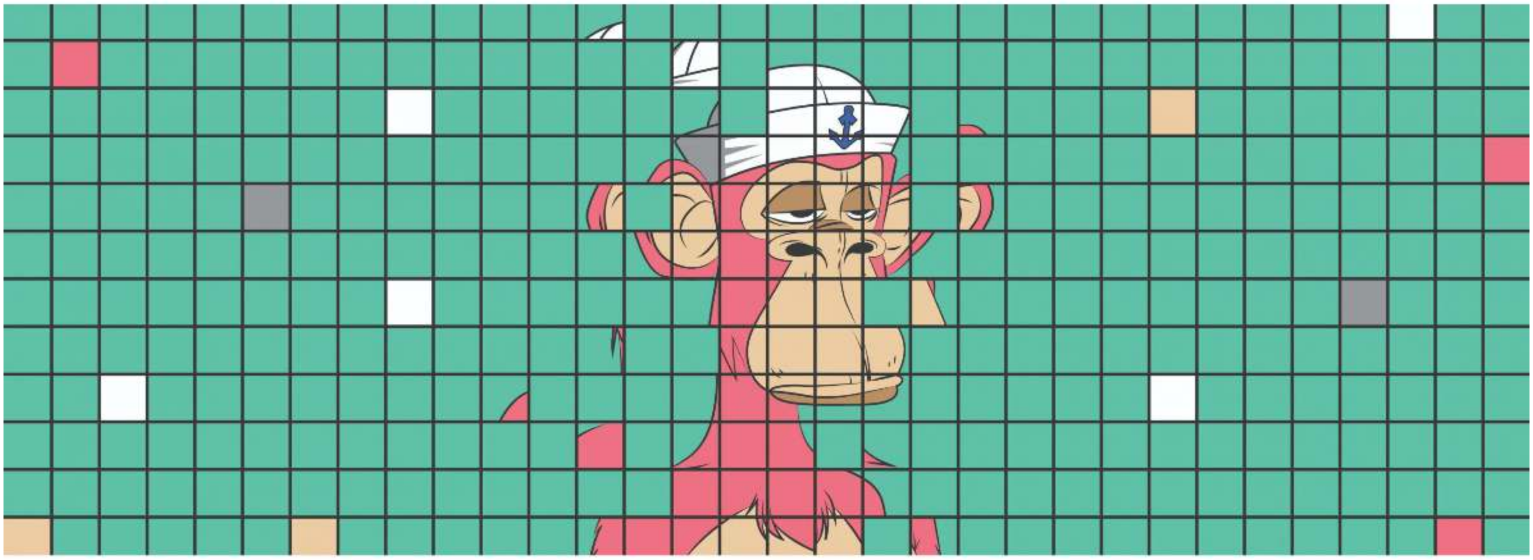

NFT

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The Rise and Risks of Fractionalized NFTs

MAY 13, 2022 | LUKE O'NEILL | READING TIME 4 MIN

Fractionalized NFTs are an effort to solve an age-old problem: affordability. With wildly popular NFTs like Bored Apes and CrytpoPunks selling for millions, sharing the costs and ownership rights could be an appealing way to invest. But is it worth it? Unchained. The Blockpit Magazine explores the opportunities and risks of shared ownership in the NFT space.

What are Fractionalized NFTs?

Fractionalized NFTs are a blockchain-era twist on an established yet risky investment method. Fractionalization sees investors buy a part — often called a 'shard' — of an expensive NFT, or a fraction of a large NFT collection.

"Popular NFTs from the likes of CryptoPunks or Bored Ape Yacht Club NFTs have expensive floor prices of 400 Ethereum, making them hard to own, said Max Bernt, Chief Legal Officer at Blockpit. "Most people can't afford that, but they still want a piece. So this is where the concept of fractionalized NFTs comes into play, so you can hold a certain percentage of such NFTs."

Fractionalisation is not a new thing. Fractionalized investments make it possible to share the ownership and costs with others, enabling people to invest in assets they might not be able to afford on their own.

Part-ownership arrangements for physical assets, such as private jets, yachts, and properties is a fairly known concept. You might not be able to afford a holiday home in Saint Tropez, but that dream could be a reality if you and three friends pool your resources.

Fractional share investing, where investors club together to purchase shares in a company, has also been around for some time.

Now, with the emergence of NFTs and the metaverse, fractional ownership is reliving a boom.

How do Fractionalized NFTs work?

Grace Rachmany, a consultant in tokenomics, decentralized autonomous organizations, distributed systems, and currency design at DAO Leadership, gives the example of an in-game item — the Great Sword of Power — to explain how F-NFTs work.

