A LEGAL EVALUATION ON EMERGING CHALLENGES OF NON FUNGIBLE TOKENS AND ITS FINANCIAL IMPLICATIONS

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ABSTRACT

Non Fungible tokens are digital assets that are acquired for monetary value with transfer of cryptographic ownership. NFT are not regulated under a legal framework for taxation, financial governance or prevention of fraudulent practices in its circulation. The Paper focuses on the lack of legal implications for trade in NFT which run in contrast to the systematic economic process that has been regulated by rule of law and statutory authorities. NFT provides a parallel economy for digital transactions and it doesn't provide any investor protection to its buyers and sellers. NFT must be treated and considered as digital security contracts like security contract derivatives that are protected under the SEBI Act. The recent cases of bankruptcy of Crypto Exchanges and complicated structures it has been involved in its risk taking and risk transfer process doesn't protect the financial creditors under the Insolvency and Bankruptcy Laws of India. Non Fungible Tokens are a risk to the economic structures of our country because the existing digital payments interfaces are sufficient to deal with such transfers. Non Fungible tokens are not consistent with Anti Money Laundering Regulations of the Financial Action Task Force and can cause financial turmoil in the digital economy that prevails in our country to bring a revolutionary change. NFT can be used to facilitate and protect cybercriminals that steal the wealth of our citizens by giving them a place for transfer of stolen assets. Non fungible tokens don't provide a value addition to our existing economy and can cause losses to amateur investors who have invested in such fragile financial liabilities that don't provide any goods or remain protected in situations of economic slowdown.

Keywords: Cryptocurrency, Money, Assets, Liability, Law

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Introduction

Non Fungible Tokens have evolved in the era of high volumes of cryptocurrency transactions but there is no institutional acceptance of NFT as a new digital collectible that provides the entitlement of transfer of ownership of intangible commodity in a digital marketplace and it can't be replaced by a legal prohibition as transactions can still continue between P2P systems that can operate from different foreign nations that give acceptability to cryptocurrency offerings and via shifting the financial base to a tax haven that doesn't have explicit legal recognition of such assets. The paper tries to construe non fungible tokens as intangible financial assets that have to considered and recognized as a security contract (Patnaik, 2022)[2] that can be traded on public exchange and the securities and exchange board of india can regulate such assets by having an offset wing for scrutinizing and regulating such financial assets because they are fundamentally different from the regular cryptocurrencies like Bitcoin, Binance Coin and tether as these cryptocurrencies are traded for a specific purpose and mission and vision. NFT are not a challenge to the existing economic system but also help in resolving some real world problems like Counterfeiting and exemplifying the legitimacy of financial transactions and prevent money laundering but the problem resides in volume of transactions in a certain geographical area like India and the legal boundaries of Taxation, Money Laundering, Foreign Exchange regulations that protect the nature of the economy by restraining the inflow and outflow of more foreign exchange that would create a currency imbalance and chaos in the forex markets as more supply increases compared to the existing demand increases volatility.

Nature of NFT in Business Law

Non fungible tokens are elevation of conventional fiat currency to create a parallel economic system which will not only create problems for the financial system but also bankrupt investors due to lack of legal protections from scams and manipulations. Although, the main purpose of cryptocurrencies is to avoid centralized fiat currencies and have an decentralized medium of transaction but the chain of transactions is controlled by demand and supply that can be manipulated by marquee investors and high net worth individuals that are called as whales and sharks in the cryptic terms can create artificial bubble to attract sheeps of retail traders and

[2] Patnaik, P. (2022, July 12). *NFTs and Mapping its Regulation in India*. IRCCL. Retrieved February 23, 2023, from https://www.irccl.in/post/nfts-and-mapping-its-regulation-in-india

dupe them to earn crores of rupees via pump and dump schemes as they hold large volumes of those cryptocurrencies and due to the anonymity and privacy protection of the transactions done on the blockchain, the real culprit of causing financial harm can never be identified. Registration in NFT markets do not require rigorous verification and KYC process as the wallet connected to the NFT profile is verified by the regular procedures and anonymity on NFT Marketplaces continue uninterrupted as money earned from NFT sale can be transferred to a new secondary cryptocurrency for trading and it remains safe from volatility as the entire volume is controlled by one person (Shrivastava & Bhat, n.d.)[3]. NFT is already setting a dangerous precedent in Business Law and only public policy can make a difference to eliminate falsified transactions chains on financial assets that are not under any form of legal scrutiny.

