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By J. Scott Christianson

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It is easy to dismiss the hype and manic speculation surrounding digital non-fungible token (NFT) art assets, but behind the wild stories and headlines is a serious technological change in how assets can be created, sold, and traded. NFTs, often pronounced "nifties," are serious innovations that have interesting implications for art investments and other asset classes.

THE REVOLUTION WILL BE TOKENIZED

When a creative work such as a movie, artwork, or book moves from being a physical object in the analog world to bits in the digital realm, some interesting magic happens. First, the cost of digitally copying and distributing a work becomes so negligible that it can be considered nonexistent. Second, when a digital asset is copied, it is identical to the original. As a result, because ownership and scarcity of a work is both hard to verify and maintain, past efforts by small companies or artists to secure their work's digital property rights either proved unsuccessful or were far too expensive to implement.[1]

Today, using cryptographic signatures and blockchain technology, artists can issue a secure NFT representing their creative work with relative ease and little expense. In essence, each NFT is a unique digital certificate of authenticity issued by the creator or holder of an asset. In contrast, a cryptocurrency asset such as a bitcoin can be exchanged only for another bitcoin or subdivided.

Although the excitement about NFTs currently is centered on the arts, NFTs also can be handy for representing various digital or analog assets. For example, NFTs are now being used in smart contracts to represent invoices, accounts, payments, and physical assets.

MANY COPIES, ONE ORIGINAL

NFTs don't prevent the duplication of digital art, but they do allow the artist to mint a digital token or tokens that can be sold like an original painting or print. The creator can issue just one NFT to represent the work (similar to an original painting) or issue a limited number of NFTs (similar to a limited-edition print).

Just as one might hang a poster of an Andy Warhol silkscreen on the wall to enjoy, the digital art of Beeple can be downloaded and displayed by anyone. However, neither is an original, nor do they possess significant value. Digital art without an NFT is the same as the poster: It is nice to look at, but it is not an investment.

In this way, NFTs can prove ownership, provide authenticity of an asset, and preserve scarcity in a digital world.

A SMARTER SALE FOR ARTISTS AND ART PATRONS

NFTs can't be copied, but they can be sold or transferred to another party via a smart contract, which can include any number of provisions or restrictions. NFT contracts typically are made using the Ethereum platform, which includes a cryptocurrency known as ether. Ether can be exchanged with U.S. dollars, euros, and other government-issued currencies. Payments are made automatic by combining the payment platform and the contract. These smart contracts are also largely peer-to-peer and can include any number of scenarios.

For example, American artist Sara Ludy recently set the terms for the sale of her digital art: 50 percent for herself, 15 percent to the platform that sells her art, and 35 percent to the gallery that represents her work. Ludy's smart contract also specifies that the gallery proceeds are divided between the gallery owner and gallery staff.[2]

One popular use of smart contracts is to allow artists to participate in their work's subsequent resale. For example, artists can sell NFTs and specify that they will receive 10 percent of any subsequent resale amounts. As the art appreciates, the artist can benefit financially for years or decades after selling the original art.

A smart contract also might benefit art investors. For example, upon resale of an NFT, the original creator of the NFT receives a certain percentage of the sale, as do all previous owners of the NFT. This type of contract could incentivize more investment and speculation in art because the act of resale also would allow early investors to profit from the rising value.

To blunt the possibility of bad behavior arising from NFT resale (pump and dump), smart contracts also can alter the proportions or amounts paid with each sale (for example, the gallery only gets a portion of the first three sales and none beyond that).

A smart contract also might limit the number of sales within a given time period, even for small-value assets. This capability has great potential outside of art. Take for example Sony's PlayStation 5 (PS5) gaming console, which was in short supply during the winter of 2020. This limited supply was made worse by scalpers who utilized computer bots to quickly purchase all available PS5 consoles as soon as they were released. At the time, Sony was accused of failing to protect consumers by permitting bot-buying. If Sony had tied an NFT to each console sale, purchasers could have been restricted from reselling the device for six months, thereby eliminating the incentive for scalpers.

