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NFT – NOT FOR TRADING?

In March 2021, the digital artwork "Everydays: The First 5,000 Days" was sold for roughly USD 70 million in an auction which definitively marked the beginning of an incredible period of NFT hype. Despite their popularity and the constantly rising demand for NFTs, it is still widely unknown what NFTs actually are. We asked **Christian-Hendrik Knappe, German Sales Director** at Spectrum Markets, to shed some light on this relatively new market for us.

Christian-Hendrik, can you please start by letting us know what NFTs are?

NFT, as most people will likely have heard already, is an abbreviation of Non-Fungible Token. In principle, that's all there is to it. A cryptocurrency, on the contrary, is a fungible token, one that is exchangeable and that is equal in value regardless of whose property it is. An NFT is unique, its digital signature is the distinctive feature that differentiates it from other NFTs, like a fingerprint is different to any other fingerprint. While both NFTs and fungible tokens use blockchain technology for authentication and storage, an NFT's non-fungibility can be considered synonymous with its uniqueness.

Since "Everydays: The First 5,000 Days", NFTs have become widely known as digital representations of modern art…

This is definitely the most common use case. But collector's items of all kinds can be found here. Consider NFTs as being used in association with any kind of blockchain-based authentication intended to remain uniquely linked to an asset or right, or attributable to a distinct number of such claims. But of course, the massive trading interest has focused on items from the art world (or at least assets that can be called art in the broadest sense).

Which blockchain project is the technical platform for NFTs and how are they created?

While there are several platforms, Ethereum is the most popular and currently the most widely used for these digital certificates of authenticity. Once the creator of an NFT obtains a wallet allowing for the storage of NFTs and the sending and receiving of cryptocurrencies, a smart contract can be entered onto the blockchain – a process which is called "minting". That contract may contain various details regarding copyrights, the delivery of the digital asset or even re-selling commissions that the creator may claim.

That sounds quite easy. What prevents me from claiming copyright for the Mona Lisa and selling it on an NFT platform?

Technically, nothing. And here's one important challenge coming with NFT trading. Unless the buyer or a third party has reasonable doubt or resilient information that the seller is not the intellectual owner of the artwork, such fraud can happen. And it happens – although the more renowned the artist or the artwork itself are, the less likely this becomes. One has to consider, however, that a lot of the artworks on sale as NFTs are contemporary works and buyers, even if art connoisseurs, are inevitably new to this scene. The risk of becoming a victim of this type of fraud is increased by the fact that the digital pieces do not disappear in the safes of collectors or behind the armoured glass of a museum's high-security area. Instead, the artworks remain available to the public where it is much easier to copy them even if the virtual item can be uniquely assigned to an owner.

Another downside to NFT trading is the transaction costs, the so-called "gas fees". Ethereum charges fees for every process that requires computational resources to execute. Let's forget that computational activities on most blockchains are very energy-intensive and cause significant CO_2 emissions, or let's at least assume that this is a problem that may be solved over time. The fact remains that Ethereum automatically prioritises trades based on the amount of gas fees offered by a trader. In the context of trading directly on the blockchain, this doesn't just have a discrimination effect, it means that when it comes to trading NFTs, the gas fees can exceed the price of the asset and even become a multiple of that.

According to a specialist report, NFT trading volume skyrocketed 21,000% to USD 17 billion in 2021. Is this clear evidence of a bubble or the birth of the market of the future?

First of all, here we have another risk inherent to markets such as the art market: in Q1 of 2022, transaction volume decreased by 47%. Anyone buying art for the purpose of holding it may not be overly concerned about this. However, if you intend to trade an asset, the combination of draining liquidity and very volatile prices makes things much less favourable. It is still difficult to determine whether this market will prove sustainable because, on the one hand, there is the art or collector aspect and, on the other hand, the underlying technology – while their interplay is a third relevant dimension.

Personally, I am not an art expert, but you have to acknowledge that there is a market for almost everything, be it an antique oil painting, rare sneakers, special edition comics or anything else you may think of. The technology aspect will be very interesting, because blockchain projects will develop dynamically and Ethereum, despite the energy aspect, is surely one of the most mature when it comes to smart contracts, which without a doubt have enormous potential.

The third element, the interaction of art trading and the technical platform will very much depend on the seriousness of players in the market and the degree to which experienced, wealthy retail clients and institutional accounts will adopt NFT trading. Irrespective of that, I still think that the NFT market, as is the case with the traditional art market, will remain a very speculative area which is not suitable for a broader retail clientele. The art market is not liquid, market information is not transparent, transaction costs are high, the long transaction times increase the execution risk and there is no mechanism available to hedge against the risk exposure taken up by investing in art.

What are the options for retail investors willing to participate in the art market via NFTs?

As I said, the art market remains a very high-risk market. And unless there is liquid trading in art objects – which I cannot see to ever become reality – they can't serve as eligible reference value for a derivative that could be created based on this object. Hence, retail investors should instead monitor the use and development of NFTs and the progress made by providers of the technology relevant for smart contracts. Participating in the value development of blockchain projects such as Ethereum is yet possible without the necessity to directly buy units of it.

Christian-Hendrik Knappe is German Sales Director at Spectrum Markets, a pan-European trading venue for securitised derivatives aimed at financial institutions and their retail investors. Since May 2022, financial institutions connected to Spectrum can offer their retail clients long and short leveraged exposure to bitcoin and Ethereum as underlying markets.

Get in touch today to discuss how the seamless market access that our venue provides, can help to grow your retail client business.

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