

Non-Fungible Tokens for Trustees

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The world of blockchain and cryptoassets is fast becoming part of the world of private-client practitioners. These entities have special and unfamiliar features and, if trustees are to invest in them or sell them, or even to consider investing in them or selling them, they need to be aware of those features and how to be confident about them. This article focusses, not on cryptocurrencies, but on non-fungible tokens.

Private investment in digital, non-fungible assets commonly known as non-fungible tokens (NFTs) is growing. While NFTs have existed for some years (some say as early as 2014), only recently have they become widely publicised.¹ NFTs depart considerably from usual sorts of investment assets, such as real property, commodities, and securities.

Trustees looking to diversify their investment strategy may find NFTs to be an attractive alternative investment. Likewise, investors in NFTs may find that trust structures are an attractive way to hold and secure their digitised investments. But before investing in, or holding NFTs on trust, trustees ought to assess whether they can properly carry out their fiduciary duties and should properly assess the risk of subjecting themselves or the trust to liability arising out of the novel way in which NFTs are created, traded, secured and regulated.

(I) NFTs — what are they, how are they transacted and how are they secured?

NFTs are units of data, which can include forms of art and media that exist on and are secured by, blockchains. As a unique kind of digital ledger, blockchains store information in chronological blocks which are chained together. When new data arrives into the ledger, such as NFT sale-purchase transactions, it is entered into a fresh block and, once filled, the block is then “chained” to the prior block, thereby creating a chronological digital ledger.² Blockchains such as Bitcoin are decentralised, meaning that no single user has control over it, and all users retain control collectively. Decentralised blockchains are immutable, that is the data once entered becomes a permanent immutable record.

It is through the blockchain that NFTs derive value. An NFT sale takes place when an NFT ownership change record is created on the blockchain, thereby producing a permanent record of authenticity. In return for paying for an NFT, the purchaser obtains a unique immutable token which is deposited into its digital wallet (discussed further in Section (3) of this article).

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¹ See for example, auction house Christies' first sale of a digital artwork by Beeple, “The First 5000 Days” which sold for US \$69,346,25. Sale #20447, Sale Date: 25 February 2021 — 11 March 2021 <<https://onlineonly.christies.com/s/beeple-first-5000-days/lots/2020>> [accessed 6 August 2021].

² Blockchains may be public, private, consortium or hybrid. On a public blockchain, anyone is allowed to join and the fact of the transaction itself is public, though the identity of the transacting parties remains anonymous. On a private blockchain, the ledger is closed to private participants and a single organisation only will have network authority. Consortium and hybrid block chains typically contains a mix of public and private elements.

NFTs are “non-fungible,” meaning that they are not exchangeable for other tokens, in the same way that fungible tokens such as cryptocurrencies like Bitcoin are. NFTs hold value distinct from cryptocurrencies, though they are usually (though not always) purchased and sold in cryptocurrency.

NFT purchasers usually do not acquire the intellectual property right to the digital work, the subject of the NFT, rather they acquire a proprietary right to the original work via the unique non-replicable secure token.³ This is similar to the purchase of a physical piece of art, where the intellectual property rights remain with the artist notwithstanding the purchase and sale of the art in a private or public market.

Digital art has historically been difficult to value due to ease of replication and lack of verifiable records of authenticity or demarcation of an “original”. NFTs on the other hand offer assurance of authenticity because of the immutable record. It is this feature which makes NFTs an attractive digital investment.

NFTs can be coded to allow the original creator of the work to receive returns each time the token attributable to their digital creation is traded, usually for between 2.5 per cent and 10 per cent of the purchase price. This recurring revenue is a unique feature of NFTs, producing an enduring income for NFT creators. Looking ahead, and though not the subject of this article, private client services for NFT creators, including estate planning and trust structures, could become a valuable tool to protect, secure and improve the returns for NFT “creators”.

(2) Cryptoassets as trust property

The question here is whether cryptoassets and cryptocurrencies are capable of being trust property. And will NFTs be treated in the same way?

The general rule, as explained by *Lewin on Trusts* is that “all property, real or personal, legal or equitable, may be made the subject of a trust provided that neither the policy of the law nor any statute prevents the settlor from parting with the beneficial interest in favour of the intended beneficiary”.⁴ Under English law there is a body of case law building which recognise cryptoassets and cryptocurrencies as possessing the characteristics of property, and as a result capable of being made the subject of a trust.

