

## Tokenized Art Legal Issues

The tokenization of physical and digital art has many advantages. Some of the advantages, create *potential* complexities under US law. Each situation is fact specific, but the following is a summary of some of the areas for which careful consideration is needed with tokenized art. This is not a complete list, but provides some of the most common issues that we typically see. These issues can impact the owners/creators of tokenized art as well as the exchanges and platforms that sell them.

Potential Legal Issues	Aspect of Tokenized Art	Comments
<b>Bank Secrecy Act (BSA) and Anti-money laundering (AML) issues.<sup>1</sup></b>	High end art used in money laundering	The Anti-Money Laundering Act of 2020 (“AMLA”) specifically adds antiquities dealers, advisors, and consultants to the definition of “financial institution” under the BSA <sup>2</sup> and requires the government to prepare a study within a year that assesses money laundering and terrorist financing through the art trade, including “which markets ... should be subject to regulation,” “the degree to which the regulations, if any, should focus on high-value trade in works of art,” and “the need, if any, to identify persons who are dealers, advisors, consultants, or any other persons who engage as a business in the trade in works of art.” <sup>3</sup>
<b>Office of Foreign Assets Control (OFAC)</b>	High end art to circumvent sanctions	<ul style="list-style-type: none"> <li>• Blocked persons and SDNs</li> <li>• The Berman amendment exempts some artworks, but not all</li> <li>• U.S. Senate, Permanent Subcommittee on Investigations, Committee on Homeland Security and Governmental Affairs, Staff Report, “The Art Industry and U.S. Policies That Undermine Sanctions,” issued July 29, 2020 (the “PSI Report”)</li> <li>• ‘high-value’ artwork associated with blocked persons, including SDNs – particular emphasis on works over \$100,000</li> </ul>
<b>Securities Law</b>	Token presales	Most NFTs are not likely to be securities, however certain token presales can be subject to US securities law if presale meets <i>Howey</i> test <sup>4</sup>
<b>Securities Law</b>	Pooling of Art	If a number of artists pool together a collection of art and share revenues, in some cases this may be subject to US securities law.
<b>Securities Law</b>	Fractional Ownership	Fractional ownership of a piece of art (or collection) by multiple investors may be subject to US securities law. If the underlying asset is a security, the pooled investment vehicle that invests may be subject to registration obligations and other requirements under the Investment Company Act of 1940 SEC’s Office of Investor Education and Advocacy released an <a href="#">Investor Bulletin</a> on fractional ownership
<b>Copyright</b>	Copyright in underlying work	Often a token confers ownership of only a digital copy of a work of art. The token sale should make clear what rights are reserved. Misstating the scope of rights associated with a token can lead to an impact on the scope of rights and/or claims of misrepresentation.
<b>Copyright Infringement</b>	Token exchange platform liability for infringing works	Exchanges or platforms that sell infringing art (even if innocently) can face lawsuits for copyright infringement. Effective use of the <b>Digital Millennium Copyright Act</b> (DMCA) can eliminate liability in many cases, but certain steps are necessary to benefit from this protection.

Potential Legal Issues	Aspect of Tokenized Art	Comments
Terms of Service	Exchanges and Marketplaces	Tokenized art marketplaces must have a customized terms of service to protect themselves from various potential liabilities e.g., clarity on scope of rights associated with token, any terms and conditions of portion of resale going to artist or others, DMCA protection issues and much more.
Patents	Novel digital art, creation tools and tokenization technology	Patenting art per se is difficult, but when there is a technical component involved, the work and/or tools to create the work may be patentable. <sup>5</sup> Examples could relate to tools and digital art relating to: <ul style="list-style-type: none"> <li>• Programmable art</li> <li>• Smart contracts for management of programmed/layered art</li> <li>• Controlling display of tokenized digital</li> </ul>

## About the Team

Sheppard Mullin's Blockchain and Fintech team helps clients develop innovative and comprehensive legal strategies to take advantage of what may be the most disruptive and transformative technology since the Internet. We focus on advising clients on how to meet their business objectives, without incurring unnecessary legal risk. Our team includes attorneys with diverse legal backgrounds who collectively understand the vast array of legal issues with and ramifications of blockchain technology and digital currencies. Sheppard Mullin was one of the first major law firms to create a multidisciplinary Games industry team. We advise clients on all aspects of interactive games and entertainment, including AR, VR, crypto games and collectibles, esports and fantasy sports. Many of the members of our blockchain team have experience with advising game companies on legal issues with digital assets in addition to the full range of IP and other legal issues faced by game companies.

## For More Information, Contact:



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## Relevant Article:

- Law of the Ledger

<sup>1</sup> See, *Application of FinCEN's Regulations to Certain Business Models Involving Convertible Virtual Currencies* which explains how FinCEN interprets the applicability of the Bank Secrecy Act applies to convertible virtual currencies. In part, it focuses on "money transmission services" which is defined to mean the acceptance of currency, funds, or other value that substitutes for currency from one person and the transmission of currency, funds, **or other value** that substitutes for currency to another location or person by any means. The term "other value that substitutes for currency" encompasses situations in which the transmission does not involve currency or funds, but instead involves something that the parties to a transaction recognize **has value** that is equivalent to or can substitute for currency. Consideration needs to be given whether an NFT is a thing of value under this test.

<sup>2</sup> AMLA, § 6110(a)(1) (31 U.S.C. § 5312(a)(2)(Y) as amended).

<sup>3</sup> AMLA, § 6111(e).

<sup>4</sup> Under the Howey test, a sale of assets may be a security if there is an investment of money, in a common enterprise, with the expectation of profit based on the effort of others. Often, if funds are raised to build a platform on which the items will ultimately be used and they are likely to increase in value once the platform is built, securities issues may arise. See, Framework for "Investment Contract" Analysis of Digital Assets

<sup>5</sup> See our white papers on Patent Strategies for Cryptocurrencies and Blockchain Technology and Drafting Effective Blockchain Patents. Few blockchain art patents exist, but there is no doubt the number will increase.