

Regulatory Approaches to Nonfungible Tokens in the EU and UK

06 / 15 / 21

If you have any questions regarding the matters discussed in this memorandum, please contact the attorneys listed on the last page or call your regular Skadden contact.

This memorandum is provided by Skadden, Arps, Slate, Meagher & Flom LLP and its affiliates for educational and informational purposes only and is not intended and should not be construed as legal advice. This memorandum is considered advertising under applicable state laws.

One Manhattan West
New York, NY 10001
212.735.3000

Interest in nonfungible tokens (NFTs) — *i.e.*, certificates of ownership stored on a blockchain that are typically associated with a digital asset, such as visual art, videos, music or collectibles — has increased dramatically in recent months. Unlike certain other virtual assets, such as cryptocurrencies, NFTs are unique or “nonfungible”. Based on current legislative proposals, NFTs may in the future be managed differently by EU and UK regulatory regimes. In the EU, the draft Markets in Cryptoassets Regulation, proposed in September 2020, could be construed to regulate certain NFT-related market activities. In the UK, it is likely that NFTs will fall outside the current regulatory perimeter; however, a case-by-case analysis of the manner in which an NFT is sold or marketed and how it is used as a form of value will need to be undertaken to determine whether or not it would fall in-scope. Additionally, due to the implementation of the EU’s Fifth Anti-Money Laundering Directive (AMLD5) into national law in EU member states and the UK, NFT sales also may raise money-laundering compliance considerations for market participants.

The EU Approach

While the EU extended its AML regulatory framework to include “virtual currency exchanges” and “custodian wallet providers” through its implementation of the AMLD5 in 2018,¹ it did not define regulations specific to NFTs, most probably because NFTs, although well known to crypto enthusiasts, were not widely being used.

However, on September 24, 2020, the European Commission adopted a digital finance package that includes a legislative proposal for the regulation of cryptoassets, the Markets in Cryptoassets Regulation (the MiCA Proposal).² The MiCA Proposal includes regulations that would apply to NFTs in certain cases and defines for the first time in the EU a cryptoasset as a “digital representation of value or rights which may be transferred and stored electronically, using distributed ledger technology or similar technology”.

The MiCA Proposal is intended to provide comprehensive regulation of cryptoassets not yet covered by EU financial law,³ in order to streamline distributed ledger technology and virtual-asset regulation in the EU. The proposal is currently going through the first reading phase of the legislative process, during which the European Parliament and Council of Ministers will either approve or amend the proposal. Although there is no specific public timeline for its implementation, the European Commission expects the MiCA Proposal to be implemented within the next four years.⁴ As an EU Regulation, it will apply directly in all EU member states and will not require implementation in national laws.

The MiCA Proposal aims to regulate (i) the public offering of cryptoassets, (ii) the admission of cryptoassets to trading on a trading platform, (iii) the licensing of cryptoasset service providers (CASPs) and (iv) the implementation of market abuse rules for cryptoasset businesses.⁵ The MiCA Proposal generally references three main categories of token (asset-referenced token, e-money token and other cryptoassets), with different requirements for each regarding licensing and operations of issuers. Under Title II of the MiCA Proposal, NFTs would likely fall into the “catch-all” category of other cryptoassets.

¹ Directive (EU) 2018/843 of the European Parliament and of the Council of 30 May 2018 on the prevention of the use of the financial system for the purposes of money laundering or terrorist financing.

² Proposal for a Regulation of the European Parliament and of the Council on Markets in Cryptoassets, and amending Directive (EU) 2019/193, COM/2020/593 final.

³ *I.e.*, not financial instruments as defined in Directive 2014/65/EU, the so-called MiFID II.

⁴ Communication from the Commission to the European Parliament, the Council, The European Economic and Social Committee and the Committee of the Regions on a Digital Finance Strategy for the EU, September 24, 2020, COM(2020) 591 final.

⁵ See MiCA Proposal, Reasons and Object for the proposal, Page 2.

