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THE LEGAL FRAMEWORK OF ART INVESTMENTS

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THE APPLICABILITY OF EU AND US INVESTOR PROTECTION REGULATIONS TO THE ART MARKET

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ABSTRACT

In the face of increasing inflation rates and global political as well as economic turmoil, investors are looking for alternatives to securities and bonds to store values. Among those asset classes benefitting from this trend is art. Record-breaking results at auctions, a quick market recovery following the pandemic as well as stable compound annual growth rates of the art market have stirred the interest of a growing number of investors in this form of alternative investment which promises stability in times of economic uncertainty. This trend is furthermore spurred by technological advancements; especially DLT-based business models add to the practicability and accessibility of investment models. For the art market, which previously used to be an investment option reserved rather for high-net worth individuals, the digitalization of values brings the opportunity to address new market participants. As an example, concepts such as the "tokenization" of artworks and "fractional ownership" invite a broader public, who would otherwise hardly have access to this asset. By extending the offer to invest in an artwork to many instead of just to a single collector, the costs for each individual investor are reduced to only a share of the actual sales price. Accordingly, art has become a widely recognized alternative asset class, which is constantly compared to conservative forms of investment, such as stocks and bonds. Against this background, the question arises as to what extent art is regulated as an asset class. The importance of an in-depth analysis of the applicable investor protection rules becomes even more apparent in consideration of the opacity of the art market, which also accounts for a reason why this sector has been only scarcely addressed by legal academia so far. The relatively new practical accessibility of the art investment market stands in stark contrast to the lack of available information on the traded properties. The deep-rooted tradition of discretion in art trades continues to shroud a cloak of silence over essential data on past and ongoing sales, with the result of there being an insufficient informational basis for investors to predict price developments.

This dissertation project aims to shed light on the opaque structures of art investments and examine the currently applicable level of investor protection rules in direct comparison to that in traditional securities markets. The jurisdictional scope of this paper extends to both, the financial market laws of the European Union as well as of the United States of America. In this context, also the question will be raised as to how art investment instruments can be categorized from a legal point of view, in particular, whether they fit into the existing framework of financial instruments.

"Art is the beautiful way of doing things. Science is the effective way of doing things. Business is the economic way of doing things."

– *Elbert Hubbard*[1]

[1] Elbert Hubbard (1856 – 1915) was an American writer, philosopher and artist and founded the Roycroft artisan community, which is part of the British Arts and Crafts Movement.

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INDEX

Index I

List of Abbreviations V

Table of Figures and Illustrations VI

Introduction and Methodology 1

I. Introduction 1

II. State of Research 2

III. Research Question 4

IV. Methodology 5

V. Structure 7

VI. Scope of the Analysis 8

Chapter I –

Financialization of Art 9

I. Art in Times of Crisis 9

II. Regulation of the Art Market 14
1. Art Law 14
2. Lack of Investor Protection Regulations? 16
a) Lack of Transparency and Available Relevant Information 18
b) Unwritten Agreements 20
c) Secretive Commission System 22
d) The Tradition of Discretion 24
e) Complexity of the Subject 25

III. Thesis 25

Chapter II –

Investor Protection Rules and Their Applicability to Investments in Art 27

I. Investor Protection Regulation in the European Union 28
1. Key Investor Protection Obligations under MiFID II 30
a) Fair Treatment and Best Interest of the Client 30
b) Disclosure of Relevant Information 33
c) Formality and Record Keeping Obligations 34
d) Conflicts of interest 34
e) Operation of a Trading Venue 36
2. Applicability of MiFID II to Direct Investment in Artworks 36
a) Investment Firms 37
b) Art as a Security? 39
c) Application to the Traditional Art Investment Model 40
aa) Standardization 40
bb) Negotiability on Capital Markets 44
cc) Functional Comparability with Shares or Other Security Standards 45
3. Central Findings 47

II. Regulation of Art Investments under US Securities Law 48
1. Definition of Securities under US Law 48
2. Investment Contracts 50

3. Application of the Investment Contract Definition to Artworks 50
a) Expectation of Profits 51
b) Common Enterprise 53
c) Efforts of Others 55
d) Functional Approach 57

III. Conclusion 58

Chapter III –

Regulation of Alternative Investments in Art: 59

The Case of Art Funds 59

I. Introduction 59

II. Current State of the Art Fund Market 61

III. Business Concept of Art Funds 63
1. Company structure 63
2. Course of Business 66
3. Business case: Art Funds 71
a) Guernica V. Fund 72
b) Art Equity Fund II 73

IV. Regulation of Art Funds 75
1. Regulation of Art Funds in the EU 77
a) AIFMD 77
aa) Scope of Application 77
bb) Obligations arising under the AIFMD 80
(1) Requirements for Authorization under AIFMD 82
(2) Excursus: Investment in Contemporary Art 84
(3) Investment Portfolio 87
cc) Marketing of Units to Investors 88
(1) Client categorization in the ambit of art funds 89
(2) The specific case of Luxembourg 95
bb) Applicable Investor Protection Rules under AIFMD 98
(1) Distinct Behavioral and Organizational Obligations Towards Investors (Investor Protection Rules) 98
(a) Disclosure Rules 99
(b) Valuation of funds 101
(2) Applicable Rules to "Smaller Art Funds" 103
b) MiFID II 105
c) Central Findings 108
2. Regulation of Art Funds under US Securities Laws 111
a) Investment Company Act 111
b) Securities Act of 1933 115
aa) Accredited Investors 116
bb) Legal Obligations Arising under the Securities Act 118
c) Investment Advisers Act of 1940 120
aa) Registration Obligation arising under the Investment Advisers Act 122
bb) Anti-fraud 124
cc) Performance Fees 124
dd) Evaluation of Assets under Management for Private Funds Advisors 126
ee) Proposed Rules on Private Fund Advisers 126
d) Securities Exchange Act of 1934 127
3. Central Findings 129

V. Conclusion 130

Chapter IV – 132

Regulation of Alternative Investments in Art: 132

The Case of Fractional Ownership 132

I. Introduction 132
1. Concept of Fractional Art Ownership 133
a) The Promise of Becoming the Owner of an Artwork 136
b) Securitization and Tokenization of Non-bankable Assets 138
aa) Consequences of securitization 140
bb) Tokenization of Securities 142
cc) Tokenization of Rights in Artworks 146
(1) The Tokenization-Process 149
(2) The Transfer of Title of Artworks through Tokens 149
2. The Business-Set Up of Fractional Art Ownership 151
3. Secondary Private Markets 154

II. Regulation of "Fractional Ownership" in Artworks 155
1. Regulation of "Fractional Art Ownership" in the EU 155
a) Regulatory Steps in the EU 156
b) Regulation of "Fractional Ownership Units" Under MiFID II 156
aa) Qualification of Fractional Ownership Units as Financial Instruments 158
(1) Exchange Platforms as Regulated Trading Venues 162
(2) Sufficient Level of Negotiability 165
bb) Marketing to retail investors 167
cc) Fractional Ownership Platforms as Alternative Trading Systems 170
c) The DLT Pilot Regime 2022 173
aa) Scope and Aim of the Regulation 173
bb) Applicability to Fractional Art Ownership Trading Platforms? 176
d) Interim Result 177
2. Regulation of Fractional Ownership under US Securities Laws 178
a) Recent Developments in the Regulation of Tokens 178
b) Business Set-up of Fractional Art Ownership 181
c) Regulation of Fractional Ownership under US Securities Law 183
aa) Regulation D Offerings 184
bb) Regulation A Offerings 184
cc) Regulation Crowdfunding Offerings 186
dd) Secondary Market 189

III. Conclusion 193

Chapter V –

Regulation of Alternative Investments in Art: The Case of NFTs 195

I. Introduction 195

II. Definition and Concept of NFTs 197
1. Taxonomy of Tokens 199
2. NFTs and fractional ownership 200

III. Legal Implications of NFT-Technology 203
1. Regulation of NFTs under EU Law 204
a) NFTs as Financial Instruments under MiFID II 204
aa) Standardization of NFTs 204
bb) Transferability of NFTs 207
cc) Negotiability of NFTs on Capital Markets 208
dd) Functional Comparability of NFTs with Securities 209
ee) NFTs as Derivatives? 212
b) Market Platforms for NFTs as Regulated Trading Venues 214
c) F-NFTs as Financial Instruments under MiFID II 217
d) MiCAR 219
e) Central Findings 222

2. Regulation of NFTs under US Securities Law 223
a) NFTs as Securities Under US Law 223
b) Fractional NFTs as Securities Under US Law 224
IV. Conclusion 225

Key Findings **226**

Bibliography **229**

Index Legal Acts and Official Reports and Guidelines **238**
I. Official Reports and Guidelines 238
II. EU Legislative Acts 240
III. CJEU Jurisdprudence 241
IV. US SEC Communications 242
V. US Jurisprudence 244

Annex

Annex I: Overview Art Funds in the EU and the US I

Annex II: Overview Fractional Ownerhsip Providers in the EU and the US V

List of Abbreviations

Abbreviation	Meaning
ACAL	New York Arts and Cultural Affairs Law
AIF	Alternative investment fund
AIFMD	Alternative Investment Fund Managers Directive (2011/61/EU)
AML	Anti-money laundering
AP	Active Promoter
ATS	Alternative trading system
AUM	Assets under management
BaFin	Bundesanstalt für Finanzdienstleistungsaufsicht (German Federal Financial Supervisory Authority)
CESR	Committee of European Securities Regulators
CoI	Conflict of interests
CSDR	Central securities depository regulation
DAO	Decentralized autonomous organization
DLT	Distributed ledger technology
DLT-MI	Distributed ledger technology-based market infrastructure
DLTR	Distributed Ledger Technology Regulation (Pilot Regime) (2022/858)
EBA	European Banking Authority
EDGAR	Electronic Data Gathering, Analysis and Retrieval
ESMA	European Securities and Markets Authority
ESRB	European System Risk Board
EU	European Union
KYC	Know-your-client
MiCAR	Proposal for Regulation on Markets in Crypto-Assets (2020/0265)
MiFID	Markets in Financial Instruments Directive (2004/39/EC)
MiFIR	Markets in Financial Instruments Regulation (600/2014)
MTF	Multilateral trading facility
NCA	National competent authority
NFT	Non-fungible token
OC	Offering circular
OTF	Organized trading facility
PPM	Private placement memorandum
SEC	US Securities and Exchange Commission
SPV	Special purpose vehicle
(U)HNWI	(Ultra) high net worth individuals
UBO	Ultimate beneficial owner
UCITS	Undertaking for Collective Investment in Securities
US	United States
VARA	Visual Artists Rights Act

TABLE OF FIGURES AND ILLUSTRATIONS

Chart no.	Title	Page
Chart I	Artnet Index for Fine Art	9
Chart II	Stakeholder Comparison: Which of the following issues do you feel are the most threatening/damaging to the reputation of the art market?	18
Chart III	Structure of an EU-US Art Fund with Feeder-Fund in the US	64
Chart IV	Percentage of Art Funds Established in Different EU-Member States	66
Illustration	Two examples of works issued as NFTs in the series “The Currency” by Damien Hirst (2022)	87
Chart V	Applicability of the Investment Company Act of 1940	114
Chart VI	Applicability of the Securities Act of 1933	120
Chart VII	Chart V: Applicability of the Investment Advisers Act of 1940	127
Chart VIII	Overview US Investor Categories	129
Chart IX	Google trends: Interest in the term “NFTs” in the course of time (worldwide google searches, time span: 1 March 2020 until 22 August 2022)	195
Chart X	The 6 Largest NFT Marketplaces according to their Volume in November 2022	214
Table	Features of the Largest NFT-Marketplaces	215

INTRODUCTION AND METHODOLOGY

I. INTRODUCTION

Against the background of rising inflation rates and global political as well as economic turmoil following the recent pandemic, savers and investors are increasingly looking for alternatives to the conventional capital and commodities markets. Today's technology contributes to the easier access for new market participants to investment opportunities, with online platforms rendering exchanges and trading constantly available. We are thus experiencing a period where alternative and new investment models are booming[2] One segment that has benefitted from this development as well is the art market. With stable annual growth rates over the past 15 years,[3] the art market demonstrates resilience and continues its upwards trend, regardless of political insecurity or the pandemic-induced restrictions.[4] Indeed, throughout history art has shown that it can be a reliable form of value preservation in times of turbulence and war.[5] It can hence not come as a surprise that art investments and related forms of portfolio diversification, that no longer correspond to the traditional collector model, attract an increasing audience, also outside the group of ultra-high net worth individuals (UHNWIs).[6]

Against this trend, the argument that art as an asset class is reserved only to "the richest, savviest buyers", who do anyway not have a strong need for statutory protection, is called into question. New investors are currently entering the scene, who are not part of the closely knit network in the art world. The reason for this can partly be seen in the digitalization of art investment, which facilitates access to this asset class through online auctions and storage of values in "wallets" rather

[2] A currently prominent trend which is well described and analyzed in the FT-article 'Time for retail investors to go into private equity?' by Joshua Oliver (23 September 2022), <https://www.ft.com/content/8875aed5-ebb7-466c-ad6e-287a22eecd0e> accessed 10 October 2022.

[3] According to the Artnet Index for Fine Art, the CAGR between 2005 and 2020 was at 4.9%, with even a mildly positive return in the Covid-influenced period of 2019-2020, see Deloitte and ArtTactic, 'Art & Finance Report 2021' (2021) 23, 225.

[4] This can partly also be attributed to a strengthening "middle market" in the art sector, which stands in contrast to the high-end segment that depends heavily on in-person viewings and auctions with event-character, all of which were drastically reduced during the pandemic. In the growing middle-priced section, technology plays a decisive role, as it allows a larger audience to participate in sales from their home computer screen; see on this point e.g. Deloitte and ArtTactic, 'Art & Finance Report 2021' (n 3) 231.

[5] According to the Mei/Moses Fine Art Index, art outstripped the S&P 500 for most of the years of World War I and recovered better in the years after the war, which led the authors of the paper 'Economic Activity and Painting Performance' to the conclusion that "During the armed conflicts of lengthy duration of the last century, art indices outperformed major stock indices." (Jianping Mei, Michael Moses, 'Economic Activity and Painting Performance' (August 2002) <https://www.google.com/url?sa=t&rct=j&q=&esrc=s&source=web&cd=&ved=2ahUKEwi-woey-L_6AhXHuaQKHfWtC3sQFnoECAsQAQ&url=https%3A%2F%2Fwww.stern.nyu.edu%2Fom%2Ffaculty%2Fmoses%2FFineArt%2FCULTURALECONOMICS7581402.doc&usg=AOvVaw2V4eEXlo7ZfMfgtbX58Yj2 > accessed 1 October 2022; see also Godrey Barker, 'Give 'Em Shelter', *Forbes* (24 December 2001) < https://www.forbes.com/forbes/2001/1224/082.html> accessed 1 October 2022.