The UK Jurisdiction Taskforce 2019 Legal Statement on Cryptoassets and Smart Contracts (the UKJT Legal Statement) provides that in general “cryptoassets have all the indicia of property,” and therefore “should be treated in principle as property.” In *AA v Persons Unknown*⁵ the English High Court adopted the UKJT’s Legal Statement and decided that cryptocurrencies are property under English law because they possess the indicia of property in that they are “definable, identifiable by third parties, capable in their nature of assumption by third parties, and [have] some degree of permanence”.⁶ In *Vorotyntseva v Money-4* the English High Court held that Bitcoin possesses sufficient proprietary characteristics to support the grant of a proprietary injunction.⁷ Similarly, in the unreported decision in *Robertson v Persons Unknown*,⁸ Moulder J held that £1.2 million worth of Bitcoin which had been removed from a cryptocurrency fund following a phishing attack was capable of being the subject of an asset preservation order, preventing the phished Bitcoin from being transferred or disposed of.⁹

Earlier decisions have suggested that digital currencies and assets cannot be property under English law, because their essential characteristics comprise a digital record and something which exists only in electronic form cannot be the subject of possession.¹⁰ On this basis, it is said that cryptoassets, being

³ In the case of Beeple’s work referred to above at footnote 1, the purchaser received a JPEG of the artwork backed by the unique NFT.

⁴ L. Tucker and others (eds.) *Lewin on Trusts*, 20th ed. (London: Sweet & Maxwell, 2020) at 2–034.

⁵ *AA v Persons Unknown* [2019] EWHC 3556 (Comm); [2020] 4 W.L.R. 35.

⁶ *AA* [2019] EWHC 3556 (Comm) at [57]–[59], applying the four criteria of property established by Lord Wilberforce in *National Provincial Bank v Ainsworth* [1985] 1 A.C. 1175. *B2C2 Ltd v Quoine Pte Ltd* [2019] SGHC(1) 03, a decision of Simon Thorley LJ.

⁷ *Vorotyntseva v Money-4 Ltd* [2018] EWHC 2596 (Ch).

⁸ *Robertson v Persons Unknown* (unreported, CL-2019-000444). See also *Copytrack Pte Ltd v Wall* [2018] BCSC 1709, where the British Columbia Supreme Court held that Ether Tokens are species of property susceptible to tracing.

⁹ *Robertson* (unreported, CL-2019-000444) at pp.21E-F, 25D-F.

¹⁰ *Armstrong DLW GmbH v Winnington Networks Limited* [2012] EWHC 10 (Ch); [2013] Ch. 156.

intangible objects, are incapable of possession under the law of property. Indeed, the UKJT's Legal Statement notes that it may be overreaching to assume that English law would treat all kinds of cryptoassets as property, and their characterisation will likely depend on the nature of the asset, the rules that govern the system by which it comes into existence and the purpose for which the question is being asked.¹¹ In *Quoine v B2C2*¹² the Singapore Court of Appeal was asked to consider whether a decision of currency exchange platform, Quoine, to reverse a series of cryptocurrency trades in favour of B2C2 which had been executed at 250 times the market rate was both a breach of contract and a breach of trust. At first instance Thorley LJ held that cryptocurrencies are property and therefore capable of being held on trust. However, on appeal the Court of Appeal was hesitant to conclude that cryptocurrencies are property. Menon CJ referred to the UKJT Legal Statement and then stated: "There may be much to commend the view that cryptocurrencies should be capable of assimilation into the general concepts of property. There are, however, difficult questions as to the type of property that is involved."¹³ The Singapore Court of Appeal was not convinced that, even if cryptocurrency were property, any trust had arisen on the facts before it, because there had been no certainty of intention to create a trust.¹⁴

While there is limited, if any, judicial authority on whether an NFT (as opposed to cryptocurrency) is property under English law, the UKJT's Legal Statement and recent decisions of the English High Court would appear to support the proposition that NFTs, which are definable and identifiable by third parties through their existence on the blockchain, possess the necessary proprietary characteristics recognised by English law and therefore are capable of being held, acquired and disposed of by a trust established by statute or common law.

There are several important considerations trustees ought to assess before agreeing to invest in or hold NFTs as trust property, some of which are considered below in section (3) below.

