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NFTs - Frequently Asked Questions

Key Terminology

Blockchain – a type of DLT where transactions are recorded with cryptographic signatures.

Cryptoasset – cryptographically (through encryption) secured digital representation of value or contractual rights that uses some type of DLT and can be transferred, stored or traded electronically.

Cryptocurrency – an example of a cryptoasset, for example Bitcoin, Ether, Litecoin.

Ledger – type of database.

DLT – a digital distributed database that records transactions which are authenticated and verified across multiple systems (a peer-to-peer network).

Minted (minting) – the process in which an NFT is created – the specific characteristics are coded and embedded within the NFT.

Node – computer participation in the operation of a DLT arrangement.

Non-fungible – unique and not interchangeable. Cars and houses are non-fungible property.

What are non-fungible tokens (NFTs)?

'Non-Fungible Token' ("NFT") was selected by Collins Dictionary as their 'Word of the Year' for 2021. Putting aside the fact 'NFT' is an acronym and not a word, given the high-value and high-profile nature of many NFT auctions, collections and follow-on transactions, this recognition of the emergence of the term should not be a surprise. With investors and creators from all sectors keeping a keen eye on how the NFT market develops, this article answers some Frequently Asked Questions about NFTs.

What is an NFT?

Non-fungible tokens or NFTs are cryptographically-secured units of data which confirm the authenticity and ownership of a digital asset.

The NFT is secured on a blockchain. This means that the data pertaining to the asset and its ownership is recorded on a distributed ledger. Recording on a distributed ledger as opposed to a centralised system means there is no single record of ownership, rather there is a database that is synchronised across many nodes with each transaction witnessed by all participants. Therefore all ownership and change of ownership is verified by multiple systems. As such, distributed ledgers have an inbuilt protection from counterfeiting, corruption, and cyber-attacks that is not available in traditional ledger systems. And furthermore, the proof of ownership is immutable.

A fundamental characteristic of an NFT is its non-fungibility. Fungibility refers to mutual interchangeability; for example, fiat currency such as British Pounds Sterling is fungible in that a £10 note can be interchanged with or two £5 notes, ten £1 coins, twenty 50 pence pieces or any other combination of the currency – the units of the commodity are equivalent and indistinguishable. An example of a fungible cryptoasset or crypto-token is Bitcoin. By contrast, NFTs are non-fungible which means that they cannot be subdivided or substituted. Each NFT is truly unique (in a way that £1 coins or other fungible assets are not).

How are NFTs made?

If you want to create an NFT, you must first decide what digital media asset you want to be represented in an NFT. After doing so, the asset must be 'minted'. This involves the use of a cryptographic key to secure the token which is created on a blockchain (simply put, a unique key is created and recorded on the ledger to represent the asset). The most popular blockchain for NFTs is Ethereum. The 'digital media asset' (for example, a video) is typically stored elsewhere (this is 'off-chain').

The cryptographic key, as recorded on the blockchain, is coded so as to contain details of the asset (metadata), verify whether a corresponding file is authentic (with links), confirm the identity of the owner, and many are also coded to contain standard smart contracts.

How are NFTs purchased and traded?

Once the NFT has been minted, the creator can list it on an NFT marketplace (for example, OpenSea or Rarible) for auction.

Some NFT creators set up their own marketplace. A marketing campaign will be launched to promote the auction and those interested in the NFT will join the marketplace when the auction is live and place bids using their on-marketplace wallet which may hold cryptocurrency (like Ethereum) or fiat-currency. The successful bidder will exchange their funds and the NFT can then be transferred to their off-marketplace wallet.

NFTs can be resold on secondary markets hosted by NFT marketplaces or by directly selling to a buyer by transferring between off-marketplace wallets. All transactions are recorded on the blockchain and due to this being a distributed ledger each transaction is 'witnessed' by all ledger participants. In this way, there is a clear record of ownership.

What can NFTs be used for?

Due to their protection from corruption, guarantee of authenticity and ownership, and non-fungibility, NFTs are becoming increasingly popular and have a wide range of uses.