[6] For an overview on ongoing and defining art market trends, see Natasha Degen, 'The art market in the 21st century (28 March 2019) <https://doi-org.emedien.ub.uni-muenchen.de/10.1093/oao/9781884446054.013.2000000147> accessed 30 October 2022.

than freeports.[7] In line with this, a trend towards a growing middle and lower price segment can be observed.[8] Among contemporary art sales, 90% of lots at auction are sold under USD 20,000.[9] In the American market in 2021, 73% of contemporary artworks were auctioned off for less than $5,000; in France, the respective percentage is at 82%.[10] Accordingly, there is a detectable shift of the art market and associated investment forms towards a new target audience, namely retail investors, who consequently find themselves exposed to the risks inherent to the unwritten laws of the art market.[11] This change indicates an increased necessity of information disclosure to new investors and by the same token, demands additional measures to spread risk awareness. Parallels can be drawn between the current trend and the early days of the opening of the stock market to the broader public in the in the last decades of the 20th century. Whereas stock investments used to be an activity mainly reserved to the wealthier part of the population, especially in the 1990's also the middle-income population developed a growing demand for increasingly complex financial products.[12] The reasons behind this development were similar to today's market drivers: due to advertising suggesting accessibility and the broadening media coverage, combined with a strengthening interest in yields from capital, [13] more and more small investors dared to take their first steps on the financial parquet.[14] As a response to this influx of retail investors into the capital markets, a wave of financial market regulations followed , but only *after* investor confidence had been shaken due to financial crises. It is therefore an urgent matter to examine the current factual as well as legal circumstances of investor protection in the art investment sector in order to evaluate whether the regulatory mechanisms in place provide for an adequate solution also to future challenges.

II. State of Research

While the idea of art as an alternative asset class is increasingly solidified in the investment sector, the extent of legal analysis scrutinizing the regulatory framework applicable to art as an alternative form of investment is surprisingly limited. Indeed, whereas the economic field has paralleled the increasing interest by service providers as well as clients in the art sector by a growing body of literature examining the common characteristics and mutual impacts with regard to financial markets,[15] an analogous endeavor in legal academia cannot be observed. A reason for this can be

[7] For an overview on the driving forces of online sales, see Deloitte and ArtTactic (n 3) 48.

[8] The price segments in the art market are generally threefold, ranging from low-key over mid-range to high-priced art.

[9] Artprice, 'The Contemporary Art Market Report 2021' (2021) 8.

[10] ibid 14.

[11] Anne Laure Bandle, 'Arbiters of Value: The Complexity and Dealers' Liability in Pricing Art' in Pierre Gabus and Anne Laure Bandle (eds), *L'art a-t-Il Un Prix? The Art of Pricing the Priceless* (Schulthess 2014) 30.

[12] Charlotte van Kampen, *Der Anlageberatungsvertrag* (Mohr Siebeck 2020) 1.

[13] According to Robert Piwowarski, from the 1970's onward, with a drastic increase again in the 1990's, the disposable income of the middle class had achieved levels which allowed individuals to invest money in capital investment products, as opposed to saving, see *Anlegerleitbilder Und Anlegerschutz Der MiFID II* (Nomos 2020) 95.

[14] As Joel Peress observed in his article 'Information vs. Entry Costs: What Explains U.S. Stock Market Evolution?', the percentage of stock market participation raised from 6% in 1952 to 32% in 1989, (2005) 40 Journal of Financial and Quantitative Analysis 3, 563.

[15] Including studies by William J Baumol, 'Unnatural Value : Or Art Investment as Floating Crap Game' (1986) 76 The American Economic Review 10; Bruno S Frey and Werner W Pommerehne, 'Art Investment: An Empirical

seen in the art market being known for its opaque structure with very limited access to information and few objective parameters that would allow for an easier tracking of its market mechanisms. What is more, the customs of discretion and informality also account for the art market being a difficult field to examine. Theoretic research in the art market is impeded by the lack of written agreements and public registers, with handshake agreements continuing to be common practice even for multi-million-dollar deals.[16] Even where publications on the art market offer an inside to the closely knit network, which is difficult to access for outsiders, information is often revealed only anecdotally, thus not providing for empirical evidence.

Against the discerned lack of transparency, the question of art market regulation has indeed been raised on several occasions, though only exceptionally with explicit focus on the investment aspect of art.[17] The scarce scientific literature which in the past has dedicated thoughts to the topic of regulation of art as an asset class in the past was scrutinized in detail and examined against their continued applicability in current times of digitalization.[18]

This dissertation aims at remediating the detected lack of scholarship on the issue of applicable regulation to art as an asset class. It shall not only contribute to the sparse theoretic knowledge on this topic but is also intended to bridge the "fundamental schism" between theory and practice in the field of art investment.[19] In pursuing this objective, conferring with professionals in the art investment sector was an essential component of the conducted research, in addition to literature review.

Inquiry' (1989) 56 Southern Economic Journal 396; Jianping Mei and Michael Moses, 'Beautiful Asset: Art as Investment' (2005) 7 The Journal of Investment Consulting 1; Luc Renneboog and Christophe Spaenjers, 'Buying Beauty: On Prices and Returns in the Art Market' (2013) 59 Management Science 36; Ata Assaf, 'Testing for Bubbles in the Art Markets: An Empirical Investigation' (2018) 68 Economic Modelling 340, or more recently:; Paola Fandella, 'Lo Sviluppo Dei Fondi in Arte Come Opportunità Di Diversificazione Del Portafoglio Di Investimento' [2018] Rivista Bancaria 85; Anna Zhukova, Valeriya Lakshina and Liudmila Leonova, 'Hedonic Pricing on the Fine Art Market' (2020) 11 Information (Switzerland) 1.

[16] The Serpentine Legal Lab Report employs the terms "anti-contract mindset" due to the observed "infrequent use of written contracts", Serpentine Legal Lab, 'Legal Lab Report 1: Art + Tech/Science Collaborations' (2021) 15.

[17] See e.g. as a selection of various approaches on art market regulation: Patty Gerstenblith, 'Picture Imperfect: Attempted Regulation of the Art Market' (1988) 29 Wm. & Mary L. Rev. 501 <https://scholarship.law.wm.edu/wmlr/vol29/iss3/3> accessed 22 November 2020; Nicole Dornbusch Horowitz, 'Price Fixing the Priceless? Discouraging Collusion in the Secondary Art Market' (2014) 66 Hastings Law Journal 331; John P Shinn, 'A New World Order for Cultural Property: Addressing the Failure of International and Domestic Regulation of the International Art Market' (1994) 34 Santa Clara Law Review 977 <http://digitalcommons.law.scu.edu/lawreviewhttp://digitalcommons.law.scu.edu/lawreview/vol34/iss3/4> accessed 22 November 2020; Saskia Hufnagel and Colin King, 'Anti-Money Laundering Regulation and the Art Market' (2020) 40 Legal Studies 131.

[18] See principally Jason-Louise Graham, 'Art Exchange? How the International Art Market Lacks a Clear Regulatory Framework' in Valentina Vadi and Hildegard EGS Schneider (eds), *Art, Cultural Heritage and the Market: Legal and Ethical Issues* (Springer Berlin Heidelberg 2014) <http://link.springer.com/10.1007/978-3-642-45094-5>; Maureen Holm, 'The Art Investment Contract : Application of Securities Law to Art Purchases' (1981) 9 Fordham Urban Law Journal; see also Paul Bator, *The International Trade in Art* (University of Chicago Press 1982); Rachel AJ Pownall, 'Art as an Alternative Asset Class' [2005] SSRN Electronic Journal; Rachel AJ Campbell, 'Art as a Financial Investment' [2008] Journal of Alternative Investments 64; Melanie Gerlis, *Art as an Investment?* (Lund Humphries 2014); Fandella (n 15); Valentina Vadi and Hildegard EGS Schneider, *Art, Cultural Heritage and the Market: Ethical and Legal Issues* (Valentina Vadi and Hildegard EGS Schneider eds, Springer 2014).

[19] Noah Horowitz, *Art of the Deal* (Princeton University Press 2011) 170.

III. RESEARCH QUESTION

The work at hand scrutinizes the extent to which financial market regulations, specifically investor protection rules, find application to art as an alternative asset class. In light of the increasingly speculative character of investment decisions in the broader art market, the issue emerges whether interested parties can expect a similar or an equivalent level of investor protection in the sphere between classic art purchases and modern, digital forms of capital allocation in collectibles. Whereas the securities market is in principle a highly regulated sector, alternative investment forms in art often fall within regulatory gaps – be it due to narrow definitions or to investment service providers intentionally evading supervision in order to maintain the greatest possible flexibility. In view of an expanding art market, which aims to address socio-economic groups which were previously not granted access to the fairly closed network of collectors, dealers and gallerists, a comprehensive overview of applicable financial market laws to art investment vehicles was long overdue. In answering the questions whether art qualifies as a security, whether it would have to be considered a complex investment product, or whether conflicts of interests rules apply to its distributors, close attention will be paid to the common ground between both, the financial and the art market.

In line with the observed "opening" of the art market due to increasing digitalization and the usage of distributed ledger technology (DLT), the analysis of applicable securities regulations does not limit itself to the traditional form of direct investment in art, but further includes the modern forms of alternative investment in art, i.e., art funds, fractional ownership of artworks, as well as non-fungible tokens (NFTs). For each investment vehicle, the following questions will be answered on the basis of the conducted market analysis: how is it structured, what role does it currently assume in the art investment sector and to which extent is it subjected to financial markets laws?

Given the aspiration of this work to reflect the actual conditions of the market, the analysis acknowledges the international scale of art trades by putting two of the most relevant art (investment) markets into direct comparison, namely that of the European Union (EU) and of the United States of America (US).[20] Accordingly, differences in the economic landscape as well as the variations in regulatory approaches to the protection of investors will be highlighted.

[20] The United Kingdom and Switzerland, despite assuming important roles in the international art market, are not among the examined jurisdictions, as they are not Member States of the EU, and thus, their treatment would have transcended the scope of this work.

To summarize, the objective of this analysis is to determine to what extent it is possible to apply financial market regulations in the EU and the US to modern forms of art investment and based on these findings, whether the interests of investors are met by the currently established set of provisions.

IV. METHODOLOGY

This dissertation aims to provide for an in-depth investigation of the complex matter of art and finance by bridging the gap between a theoretic academic analysis and a practical synthesis of the current trends and challenges in the art investment segment. To this end, it draws on a variety of sources from different sectors, including legal academic texts, studies in the field of economics and art history, as well as observations on digital finance, and goes beyond the current level of research in this field by providing updated data on the number and economic scope of art investment vehicles in the EU and the US. Accordingly, a three-step research approach was applied, consisting of literature review as the first step followed by a comprehensive market analysis on the current economic status of the various art investment vehicles. Lastly, I interviewed market experts and discussed with them the results of the research to refine the initial theoretical and practical findings, so that finally, a substantiated critical assessment of the current state of the art investment market and its regulation by financial market laws could be presented. The jurisdictional scope of this paper extends to both, EU as well as US law; national respectively State law is being dealt with only exceptionally as an example for individual implementation models.

For the first step, consisting in the review of primary and secondary literature, legislative acts as well as recommendations, guidelines and reports issued by the relevant authorities were analyzed in view of their relevance for art investments. The rather scarce secondary literature dedicated specifically to the regulation of art as an asset provided for a valuable addition to relevant sources in the field of financial market regulation, finance, and art history. Complementary to academic sources, also newspaper articles and other online available free sources were consulted. To gather the relevant information on the modern forms of art investment, and in view of the earlier mentioned research gap, it was necessary to turn to the art investment sector by addressing its participants directly. In this way, original documents generally provided in the ambit of offerings

of investment instruments (white papers, basic information sheets) as well as contractual texts and terms and conditions could be obtained.

The information collected throughout the market analysis and revealed in Annex I and Annex II of this work essentially stem from online research on the companies' websites, in art and finance newspapers and magazines, in online trade registers,[21] as well as statements provided directly from the managers or employees. For a better overview and comparability, the data has been tabulated and sorted according to the pertinent jurisdiction, including the company structure, assets under management, investor information, etc. Annex I shows the relevant numbers for art funds; Annex II comprehends an overview on the distributors and service providers relating to fractional ownership of artworks. Initial findings could be validated in conversations with art fund managers, broker/dealers, and art lawyers.[22]

In my research on art funds, I relied on the most recent comprehensive list of all art funds which was compiled by Noah Horowitz and published 2011 in his book 'Art of the Deal'.[23] Only funds for which sufficient data suggested their continued existence or successful termination within the past two years were taken into consideration, which means that funds, for which no further information on their business was issued since December 2020, either passively or actively, i.e. on their own or other websites, were excluded. As a consequence to the discretional business approach assumed by art funds and their minimal legal publication obligations, it is not always possible to determine with certainty whether they still exist and as such, the numbers published are to be considered an estimate of the current market situation in EU Member States and the US.[24]

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[21] Including, among others, ESMA Register of management companies, investment firms, alternative investment fund managers, regulated markets, et al. <https://registers.esma.europa.eu/publication/searchRegister?core=esma_registers_upreg>, Luxemburg Registre de Commerce et ds Sociétés>, <https://www.lbr.lu/mjrcs/jsp/IndexActionNotSecured.action?time=1669828903490&loop=1>, SEC Investment Adviser Public Disclosure, < https://adviserinfo.sec.gov> all accessed 11 November 2022.

[22] The transcripts of the interviews conducted with Javier Lumbreras, CEO and Founder of Artemundi, one of the largest art investment companies worldwide, Rebecca Fine, Managing Director and Head of Art Investments at Athena Art Finance and Yieldstreet, which have set up some of the biggest art funds in the US, as well as Paul Huelsmann, CEO and Founder of Finexity, a young but nonetheless predominant German Start up in the sector of art fractional ownership, are with the author and will be published with this thesis upon receival of the consent by the interview partners. The respective e-mails as well as short transcripts of conversations with other art market professionals are also with the author. In this context, the author would like to express her gratitude again towards all those art market professionals who kindly agreed to share their knowledge and understanding of the art market.