"The Great Sword of Power provides the hero with special abilities to slay the most frightening dragons, but unfortunately, there is only one sword and it's very expensive. To buy the Great Sword of Power, a few players get together and buy it, which means they each own a 'fraction' of the NFT," she said.

If one person decides they want to sell their fraction, they can do that, without the permission of the other holders of the sword. "Depending on how the F-NFT ownership is set up, they might all have voting rights that allow them to make decisions about the sword," adds Rachmany. For example, they could vote to rent it to other players at a particular price and split the profits.

There are many more examples of F-NFTs. Recently, in Austria, Gustav Klimt's early 1900s masterpiece, Der Kuss, was fractionalized into 10,000 digital shards and sold by a Vienna museum. Other examples include a fractionalized image of a Shibu Inu dog that led to Dogecoin. And recently, crypto users have auctioned F-NFTs to fund humanitarian efforts in Ukraine.

Fractional NFTs are big in the metaverse, where people can partly purchase digital land, with each owner's property rights encoded on the blockchain. For example, a 'plot' next to Snoop Dogg's mansion in metaverse game The Sandbox was recently sold for $450,000.

What are the risks of F-NFTs?

While fractional ownership makes investment opportunities more accessible, there are risks involved.

"It's important to consider who has custody of the underlying NFTs and who has the ultimate rights to it," said Brock Pierce, Chairman of the Bitcoin Foundation. "There are legal considerations when you fractionalize NFTs that may make it more like a security and require other hurdles."

Emerging regulatory landscape

Emerging regulatory landscape

Regulators will potentially classify F-NFTs as security to protect the general population. "In that case, NFTs will only be exchangeable on a regulated platform or exchange," according to Benjamin Zennou, managing partner at Enigma Securities, a regulated cryptocurrency liquidity provider.

America's Securities and Exchange Commission (SEC) has recently begun to investigate F-NFTs. If they decide they are securities, this means F-NFTs will be handled in the same way as other tradable financial instruments, like company shares, bonds, or derivatives.

Confusion about jurisdiction

"There are still no uniform legal regulations, let alone guidelines, on the tax law treatment of F-NFTs. However, intensive discussions are currently being held at the OECD level, the results of which will have a significant impact on the international legal landscape," said Blockpit chief legal officer Max Bernt.

Justin Daniels, a shareholder in the Atlanta-based office of law firm Baker Donelson, said questions of jurisdiction may make solving disputes over transactions difficult for courts. "If an NFT royalty is not paid, how do you reverse it on an immutable blockchain? If you buy an NFT from a French Seller on a UK-based exchange with a German buyer whose law applies?" said Daniels.

Governing voting rights

Dr Ben Charoenwong, an assistant professor of finance at the National University of Singapore, said difficulties may also arise from the uncertainties about how to govern F-NFT bids and the transfer of ownership.

Traditional finance has rules to prevent minority shareholders from stopping a deal from going through. "Not having a resolution on this will tend to make owners of NFTs stuck, and therefore the transfer of ownership may not be smooth-sailing if a new buyer needs to get the unanimous consent of all NFT owners," said Dr Charoenwong.

Doubtful investment returns

As with any investment, there is the risk of loss. As Chainalaysis's 2021 NFT Market Report explained, only 28.5% of NFTs transacted on OpenSea's marketplace result in profit, when they have been purchased during minting and subsequently sold on the same platform. The prospect of real returns is likely just as small, or even smaller, with fractionalized NFTs.

Bad actors and bots

The Chainalysis report also warned: "A very small group of highly sophisticated investors rake in most of the profits from NFT collecting ... We also see possible evidence of the use of bots by investors looking to purchase during minting events, which could shut out less sophisticated users, and even result in failed transactions that cost them in fees."

An undecided future for fractionalized NFTs

The concept of fractional NFTs is still fairly new, but as the NFT market continues to boom and prices increase, it could be the next big trend in the crypto space.

While F-NFTs are another new class of digital asset, the issues they have created are not new to investors, regulators, and intermediaries.

Brock Pierce is optimistic, stating, "I think there will be more-and-more experimentation in the NFT world around fractionalizing, trading, borrowing, and other actions and we will see a lot more innovation around NFT."

NFT fractionalization opens up the market to a wider pool of investors, enables greater liquidity and opens the door to new investment strategies. However, the motto of "DYOR" – Do Your Own Research – is more relevant than ever, as shared ownership brings yet another element of risk to the wild-west of the NFT space.

ABOUT THE AUTHOR

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