(3) Trustee considerations in holding and acquiring NFTs

Suitability considerations

Before making investment decisions trustees must pay regard to both (i) their investment management powers and duties under the terms of the trust deed and (ii) any obligation under statute or general law which applies to the trustee when buying, selling or managing a particular kind of asset.

Trustees have a duty to invest with due care and prudence¹⁵ and to ensure that investment risk and diversification is consistent with the trust deed mandate provided for by the settlor or settlors. Trustees must also balance the interests of different categories of beneficiaries with different risk appetites. Suitability assessments consider the needs of the beneficiaries, the purpose of the trust and the relative diversification and kinds of existing investments, and whether it would be more appropriate to make different kinds of investment. The need for diversification usually requires a trustee to pursue a range of different investments with the goal of reducing the risk contour of the trust. In this context, and consistent with the trustees' ongoing duty to review and assess the suitability of investments, trustees should carefully consider whether investment diversification should include investments in NFTs.

When making an investment decision, trustees have an obligation to consider whether a proposed investment is a suitable one in the context of the range of investment options open to them.¹⁶ For example, s.4 of the Trustee Act 2000 provides a standard of investment criteria that a trustee must have regard to, namely:

¹¹ UK Jurisdiction Taskforce, LawTech Delivery Panel Legal statement on cryptoassets and smart contracts (November 2019) at para.[15].

¹² *Quoine Pte Limited v B2C2 Limited* [2020] SGCA(I) 02 on appeal from *B2C2 Limited v Quoine Pte Limited* [2019] SGHC(I) 03.

¹³ *Quoine* [2020] SGCA(I) 02 at [144].

¹⁴ *Quoine* [2020] SGCA(I) 02 at [145].

¹⁵ *Re Whiteley* (1886) 33 Ch. D. 347. See also Trustee Act 2000 s.1.

¹⁶ Trustee Act 2000 s.4.

- (a) the suitability to the trust of investments of the same kind as any particular investment proposed to be made or retained and of that particular investment as an investment of that kind, and
- (b) the need for diversification of investments of the trust, in so far as is appropriate to the circumstances of the trust.¹⁷

The NFT market is a speculative one and is experiencing swings and roundabouts while real value is established. While returns on NFTs can be lucrative, NFT returns are volatile. For example, in the first week of April 2021, the average NFT price was 70 per cent lower than prices in late February 2021, though the April 2021 average price still represented approximately an increase of 10 times the average price of NFTs from that in October 2020.¹⁸

Some trust deeds expressly permit a trustee to make speculative or higher-risk investments. Where such provision is included in the terms of the trust deed, a trustee may obtain a degree of comfort that they have not fallen short of their duty of care and have acted within the scope of their mandated authority. Trustees will have to assess the risk-return profile of NFTs relative to historically more stable investments including bonds, bullion and real property, and whether the trustee's mandate extends to taking on such a risk. Where a trust deed specifically denotes that investments should include investments in NFTs, it will therefore be important to ensure that the trust deed clearly addresses the trustee's liability for investment losses including where an investment manager is appointed to carry out the trustee's investment powers.

Trustee duty to protect trust assets

Digital wallets

Trustees tasked with holding NFTs on trust should agree with settlors the manner in which the trustee will maintain safe storage of the keys (password) to the digital wallet which controls access to, and use of, the NFT. Software wallets are available through web extensions, mobile and desktop applications. Potential liability for loss of a password to a digital wallet is a critical consideration that trustees should assess before agreeing to hold NFTs as trust property. Digital wallets are secured by a strong password (typically strings of numbers and letters). Digital wallet service providers usually provide users with a certain number of password attempts, before permanently encrypting the content of the digital wallet from access. Loss of a password is therefore loss of value of the tokenised investment held in the wallet. Such losses can be significant, for example:

- In 2019, when the CEO of Quadriga CX passed away suddenly, the company had no ability to release investor money valued at approximately US \$145 million in Bitcoin, Litecoin, Ether and other digital tokens. The deceased CEO was said to be the only person with knowledge of the keys and passwords to access the company's cryptoassets, and upon his death the company had no ability to derive value from these cryptoassets.
- In January 2021 the value of Bitcoin dropped sharply when it was reported that approximately 20% of the total 18.5 million issued Bitcoin, worth approximately \$140 billion, became inaccessible because the passwords to wallets holding the digital keys to unlock and use these Bitcoins had been lost by the currency holders.