Regulatory Approaches to Nonfungible Tokens in the EU and UK

Under the MiCA Proposal, issuers of other cryptoassets — *i.e.* cryptoassets that are not asset-referenced tokens or e-money tokens — do not have any specific licensing obligations but are required to be a legal entity (which may be established outside the EU) and to comply with certain governance and business conduct requirements.⁶ Other cryptoassets would be subject to regulations concerning the admission to trading on a trading platform and the authorization of related service providers, as well as market abuse rules for related businesses. However, the MiCA Proposal exempts issuers of “crypto-assets [that] are unique and not fungible with other crypto-assets” from the requirement to publish a white paper for public offerings.⁷ This exemption would likely extend to NFTs. Notably, this exemption is the only place in the MiCA Proposal where cryptoassets that are “unique and not fungible” are called out specifically.

The MiCA Proposal includes licensing and operating requirements for CASPs. Companies providing services related to NFTs, which would likely fall under the general definition of cryptoassets in the MiCA Proposal, would therefore need to meet the requirements for CASPs. The definition of “cryptoasset service” under MiCA is broad and includes the custody and administration of cryptoassets on behalf of third parties; the operation of a trading platform for cryptoassets; the exchange of cryptoassets for fiat currency that is legal tender or for other cryptoassets; the execution of orders for cryptoassets on behalf of third parties; the placement of cryptoassets; the reception and transmission of orders for cryptoassets on behalf of third parties; the provision of advice concerning the acquisition or the sale of one or more cryptoassets; or the use of cryptoasset services.

Specifically, Title V includes requirements for the authorization and operating conditions of CASPs, many of which are similar to requirements for investment companies under MiFID II. In order to provide cryptoasset services, companies will need to have a registered office in an EU member state and to have been authorized as a CASP by a competent member authority of the EU member state. Such authorization will be valid across the EU. If an EU member state already has established an authorization regime for CASPs, regulators will apply a simplified process to help companies transition from a national authorization to a

MiCA authorization, which will be valid across the EU. The MiCA Proposal provides that the European Securities and Markets Authority (ESMA) will establish a register of all CASPs, which will be publicly available on its website and updated on a regular basis.

In its recitals, the MiCA Proposal states that any legislation adopted in the field of cryptoassets should also contribute to the objective of combating money laundering and the financing of terrorism and should adopt the definition of “virtual assets” set out in the recommendations of the Financial Action Task Force (FATF).⁸ In its most recent draft guidance, issued in March 2021, FATF replaced a previous reference to “assets that are fungible” with “assets that are convertible and interchangeable,” in defining the scope of virtual assets that in FATF’s view warrant regulation, raising the possibility that NFTs could be included within this definition.⁹

The UK Government’s Approach

The UK government’s approach to cryptoasset regulation has been to attempt to balance the need to foster innovation against a desire to ensure consumer protection.

In order to define cryptoassets and describe how they relate to the current UK regulatory perimeter, the UK Financial Conduct Authority (FCA) published guidance in 2019 that describes the following three categories of cryptoassets:

- E-money tokens — tokens that meet the definition of electronic money under the UK Electronic Money Regulations 2011; this category broadly encompasses digital payment instruments that store value, can be redeemed at par value at any time and offer holders a direct claim against the issuer of the token;
- Security tokens — tokens that have characteristics akin to specific investments under the UK Financial Services and Markets Act 2000 (Regulated Activities) Order 2001 (e.g., shares or debt instruments); and
- Unregulated tokens, including utility tokens — tokens used to buy a service (or access to a distributed ledger technology platform) and exchange tokens (*i.e.*, tokens used primarily as a means of exchange.) High-profile examples include Bitcoin and Ether.

⁶ See Art. 13 of MiCA Proposal (requirements to act honestly, fairly and professionally; communicate with the holders of cryptoassets in a fair, clear and not misleading manner; prevent, identify, manage and disclose any conflicts of interest that may arise; and maintain systems and security access protocols to appropriate Union standards, to be further defined in joint European Securities and Markets Authority (ESMA) and European Banking Authority (EBA) guidelines).

