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Trading NFTs? A few legal reminders

Ian Liu

Did you know?

NFTs (Non-Fungible Tokens) are unique records stored on a blockchain to provide proof of ownership of a digital asset and they have taken the world by storm. Each NFT is uniquely identifiable and can be traded using blockchain technology. Although they are usually associated with virtual products, such as digital artworks and videos, NFTs can also represent physical assets such as real estate or even training shoes.

Why does this matter to you?

As the metaverse provides a new arena for brands to promote their brand awareness, more and more businesses are looking to set up shop in the metaverse, and profit from sales of NFTs. Although there is currently no solid legal framework regulating the NFT market, there are a number of areas that any business issuing and trading NFTs should consider:-

- Ownership of NFTs
  As with ownership of tangible assets, the title to an NFT must be clearly set out. Due diligence is required to ensure that the tokenized asset has a clean and good title to minimize the risk of ownership challenges from third parties. This is particularly important if the works are co-authored, licensed or commissioned.

- Intellectual Property Rights Protection
  Recent cases have seen brand holders bringing enforcement actions against sellers of NFTs that infringe their intellectual property rights. Many brand owners have started filing trade mark applications in relation to digital goods/services. However, IP investigation and enforcement in a cross-jurisdictional decentralised space, such as NFT host services and metaverses, can be complicated. Brand owners should have an IP protection strategy in place for NFTs and the metaverse. As a starting point, it is advisable to start registering trade marks with the virtual marketplace and digital assets in mind.

- Smart Contracts and Legal Contracts
  Transferring ownership of NFTs is documented by “smart contracts” which are programmes that automatically execute transactions and are significantly different from legal contracts. A review of the smart contract is required to ensure that the mechanism conforms to the legal relationship of the parties. It is now common to conduct security audits on smart contracts to ensure that it will behave as anticipated and that it complies with relevant laws. In an NFT project, a smart contract cannot replace a legal contract and proper terms and conditions governing the ownership, creation and use of the NFT.

- NFTs and Securities Law
  A smart contract allows NFTs to be minted in such a way that the original NFT issuers receive a share of the proceeds or commissions whenever the NFT is transferred. Care is required to structure the smart contracts and NFTs so that they do not resemble securities, collective investment schemes or other regulated activities governed by the Hong Kong Securities and Futures Ordinance. Otherwise, the platforms selling and trading NFTs may find themselves impacted by securities law and regulations.

- Tax
  The trading of valuables may attract taxes in the same way as any other retail operation or real-world investment. NFT issuers and buyers should make sure that they seek tax advice.

- Data Protection
  Whilst not all data relating to NFTs will be personal data, the issuer of NFTs should bear in mind potential data protection and cross-border data transfer issues. The immutability of blockchain technology, and the fact that NFT transactions are recorded on public ledgers, creates tension with existing data privacy laws.

It is also important to keep track of rapidly-evolving domestic laws and regulations that may apply to NFTs, blockchains and cryptocurrencies.

Want to know more?

Annie Tsoi
Partner
annie.tsoi@deacons.com
+852 2825 9255

Catherine Zheng
Partner
catherine.zheng@deacons.com
+852 2825 9617

Dora Si
Partner
dora.si@deacons.com
+852 2826 5394

Ian Liu
Partner
ian.liu@deacons.com
+852 2826 5360