Trustees acquiring and holding NFTs ought to consider different safe storage mechanisms, including, for example, depositing the security key in a bank vault, or with a cryptocurrency vault provider, similarly

¹⁷ Trustee Act 2000 s.4(3).

¹⁸ Gauthier Zuppinger, "Sorry ... No NFT market crash so far!" <<https://nonfungible.com/blog/sorry-no-nft-market-crash>> 6 April 2021 [accessed 6 August 2021]. The online database NonFungible.com tracks and analyses real time NFT transactions.

to the storage of physical assets such as bullion or rare artefacts. Fully insured vaults have the benefit of enabling a trustee to hold title to the asset while passing on liability for safe storage of the asset to a third-party. Fully insured cloud storage is also an option.

Blockchain security

Blockchain safety is critical to the security of NFTs. Recently, it was reported that the Nifty Gateway blockchain was hacked, with more than \$150,000 worth of NFTs being stolen from one user and another user's credit card was used to purchase NFTs.¹⁹ Before investing in NFTs trustees would be well advised to verify that the trust deed contains robust limitation of liability provisions which extend to the holding, delegation and management of NFTs by the trustee and protect a trustee from liability for loss of value or loss of access to a NFT asset caused by events including hacking or theft. Otherwise, trustees may find themselves liable to the trust for large losses.

Anti-money-laundering obligations

For some the appeal of buying art in the form of NFTs is in the anonymity which comes with transactions effected through the blockchain. Though transaction details are recorded on the blockchain, as well as users' digital wallet addresses, transacting parties remain anonymous, because usually there is no identifiable link between the digital wallet address and wallet owner's identity.

Trustees are subject to anti-money laundering and counter-terrorist financing (AML/CTF) obligations in a similar manner to other corporate services providers. It is not clear in many jurisdictions however, to what extent AML/CTF obligations are triggered by NFT transactions.

For example, pursuant to amendments to the United Kingdom Money Laundering, Terrorist Financing and Transfer of Funds (Information on the Payer) Regulations 2017 (MLRs), art market participants (AMPs) who deal in sales, purchases and/or storage of "works of art" valued at €10,000 or more (approximately USD \$14,000) are subject to reporting and obligations under the MRLs. However, the MRLs define the term "works of art" as that defined in s.21 of the Value Added Tax Act 1994 (VAT Act), which includes only categories of art "executed by hand".²⁰ While, the British Art Market Federation's "Guidance on Anti Money Laundering for Art Market Participants" issued in January 2020 states that "conceptual works of art" fall within the VAT Act's definition of "works of art",²¹ conceptual art is not an NFT, rather it is more usually understood by art industry participants as "art for which the idea (or concept) behind the work is more important than the finished art object".²² It seems therefore that NFT sales would not be subject to the MRLs, although the position is not patently clear, and trustees ought to obtain legal advice to determine the scope of their AML/CTF obligations in the context of art NFTs and other cryptoassets that they acquire and dispose of.

Taxation

Legal systems in many jurisdictions are playing catch-up, trying to find an appropriate manner with which to define, regulate and monitor the cryptoasset market, including taxation. Taxation differs considerably across jurisdictions. For example, Germany presently applies a 0 per cent charge on Bitcoin transactions, although Value Added Tax (or Goods and Services Tax) may apply to some transactions.

¹⁹ Tim Schneider "The Gray Market: Why the Hack of Nifty Gateway Raises Far-Reaching Questions About the Entire NFT Market (and Other Insights)" *Artnet* (22 March 2021) <https://news.artnet.com/opinion/nifty-gateway-nft-hack-gray-market-1953549> [accessed 6 August 2021].

²⁰ British Art Market Federation, *Guidance on Anti Money Laundering for UK Art Market Participants* (Approved by HMRC) 24 January 2020.

²¹ *Ibid* para. 13.

²² Tate, Art Terms, "Conceptual Art" < <https://www.tate.org.uk/art/art-terms/c/conceptual-art> > [accessed 6 August 2021].