[23] Horowitz (n 19).

[24] Already Horowitz observed in the context of his research that, "reporting on them [art funds] is thus fraught with inaccuracies […]very few actually exist beyond preparatory stages" (n 19) 2.

To establish a comprehensive overview of the art investment sector, I combined original transactional documents, academic sources, and lastly also expert's opinions by conducting semi-structured interviews, whose duration was set to 30 minutes, and which were conducted online. Other than that, specific topics have been informally addressed with art market and financial market professionals, auctioneers, and lawyers through e-mail conversations and at the occasion of conferences and seminars.

By delineating the applicability of financial market regulations to the predefined examples of the art markets, this work may be used as guidance in future research and regulatory endeavors not only with regard to art, but also other alternative investment forms. What is more, this chosen structures aims at reducing the complexity and vagueness of art investments by highlighting the characteristics of the different investment vehicles and art segments.

V. Structure

The structure of this dissertation is principally three-fold. After the introduction to the topicality of the subject and an overview on the academic approach assumed, the main part of the thesis follows, where the research questions are addressed and scrutinized in detail. The main part itself is subdivided into four chapters, each revolving around a different aspect of art investment, ranging from the traditional form of purchasing a tangible artwork to the modern digital alternative of NFTs. At the outset of each chapter, the art investment form under scrutiny is introduced and its relevance in today's investment business outlined. To render the theoretic framework more understandable, the investment vehicles of art funds and fractional ownership are illustrated by the presentation of a Case Study, whereby the company structures of examples are briefly summarized. Given the jurisdictional scope of this work, the following legal analysis in each chapter is two-fold, differentiating between the applicable EU and US regulations.
In the end, a conclusion is drawn by summarizing the central findings of the previous chapters and giving a critical evaluation of the delineated regulatory frameworks governing the examined art investment vehicles and their suitability to protect investors' interests.

VI. SCOPE OF THE ANALYSIS

This examination concentrates on the parallelism between securities and art transactions. Given the vast and continuously expanding framework of European financial market regulations, a focus had to be set in order to limit the area under scrutiny and therefore, allow to dive into detail rather than provide only an abstract overview. Accordingly, the legal analysis departs on the basis of the MiFID-framework as central regulatory body in this field in the EU Member States.[25] At the same time, to acknowledge ongoing trends in the investment markets, also specific legislative acts of particular relevance to the art market shall be outlined and central provisions identified; these include in particular the AIFMD, Pilot Regime, and MiCA.[26]

The remit of EU regulatory acts also sets the geographical scope of this work, which means that the legal system of countries in Europe but outside the EU, in particular Switzerland and the United Kingdom, are not taken into consideration here. The comparison will be made to federal US securities law, in particular the Securities Act of 1933, the Securities Exchange Act of 1934, the Investment Company Act of 1940, and the Investment Advisers Act of 1940, with US State law only being referred to where of particular relevance or for illustrative purposes. What is more, regulations on trans-border investments would raise different legal issues than those in the focus of this work and are hence left aside. What is also explicitly carved out of this analysis are the legal rules in the area of taxes and anti-money laundering.

[25] The objective of this work is to provide guidelines on the rarely covered topic of investor protection in the context of art investments. As such, a basis shall be laid in this work by scrutinizing the terms and definitions employed in financial market law against their literal and reasonable applicability in art trading. This aim can be achieved by focusing on the MiFID-framework, comprehending the Markets in Financial Instruments Directive (II) (MiFID II) as well as the Markets in Financial Instruments Regulation (MiFIR); the analysis of other European financial market sets of rules, such as the Market Abuse Regulation (MAR) and the Prospectus Regime, is not part of this work.

[26] Also, general civil provisions on the intermediary role of advisors and broker-dealers do not correspond to the core of this investigation and have hence been disregarded; the same is true for consumer aspects of transactions.

CHAPTER I –

FINANCIALIZATION OF ART

I. ART IN TIMES OF CRISIS

Art as an asset class has historically proven to be relatively insulated from extreme market movements.[27] This is not to say that the art market is completely unrelated to the ups and downs of global economy – it cannot be denied that in the aftermath of the financial crisis, even the international art auction market took a downfall, from which it however recovered quite rapidly.[28] If one were to compare the performance before and after the crises, it emerges from the Artnet Index for Fine Art and its comparison to stock market and commodities indices that the Fine Art Sector re-achieved its peak value by 2011,[29] whereas the S&P 500 was only able to "regain its standing" within five years.[30]

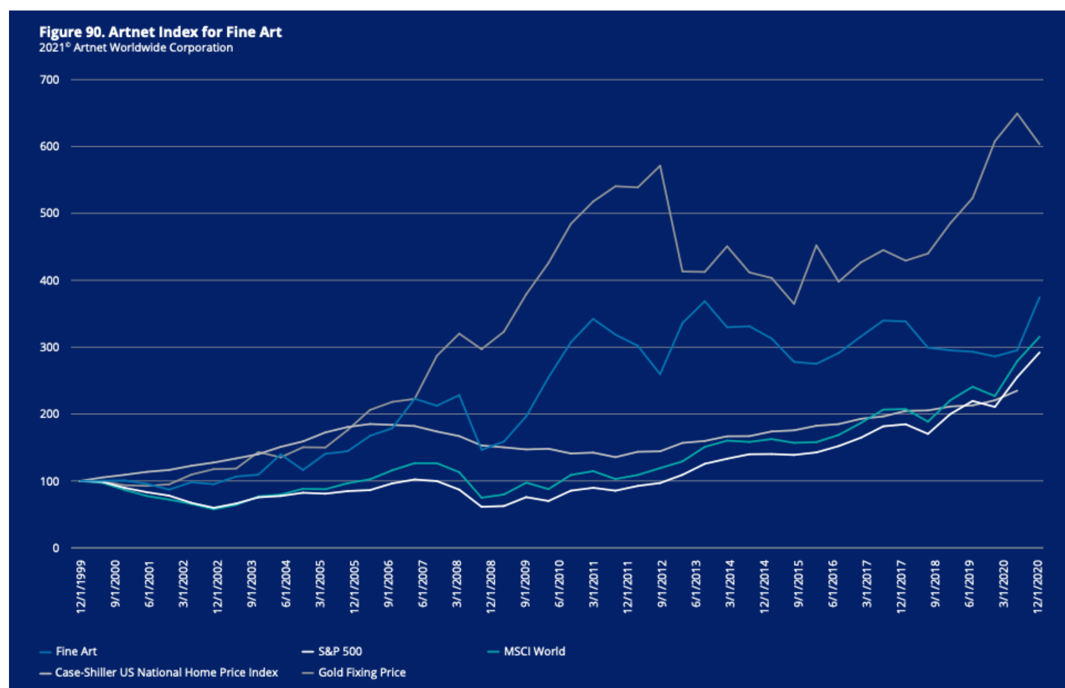

Chart I: Artnet Index for Fine Art (Source: Deloitte & ArtTactic, Art Finance Report 2021, 226. Fig. 90)

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[27] See e.g. Gerald Reitlinger's observation in his study on historical art prices '*The Economics of Taste*' (v 2 1963): "By the middle of the 1950s, after two world wars, a world financial depression, and a world wave of currency inflation, 'art as an investment' had lost any stigma that it might once have possessed." 282.

[28] See as the first authors to study the short- and long-run co-movements of art and financial markets V. Ginsburgh and P. Jeanfils, 'Long-term comovements in international markets for paintings' (1995) 39(3) European Economic Review, 538.

[29] Deloitte and ArtTactic (n 3) 226, Fig. 90, showing the Artnet Index for Fine Art.

[30] ibid 222; when taking into consideration not only the Fine Art Sector, but the entire volume traded at public auction at the three major auction houses in the US, a similarly slow recovery emerges however from Figure 33 at p. 84 of the Report, according to which the pre-crisis level was recouped only at the beginning of 2014.

Noah Horowitz attributes this phenomenon in his insider-revelation of the art market titled "Art of the Deal" to "art's intrinsic value", that "makes it especially attractive during periods of high inflation as well as the notion that interest in art can rise during period of financial and political turmoil", which is why art can recognized "as a reserve of unassailable meaning in difficult times."[31] Indeed, art and other valuable collectibles are commonly assumed to be reliable value preservers during economic turndowns.[32] What is more, uncertain social or economic conditions seem to have an advantageous effect on artworks, as many investors are rushing into the market. This becomes particularly obvious against the background of increasing inflation rates.

Art is frequently proclaimed as a "hedge against inflation."[33] In times when the value of FIAT currency falters, the prices in the art market rise, suggesting that the global art market grows over-proportionally to the rate of inflation.[34] According to the artprice "Ultra Contemporary Art Market 2022" report, which takes the auction results between July 2021 and June 2022 into consideration, "the turnover in the Contemporary art segment was exceptional" during this period, with the global auction turnover reflecting "a market that is stronger, more diversified, and denser than ever".[35] While previous to 2004, no work had ever surpassed the USD 100 million threshold,[36] in the past 18 years, it has been exceeded 18 times.[37] Placing liquid means in art therefore entails the promise to redeem the inflation-adapted rate at the moment of resale. In some cases, the taste of the market or the fascination of an enthusiast may even play out to the point of making a substantial profit.[38]

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[31] Horowitz (n 19) 153.

[32] An observation made also in a Forbes article published in 2001:"During the armed conflicts of lengthy duration of the last century, art indices outperformed major stock indices.", see Godrey Barker, 'Give 'Em Shelter' (n 5) 2001.

[33] According to the Art Basel & UBS report 2021, 64% of collectors rate the feature of art as a "hedge against inflation" a very or extremely important motivation for collecting, see Art Basel & UBS, 'The Art Market 2021' 318; see also Art Basel & UBS, 'The Art Market 2022' (2022) 192.

[34] Artnet News in Partnership with arttrade, 'Five Takeaways on the Global Art-Market Outlook' *artnet news* (26 August 2022) <https://news.artnet.com/market/five-takeaways-on-the-global-art-market-outlook-arttrade-2165885> accessed 26 September 2022.

[35] Artprice.com, 'The Ultra Contemporary Art Market in 2022' 3 (https://www.artprice.com/artprice-reports/the-contemporary-art-market-report-2022/ accessed 15 December 2022) 3.

[36] The first one was Pablo Picasso's work "Garcon à la pipe", which was auctioned off for § 104 million on 5 May 2004 (<https://www.sothebys.com/en/auctions/ecatalogue/2004/property-of-the-greentree-foundation-from-the-collection-of-mr-and-mrs-john-hay-whitney-impressionist-and-modern-art-n07989/lot.7.html> accessed 11 December 2022).

[37] Artprice.com, 'The Ultra Contemporary Art Market in 2022' 15 (https://www.artprice.com/artprice-reports/the-contemporary-art-market-report-2022/inflation accessed 15 December 2022).

[38] See e.g. Pownall (n 16), who drew the conclusion in her paper that 'although the upside potential is less significant during bull markets, the positive monthly returns occuring in period of high negative movements on both equity and commodity market, render a portfolio diversification strategy into the use of Art funds as an alternative asset highly beneficial.', 15.

This observation is not a new one. Barbara Rose pointed out a similar pattern in the New York Magazine already in 1973, where she noted: “The shakiness of the stock market, the fluctuations of currency rates, and inflation all lead to a situation in which fine art objects, because they are unique and rare, come to be a major medium of international exchange, the trading beads of the jet age. [...] The corporate mind is interested in profit, and nowhere are the profits so immense, or realizable in so short a time, as in the art market.”[39] This train of thought is however regularly refreshed and represented, e.g. in the Deloitte & ArtTactic Report, where “the art market’s ability to weather an unpredictable and unprecedented crisis” has been detected as a reason for “further attention [drawn] to art as an alternative asset class.”[40]

Already in 1961, the economist and art historian Gerald Reitlinger argued that artworks were essentially a “hard asset”, comparable to real estate or collectibles such as gold.[41] In the same year, Richard Rush published an entire book dedicated to the topic of “How to Buy and Sell Works of Art for Profit and Pleasure”.[42] Since then, art investments have gained wide recognition as an alternative asset class.[43] As a case in point, 85% of wealth managers confirm that art is now an essential part of wealth management.[44] Deloitte’s report, which is published every two years and which provides for an in-depth overview of the art market and its ongoing trends in terms of investment, thereby adding to its transparency, goes as far as to state: “Six years ago, we saw a significant shift in wealth managers’ perception of the role and value of art and collectibles in a wealth management strategy and service offering. Now, the question is not so much if art should be integrated into a wealth management offering, but rather how to do it.”[45]

The reasons for including art in one’s investment portfolio are mainly twofold: art provides for a rather inflation protected investment opportunity, with little to no discernable correlation with

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[39] Barbara Rose, ‘Profit Without Honor’ *New York Magazine* (5 November 1973), 80; on this issue also the contribution by Joshua Eversfield Jenkins to the TIAMSA Conference on 13 September 2022 titled “Nineteenth Century Complaints about Speculative Investment in Contemporary Art in Comparison to Today”.
[40] Deloitte and ArtTactic (n 3) 19.
[41] Gerald Reitlinger, *The Economics of Taste* (1st v 1961) 21.
[42] Richard H. Rush, *Art as an Investment – How to Buy and Sell Works of Art for Profit and Pleasure – an Analysis of the Art Market and Collector’s Guide* (1961).
[43] There is a range of literature suggesting so, with some of the most prominent examples being: Robert Gough, Michael Moses and Jianping Mei, “Art as Investment and the Underperformance of Masterpieces” (2002); see also Jeremy Eckstein and Randall Willette, ‘Art Funds’ in Clare McAndrew (ed), *Fine Art and High Finance* (Bloomberg Press 2010) 148.
[44] Deloitte and ArtTactic (n 3) 97.
[45] ibid 20.

the stock market. These factors are true for several alternative means of investment. As such, real estate, collectibles, and other valuables such as cars, wines, and jewelry have gained wider acceptance among investors. This trend is accelerated by volatility in other, traditional investment markets such as the stock market. Consequently, many investment firms or wealth managers draw a direct comparison between the art market and the securities market, thereby bolstering the impression that investing in art is at least as lucrative as buying stocks, bonds, currencies etc.