Ultimately, the terms used in smart contracts will determine which behaviors will be incentivized. Many NFT fans hope that NFTs will allow artists to bypass the current gatekeepers (gallery owners, art critics, etc.) and democratize art investing. But, of course, it also could happen that NFTs create new gatekeepers or fuel investments in bad art.

YA BURNT, BANKSY

The question "What is art?" takes on new twists in the world of NFTs. In March 2021, a collective of "art and NFT enthusiasts" called Injective Protocol purchased a Banksy original print titled *Morons (White)* valued at US$95,000. The collective then made an NFT to digitally represent the print and burned the original. The resulting NFT was sold at auction several days later for US$380,000.[3]

This is reminiscent of an episode in the 1950s when Willem de Kooning gifted a drawing to Robert Rauschenberg, knowing that Rauschenberg intended to erase it and thereby create a new piece titled *Erased de Kooning Drawing*.[4]

Asks writer Kriston Capps:

> *Had Rauschenberg destroyed one artwork to create another? Or was de Kooning's piece, altered by Rauschenberg, still a de Kooning? Modern conservation complicates the question: In 2010, scientists at the San Francisco Museum of Modern Art used infrared digital processing to trace the original drawing, revealing the lost de Kooning. In so doing, did they erase Rauschenberg's erasure?*[5]

When a physical object of art no longer exists except as digital ephemera, is there any art left? Is the NFT now art or a financial derivative? If it is art, what does it represent? The Banksy, or the performative art of destroying the Banksy?

THINGS MIGHT GET WEIRD

Smart contracts also allow NFT issuers to include an end-user agreement with the creative work.[6] The popular NBA Top Shots NFTs of basketball videos and photos include an end-user agreement that restricts the user from modifying the art post-sale or associating it with images or issues the NBA deems inappropriate (hate speech, pornography, etc.). However, it is unclear how the NBA will enforce these rules once ownership of the art is transferred.

Because smart contacts are peer-to-peer and are not validated or litigated by a third party, smart contracts allow for the re-creation of established financial instruments and the invention of imaginative new arrangements. A synthetic NFT can be created by embedding a smart contract within another smart contract. Options contracts for NFTs also might be popular. Basically, any scenario that can be programmed can be part of a smart contract. Welcome to the world of programmable assets.

NFTs FOREVER

Because of the distributed nature of blockchains, every network node provides a backup for NFT assets. NFTs are not subject to the dangers of loss or destruction in the way that an accident or security breach can destroy a digital asset on a central server. Nor can they be damaged or destroyed like a physical asset.

Although NFTs can't burn in a fire, they can become unobtainable if the encryption keys used to prove ownership are lost. If an NFT owner loses the private encryption key, the NFT would exist in perpetuity on the blockchain but would be out of the owner's reach permanently.

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Several people who obtained bitcoin when it was worth very little have experienced this scenario. Because the bitcoin had little value at the time, they didn't bother with transferring their encryption keys to a new phone or computer when they upgraded old technology. The bitcoins owned by these people still exist on the bitcoin blockchain, but without their encryption keys that value can't be accessed. It's estimated that due to lost encryption keys, some US$200 billion in bitcoin is now forever inaccessible.[7]

Likewise, if an NFT owner dies without passing on information about how to access the private encryption keys, then these assets will not be transferable to any heirs. For all practical purposes, the NFT would be lost. Therefore, estate planning for crypto assets needs to be considered whenever investors dip their toes into the world of NFTs or cryptocurrency.

INVESTING IN NFTs

The market cap for NFT art was US$338 million in 2020, and if current trends continue will be double or triple that amount in 2021.[8] Like many art investments, NFTs of creative works are highly speculative and should be approached with caution, especially in a volatile market where bitcoin millionaires and reddit WallStreetBets followers are looking to buy into the next wave of crypto wealth. As blockchain expert Andreas M. Antonopoulos remarked: "Investing in NFTs (and everything crypto) is like adding spice to a dish. A sprinkle makes it exciting; a cup makes it inedible."[9] It is all a matter of proportion.

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