, nor are they used as a medium of exchange when representing unique objects.

NFT vs. Copyright – A Quest for a Further Rethink

NFTs seek to aid digital creators in securing adequate royalties via a digital platform across the globe. NFTs can currently only be traded on cryptocurrency exchanges. Non-fungible tokens differ from bitcoin in that they cannot be exchanged for an identical token. The only location where NFTs exist is as a token on the blockchain, which represents a completely distinct and unique rendition of an artistic work. This token represents a singular reproduction of the artwork, but ownership of the underlying digital token is not guaranteed.

To clarify, NFT is merely an abbreviation for a cryptographically signed receipt of ownership of an original work and has nothing to do with copyright transfer. An artist who sells an artwork to another individual may also create a unique NFT representing that artwork. However, the purchase of such an artwork does not acquire legal ownership



of the work's copyrights. Unless the artist grants the bearer such rights, the proprietor of an NFT artwork on the blockchain does not obtain the copyright on the tangible artwork or the right to receive royalties from the physical artwork. Practically anyone with access to the blockchain system can create a non-transferable version of an existing work. This has prompted significant concerns regarding copyright infringement.

Section 51 of the Copyright Act of 1957 specifies situations in which a copyright is determined to be infringed. Statutory remedies are available under the law and are considered in the event of any infringement. If an NFT is created or minted without authorization or a valid license from the legitimate copyright holder, the legitimate copyright holder is entitled to legal recourses, such as damages, accounting, injunction, etc. We have taken another step toward a completely digital society as a result of NFT's creativity.

With the advent of NFTs, it is now possible to possess a genuinely distinct asset, which was previously unthinkable. It has enabled a new generation of innovators, artists, and businesses to abandon the past and establish themselves in the digital age. Despite this, numerous scientists have expressed valid concerns regarding NFTs. There is a great deal of concern about the negative effects of NFTs on the environment, and the regulations surrounding them remain unclear. As the government moves toward a compromise rather than a complete ban, the imminent bill to be introduced during the winter session raises optimistic expectations for the future of bitcoin and non-fiat currencies. Therefore, there is no doubt that NFTs have enormous potential and have created numerous opportunities; however, only time will reveal if they are sustainable or merely another mirage.

Conclusion

Due to the decentralized nature of the blockchain technology on which NFTs are based, all participants to a transaction may remain completely anonymous. While it may be possible to identify these individuals by contacting the marketplace or bitcoin wallet and providing the IP address, this is not guaranteed. As a result, there would be several ways for illegal actors to avoid detection by authorities.

The worldwide market for NFTs reached \$2.5 billion in the first half of 2021, up from \$13.7 million in the first half of 2020. This is despite the fact that NFTs are still a relatively new phenomena. NFTs have the potential to be utilized in money laundering and terror financing applications, hence regulatory monitoring is urgently needed.

One may argue that the rules already in place can be modified to serve this purpose. Intangible assets are considered legal property in India. As a result, the framework may be found in the laws that regulate the purchase and sale of products and the transfer of property. But it's a hurdle that the law hasn't yet acknowledged NFT as property you may own. The NFTs on sale have a tenuous relationship to the underlying asset in their present form. They are more like a collection of contractual rights with respect to it than a token.



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