This impression is enhanced by a range of literature and economic papers on the topic. One among the many worth mentioning is the study conducted by Moses and Mei that found that the average annual returns realized by artworks between 1875 and 2000 were between those of equities and bonds, while possessing less correlation with the latter assets than previously assumed.[46] They were among the first to ground their finding that art can be a favorable component of an investment portfolio on scientific economic research models, thereby laying the groundwork for other researchers, such as Fernwood who suggested that "Art's remarkably low and even negative correlation to other asset classes plays a key factor in the model's outcome. A portfolio's efficiency can be significantly improved by allocating some exposure to fine arts."[47]

This favorable assessment of art as an asset class is partially due to the art market's strong performance for the last 20 years. According to a report published by the US Senate's Permanent Subcommittee on Investigations, initiating an investigation of the vulnerability of the art market to money laundering and terrorist financing, "art has delivered average annual returns of 8.9 percent."[48]

But as it is often the case with investment opportunities, not all that glitters is gold. While art indices are set to underpin the profitability of art as an investment by bringing transparency to art prices, investors need to keep their limited objectivity in mind. Art market indices, the most prominent examples being the Artprice100 Index as well as the ones published by Sotheby's Mei

[46] Mei and Moses (n 15) 4; Jianping Mei and Michael Moses, 'Art as an Investment and the Underperfomance of Masterpieces' (2002) 92 American Economic Review 1656.
[47] Horowitz (n 19) 158; see also on this point: Rachel AJ Pownall, 'Art as an Alternative Asset Class' [2005] SSRN Electronic Journal.
[48] United States Senate, 'The Art Industry and U.S. Policies That Undermine Sanctions' (2020) 33.

Moses and artnet, refer only to a small fragment of the art market.[49] When cited in the context of investment, the works taken into account for this kind of market survey belong to the "blue-chip" category of artworks, thus to the highest-priced selection of artworks made by recognized artist whose position in the art market can be regarded as established by their past track record. A research project conducted at Standford University revealed that projected sales returns of 10% p.a. for the years between 1972 and 2010 were significantly overestimated by the art indices, due to their pre-selection of works taking into consideration only artists that are successful enough to bring continuous profits at auction sales, while ignoring others who cannot exhibit such a positive track record.[50]

Accordingly, there is a strong selection bias in the consulted data, which is complemented by a survivorship bias. As only published data can be used for feeding the indices, index providers rely on self-reporting from mainly auction house sales, whereas private sales do not contribute to the analysis. Auction results are however not fit to represent an average of the existing art, but instead the auction houses tend to make a pre-selection of works that are going to be sold. First, it can be assumed that a seller usually waits for a good occasion to sell something at auction. If a negative price development must be expected compared past sales results, the seller would usually opt for the private sale as alternative option, which offers discretion, instead of running the risk to have a work being "burned" at auction as a result to a non-sale.[51] In this context, it shall also be denoted that works not sold at auction are generally not included in the price overview for the artist or auction, since indeed no price was achieved. As a consequence, indices often tend to inflate the returns by looking only at a privileged section of the art market.

Also, the role of the media in the growing interest towards art investment cannot be overemphasized. Due to the extensive media coverage of skyrocketing sales results at auction, the image of the art market is created that doubling or tripling prices within only a few years is nothing unusual. In addition, the dedication of entire sections in daily newspapers to art

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[49] Artnet provides for seven different standard indices, namely the "Top 100 Artists", "European Old Masters", "Impressionist Art", "Modern Art", "Post-War Art", "Contemporary Art", "Chinese Art", and Artist indices; Sotheby's Mei Moses Index tracks auction sales at the major three auction houses Sotheby's, Christie's and Phillips.

[50] Cited in Silvia Segnalini, *Art Funds e Gestione Colletiva Del Risparmio* (G. Giappichelli ed, 2016) 107.

[51] "Burned" is a term coined in the art world for works where due to a lack of public demand no sale occurs. In general, a burned work cannot be sold within the years to follow the public auction unless one accepts significant cuts in price.

investment may lead to the impression that conventional investors may be missing out on something by not extending their portfolio.[52]

Whether in response to the spurred interests in alternative investments, or as a catalyst to spark this development, yet also the number of art investment providers has increased. According to Horowitz, Citibank's Art Advisory Service "may have inaugurated this field at the institutional level, but many have followed suit."[53] Banks, consulting and investment firms have extended their portfolio of offered services so as to include also investment advice on alternative investment strategies, including art advisership.[54]

All of the above features have led certain authors to employ the term "financialization" of art.[55] While this trend provides on the one hand significant opportunities for the art sector and invites innovative forms of investment, on the other hand, the investors who are about to enter new territory may wrongly assume that their experience in capital markets can equally be of use in the art market, thereby underestimating the existing differences. In view of the expected naivety of new market participants, it is upon the legislator to establish certain protective parameters that do not prevent inclusion of inexperienced investors but guide them along the desired paths.

II. Regulation of the Art Market

1. Art Law

The art market has often stood reprimanded of being unregulated.[56] This statement does however not reflect the true state of regulation in the art market. Probably as many aspects there are to art, as many laws there are to regulate its sale, insurance, transport, and artists entitlements related to their work. In this context, it is useful to emphasize that "art law" as segregated legal domain does not exist, not to mention a corresponding comprehensive legal code. [57] Instead, what today

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[52] E.g. the German Handelsblatt with its section "Kunstmarkt" (art market) or the business magazine Capital, which issues a ranking called "Kunstkompass" ; also, the Italian newspaper Il Sole 24 ore has the "ArtEconomy"-section, to name but a few examples; see also to this point Segnalini (n 50) 47.
[53] Horowitz (n 19) 159.
[54] Segnalini (n 50) 2; see also Beioley, K. (07/09/2018), "Private banks are now offering fine art investment advice", FT,.
[55] ibid 3.
[56] Brian L Frye, 'New Art for the People: Art Funds & Financial Technology' (2018) 1 Chicago-Kent Law Review 113; Gerstenblith (n 17); Graham (n 18).
[57] Simon Stokes, *Art and Copyright* (3rd edn, Hart 2021) 1.

is referred to as "art law" is a rather young terminology, representing an amalgam of many different matters of law.[58] It comprises various fields of law, reaching from criminal law pertinent in cases of art fraud and art-napping, to cultural heritage protection as part of public order and family as well as tax law e.g., in case of setting up art foundations.

Art law has evolved as a specialist field throughout the years and emerged together with more and more complex structures in the art world. The focus of this paper is the increasing "financialization of art". "Art" will therefore not be considered in view of its creative output and cultural impact, but instead as an asset class, whose items can be object of a sales contract or constitute company assets. As such, in the following, the term "art" will generally refer to identifiable objects and items (including digital items), rather than to abstract concepts and skills. This collectible-oriented approach also excludes the artistic categories of music and performing arts in their discontinuous status, as we will focus on visual arts fixed in a certain medium. Of course, pictures of dance performances and music sheets may in turn fall within the scope again. Already from this attempt at demarcation, it becomes clear that no clear line can be drawn as to which artistic forms of expression are potentially feasible for collecting for investment purposes, and thus, for regulation. This becomes even more true against the background of new and unconventional forms of "art" emerging in the context of technology. The focus of the following analysis is on the traditional categories of tangible fine art, including paintings, drawings, sculptures, multiples, thereby reflecting their economic importance in the market, but extends also to more modern forms of artistic expression, such as digital art.

In view of the different legal matters to be taken into consideration in the context of trading with artworks, it becomes clear that the art market cannot generally be described as "unregulated." What is true though is the fact that there is no central authority supervising the art market or its dealers. A key leadership role in setting behavioral obligations and quality standards within the art market has hence been assumed by trade associations,[59] which however lack coordination among themselves and due to their membership structure can be assumed to take a more seller-

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[58] See e.g for an overview Leonard D DuBoff, Sherri Burr and Michael D Murray, *Art Law: Cases and Materials* (2004) <http://www.law.harvard.edu/faculty/martin/art_law/war.htm>; Patty Gerstenblith, 'International Art and Cultural Heritage' (2011) 45 The International Lawyer 395 <https://www.jstor.org/stable/23644021>.

[59] "The United States is the largest art market in the world. Yet, the relationship between the U.S. government and the art market is sporadic, poorly defined, and uncoordinated. The lack of a national art and antiques trade association to represent its interests to the various government agencies touching the art market no doubt weakens the trade's position. ", see Rena Neville, in: Clare McAndrew (ed), *Fine Art and High Finance* (Bloomberg Press 2010) 182.

friendly approach than having primarily investors' interests at heart. Whether this results in individuals being exposed to abundant risks in their investment in art will be subject of the following section.

2. Lack of Investor Protection Regulations?

The matter of non-regulation is not a problem *per se*. It becomes an issue however if the lack of clear guidelines and legal consequences of unfair business behavior manifests itself in the market as being highly inefficient and, as a consequence to inaccessible information, as attracting frauds.[60] Where essential market information, e.g. on the price of an item, its availability or frequency of trade, is not readily available, it becomes unreasonable for investors to establish a strategy in an attempt to gain a profit. Hence, absent comprehensible parameters, investors are less willing to enter the market or remain involved. The consequence following from this state of affairs is an insufficient capital flow into the market.

A market is considered efficient "if prices fully reflect all available information."[61] According to the scale established by Fama,[62] the level of efficiency reaches from strongly efficient markets, where goods have the perfect price because it reflects all publicly and privately available information, to semi-strong efficient markets and weak efficient markets. In the case of the latter, only past and current prices are available; however, the return is unrelated to past returns. Based on the available information on the art market, it results that the art market is highly inefficient.[63] Such is also evidenced by a series of academic studies; for instance, David et al. reached the conclusion in their paper on market efficiency that the art market is not efficient, which is purportedly mainly attributable to the opaque price system.[64] In fact, there is no reliable central

[60] In parallel to this, two of the principal driving motivations behind MiFID II regulations consist precisely in market stability and client protection. This reflects the macro- and micro-economic ambitions behind financial market regulations in general (for an extensive analysis on why markets should be regulated, see Latimer P and Maume P, Promoting Information in the Marketplace for Financial Serices (2015). With the aim of keeping the analysis on point and focused, this work concentrates on the micro-economic aspect of investor protection.

[61] Szafarz et. al, Art Market inefficiency,

[62] Eugene F Fama, 'Efficient Capital Markets: A Review of Theory and Empirical Work' (1970) 25 The Journal of Finance 383 <https://www.jstor.org/stable/2325486?origin=crossref>.

[63] Andreas Heinemann, 'Kunstauktionen Im Wettbewerb' in Wolfgang Büscher (ed), *Festschrift für Joachim Bornkamm zum 65. Geburtstag* (Beck 2014)'hohe Unvollkommenheit der einschlägigen Märkte [i.e. art auctions].'

[64] The authors of this paper come to the conclusion that the art market is not efficient and deem this finding to be mainly attributable to opaque price information"; at the same time, there is a positive correlation between past and present prices. The reason for this can supposedly be seen in the fact that if a return is positive at the moment, it is probable that the uprise and thus positive return will persist in the future. At the same time, Szafarz also notes that the prices don't reflect objective information but instead are rather a product of ongoing speculation, hence fostering

source for price information for market participants to rely on in making an investment decision.[65] This is in keeping with informal news being attributed a central role in the art market. Plummer observed that "the art market does accommodate this lack of information in an incredibly effective oral information system and strong networks of personal relationships. There are ways in which critical information is shared between dealers, clients, and museum directors that are not always perfect, but highly effective."[66] This yields the converse conclusion that for investors who are not part of the closed-knitted network, there is hardly a chance to retrieve the necessary information to make a reasonable business decision. Absent objective and available price information, investors might not have the necessary confidence to dare embarking upon a new investment market.

Indeed, as indicated above, the lack of available information is not only an abstract concept but has left its impression on the individual investor. Such is evidenced by the survey conducted by Deloitte and ArtTactic and published in its 2021 report, in which the lack of transparency is identified as the biggest threats to the reputation of the art market by roughly 75% of collectors.[67] In addition, factors closely correlated to the opacity also account for several of the biggest concerns listed in this evaluation, e.g. price manipulation and other anti-competitive behavior, undisclosed conflicts of interest, secret commissions, confidentiality around sellers and buyers.

what will become a bubble, as in rising prices without objective justification. Géraldine David, Kim Oosterlinck and Ariane Szafarz, 'Art Market Inefficiency' (2013) 121 Economics Letters 23.

[65] Boris Groysberg, Joel Podolny and Tim Keller, 'Fernwood Art Investments: Leading in an Imperfect Marketplace' Harvard Business School 1, 4.

[66] Co-referenced by ibid.

[67] Deloitte and ArtTactic (n 3) 286, see below Chart II.