Different factors play into the taxation treatment of NFTs across jurisdictions, including for example, (i) the length of time the NFT asset is held after purchase and before disposition, which could impact the applicable rate of capital gains tax, (ii) the classification of the NFT as a collectable or rare asset, (iii) whether or not any offsetting of losses incurred from NFT trades can be pitted against future profits from other income; and (iv) whether a cryptocurrency is used to buy the NFT and how use of that kind of currency may be taxed.

Most NFTs are bought and sold using cryptocurrencies and in different jurisdictions, may be taxed depending on whether the cryptocurrency has gained value since the currency was originally purchased and the length of time the currency has been held by the NFT purchaser. It will be critical therefore for trustees to obtain regular advice on the tax implications of the trust acquiring, holding and disposing of NFTs, and the potential tax liabilities beneficiaries may incur should the trustee make distributions in the form of NFTs or proceeds from the sale of NFTs.

Regulation of trustees as virtual asset service providers

The Cayman Islands has recently implemented laws regulating the provision of virtual asset services. Under the Cayman Islands Virtual Asset (Service Providers) Act 2020 (VASP Act) “Virtual asset services” are defined as licensees whose businesses provide one or more of the following services or operations:

- issuing of virtual assets;
- exchanges between virtual assets and fiat currencies;²³
- exchanges between one or more other forms of convertible virtual assets;
- transfers of virtual assets;
- virtual asset custody services; or
- the participation in, and provision of, financial services related to a virtual asset issuance or the sale of a virtual asset.

A “Virtual asset” is defined in the VASP Act as a “digital representation of value that can be digitally traded or transferred and can be used for payment or investment purposes but does not include a digital representation of fiat currencies”. “Virtual asset custody service” is defined under the VASP Act to mean “the business of safekeeping or administration of virtual assets or the instruments that enable the holder to exercise control over virtual assets”. It is likely that a trustee tasked with holding NFTs on trust or transferring NFTs as part of its investment strategy would be carrying out a virtual asset service under the VASP Act and will be required to apply for registration as a licensee with the Cayman Islands Monetary Authority. Failure to register is an offence, and carrying out VASP custodial services without a licence is also an offence, and on conviction a trustee could be liable to imprisonment and/or a fine.²⁴

While the Cayman Islands now has distinct regulation of virtual asset service provision, there is much uncertainty in many other jurisdictions regarding whether existing financial services regulations capture virtual asset service providers or whether they are in fact unregulated. Some jurisdictions, including the British Virgin Islands and England, have prepared guidance and regulations on the applicability of existing legislation to virtual asset service providers.²⁵ Furthermore, jurisdictions such as Hong Kong are considering

²³ Fiat currency means currency that is issued by the relevant body in a country or by a government that is designated as legal tender in its country of issuance through, among other things, government decree or law.

²⁴ Failure to register as a licensee when required to do so is an offence under the VASP Act, and a person found liable on summary conviction may be fined \$25,000 and sentenced to a term of imprisonment for one year. When the VASP Act second phase comes into effect (expected later in 2021), it will be an offence for a person to carry on, or purport to carry on virtual asset custody services without being licensed to do so, or without a licence waiver issued by CIMA, and a trustee who is unlicensed or does not hold a waiver may be found liable on summary conviction to a fine of \$100,000 and to imprisonment for one year. If the offence continues after conviction, further fines may be imposed.

²⁵ See The British Virgin Islands Financial Services Commission Guidance on Regulation of Virtual Assets in the Virgin Islands (BVI) at <https://www.bvifsc.vg/sites/default/files/guidance_on_regulation_of_virtual_assets_in_the_virgin_islands_bvi_final_1.pdf> [accessed 6 August 2021] and

implementing their own licensing regime for virtual asset service providers similar to the Cayman Islands. It will be important for trustees to obtain regular advice in any jurisdiction in which they hold or trade NFTs to ensure that they are acting in compliance with any applicable regulatory obligations.

Conclusion

NFTs are not a simple asset which can be held by a trust without careful consideration. They are diverse, with different value drivers and, compared to stocks for example, NFTs are sparsely traded. Before seeking exposure to the NFT market, trustees ought to understand the blockchain technology infrastructure underlying the NFT market as well as the technology and security that the trustee must possess to hold and trade NFTs. Regulation of NFTs globally is still catching up to the rapidly developing digital market, and trustees ought to regularly obtain legal, taxation and regulatory advice to ensure that they are acting in compliance with any applicable NFT regulations as well as meeting their fiduciary duties.