Decentralized Development by NFT

Non Fungible tokens have stimulated economic growth and helped in providing an earning to artistic groups on the internet and it gives opportunity to focus on unique talent based skills like Blockchain development to boost job growth in the markets and blockchain has been crucial in conducting elections safely in countries like Sierra Leone and it also helps in protecting the identity and privacy of a person and it can have positive usage in the banking system in preventing tampering, hacking, cyber fraud and facilitate transactions in a smoother person. NFT has ideal cryptographic symbolism by hashing that provides revenue from mining and has also made us rethink on amendments to certain concepts of Intellectual Property Rights as fashions brands are stuck in litigation due to trademark infringement on the royalty based disputes (Wajiha et al., 2021, #)[4]. NFT also helps in authenticating the acceptance of social services and helps in security aspects as well in protecting the cyberspace of a country as it doesn't allow in changing the pattern of an object because the entire cryptographic chain should be compromised which is virtually impossible to do in present times. NFT's have also assigned licenses and certifications to corporate entities on document verification and reduce the time taking process of record keeping. Security challenges remain during technological growth as fraudsters can register themselves on the NFT Marketplace but changes and updates to the security protocols continue to protect the safety of the NFT domain. The government is

[3] Shrivastava, A., & Bhat, P. (n.d.). *The Legal Recognition Of Non-Fungible Tokens (NFTs) In India*. LawInSport. Retrieved February 23, 2023, from https://www.lawinsport.com/blogs/lawnk/item/the-legal-recognition-of-non-fungible-tokens-nfts-in-india?category_id=750

[4] Wajiha, R., Hijab, Z., Jaweria, I., & Narmeen, B. (2021, 12 23). NFTs: Applications and Challenges. 10.1109/ACIT53391.2021.9677260

bringing forth e-rupi as a Central Bank Digital Currency but it has different role to play out as it will be centralized regulated financial currency to trade across different currencies but the value of Decentralized Finance are currencies that give certain yield of return even though being an high risk asset but after the global financial crisis the trust on the actions of the banking institutions had collapsed due to the reckless actions of big banks by investing on non performing speculative asset that led to the global meltdown and dried up credit and liquidity in the markets which led to birth of bitcoin as a financial asset against the traditional banking institutions.

Financial Risks of Non Fungible Tokens

It has been witnessed in several instances regarding the failure of Non fungible tokens due to lack of liquidity and outflow of revenue in an highly competitive environment where cryptocurrencies can be burnt to zero due to lack of value addition and high selling pressures in the markets as the financial meltdown continues and the previous acquisition of sectoral competitors add up to the liabilities in the balance sheet to bring down the operating profit margin that it prevents the financial growth of steady and good cryptocurrency exchange. NFT Marketplaces run on cash burn invested by a group of investors and the cash flow dries up during volatile sessions of the market when investors jump ship to low risk assets to generate positive returns. Users of an NFT Marketplace contribute licensing fees, listing fees, minting fees and pay related charges including premium to keep their listing above in the list of NFT's that are likely to be subscribed and invested in by buyers. The risks of Non fungible tokens are the ultimate pathway to Insolvency and Bankruptcy and this high class crazy product can create poverty overnight through the collapse of the general crypto index. There is no stability or circuits in the crypto indices or markets to control volatility. It remains a free fall market in an artificially floated bubble that can burst at any point of time. These NFT are called the futuristic revolutionary tool but it can't be construed as a normal financial asset that creates or generates wealth. Non fungible tokens or Cryptocurrencies hardly generate any returns for the retail traders unless they have bought such financial products at very low price. These are highly speculative products that are worse than gambling in a casino or lottery tickets because it is highly a game of chance and there are a lot of big investors at the top who earn money by duping others into a get rich quick scheme by extensively false and misleading third party advertisements. There are genuine crypto exchanges operating in good faith with better business code but the seductive advertisements of crypto exchanges tend to mislead investors often and there is no oversight body to punish such people who create a fake aura of wealth and richness while its supposed to benefit the ultra-rich whale sharks that feed upon the fear of other investors by creating a phenomena of Fear of Missing Out (FOMO).

Comparison with other countries

1. **United Kingdom -** It doesn't have any particular legislation that regulates NFT as an financial asset because they haven't given any statutory attention to NFT as an asset class but the taxation on NFT is via capital gains and we can safely assume it as capital asset in the UK as a security token as VAT is also included on NFT transactions.