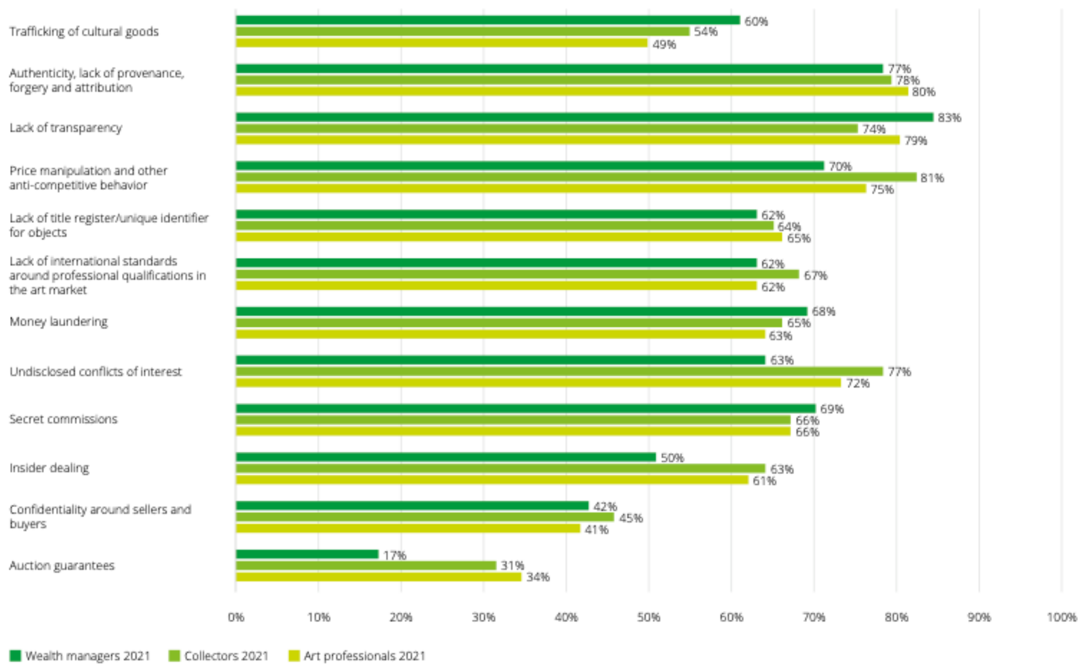

Chart II: Stakeholder Comparison: Which of the following issues do you feel are the most threatening/damaging to the reputation of the art market? (Deloitte & ArcTactic, Art Finance Report 2021, 286, Fig. 107)

The following section thus targets to pinpoint and examine the most pressing challenges in the art market with regard to investors' trust.

a) Lack of Transparency and Available Relevant Information

The art market has notoriously stood reprimanded of being "opaque and insular."[68] Indeed, with buying art always resonates a certain mystical congeniality, to put it mildly, since the art market is not easily accessible and its mechanisms not generally comprehensible. The deep-rooted tradition of discretion shrouds a cloak of silence over essential information such as prices of past and ongoing sales or the identity of the parties to a transaction.[69] Thus, to the majority of the general public, the dealings in the artworld remain a mystery – which is not to say that prices or performance are predictable by experts in the scene either.[70] Instead, art as an investment category remains subject to its own rules. For a start, art has no intrinsic value to itself. The used materials as canvas and colors are not crucial for allocating a price to a work. While it is true that some

[68] Frye (n 56) 113; see also Horowitz (n 19) 170; Graham (n 18).
[69] "Art fairs have made changes and so have databases. But things are still run by a small group of insiders. And there is a lack of capital because of that.", Horowitz (n 19) 181 verweist auf Plummer quoted in Anthony Haden-Guest, 'Promises of Perfection', FT 17 June 2006.
[70] See Bandle, in Gabus and Bandle (n 11) 30.

perceivable aspects such as the size of the object as well as its condition play a role in determining its price, the most essential factors elude the naked eye: The value is created principally on the basis of 1) scarcity or uniqueness of the work, and in correlation thereto its authentic provenance from a recognized artist, and 2), the current "vagaries of taste" of the public.[71] Both are verifiable by the potential purchaser only to a limited extent. Accordingly, many investors have to rely on an intermediary, namely an art advisor, to make an ostensibly sound investment decision. It is the advisor's task not only to collect the necessary background information on the targeted artefact, but also on the seller or representative, past prices and currently interested parties, and in the best case, on the future value development of the item, if bought not only for aesthetic purposes, but also against the background of storing and appreciating value.

The very lack of available information and, resulting from this, potentially unproportioned transaction costs for parties account for the profit margin of art market intermediaries.[72] Without someone knowledgeable and (equally importantly) well-connected in the art scene, this investment segment may seem to many a hostile territory, where returns cannot be counted on but instead are the result of obscure arrangements within a closed network.[73]

This impression is fostered through the expanding sector of private sales.[74] While most auction houses, referring not only to the "Big 3" but also to smaller regional ones,[75] have taken up the custom of publishing their auction results online, for everyone and not only the participants of

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[71] Holm (n 18) 386.

[72] 'Es kommt wohl generell dazu, dass Marktinformationen sehr schwer erhältlich sind; es herrscht relative Intranzparenz, welche der Manipulation Tür und Tor öffnet." (In addition, it is probably generally the case that market information is very difficult to obtain; there is a relative lack of tranparency, which opens the door to manipulation.), "Le marché de l'art repose sur le manque de transparence (...) C'est le fonds de commerce de la majorité de ses acteur"' (The art market is based on the lack of transparency [...] It is the business of the majority of its actors), M. Roth in: Mosimann/Schönenberger (eds), Kunst & Recht (2014) 55, cross-referened in Fausto Martin De Sanctis, *Money Laundering Through Art* (Springer International Publishing 2013) <http://link.springer.com/10.1007/978-3-319-00173-9> 84.

[73] Groysberg, Podolny and Keller (n 60) 4, citing Jennifer Winn, senior vice president of marketing at the Fernwood Art fund at that time: "There are element of the art market that thrive on lack of transparency; no one person knows where much of the art work is. So, in order to locate a particular type of work, you may have to employ an army of dealers to scurry around each other's inventory to find the items that they'll then mark up to 250% or more. [A] dealer's intrinsic value to the market is quite opaque."

[74] According to the UBS Art Market Report 2022, private sales by auction houses increased by 32% in 2021 to an estimated $4.1 billion, compared to a total estimate of $30.4 billion in both public and private auction sales (UBS Art Market Report 2022, p. 16, 123). This does not include any numbers of sales by dealers which by nature are to be considered as private sales.

[75] The top-tier auction houses in the US and the EU with the highest sales volume are Sotheby's ($7.3 billion), Christies ($7.1 billion), and Phillip's ($1.2 billion) (aggregate global sales volume in 2021, according to Art Basel & UBS [n 33] 126.

the auction to see, an unknown percentage of art sales is conducted privately.[76] The total value of private sales, encompassing transactions through a gallery or dealer as well as the private sales segment of auction houses, can only be estimated. Of all the major art market reports,[77] only the one published by Art Basel and UBS even takes private sales into account. The estimate presented there for the value of privately sold works at public auction houses accounts for a total of $4.1 billion in 2021. [78] In view of the aggregate global sales value by dealers and auction houses combined in 2021 being set at $65.1 billion and $26.3 billion of this being attributed to public auctions,[79] $34.7 billion worth of sales are left to occur outside public auctions, thus without publicly available registration of prices.

b) Unwritten Agreements

The lack of essential information is not only characteristic of the art market with regard to publicly available data, but also symptomatic for contractual relationships in this field. Since unwritten agreements continue to be quite popular in the art world,[80] most terms are indorsed orally and contracts concluded with handshakes.[81] Although new customs slowly begin to settle here as well, "outsiders are sometimes still surprised at how much business can be conducted outside these formal agreements." [82][83] As a consequence, there are no concise parameters to which an intermediary or contracting party can be bound. This means that uncertainties in the execution of the contract are inevitable, and often result to the detriment of the client. As a prominent case in point, the so-called "Bouvier Affaire" shall be briefly introduced. The facts of the case were the following:

[76] According to Horowitz (n 19) 170, 'auction prices are transparent but dealer prices are not.'
[77] The other major ones being issued by Deloitte, TEFAF, and Artprice.
[78] Art Basel & UBS (n 33) 123.
[79] ibid 14, 120.
[80] The Serpentine Legal Lab Report employs the terms "anti-contract mindset" due to the observed "infrequent use of written contracts", Lab (n 16) 15.
[81] Donald R Simon, 'Fix and Tell : The Sotheby ' s / Christie ' s Antitrust Scandal and Proposed Changes to Illinois Art Auction Law' (2002) 12 DePaul Journal of Art, Technology & Intellectual Property Law 269, 287; see also DAvis v. Carroll, 937 F.Supp. 2d 390 (2013).
[82] T. Christopherson, in: Risk and Uncertainty in the Art World, p. 63.
[83] Tom Christopherson, 'Art Market Risk and Complexity: An Insider's View' in Anna M Dempster (ed), *Risk and Uncertainty in the Art World* (Bloomsbury 2014) 63.

The Russian oligarch and collector Dmitry Rybolovlev had entrusted the renowned Swiss art dealer Yves Bouvier with the task of locating new artworks for purchase for his collection and with the negotiations involved in the sales. After having worked with Bouvier as his art advisor for more than ten years and thereby creating one of the most impressive collections of modern times, including works of Pablo Picasso, Auguste Rodin and Amedeo Modigliani, Rybolovlev discovered that he had been systematically overcharged by his advisor, who thereby allegedly defrauded his client of billions. Bouvier was confronted with the allegation of having sold the paintings to Rybolovlev with escalated mark-ups compared to their original purchase price. In the case of "Salvator Mundi", attributed to Leonardo da Vinci (and before it became the world's most expensive painting), Rybolovlev paid US$ 127.5 million to Bouvier, who had bought the painting shortly before through Sotheby´s for only US$ 80 million.[84] The allegations of fraud brought by Rybolovlev in front of the courts of different states such as Monaco, Singapore, the US and Switzerland, were based on the claim that Bouvier had been acting as an agent to him and therefore only been entitled to the commission incorporated in the purchase price.[85] Bouvier however claimed he had purchased the paintings for himself and that he would hence have been free to sell them at any price the market would bear, without having to reveal the full background.[86]

The fact that this scheme could go on for more than a decade without being discovered shows how notoriously opaque the art market is, where even the buyer may not know of the actual sales

[84] Graham Bowley, William K. Rashbaum, "Sotheby's Tries to Block Suit Over a Leonardo Sold and Resold at a Big Markup", *The New York Times* (28 November 2016), < https://www.nytimes.com/2016/11/28/arts/design/sothebys-tries-to-block-suit-over-a-leonardo-sold-and-resold-at-a-big-markup.html> accessed 10 September 2022.

[85] Polina Devitt, Nathan Layne, "Russian tycoon sues Sotheby's for $380 million over art deals,3/10/2018" *Reuters* ((13 October 2018) <https://www.reuters.com/article/us-art-sotheby-s-rybolovlev/russian-tycoon-sues-sothebys-for-380-million-over-art-deals-idUSKCN1MD1Y1> accessed 10 September 2022.

[86] After the initial sellers had learned of the sale to Rybolovlev for US$ 127.5 million, they started inquiries with Sotheby´s to find out whether the auction house had any previous knowledge of Rybolovlev´s interest in this painting and the value attributed to it, alluding to the fact that there was a collusive behavior by Sotheby´s in Bouvier´s favor. However, it was Rybolovlev who in 2018 pressed charges against the auction house after he had been given access to their documentation with permission of the US District Court in New York. He thereby claimed damages in the amount of US$ 380 million, arguing that Sotheby´s "materially assisted the largest art fraud in history" (Kazakina, "Billionaire Slaps Sotheby's with $380 Million Lawsuit" (03 October 2018) <https://www.bloomberg.com/news/articles/2018-10-02/billionaire-rybolovlev-slaps-sotheby-s-with-380-million-lawsuit> accessed 10 September 2022). Sotheby´s allegedly backed the sale prices of Bouvier by issuing insurance appraisal valuation that were closer to Bouvier´s sale prices than to the original ones. In the case of "*Salvator Mundi*", Sotheby´s had issued an appraisal amounting to US$ 113 million, in spite of having sold the same painting shortly before for only US$ 80 million (Bowley/ Rashbaum (2016)). Sotheby´s denied all accusations of fraud.

price. This is not an isolated case. By way of illustration, also the case of *Accidia Foundation v. Simon C Dickinson Ltd.* revolves around the question whether the intermediary in an art sale is entitled to keep the commission amounting to $1 million that was unknown to the seller.[87]

The underlying facts were the following: the claimant i.e., the seller, engaged an international art dealer and consultant with the sale of a da Vinci drawing, who in turn asked another agent and art dealer, the defendant, for help. The second agent was indeed able to find a buyer who wanted to purchase the drawing for $7 million. In the sales agreement with the buyer stipulating $7 million as purchase price, the defendant appeared as "agent for the Owner". However, in the agency agreement that was drawn up, in preparation of the deal, between the seller and the first art consultant, the former agreed for the consultant to transfer the property for an "agreed upon net price to seller of USD 5,500,000.00." The commission for the seller's consultant was established as "introductory commission in the sum of US$500,000 on a sales price stated to be US$5.5 million." The seller, being unaware of the exact amount of the commission awarded to the second agent, upon learning about the difference of the exact sales price and the $1 million retained, initiated proceedings against the second agent. The court ultimately held that the defendant had acted as an agent to the seller and thus, was not entitled to keep the commission as this would contravene his fiduciary duty owned to the principal.

This is but another example of how little information is commonly disclosed in an art deal, not even to the parties of it. It also points to another central issue in the art world, namely the secret commissions.[88]

c) Secretive Commission System

The art market works largely on a commission-based revenue model,[89] where intermediaries act on behalf of a client, who occasionally has an interest in remaining anonymous,[90] and where the contractual relations are not necessarily disclosed throughout the transaction, which is well illustrated by the *Accidia Foundation* case. The involvement of several intermediaries in a single transaction poses a problem when it comes to define the actual agent, principal, or beneficiary of a sale. Absent a written agreement, who is to say that the intermediary did not act on her/his

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[87] *Accidia Foundation v Simon C Dickinson Ltd.* [2010] EWHC 3058 (Ch).

[88] Which are identified by 2/3 of art market participants as one of the most threatening aspects to the art market reputation (Deloitte Art Finance Report Figure 107, see above).

[89] Deloitte, *Art and Finance Report 2017*, p. 240.

[90] See e.g. *Frank Fertitta et al. vs. Knoedler-Gallery et al.*, US DC Southern District NY, 14 CIV 2259, where the agent acted on behalf of an "undisclosed seller".

own behalf. These opaque principle-agent constellations are characteristic of the art investment market and to some point even intended.[91] It is precisely because intermediaries do not reveal their knowledge to their clients that they are attributed such an essential role in the art market. Because there is no structure where offers and demands are concentrated, similar to a central market or register, but instead, people are dealing with unique goods for which there is hardly a fair market value, which may however account for an enormous emotional value, information is key in this sector to success.[92] If art advisers were to reveal the identity of their principals or interested parties the know of as well as other essential information, they would render themselves useless within a very short period of time. Art advisors and intermediaries thus draw their legitimacy from information asymmetries that are a result of the inefficiency, opacity, and heterogeneity inherent to the market.