Memorabilia and Collectibles – NFTs and their off-chain data are being used mainly in the arts, entertainment and creative industries. Sporting bodies, clubs, leagues, and sportspersons are utilising them to monetize digital player images, digital collectibles, and videos of famous sporting moments etc. Success stories include the NBA's Top Shots marketplace, which has made over $700m in sales, and Sorare, an NFT fantasy football game with licensing agreements with several football federations, clubs, and high-profile players. By allowing 'trading' and resales, these marketplaces and their partners can continue to make profit over time through fees and royalties and also maintain some level of control.

Tickets – NFTs have been used for smart tickets (which are more than just digitalised tickets). Real Madrid are using NFT smart tickets to provide exclusive rewards to fans attending or watching matches. Kings of Leon released an NFT version of their album with 'golden tickets' that could unlock guaranteed front row VIP seats to one of their concerts.

Video Games – some creators have used NFTs and blockchain technology to develop video games, most of which are built upon collect-and-trade marketplaces. Axie Infinity is a video game based on NFTs where individuals buy and trade cartoon monster NFTs, each of which have unique traits and 'powers'; these NFT monsters are then used in battles with other players. The current equity valuation of Axie Infinity is $3 billion, and its fully diluted valuation is $30 billion. Emojibles is a video game where players buy, trade and 'battle' Emoji NFTs. These games encourage competition between players by creating a hierarchy of NFTs with corresponding scarcity, and this fosters an active sale and resale market.

Digitised Metadata – Various musicians (like Grimes or Steve Aoki) have used NFTs to release music videos or songs that were not available on other platforms. Artists (like Damien Hirst and Andy Warhol) have also 'dropped' NFT collections. Many artists have indicated that using NFTs has been extremely cost-effective as the need for intermediaries is reduced. Additionally, musicians have started to adopt NFTs in order to make use of higher royalties from resales (following well-publicised complaints of low royalties from streaming platforms). There are many movies and TV shows that are also set to be released as NFTs. Also, the very first Tweet, on Twitter, was converted into an NFT.

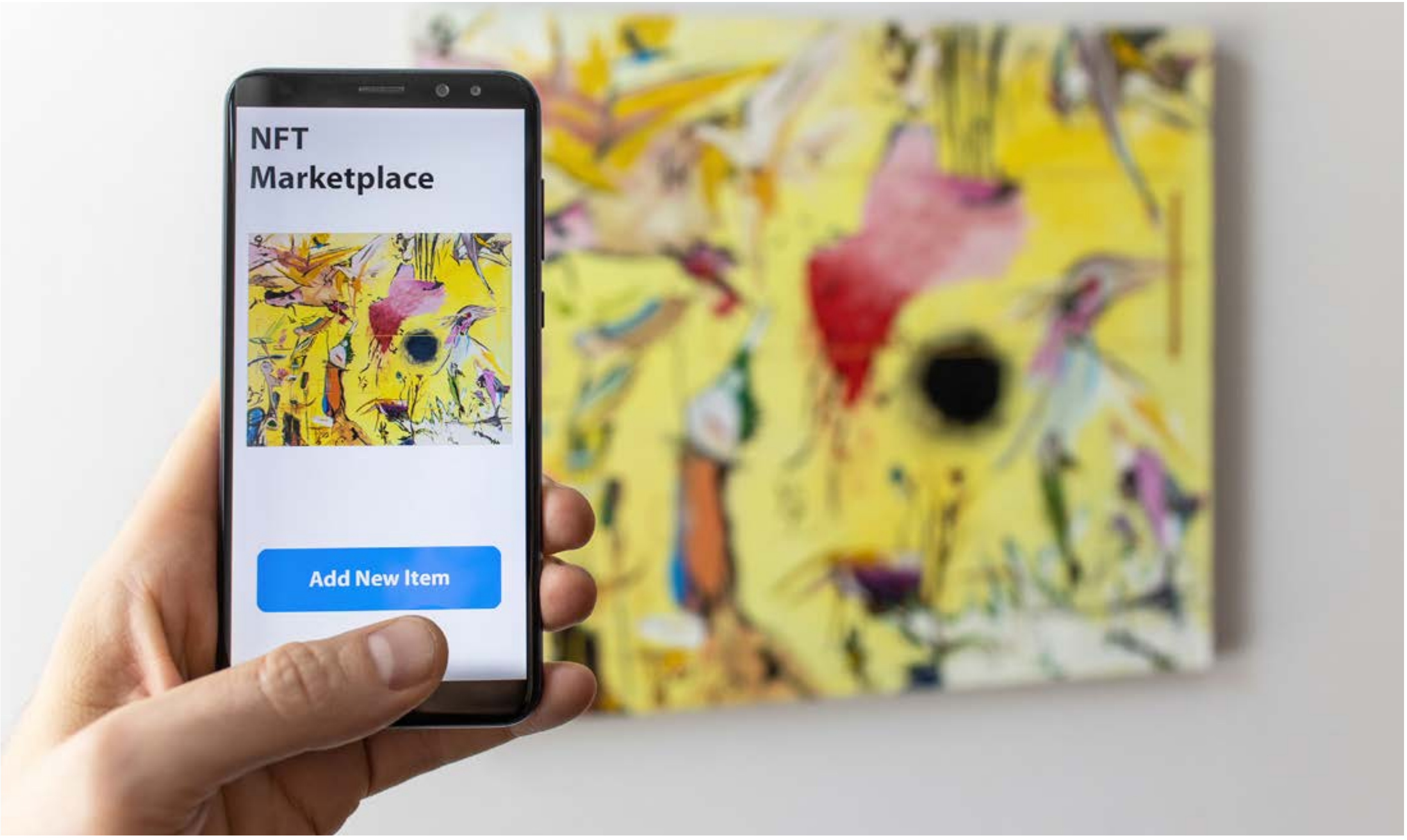
Contract Verification – as NFTs are programmed using smart contracts in their code (with many using Ethereum standards), the code can include links to documents (like other contracts or deeds), require proof of identity, and confirm document authenticity (which is crucial where counterparties are used). This can minimise delays in property transactions.