2. **China -** This country has banned cryptocurrency altogether but hasn't taken any step to prohibit NFT transactions as they still continue in china but the National Internet Finance Association of China, Securities Association of China and Banking Association of China have jointly issued an initiative to prevent NFT related financial risks but initiative is not a regulation under the laws of Mainland china but a gentle suggestion from industry experts.

3. **European Union -** This body or group of countries don't have a collective set of legislation that legally evaluates or determines the status of Non fungible tokens as a financial asset. There is no particular legislation but the countries individually are free to enact their legislation.

4. **Japan -** The Japanese government had hinted at creation of an NFT Taskforce in January 2022 but presently if a NFT holder continues with actions such as sharing of profits then it will be considered as a security under Financial Instruments and Exchange Act. Japan will specifically consider whether NFTs come under the purview of gambling laws or not.

5. **Singapore -** The Singaporean central bank has made it clear that they will not regulate the NFT markets as they are a promising market in south east asia and moreover NFT would be considered as security under the Securities Regulations of Singapore.

6. **United Arab Emirates -** The market regulator in Abu dhabi has considered in its proposal that they would consider companies requiring license for NFT trading in the free zone area and they would have to comply with the Anti Money Laundering and

Sanction Rules. These proposals have not been implemented into full stage regulations for the time being. (Boggs, 2022)[5]

Legal Framework for Non Fungible Tokens

The securitisation of any smart contract can be considered under Securities Contract Regulations 1956. But, the government is considering a blanket ban on all private cryptocurrencies and this would create more ambiguity towards Non Fungible Tokens as they can be traded in off market transactions that would cause more problems and further larger loss to the Indian Economy and business houses because it would attract violations of the FATF regulations. The word private cryptocurrency is ambiguous since they are not controlled by a single organization or individual as the supply and demand is between different anonymous individuals. Legal Framework specifically targeted at Non Fungible Tokens can prevent copyright fraud, sleepminting, insider trading, wash trading and covering transfer of royalties. Significant levels of financial crimes can be reduced and NFT can be used in favor of the people to increase digital transactions with safety and interconnect the United Payments Interface at a Global level with better user interface and features. The income tax act is the only act that can regulate the transactions of NFT transfers, buying and selling in India because of its style of interpretation that provides clarity on the taxing structure on cryptocurrency. The consideration of Non fungible tokens under the Sale of Goods Act, 1930 is a hurdle towards providing relief because the transaction facilitated between two users has anonymity and case can't be instituted against the NFT Marketplace because it remains an aggregator and the initial seller or person accepting the transaction. Investors of Non Fungible Tokens remain protected under the Consumer Protection Act, 2019 until liability claims can be proven beyond reasonable doubt (Anand et al., 2023)[6].

Case Law Analysis

1. **Internet & Mobile Association of India v. Reserve Bank of India**[7]

The Supreme Court of India in this case held that RBI Circular prohibiting trade of crypto

[5] Boggs, P. (2022, June 30). *Worldwide Regulatory Review Of NFTs*. National Law Review. Retrieved February 23, 2023, from https://www.natlawreview.com/article/nft-collection-brave-nft-world-regulatory-review-nfts-part-2
[6] Anand, P., Anand, D., Patro, U., & Singh, S. (2023, January 31). *NFTs regulation in India - Asia | Law.asia*. Asia Business Law Journal. Retrieved February 23, 2023, from https://law.asia/nft-regulation-in-india/
[7] 2020 SCC online SC 275

currency was violative of Article 19(1)(g) of the Constitution because every Indian citizen has the right to carry legitimate trade within the territory of the country and the circular is unlawful on grounds of proportionality and directed the central bank not to freeze the bank accounts of the petitioner[8].

2. **Juventus FC v Blockeras**[9]

The Court of Rome has granted preliminary injunction in favor of Juventus Football club that the respondent was producing, marketing and promoting online NFT cards without authorization of the petitioner which is a well known trademark. The court also pointed out that the petitioner had proved that it was active in the crypto games field and blocked the respondent from selling similar products[10].

3. **Miramax v. Quentin Tarantino**

This is the first NFT Intellectual Property Rights case where the legitimacy and value of such digital assets was in question because a director of a film decided to sell certain uncut scenes as NFT and the studio approached the court to block the release of those clips as it was a copyright violation, breach of contract and trademark violation. Later, both the parties informed the court in a filing that they had settled the dispute.