At the same time, the current confidentiality-based structure is prone to constitute loyalties towards different parties and thus give rise to conflicts of interests or moral hazard.[93] For instance, an adviser may assume several roles at one transaction and thereby double her/his commission.[94] When the art dealer and consultant Philippe Ségalot, who acted on behalf of both, sellers and buyers, was asked whether this constituted a potential conflict of interest to him, he responded that it was not a problem.[95] But in fact, the incentives are different: while the agent of the seller is supposed to achieve the highest price, it is the buyer-agent's responsibility to find a work at a fair market value.[96] Unfortunately, the general commission scheme stands in conflict with the latter, since the remuneration of the agent is often based on the size of the sales price.
Undisclosed payments may take several forms, such as or consultant's fees, or introductory commissions and kickbacks, which are to be paid by the auction house and the dealer to the

[91] Dalley, J. (12/20/18), "Banksy, trust and the art market – the inside story", *Financial Times*, available: https://www.ft.com/content/f62a69d2-cd45-11e8-b276-b9069bde0956; Gunn, D. (2017), "Reducing risk in art transactions", in Deloitte, *Art and Finance 2017*, p. 264 ff. On the one hand, dealing in a market where disclosure is not obligatory opens up additional options for competition, on the other, it might as well protect from competitors. Clients and their businesses may prefer the art market precisely for the reason of its opacity, since their investment cannot be traced back to them, thereby surpassing even modern data privacy and confidentiality regulations. Hence, "discretion", as it is called in the art world, is generally considered essential to the economic performance of the art market. *See* Bowley/ Rashbaum, "Has the Art Market become the Unwitting Partner in Crime?", *The New York Times* (19 February 2017), <https://www.nytimes.com/2017/02/19/arts/design/has-the-art-market-become-an-unwitting-partner-in-crime.html> accessed 10 September 2022.
[92] See (n 73), Groysberg, Podolny and Keller (n 65) 4.
[93] Gunn, D. (2017) (n 91), 265.
[94] Roth, M. (2015), "Es sind Interessenkonflikte, Dummkopf!", *KUR* (6), p. 165 (167).
[95] Sarah Thornton, A passion that Knows No Bounds, *The Economist* (19 November 2010), <https://www.economist.com/news/2010/11/19/a-passion-that-knows-no-bounds> accessed 10 September 2022.
[96] Dornbusch Horowitz (n 50) 336.

adviser once a new client is introduced. Without the obligation to disclose those adverse interests, clients who rely on the quality of expertise run the risks of following the advice of a biased commissioner without even considering that there might be a hidden motivation for their own agent's recommendation.[97]

In line with the above, the role of a closely-knit network becomes evident. In order to be able to establish a profitable business, the existing inefficiency needs to be recognized and seized as arbitrage opportunities. Especially in the primary market, where there are no publicly available information and where product availability is limited and generally channeled through the representing gallery, only insiders have access to the desirable works. Galleries may in exchange for granting one of the few available works expect a certain level of discretion. Consequently, on the primary market, often even the prices remain confidential.

d) The Tradition of Discretion

The idea of discretion in the art world, or confidentiality, is a handed-down and by some highly praised custom that allows for the parties of a transaction to remain anonymous to the public or the other contracting party.[98] As such, it is a quite common practice to indicate in auction catalogues only "from private collector/seller" as a reference to the work's background. As pointed out in the Report on the art industry issued by the US Senate: "In a typical transaction, a purchaser may not ask who owns the piece of art they are purchasing; the seller may not ask for whom it is being purchased or the origin of the money. And in general an art advisor would be reluctant to reveal the identity of their client for fear of being cut out of the deal and losing the business".[99] Indeed, some parties may have been attracted to investments in the art market precisely because of their preference for anonymity and secrecy. Whereas some may argue that their client's desire for data privacy can thereby be catered to successfully, there are also downsides to this. What evidently rides on the coattails of this withholding of information is the risk of money laundering. In fact, legislative projects specifically targeting the art market for this reason were initiated or prepared in both, the EU and US. Whereas respective protective measures were

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[97] Gabrielli, E. (2013), "Vendita di opera d'arte, violazione dell'impegno traslativo e nullità del contratto per illiceità del suo oggetto", Corr. Giur. (4), p. 464.

[98] Hufnagel and King (n 17) 7.

[99] United States Senate, (n 25) 3.

installed only with regard to antiquities dealers in the US, leaving out art dealers, the EU has explicitly included art market intermediaries in its 5th Anti-Money-Laundering Directive.[100] As a consequence, the dealers and intermediaries are not imposed new obligations with regard to background checks on the ultimate beneficial owner of a transaction and respective reporting duties to authorities. This subject shall however not be examined further in detail, as it goes beyond the scope of this dissertation. At this point, it should only be pointed out that often enough, essential information is not even available to the parties of a contract in the art sales context.

e) Complexity of the Subject

Another characteristic aspect of the art world that has an intimidating effect on potential investors is the complexity of the matter. In addition to the often high values traded in the art world, retail investors are also deterred by the necessary level of art and financial knowledge that is needed to justify a specific investment decision.

Taking up one of the points made above, investing in art in a profitable way requires extensive knowledge of the subject and the market itself, which is why many interested parties seek the help of an adviser to mitigate the gaping information asymmetry, thereby paralleling the typical new investor behavior in financial markets. The line of thought is relatable: if in a market where retail investors are generally not entrusted to execute their own investment decisions with regard to more complex investment opportunities, and are thus required to consult with an adviser first, this must be all the more true in an investment segment that adds the factor of unpredictability, opacity, and illiquidity to the already existing complexity of financial investments.

III. THESIS

In light of the above, a deficiency of relevant market information can be detected as the central challenge of the art market. Elaborating on this general diagnosis, we can identify in particular the withholding of essential information to the client and absence of sufficient organizational requirements to avoid or mitigate conflicts of interest as deterrence to potential investors, who do hardly have any possibility even in hind-sight to control the fairness and impartiality of the

[100] Art. 2(1)(3)(i), (j) of the Directive (EU) 2018/843 of the European Parliament and of the Council of 30 May 2018 amending Directive (EU) 2015/849 on the prevention of the use of the financial system for the purposes of money laundering or terrorist financing, and amending Directives 2009/138/EC and 2013/36/EU, which refer to "persons trading or acting as intermediaries in the trade of works of art".

market participants' conduct. Instead, the art market's complexity as well as preference for discretion and secrecy provide opportunities of taking advantage of the existing information asymmetry between insiders and newly joined investors.

In an attempt to strengthen the confidence of investors and protect the integrity of the market, one could spin the often-employed comparison between art and traditional investment assets further and consider extending the existing legal framework to an evolving investment market. The regime that instantly comes to mind when reading the identified challenges is that of MiFID and the corresponding US federal securities laws. These have a common purpose, which is increasing transparency in the relevant transactions to ascertain investor protection. The remainder of this dissertation is therefore dedicated to scrutinizing the extent to which the above-mentioned legislative acts apply to the art market.

CHAPTER II –

INVESTOR PROTECTION RULES AND THEIR APPLICABILITY TO INVESTMENTS IN ART

In light of the earlier outlined challenges of the art market,[101] which can be roughly summarized by a lack of available information and complexity of the issue, the question prompts itself whether there are any protective measures in place that can solidify investors trust in the art market. Given the current stream of investors diverging into alternative investments, it is a matter of practical relevance and almost urgency to come to a valid conclusion on the question whether the expectations built on the basis of an extensive investor protection system in financial markets can also be met outside traditional asset classes, e.g., in the art investment sector. From an investor's point of view, it might not always be obvious to which extent different rules and regulations apply among diverse asset classes, which are purchased for the same reason of value appreciation over time and even intended to mitigate each other's risk in a single portfolio.

The question to which extent investors in art may benefit from the existing vast system of financial market regulation must be answered based on the qualification of the assets as financial instruments respectively securities,[102] as this term can be seen as the "key" to the application of securities laws. As we will see, investment in art does not only refer to the classical form of purchasing an artwork at a gallery or auction in the expectation that the artist's name may increase in recognition and with it, the works in value. There are also other forms of investment in art which have come into existence only within the last 100 years, with art funds being the pioneer of alternative investment structures in art. In today's time, with the assistance of DLT, market structures may decrease in complexity and the roles of established art market participants such as dealers put into question. The innovative models raise new questions of regulation – and invite to take a closer look at the existing legal framework.

[101] See Chapter I.

[102] "Financial instruments" as central term in the European financial markets law includes among others the subcategory "securities"; at the same time, the term "securities" under US securities laws is used to refer to the total width of financial instruments. Given the geographic scope of this dissertation, both terms may be used interchangeably to refer to the broader concept of interests in a company which are recognized under the regional securities laws. Where a "security" in its stricter European understanding is intended, it will be indicated as such.

At the outset, the question will be answered whether financial market regulations apply to the traditional form of art investment, i.e., to the sale and purchase of an artwork for pecuniary purposes. The main parameter in this issue is the scope of the "securities" term, which will be outlined for the EU as well as for the US. This chapter at hand shall lay the basis for the following examination, which enlarges the term of "art investment" to include modern day investment models, which do not revolve as much around the traditional artwork itself as rather representations or fragments of it. Regarding the EU, the language and scope of the MiFID framework shall be analyzed, given its fundamental role in financial market regulations, whereas for the US, the Investment Company Act, Securities Act, Securities Exchange Act, as well as the Investment Advisers Act will be taken into consideration in view of their relevance to art investments.

I. INVESTOR PROTECTION REGULATION IN THE EUROPEAN UNION

Investor protection has been an essential driver in the EU regulatory policy for the past 15 years. Following the financial crises in 2008/2009, the framework applicable to investment and financial markets "has become wider, deeper, more technical, and more complex" to the point of achieving today an unprecedented level of financial regulation and harmonization among Member States.[103] What however remains a scarcely addressed topic even until today is the art market in the context of investments, or any valuable collectibles market for that matter.[104] This stands in stark contrast to the trends which can currently be observed in the investment sector: here, alternative asset classes are experiencing an explosive popularity in the recent years, with more and more investors delving into non-bankable assets for portfolio diversification and hedge against rising inflation rates.

The backbone of the European financial market laws is constituted by the Markets in Financial Instruments Directive (MiFID) and its supplementary regulations, principally by the revised

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[103] Niamh Moloney, 'EU Financial Governance and Transparency Regulation - A Test for the Effectiveness of Post-Crisis Administrative Governance' in Danny Busch and Guido Ferrarini (eds), *Regulation of the EU Financial Markets MiFID II and MiFIR* (Oxford University Press 2017) 315 f.

[104] The only EU-wide legislative act which proposes an equal legal treatment for art trading and financial services is the Anti Money Laundering Directive from 2018 (Directive (EU) 2018/843, AMLD 5), which by placing "persons trading or acting as intermediaries in the trade of works of art" alongside financial intermediaries openly recognized for the first time a similar level of risks inherent to both markets, at least with regard to money laundering (Art. 2(1)(3)(i),(j) AMLD 5).

Directive dated from 2014 (MiFID II)[105] and the corresponding new Regulation (MiFIR), which are further complemented by Level 2 and 3 delegated acts and guidelines within the Lamfalussy-process. In this context, an important role is attributed to the European Supervisory Authorities (ESAs), which through consultation and guidance papers provide for valuable technical implementation support.[106] This set of various rules and regulations shall henceforth be referred to as "MiFID II framework." In addition to this, other seminal legislative acts whose primary goal consist in investor protection and market stability include the Prospectus Regulation and Prospectus Directive ("Prospectus Directive") as well as the Market Abuse Regulation (MAR). This being said, the objective of this work is not to provide a comprehensive picture on the entirety of financial market provisions of the EU; instead, in keeping the focus on the topic of art investment, the following analysis concentrates on the central pillar of investor protection rules, namely the MiFID framework. From this point of departure, we will diverge only exceptionally towards other EU legislative acts where these are of integral relevance to understand the extent of protection in the art investment sector. This will be the case e. g. with the AIFMD with regard to the chapter on art funds and the pilot regime with regard to art tokens.

One of the fundamental regulatory objectives of MiFID II is "to protect investors".[107] To achieve this goal, "increas[ing] transparency" and "reinforc[ing] confidence" were identified as central concerns within MiFID II."[108] Indeed, as numerous studies have shown, building trust in the functioning of a system and in the available information is essential in the attempt to re-incentivize investments.[109]

In order to attain the said objectives in the securities market, the Directive imposes on its addressees a number of obligations which consist primarily in the disclosure of relevant information and potential conflicts of interest towards the national competent authority (NCA) and investors. The most relevant protective measures also with regard to their potential applicability in the art investment segment include the following precepts:

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[105] Directive 2014/65/EU of the European Parliament and of the Council of 15 May 2014 on markets in financial instruments and amending Directive 2002/92/EC and Directive 2011/61/EU.

[106] See e.g. ESMA Final Report on MiFID II.

[107] Pursuant to recital 86 MiFID II.

[108] See recital 4 MiFID II; Apart from the rules aimed at investor protection, maintaining the systemic stability of the market is another key concern under MiFID II. In line with the investor-oriented approach assumed by this dissertation, however, the corresponding macro-prudential rules will not be the focus of the following analysis.

[109] To name but a few: Laura Bottazzi, Marco Da Rin, Thomas Hellmann, 'The Importnce of Trust for Investment: Evidence from Venture Capital' (2016) 29 The Review of Financial Studies (9) 2283; Richard T. Harrison, Mark R. Dibben, Colin M. Mason, 'The Role of Trust in the Informal Investor's Investment Decision: An Exploratory Analysis' (1997) 21 Entrepreneurship Theory and Practice (4), 63.

1. Key Investor Protection Obligations under MiFID II

a) Fair Treatment and Best Interest of the Client

In the course of providing investment services, investment firms are required to act honestly, fairly, professionally and in accordance with the best interest of their clients.[110] To understand the best interests of the client, the provider has to take the specific requests and circumstances of each transaction into consideration. The necessary level of investigation in this regard depends on the client's need for protection.[111] Accordingly, where services consist in "execution only" with regard to non-complex products, the need to obtain information on the background and experience of the client is reduced to a minimum.[112] However, even in this constellation, investment firms are required to achieve the best possible results for their clients in terms of price, costs, speed, size, nature or any other relevant aspect when executing orders.[113]

Another manifestation of this general principle can be seen in the anti-discrimination rule which dictates that the total consideration charged with the client must not contain any hidden fees which can be traced back to different commissions or spread on different execution venues, where such differences do not reflect actual costs to the firm.[114] Instead, in the execution of orders, all costs must be passed on to the client as they actually occurred in line with the requirements on conflicts of interest.

Where the service provided offers more room for discretion by the investment firm, all relevant available information on the product and the client have to be taken into consideration to assure concordance between the two and that "financial instruments are offered or recommended only when this in the interest of the client".[115] An assessment not only of the financial product, but also of the targeted client is therefore compulsory.