⁷ Token whitepapers must comply with minimum disclosure requirements similar to the ones applicable to a prospectus, including the description of the issuer, the offered tokens, and the rights and risks associated with them. The MiCA Proposal requires the disclosure of specific information depending on the type of token.

⁸ See MiCA Recital (8).

⁹ FATF develops standards to combat money laundering and terrorism financing. For a discussion of FATF guidelines and the developing U.S. approach to NFTs, see our April 16, 2021, client alert, “[Are Nonfungible Tokens Subject to US Anti-Money Laundering Requirements?](#)”

Regulatory Approaches to Nonfungible Tokens in the EU and UK

Cryptoassets categorised as either e-money tokens or security tokens already fall under the scope of the UK regulatory perimeter. This means that carrying out certain activities in relation to these assets will be classified as a controlled activity and require authorisation from the FCA. Furthermore, any offer or marketing of security tokens in the UK is subject to the requirements and restrictions of the UK financial promotion regime, as security tokens are classified as “controlled investments”.

Based on the current FCA guidance, it is likely that most NFTs would be classified as unregulated tokens. However, if an NFT exhibited characteristics akin to e-money or a security token, then it is possible that a specific NFT may fall within the UK’s regulatory perimeter. In order to determine the classification of a particular NFT, an analysis must be undertaken on a case-by-case basis, with reference to the structure and nature of the subject NFT.

Furthermore, the UK government has transposed the requirements of the EU’s Fifth Anti-Money Laundering Directive into national law. One of the changes to the AML framework was to expand the scope of the existing regulations to include cryptoasset exchange providers and custodian wallet providers. Under the Money Laundering, Terrorist Financing and Transfer of Funds (Information on the Payer) Regulations 2017, as amended by the Money Laundering and Terrorist Financing (Amendment) Regulations 2019 (the MLRs), such cryptoasset businesses are required to register with the FCA before undertaking any cryptoasset activities. In order to register, these businesses must demonstrate that their senior managers are fit and proper and will be subject to ongoing reporting requirements and supervision by the FCA. Under the MLRs, “cryptoassets” are defined broadly to capture any “cryptographically secured digital representation of value or contractual rights that uses a form of distributed ledger technology and can be transferred, stored or traded electronically”. As a result, in-scope businesses that are providing cryptoasset exchange services or custodian wallet services, by way of business in the UK, may still be required to register with the FCA for money-laundering supervision, even if the cryptoassets being dealt with are NFTs. Businesses may be classified as cryptoasset exchange providers if they are providing a service for exchanging cryptoassets for money or vice versa, or exchanging cryptoassets for other cryptoassets, e.g., if an NFT is exchanged for Ether. However, an analysis of the specific activities would need to be undertaken before reaching a definitive conclusion.

More broadly, the UK Treasury issued a consultation in July 2020 that proposed expanding the current UK financial promotions regime to encompass “qualifying cryptoassets”.¹⁰ The UK government’s approach requires the cryptoasset to be both fungible and transferable in order to qualify under the expanded financial promotion regime, and as a result the marketing of NFTs (which are nonfungible) will fall outside the UK financial promotion regime based on the current regulations. The UK government’s view is that these conditions make it more likely that cryptoassets will give rise to consumer protection issues. The reasoning provided by the UK Treasury is that both fungibility and transferability are core characteristics of money and other widely used regulated products (such as stocks), and as such consumers may expect such cryptoassets to hold a stable value and the markets to be sufficiently liquid to permit these to be sold easily. When carving out nonfungible tokens, the UK government considers the value of such products to be attributable to the specific characteristics of the particular cryptoasset and the utility afforded to its holder. In the UK government’s view, such cryptoassets pose less risk from a consumer protection perspective, as they are less readily interchangeable and the relative value of such tokens is difficult to predict.

While the UK government has employed a restricted notion of a “qualifying cryptoasset”, it has reserved its right to expand the UK regulatory perimeter to a broader range of tokens in the future. Furthermore, intergovernmental organizations such as FATF, to which the UK, the European Commission, and EU member states such as France and Germany belong, may in the future take a stance in favor of regulating NFTs.