New Challenges by Non Fungible Tokens

Non fungible tokens can create a network of trade that exchanges digital collectibles between content creators, artists and other crypto traders that seek to make profit out of their novelty by selling their own creation in the digital world without transfer of tangible ownership of the product. The risk taken by the investor in purchasing the asset can't determine the future resale value of that same digital collectible as it doesn't provide any value addition. It provides good financial valuation to the NFT Marketplace as a startup and marketing of its platform for exchange of digital collectibles (Mieszko, 2021, #)[11]. The laws enacted by India like Foreign Exchange Management Act 1999, Banking Regulation Act 1949 and Prevention of Money

[8] *INTERNET AND MOBILE ASSOCIATION OF INDIA V. RESERVE BANK OF INDIA*. (2021, July 14). Law Essentials. Retrieved February 23, 2023, from https://lawessential.com/all-blogs/f/internet-and-mobile-association-of-india-v-reserve-bank-of-india?blogcategory=Case+Comments
[9] *s.r.l.*, No. 32072/2022
[10] https://www.trevisancuonzo.com/static/upload/juv/juventus-nft-order---en.pdf
[11] Mieszko, M. (2021). *Non Fungible Tokens(NFT) - The Analysis of Risk & Return*. IESEG Publishers.

Laundering Act 2002 are meant to protect the economy from foreign influence and prohibit illegal financial activities within the territory of India. Income generated from Non Fungible Tokens are not clearly classified under the general taxation rules of the Income Tax Act, 1961 as it can be categorized income from capital gains and income from profession for some people that are involved in the trading of such tokens. The risk reward ratio for non fungible tokens is beyond the apprehension of a usual capital markets earner as there are regulations to protect him but in cases of NFT's these companies are incorporated and registered in offshore tax havens with loosened tax laws and legal regulations. Investor Protection Fund is for those people that have invested in regulated assets and those corporate entities that have an unclaimed corpus of dividends, unclaimed deposits, matured debentures and share application money. NFT investors fall into an string of pyramid schemes that can collapse in cases of recession where the investors will be stuck in large creditors process while insolvency proceedings are initiated and application for restructuring is submitted before International Arbitration forums seeking legal restraints from further lawsuits until moratorium is granted to the corporate debtor for repaying the creditors. NFT is in the middle path of two new technological evolutions such as metaverse and decentralized currencies, both of which have opposite visions and purpose to be achieved that remain contrary to each other.

Proposed Solutions

The primary solution to addressing Non Fungible Tokens in the context of Business Law is the need for legal recognition and lack of public awareness. If people are more educated on such financial issues and its applicability to business law, it can be made into public policy. The suggestions which can be taken from this research includes:

1. The Securities Contracts Regulations Act, 1956 can be amended to include provisions which facilitate and regulate Non Fungible token transactions

2. The Securities & Exchange Board of India can create an offset wing to regulate and penalize NFT transactions on a case to case basis.

3. The courts can play an active role in recommending changes to NFT regulations in consultation with SEBI & RBI.

4. Legislature and Courts can make sure that Non fungible tokens are not utilized for

transnational crimes.

Conclusion

The Legal evaluation of Non Fungible Tokens and its applicability on business enterprises has its own benefits and challenges. The application of consumer laws and Securities Contract Regulations, 1956 would further analyze the practical feasibility of transactions involving Non Fungible Tokens. This can lead to positive development of technology law and fintech innovations consistent with the financial needs of the country. The institutionalization of Non Fungible tokens would create a transformative approach towards business law in India. The basic principle behind legal acceptance of NFT should be consent and agreement of parties involved in the transaction. Constructive changes can be made to the regulatory process in India but manipulation in the minting and listing of NFT has to be prohibited and penalized to avoid violation of Anti Money Laundering Regulations in India as dark money must not be processed via Non Fungible Tokens for layering and whitewashing. NFT has a long way to go in India. The Supreme Court of India has adjudicated on Cryptocurrencies in general but has not decided on the legal validity of Non Fungible Tokens as its still in the growing phase in India. Technocrat adjudicators will consider the future and acceptable standards of Non Fungible Tokens in emerging business friendly new india that already leads in the world by providing the highest numbers of techpreneurs to the world that contribute socio-economic growth by creating innovative products that remains the desire of the business world in general.