In fact, the congruency between product and client shall be ascertained through pre- and post-sale measures required by all concerned service providers throughout the "product chain". Manufacturers of financial instruments that are offered for sale need to obtain approval for each

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[110] Art. 24(1), recital 71 MiFID II.
[111] See as a case in point the differentiation in Art. 30(1), according to which investment firms are not required to apply the requirements under Art. 24 (other than para. 4, 5) in their dealing with eligible counterparties; they do however have to act "honestly, fairly, and professionally" towards every client, regardless of the category.
[112] Art. 25(4), Recital 80 MiFID II.
[113] Art. 27(1), recital 91 MiFID II.
[114] Art. 27(2), recital95; see also
[115] Art. 24(2) subpara. 1, recital 82 MiFID II.

instrument to be issued. This entails a proposal on a target market, where the category of end clients is supposed to be identified in light of pertinent risks.[116] This information must also be made available to distributors, since investment firms which do not manufacture but offer financial instruments must also be able to understand the classification process of the product and suitability for a particular investor category.

The decisive factor in the selection of a suited financial instrument lies with the client's risk preferences. Generally, firms have to differentiate between high and low risk investments.[117] Investment firms that manufacture financial instruments need to identify the respective target market and the corresponding category of clients.[118] In the end, a client shall only be proposed products from the target market that corresponds with the client's risk tolerance. Another essential aspect in the decision for a special instrument is the time horizon for the investment.[119]

In accordance with the client category and knowledge background, certain financial instruments are to be excluded from the offer selection which due to their complexity or risk structure are not considered appropriate.[120] To allow for a general allocation to a market segment for each product in advance, a client categorization is established under MiFID II which divides clients principally into two types, namely retail investors and professional investors, with eligible counterparties being a subcategory of professional investors.[121] Firms falling within the scope of MiFID II are obliged to assess the category of their client and accordingly the suitability of products. By default, investment firms have to assume that their clients are retail clients. Upon request, retail investors may be treated as professionals, with respect to a single or all future transactions.[122] This does

[116] Art. 16(3) MiFID II.
[117] Every investment firm is tasked with defining *a priori* a level of risk of the offered financial instruments, taking into consideration e.g. the probability of total loss and the relationship between risk and return on investments.
[118] Art. 16(3) MiFID II.
[119] Stefan Grundmann and Philipp Hacker, 'Conflicts of Interest' in Danny Busch and Guido Ferrarini (eds), *Regulation of the EU Financial Markets MiFID II and MiFIR* (Oxford University Press 2017) 185; see also Martin Brenncke, Der Zielmarkt eines Finanzinstruments nach MiFID II (2015) Wertpapiermitteilungen (WM) 1173, 1174-5.
[120] As we will see in the following chapters, this is an essential aspect in the context of art investment, as many different forms of art-related business concepts can be considered highly complex, high-risk and hardly predictable (see e.g. Alternative Investment Funds (non-UCITS collective investment undertakings as in recital 80 MiFID II) or Fractional Ownership-Tokens).
[121] Artt. 4(1)(10, 11), 24(2) MiFID II.
[122] Sect. II Annex II MiFID II.

however not release investment firms from their obligation to assess the expertise, experience and knowledge of the client in order to make a judgment on the appropriateness of such a request.[123]

Significant investor protection concerns may arise from the structure and risks of financial products, such as complex and non-transparent financial products. Whereas certain products may be directed towards a broad target market, including all categories of investors, others which exhibit a more complex profile, aim at a narrower target market, assuming from the outset that the product will only be marketed to professional investors. Financial instruments where the probability of return and risks are difficult to understand, are considered “complex”, as well as the platforms providing access to these means. These financial products are only to be marketed to those clients who can prove a certain level of knowledge and experience, to prevent inexperienced retail investors from acquiring products that are highly disadvantageous or disproportionately risky for them.

Even though MiFID II does not recognize any interim category, many Member States have taken advantage of the possibility to introduce a semi-professional investor category within their national financial market laws. This allows investment firms to market to a group of investors who are typically wealthy private individuals. The relevant thresholds with regard to this category is generally linked to the financial means of the subject, the investment amount (in a single investment or the total portfolio) and/or the knowledge and experience in the investment sector (e.g. as manager or employee of a fund managing entity). Depending on the investor level, there is a gradation in information that the investment firms have to collect and provide to their client. For example, to retail clients a suitability report must be issued whereby the advice given is explained, including the basis for the recommendation as well as the reasons for the assumed compatibility of the proposed financial instrument and the client’s needs and risk tolerance. With regard to semi-professional clients, the requirements are reduced, even more so towards professional clients, who are assumed to be aware of the circumstances of their investment.

[123] See ESMA, ‘Questions and Answers on MiFID II and MiFIR investor protection and intermediaries topics’ ESMA35-43-349 (19 November 2021), Question and Answer 2, 102, < https://www.esma.europa.eu/sites/default/files/library/esma35-43-349_mifid_ii_qas_on_investor_protection_topics.pdf> accessed 24 November 2022.

b) Disclosure of Relevant Information

The generic provisions on "best execution" employed by MiFID I,[124] which commanded disclosure of material changes and the investment policy to the client as well as post-transaction monitoring, were adapted and concretized by MiFID II.[125] Clients shall now receive detailed information about the investment firm as well as proposed products in order to better understand their characteristics and risks and take an investment decision on an informed basis.[126] This includes in particular information about costs: investment firms have to present the relevant information in a timely manner, electronically or on paper, to the client, entailing all costs and any ancillary costs related to the product and the services as well as the impact of the costs on the return (including a cost breakdown with individual items at the client's request).[127]

In line with what has been established previously, an advisor may only recommend financial instruments that are suitable for the client.[128] In the assessment of suitability, objective criteria are to be employed, which shall also be reflected in the final statement of suitability that is issued to the client. The advisor thus has to make sure that the recommendation meets the investment objectives, risk profile, financial situation and is compatible with the knowledge and experience of the client.[129] In broad terms, the differentiation between retail clients and professional clients needs to be respected.[130] The statement is to be understood as an explanation why the recommendation was issued and how the proposed financial instruments meet the preferences and needs of the client. It must be provided to the client before the transaction is affected,[131] with an exception applying e.g. if consultations take place over the phone.

Of particular relevance in view of investment advice is the need to specify whether or not the advice is given on an independent basis.[132] In the case of independent investment advice, an additional number of revelations have to be made, including other entities with which the

[124] See e.g. Artt. 21, 27 MiFID I, see also Art. 44(3) Commission Directive 2006/73/EC of 10 August 2006.
[125] Grundmann and Hacker (n 119) 194.
[126] See e.g. Art. 24(4) MiFID II.
[127] Here again exist pre- and post-trade obligations, which require the investment firm to provide information on the actually occurred costs, see on costs Art. 24(4)(c), subpara. 2 MiFID II.
[128] Art. 25 MiFID II.
[129] Art. 25(2) MiFID II.
[130] Art. 24(4)(b) MiFID II.
[131] Art. 24(5) MiFID II.
[132] Art. 24(4)(a) MiFID II.

investment firm has close legal or economic relationships which might bear the risk of impairing the independent advice.

c) Formality and Record Keeping Obligations

For all investor categories, the information provided must be clear, comprehensive and not misleading.[133] Standardized formats are eligible for the disclosure of costs and charges.[134] The suitability statement must be provided in writing, in a durable, e.g. an electronic, medium.[135] In addition, under MiFID II, investment firms are required to record telephone conversations and emails relating to client orders ("taping"), thereby allowing supervisory authorities to exercise post-trade verification that all obligations were complied with.[136] The records must be kept for at least five years (seven years upon request by the national competent authority (NCA)).[137] Clients shall be informed in advance about the recording obligation, with the option to object.

d) Conflicts of interest

The seminal duty to act in the client's best interest is concretized in various provisions which aim at preventing conflicts of interest (CoI) or, where not feasible, to disclose them to the client.

In terms of prevention, investment firms are obliged to take the adequate steps to predict situations in the course of providing investment services which are particularly likely to provoke CoIs.[138] Such may arise between firms, their managers, employees or any other linked or controlled person, and clients, respectively between one client and another.[139] The management body of an investment firm is therefore required to define, oversee and implement the reasonable measures to ensure a segregation of duties and prevent CoIs, including a remuneration policy of service providing persons that assures accordance with the best interests of clients.[140] Also

[133] Art. 24(3) MiFID II.
[134] Art. 24(5) MiFID II.
[135] Art. 25(6), Recital 82 MiFID II.
[136] Art. 16(6), (7) MiFID II.
[137] Art. 16(7) MiFID II.
[138] The general provision on avoiding and under certain conditions revealing CoIs is supplemented by the Commission Delegated Regulation (EU) 2017/565 of 25 April 2016; see here in particular recital 48 Del. Reg. 2017/565.
[139] Art. 23(1) MiFID II.
[140] Artt. 9(3), 24(10), recital 77 MiFID II.

administrative arrangements and the firm's organization must be designed with a view to assure that the client's interest are not adversely affected.[141]

Additionally, in the context of advisership, where reliance on the service provider is particularly strong and the information asymmetry presumably significant, it needs to be revealed to the investor whether the advice is given on an independent basis or not.[142] In order to maintain their objectivity, independent advisers must not limit their offered instruments to those provided by other entities with a close legal or economic relationship that might pose a risk of impairing the advice. Also, independent advisors and portfolio managers are not allowed to accept other inducement of any kind, such as fees, commission, or non-monetary benefits by third parties.[143]

Where organizational measures to prevent a CoI are not sufficient or feasible, the duty to disclose the circumstances to the client arises. While it is not expected to take every possible prudential measure, the firms have to make sure to comply with what can reasonably be expected.[144] Disclosure shall remain the mean of last resort and is not to be considered a general alternative to preventive measures.[145] In the case of an unpreventable CoI, the relevant nature and sources have to be revealed to the client, as well as the steps undertaken to mitigate the risks, providing sufficient details to allow for the client to make an informed investment decision.[146] The disclosure notice has to be in a durable medium and sufficiently detailed to allow the client to make an informed decision.

The above obligations relating to CoIs are not only aimed for the visibility of all investment-relevant information; as Grundmann and Hacker observed in their detailed elaboration on the topic, "the scope [of the CoI-provisions] is threefold, really: first, to make (a good part of the) clients aware of the fact that there are considerable conflicts of interests potentially affecting investment advice; second, to give them the information needed to properly assess the number and the mechanisms of the different sources of conflict of interests [...]; and third, to serve as a disincentive for providers to cede to their conflicts of interests." Indeed, the last aspect needs to

[141] Art. 16(3) MiFID II.
[142] Art. 24(4)(a)(i), (7) MiFID II.
[143] Art. 24(7) MiFID II.
[144] Grundmann and Hacker (n 119) 186.
[145] Art. 23(2) MiFID II; Art. 34(4) Del. Reg. 2017/565.
[146] Art. 23(2) MiFID II.

be emphasized: according to several studies,[147] the willingness of investors to trust others with their investment decisions drops drastically as soon as they are informed of a potential CoI, as a consequence of the stigma/negative connotations generally attributed to CoIs. Accordingly, the duty to inform clients of a potential CoI equals in effect a disciplinary measure set at preventing CoIs in a market.

e) Operation of a Trading Venue

In addition to the general obligations, investment firms which operate a trading venue for financial instruments have to meet further requirements, especially with regard to the transparency and non-discriminatory access to trading venues.[148] The exact extent of reporting and organizational obligations of operators of trading venue depends on the traded instruments,[149] as well as on the structure of the venue, where one needs to distinguish between regulated markets, multilateral trading facilities (MTFs), and organized trading facilities (OTFs).[150]

2. Applicability of MiFID II to Direct Investment in Artworks

With art being purchased for pecuniary motives,[151] the question deserves to be addressed whether traditional art investment also invokes investor protection laws. To this aim, it shall be scrutinized whether artworks as in tangible objects belonging to the category of fine art may under certain circumstances constitute securities. The fact that the qualification of art as a security has rarely been suggested in legal academia makes it all the more vital to address the issue in a thorough manner which delves into the details of the requirements instead of simply dismissing the proposal with reference to seemingly irreconcilable differences.

MiFID II identifies its scope of application in Art. 1(1) as follows: "This Directive shall apply to investment firms, market operators, data reporting services providers, and third-country firms

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[147] For example: Bryan K. Church, Xi Kuang, 'Conflicts of Interest, Disclosure, and (Costly) Sanctions: Experimental Evidence' (2009) 38 The Journal of Legal Studies (2) 505; Yuanyuan Liu et. al, 'Are Investors Warned by Disclosure of Conflicts of Interest? The Moderating Effect of Investment Horizon' 95 (2020) The Accounting Review (6) 291.

[148] Recital 14 MiFID II.

[149] See e.g. Art. 58 MiFID II.

[150] Art. 4(1)(21,22, 23) MiFID II.

[151] Evidenced by the fact that 36% of collectors named "investment returns" as motivation for buying art, 40% said "portfolio diversification", see Deloitte and ArtTactic (n 3) 102.

providing investment services or performing investment activities through the establishment of a branch in the Union." With regard to the subject at hand, investment firms are of particular interest among the listed entities and shall hence be examined in detail.[152]

a) Investment Firms

The term "investment firms" refers to "any legal person whose regular occupation or business is the provision of one or more investment services to third parties and/or the performance of one or more investment activities on a professional basis."[153]

Interestingly, also natural persons providing services involving the holding of funds of a third party or transferable securities may fall within the term of an investment firm under the premise that they comply with all of the following conditions:[154]

(a) The ownership rights of third parties in instruments and funds must be safeguarded, especially in the event of the insolvency of the firm or of its proprietors, seizure, set-off or any other action by creditors of the firm or of its proprietors;
(b) The firm must be subject to rules designed to monitor the firm's solvency and that of its proprietors;
(c) The firm's annual accounts must be audited by one or more persons empowered, under national law, to audit accounts;
(d) Where the firm has only one proprietor, that person must make provision for the protection of investors in the event of the firm's cessation of business following the proprietor's death or incapacity or any other such event.

In order to determine the conceptual scope of "investment firms", "investment services and activities" further need to be defined. Instead of an abstract description of these terms, MiFID II employs a list of pertinent activities, including:[155]

(1) Reception and transmission of orders in relation to one or more financial instruments;
(2) Execution of orders on behalf of clients;
(3) Dealing on own account;
(4) Portfolio management;

[152] The interesting issue of intersections between data reporting services providers and art indices in their various forms as well as any resulting legal obligations is beyond the scope of this book and can thus not be further explored here.
[153] Art. 4(1)(1) MiFID II.
[154] Art. 4(1)(1) third paragraph MiFID II.
[155] Art. 4(1)(2) in conjunction with Section A of Annex I, Section C of Annex I MiFID II.

(5) Investment advice;
(6) [...]
(7) Placing of financial instruments without a firm commitment basis;
(8) Operation of an MTF;
(9) Operation of an OTF.