What are the economics?

Generally, with respect to NFTs that authenticate digital art and collectables, NFT marketplaces provide a platform for artists and content creators to sell their work through the sale of an NFT directly to individual purchasers who are users of the NFT marketplace.

In terms of economics, on initial sale the creator and the development team will share in the initial auction price, as will the auction platform. On subsequent trades of the NFT the creator, development team and potentially the platform may participate in the profit made on the secondary sale.

It is also possible to program NFTs with maximum or minimum or indeed maximum and minimum sale prices which can regulate the secondary market for the specific NFT. This may be done to maintain a level of prestige and encourage, or discourage, frequent trading or speculation on the NFT depending on the creator's objectives, personal image etc.



What do I own in an NFT?

When individuals buy an NFT, the extent of ownership will depend on the smart contract of the NFT itself and/or the terms and conditions of the marketplace or creator. Creators thus have wide discretion.
At a minimum, buyers will be able to own the NFT itself on the blockchain and the corresponding digital asset, however this does not mean that they own the underlying copyright, or any other intellectual property rights. Consider how when an individual buys a painting, they do not automatically acquire the right to reproduce the painting and/or sell it as their own work, because the copyright is retained by the painter.

Kings of Leon limited their NFT album to personal-use only, prohibiting all commercial use. In some cases, developers will allow their NFT to be used commercially, however this is usually by way of a non-transferable and non-exclusive licence. For example, the terms and conditions of CryptoKitties entitles the purchaser to commercial use of their CryptoKitty, including by merchandising, for up to $100,000 gross revenue each year.

Many NFT smart contracts also contain code that allows the original creator to participate in a share of revenues and receive royalties in sale and use of NFTs; for example, Beeple, a successful digital artist, NFT creator and seller of the most expensive NFT for $69 million, receives a 10% royalty from each subsequent sale of his NFTs.

Creators should consider whether they have the right to create NFTs, ensuring that they do not infringe third party intellectual property rights. Similarly, creators who own the rights in the content of their NFT should consider whether their own intellectual property rights are adequately protected and if any licence or assignment of rights in relation to the creative and technical content (including the underlying work and code) is appropriate. Legal advice should be sought to ensure intellectual property rights are properly used and maintained.

Are NFTs here to stay?

Although the continued success of any technology cannot be guaranteed, the incredibly versatile nature of NFTs means that they will likely continue to prove popular.

The smart contract provides immutable proof of ownership, the non-fungibility confirms uniqueness, and the decentralised technology ensures protection and security. As the NFT market matures, more industries will use NFTs and blockchain technology.

If you have any questions about NFTs and how you or your business can learn more about developing NFTs or entering the NFT market, please contact a member of our Brabners Technology Sector NFT team below.

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