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WHAT YOU NEED TO KNOW ABOUT NFT TRENDS IN THE CONSUMER SECTOR

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Legal Briefings – By **Julian Lincoln, Susannah Wilkinson, Alex Lundie and Sean Tran**

Mainstream consumer brands are beginning to capitalise on the new commercial opportunities that NFTs have to offer.

Brands considering NFT arrangements should be mindful of the various legal issues which accompany these types of structures and products.

These involve: the risks associated with third party arrangements; the rights of NFT holders; regulatory considerations; consumer protection; and tax.

NON-FUNGIBLE TOKENS ARE GOING MAINSTREAM

Increasingly, companies in the consumer sector are entering new markets by leveraging the unique opportunities that non-fungible tokens (**NFTs**) have to offer. These one-of-a-kind digital tokens, backed by blockchain technology, give brands the opportunity to sell:

- tokenised products that are entirely digital in nature (**digitally native NFTs**); and
- tokens that are tethered to real-world assets (**real-world asset backed NFTs**).

Recently, Herbert Smith Freehills advised Treasury Wine Estates (TWE) on the sale of a rare Penfolds Magill Cellar 3 barrel of wine to be traded through NFTs on the BlockBar blockchain platform, an NFT marketplace for luxury wine and spirits. The barrel NFT will be converted to 300 bottle NFTs which will be uniquely tethered to real-world wine bottles. Purchasing the NFT provides the holder the right to redeem the individual bottle (further details). The barrel NFT was purchased within a minute or so of the auction going live on the platform.

Various notable fashion brands are driving NFTs into the mainstream market. For instance companies are looking to tokenise exclusive product (e.g. shoes) ownership through NFTs. Drawing on features of the CryptoKitties blockchain game craze, owners of the NFTs will be able to ‘breed’ new designs for shoes (subject to manufacturing restrictions), where ownership rights in every successive generation will be linked to the original digital asset. In this example NFT holders will be able to claim their newly bred shoe ‘offspring’ to be custom made as a new, tangible pair of shoes.

These brands are using NFTs as an opportunity to appeal to a new market segment of digitally-connected consumers, who place significant value in digital assets.

WHAT DO YOU NEED TO KNOW?

Given that NFTs are a relatively new opportunity for consumer companies, it is important that the legal & reputational issues are properly considered in light of the enabling technologies used to deliver the NFT and associated transaction processes.

THIRD PARTY PROVIDERS

In preparing for an NFT release in respect of certain rights to underlying physical goods, brands may work with various third parties to facilitate the creation, sale and management of their NFTs. These providers include third party digital asset management services and NFT marketplaces.

Digital Asset Management Platform – these third party providers assist in creating, or “minting”, the NFTs and managing the storage & custody arrangements of the digital asset. When dealing with these providers it would be prudent for companies to be satisfied of:

- the tethering of the real world physical asset to the NFT;
- the custody & control arrangements of the NFT as a digital asset;
- the security protocols of the platform; and
- the company’s legal position with respect to loss of access to or control over the NFT, and where applicable, loss or damage to the physical product.

NFT Marketplace – NFT marketplaces are platforms where NFTs (and the associated rights in the physical product) are traded. In some arrangements, the legal risk and ownership of the NFT and any connected rights in the physical products will have transferred from the brand to the platform. In such cases, the platform would have ultimate responsibility for the delivery of any 'redeemed' physical assets. A brand's reputation may be exposed to reputational harm if, for example, a third party platform fails to satisfy its redemption obligations. It would be prudent for companies to conduct adequate due diligence on the NFT marketplace to mitigate this risk.

RIGHTS OF NFT HOLDER

An NFT's legal status and treatment will depend on the nature of the rights provided when the NFT is minted and transferred. These rights are not entirely dependent the technology, but will also be shaped by the contractual environment in which the NFT is used. For example, copyright may subsist in a digital artwork incorporate into an NFT. Alternatively, an NFT may grant a right to redeem or be a record of ownership. Companies should therefore be mindful of holders' rights and responsibilities when defining the precise nature of an NFT.

REGULATORY CONSIDERATIONS

NFTs as Financial Products

Australian brands will need to consider whether by issuing NFTs they will be carrying on a financial services business. This will lead to regulatory consequences. Financial services include advising, dealing and holding 'financial products' including, but not limited to securities, derivatives, debentures, non-cash payment facilities and interests in managed investment schemes (MIS). Whether an NFT is a security or an interest in an MIS depends on the circumstances and each NFT release will differ. Additional considerations may apply if other jurisdictions are involved in aspects of the process, e.g. in the minting of the NFTs or if there is active promotion of the NFT in other markets. A careful analysis of the specific underlying arrangement will be key to appropriately characterising the NFTs.

Anti-Money Laundering & Counter Terrorism Financing (AML/CTF)

In 2018, NFTs (among other crypto assets) were brought within the scope of Australia's AML/CTF regulatory framework. Companies structuring their NFT releases should therefore seek advice about whether they will be subject to AML/CTF reporting obligations. When structuring these arrangements, it would be prudent for companies to consider:

- whether they will be providing 'designated services' which might pose a money laundering or terrorism financing risk; and
- any geographical links they may have to Australia.

CONSUMER PROTECTION

The Australian Consumer Law (**ACL**) will also apply to NFTs that are marketed to Australian customers. Brands that are advertising their NFT offerings to Australian customers should ensure that they comply with their ACL obligations such as including appropriate disclaimers regarding the risks of investing in such digital assets. Otherwise, they may be at risk of engaging in misleading and deceptive conduct.

TAX

Brands involved in the sale of NFTs and that transact in cryptocurrency will also need to adequately understand the tax consequences with respect to their digital assets. The ATO has noted that the tax treatment of NFTs will depend on its use and the reason its owner has for holding and transacting the NFT.

KEY CONTACTS

If you have any questions, or would like to know how this might affect your business, phone, or email these key contacts.

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