Money-Laundering Rules for Art Market Participants

Existing EU and UK anti-money laundering rules applicable to certain art market participants could apply when such parties are involved in the sale of NFTs for an amount of €10,000 or more.

Under AMLD5, “persons trading or acting as intermediaries in the trade of works of art” must implement certain anti-money laundering measures where the value of a transaction (or a series of linked transactions) amounts to €10,000 or more.¹¹ Such persons are required to implement a risk-based AML/CFT

¹⁰ See [HM Treasury, Consultation: Cryptoasset promotions, July 2020](#).

In the consultation, the UK Treasury proposed the following definition for “qualifying cryptoassets”: ““Qualifying cryptoasset” means any cryptographically secured digital representation of value or contractual rights that uses a form of distributed ledger technology which — (a) is fungible; (b) is transferable or confers transferable rights, or is promoted as being transferable or as conferring transferable rights; (c) is not any other controlled investment described in this Part; (d) is not electronic money within the meaning given in the Electronic Money Regulations 2011; and (e) is not currently issued by any central bank or other public authority”.

¹¹ Directive (EU) 2018/843 of the European Parliament and of the Council of 30 May 2018 on the prevention of the use of the financial system for the purposes of money laundering or terrorist financing (AMLD5), Article 1(1)(c)(i).

Regulatory Approaches to Nonfungible Tokens in the EU and UK

program; conduct initial and ongoing client due diligence, which includes identifying and verifying clients' identity; document such diligence and maintain records; monitor for politically exposed persons (PEPs) and adverse media; monitor transactions for suspicious activity; and submit suspicious activity reports.

In the UK, the MLRs also require "art market participants" who deal in sales, purchases and/or storage of works of art, where the value of the transaction, or a series of linked transactions amounts to €10,000 or more, to register with HM Treasury for money-laundering supervision and to comply with the requirements of the MLRs. This obliges such businesses to nominate a person responsible for anti-money laundering compliance, apply customer due diligence procedures, train staff appropriately, report suspicious transactions and keep records.

AMLD5 does not define or explicitly mention NFTs, nor does AMLD5 provide a definition of "works of art". It remains to be seen whether, for example, a party that deals exclusively in NFTs that provide an ownership interest in digital art (such as a photograph, a song, a digital artwork or animation) would fall under AMLD5 and its requirements for persons trading or acting as intermediaries in the trade of works of art. Because the NFT and traditional art market share certain risk factors regarding money laundering and terrorist financing, including price volatility and anonymity of buyers and sellers, it is possible that regulators would take a broad view of NFTs as "works of art" whose sale could be subject to anti-money laundering requirements for gatekeepers in the EU and UK under existing regulations.

Key Takeaways

NFT market participants should consult with their advisers to understand the potential impact of existing and forthcoming regulations, such as the MiCA Proposal, on their licensing, market communications and compliance frameworks. In the UK, NFT market participants should consult with their legal advisers to understand whether the specific NFT they are dealing with may fall within the regulatory perimeter. In particular, art market participants should consider whether their current anti-money laundering policies require any updates to account for NFT-related transactions, while NFT marketplaces that may not originate from the traditional art market should consider whether they could be subject to the application of anti-money laundering requirements for art market participants.

Contacts

Pascal Bine

Partner / Paris
33.1.55.27.11.01
pascal.bine@skadden.com

Simon Toms

Partner / London
44.20.7519.7085
simon.toms@skadden.com

Nadine Kari

Associate / Paris
33.1.55.27.11.65
nadine.kari@skadden.com

Gregory Vianesi

Associate / Paris
33.1.55.27.61.12
gregory.vianesi@skadden.com

Elizabeth Robertson

Partner / London
44.20.7519.7115
elizabeth.robertson@skadden.com

Sidne Koenigsberg

Counsel / Paris
33.1.55.27.11.39
sidne.koenigsberg@skadden.com

Abigail B. Reeves

Associate / London
44.20.7519.7282
abigail.reeves@skadden.com