What all of the above activities have in common is their reliance to some extent on the handling of financial instruments. MiFID II resorts to a list of examples for financial instruments instead of providing an abstract description. Financial instruments are among others the following:

(1) Transferable securities;
(2) [...]
(3) Units in collective investment undertakings;
(4) Options, futures, swaps, forward rate agreements and any other derivative contracts relating to securities, currencies, interest rates or yields, emission allowances or other derivatives instruments, financial indices or financial measures which may be settled physically or in cash;
(5) Options, futures, swaps, forwards and any other derivative contracts relating to commodities that must be settled in cash or may be settled in cash at the option of one of the parties other than by reason of default or other termination event;
(6) Options, futures, swaps, and any other derivative contract relating to commodities that can be physically settled provided that they are traded on a regulated market, a MTF, or an OTF, except for wholesale energy products traded on an OTF that must be physically settled;
(7) Options, futures, swaps, forwards and any other derivative contracts relating to commodities, that can be physically settled not otherwise mentioned in point 6 of this Section and not being for commercial purposes, which have the characteristics of other derivative financial instruments;
(8) Derivative instruments for the transfer of credit risk;
(9) – (11) [...]

The decisive factor with regard to the question of whether art investments falls within the remit of MiFID II is therefore primarily the classification of the product to be traded. The key question thus is: Do artworks qualify as a financial instrument, and in particular, as securities?

b) Art as a Security?

The list of financial instruments recognized by MiFID II only hints at the vast number and great variety of types of investment products.[156] A conclusive listing in detail would not provide for a viable long-term solution due to the creativity of providers, who are constantly developing new investment concepts.[157] In line with this, the term "transferable securities" is rather broadly described as any class "of securities which are negotiable on the capital market, with the exception of instruments of payment."[158] The definition furthermore contains an exemplary enumeration of securities, which reads as follows:[159]

(a) Shares in companies and other securities equivalent to shares in companies, partnerships or other entities, […];
(b) Bonds or other forms of securities debt, […];
(c) Any other securities giving the right to acquire or sell any such transferable securities or giving rise to a cash settlement determined by reference to transferable securities, currencies, interest rates or yields, commodities or other indices or measures."

Notably, also in the art investment segment, the dichotomy of equity (shares) and non-equity (bonds) investment persists, as structures can generally be assigned to one of the two types.

From the legal definition in Art. 4(1)(44) MiFID II, several constitutive elements for securities emerge. The *communis opinio* educes the following requirements which in order to qualify as a security must be met:[160]

1) transferability of the issued units,
2) standardization, and
3) negotiability on capital markets.[161]

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[156] Annex I Section C MiFID II.
[157] Indeed, in view of continuous new proposals of issuers and market participants, a functional approach as employed by MiFID II through its open wording ("securities equivalent to shares", other forms", "any other") is preferable and comprehensive; it also parallels the US approach of defining securities.
[158] Art. 4(1)(44) MiFID II.
[159] As is implied by the wording "such as" applied by MiFID II, Art. 4(1)(44) MiFID II.
[160] Hacker and Thomale (n 24) 664.
[161] Given that not all directives consistently assume this definition, there exists not a uniform concept of 'securities' within EU Law. For example, the Takeover Bids Directive (Dir 2004/25) places an emphasis on the voting rights

In addition to these three requirements, a functional comparison to securities shall be applied, in that the item under scrutiny must correspond with regard to its purpose and characteristics to tradable financial instruments such as shares, bonds or other securities listed as an example.[162]

c) Application to the Traditional Art Investment Model

At first glance, taking into consideration the above criteria, the concept of artworks and securities seem quite incompatible. Whereas the first requirement is still readily applicable also to artworks, whose transferability is in principle indisputable,[163] the remaining two criteria present more of an issue. Especially the requirement of standardization presents a seemingly insurmountable obstacle to the recognition of artworks as securities.

aa) Standardization

In fact, artworks are exemplary of unique and non-fungible goods, which cannot be substituted by another. In this regard, art is centrally and irreconcilably opposed to stocks, being exchangeable units that share the same value and represent an equal claim. Indeed, it is the "one of a kind"-character of artworks that make price predictions so unreliable since there is no homogeneity which could allow to make assumptions based on previous sales, but instead, each piece may attract its own aficionados. Dimitriu and Hurduzei observed in this context that "even if the artist made the same theme in more than one painting, they are not the same, they come to complete each other, and they form the message the painter wanted to transmit. If we are looking at Edvard Munch, Melancholy series painted between 1891 - 93, we can understand better the message of the artist if we are looking at the entire series than if we are looking only at on piece of the work. Monnet with his water lily is another example of the different painting with the same topics, showing how the artists evolved and played with the color to verge toward abstraction. The aim of his large Water Lilies (1914 -26), found in our days at the Museum of

associated with holding shares in a company ('transferable securities carrying voting rights in a company', see Art 2(1)(e) of the Takeover Bids Directive). The above criteria have however been generally recognized as the basic common denominator.

[162] That material comparability is imposed by MiFID II can be deduced from the exemplary listing of securities, which shall provide for models on assessing the nature of other units.

[163] Although in special cases, export restrictions under cultural heritage law could impose limitations, see e.g. on this issue Alberto Frigerio, 'The New Italian Law on the Exportation of Cultural Goods and Its Relationship with EU Regulations' (2019) 24 Art Antiquity & Law (3) 263.

Modern Art, New York, was to supply “the illusion of an endless whole, of water without horizon or bank.”[164]

It thus seems that each artwork is different from each other, even if created by the same artist and depicting the same subject. While this observation may certainly be true with regard to works created by Munch and Monet, who painted their masterworks in a classic manner, other artists employed different techniques which made it possible to produce artworks that were more than alike – that were identical to the human eye: casts and prints are only two forms of multiplied artistic works, that can be created in the desired quantity.

A print is defined as an image or design impressed or stamped e.g. on paper or fabric. Nowadays, it is mostly through mechanical reproductions that multiple versions of the original design can be produced,[165] although the concept of “printing” images was already in the Middle Ages a popular means to distribute religious representations among the people.[166] With regard to the value of an artwork, one needs to differentiate: [167] “The distinction made between ‘original’ and ‘reproductive’ prints is controversial. From the aesthetic point of view, it matters if the artist’s personal touch adds an important quality to the ‘original’ print—especially if exploration of graphic media affects the artist’s style. With geometric, hard-edged prints, originality is of less importance because of the impersonal finish, but it does still affect the price.”[168] Whereas original prints are usually printed by hand by the artist her/himself or at least under the artist’s supervision, with a number and signature indicating the work’s affiliation to a limited edition, reproductive prints are printed from blocks by a professional printmaker, “who translates the artist’s work into a print medium.” [169] The most common form of prints today are photomechanical ones which “have largely replaced handmade reproductive prints because of

[164] Ana-Corina Dimitriu and Gheorghe Hurduzeu, ‘Investment in Fine Art Market Versus Investment in Financial Instruments’ [2020] KnE Social Sciences <https://knepublishing.com/index.php/KnE-Social/article/view/5991/11378> accessed 1 October 2022.

[165] Katharina Mayer Haunton, Laura Suffield, Ilja M. Veldman, Elizabeth Miller, Anthony Dyson and Charles J. Semowich, ‘Prints’ Grove Art Online (2003) Oxford Art Online, <https://doi-org.emedien.ub.uni-muenchen.de/10.1093/gao/9781884446054.article.T069624> accessed 1 October 2022.

[166] One of the first artistic masters to eagerly employ printmaking in the creation of his works was Albrecht Dürer, who used this technique to distribute a larger number of works over the European continent already in the 15th century (see e.g. Hans Düfel, ‘Albrecht Dürer (1471-1528)’ Theologische Realenzyklopädie Online (De Gruyter 2010) <https://www.degruyter.com/database/TRE/entry/tre.09_206_33/html> accessed 15 December 2022).

[167] For an original print (or cast), generally three conditions have to be fulfilled, namely: 1) Master plate or mould was created by the artist herself; 2) the print/cast was created under the supervision of the artist; 3) authorization/recognition by the artist of the final product.

[168] Haunton et al. (n 165).

[169] ibid.

their accuracy and cheapness."[170] The lack of uniqueness of each of these products emerges properly from the aim of the print itself: its primary function consists in the fast and identical multiplication of images. This way, the artist may reach a far larger audience and become available to many for an individually lower price, instead of to just a few for a sizeable compensation.[171] In this regard, a generally known market principle applies: the larger the number of available copies, the less is the value of each individual print – thereby interconnecting each specimen of an edition to the others and subjecting the value of each print to the discretion of the creator, who in theory is free produce an unlimited amount.

A cast is a reproduction of a three-dimensional object which is crafted with the use of a mould as the "negative" of the original sculpture.[172] The mould is hollow and can be filled with for example plaster, cement, or bronze to produce a visually identical replica of the original.[173] To give an example, the artist Auguste Rodin (1840-1917) left his moulds and the right to their commercial exploitation to the French state after his death. As a consequence, sculptures "by Rodin" continue to be produced under authorization of the "Musée Rodin." The price for these sculptures varies greatly, depending to a large extent on the vicinity of the cast to the artist's lifetime and the use of original moulds.[174] For the lay collector who is unfamiliar with the process of recasts, it is not always obvious from the description of the item that in fact, the object of sale was never even touched by the master's hand but is only brought in direct connection with the artist's name due to the remaining mould. However, the discrepancy between the original produced by the artist and the posthumous replica is detrimental, especially in terms of value. By way of illustration, the arguably most famous sculpture by Rodin, "Le Penseur" ("The Thinker") is regularly sold at auction, the last time by Christie's in June 2022. This posthumously created cast from December 1924 achieved the price of USD 8.2 million at auction. The same form but cast still under the

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[170] Ibid; "The term 'artist's print' should signify the same as 'original' print but is often wrongly employed for signed photomechanical reproductions of artists' drawings".

[171] Reaching a larger audience and "democratizing" art has precisely been the motivation behind the creation of "multiples" as a specific genre that emerged in the 1960s. Contrary to "prints", multiples are three-dimensional works and the artists generally renounce to the use of historic reproduction technology (see Stefan Germer, 'Das Jahrhundertding' in: Felix Zdenek (ed), *Das Jahrhundert Des Multiple - Von Duchamp Bis Zur Gegenwart* [Oktagon Verlag 1994] 17.

[172] Tim Smare, Cast, Grove Art Online, 2003, Oxford Art Online, https://doi-org.emedien.ub.uni-muenchen.de/10.1093/gao/9781884446054.article.T014626.

[173] Brockhaus Encyclopedia Online, 'Abguss', *Brockhaus*, <https://brockhaus-de.emedien.ub.uni-muenchen.de/ecs/permalink/0C8D3FA2E6A9ADF455CBD511D208DF05.pdf> accessed 1 October 2022.

[174] "Penseur" ("The Thinker"), moyen modèle, sold in 2013 by Sotheby's New York for $15.3 million (https://www.sothebys.com/en/auctions/ecatalogue/2013/impressionist-modern-art-evening-sale-n08987/lot.45.html); replica cast in December 1924 sold by Christie's in May 2018 for $8.2 million (<https://www.christies.com/lot/lot-6140957>) (all accessed 1 October 2022).

supervision of Rodin himself in 1906 had been sold in 2013 by Sotheby's New York for USD 15.3 million. Following the creation of new casts authorized by the Musée Rodin in 1999, several statutes were sold by the Galerie Sayegh for around USD 1 million.[175] Whether these different sculptures each deserve to be considered "unique" is doubtful. In any case, the replicas of Rodin do not form a uniform class, as they differ in essential characteristics, such as the authorizing entity, year of manufacture, size, etc. Taking these criteria into account, however, it would be possible to delineate different classes each encompassing a group of casts that are alike. The term "standardization" therefore seems appropriate insofar as multiple replicas and prints exhibit strong parallels which simultaneously allow to distinguish them from others – as is the case with editions.

The essential characteristic of prints and casts is their affiliation to an edition, i.e., to a series of identical artworks which all originate from a pre-defined template.[176] In this respect, deviations, if any exist, are minimal, coincidental and often owed to the wear and tear of the material rather than intended as artistic means of expression.[177] The number of editions is generally pre-defined by the artist, thereby informing the audience of the total intended number of units within the production process. Therefore, the "uniquess" of artworks can indeed not be readily assumed at least for works issued within an edition; hence, the classification of artworks as securities cannot already be excluded at the level of standardization, at least not with regard to prints and casts.

Furthermore, there are also statutory arguments supporting the finding that artworks issued in larger numbers may lose their "uniqueness." As a case in point, the American Visual Artists Rights Act (VARA) can be referred to, according to which moral rights are only granted to authors of artistic works with regard to single copies or limited editions of graphics or casts with 200

[175] Interestingly, the Musée Rodin sued the American Gerry Snell for selling "authentic" casts for an estimated average of EUR 35.000 each which were fabricated using original Rodin molds; the legal dispute went on for almost two decades, which hints at the complexity of the topic, that an investor cannot possibly grasp within the contractual negotiations (see for an overview: Benjamin Sutton, 'A French court sentenced an art dealer and a businessman to prison over counterfeit Rodin sculptures' *artsy* (23 April 2019) <https://www.artsy.net/article/artsy-editorial-french-court-sentenced-art-dealer-businessman-prison-counterfeit-rodin-sculptures> accessed 10 October 2022).
[176] Also the term "edition" was coined by the multiple movement in the 1960's (see e.g. "Edition MAT"), referring to a group of works that by instructions of the artist or factual predicates of the creation can be distinguished from other creations.
[177] Of course, also to this general assumption there are exceptions where artists intended there to be variations from the used materials, and where the works hence cannot be considered homogenous in their different versions, see e.g., with Robert Rauschenberg, Richard Hamilton, or where the dichotomy between original and reproduction is precisely the central topic of the artwork, as was often the case in the Postwar period and with *objet trouvé* artists.

copies or fewer.[178] The Act presupposes that in exceeding this number, the essential bond between an artist and her/his work can no longer exist towards each individual unit of the edition.

Also the fact that risks may arise for buyers from an artwork not being one of a kind has already been recognized by law. The New York Arts and Cultural Affairs Law (ACAL) establishes specific rules for the sale of multiples and prints. This includes special "investor" or buyer protection rules, as for example Art. 15 ACAL, which imposes on art merchants the duty to reveal a vast array of relevant information in writing for any copy that is sold for more than USD 100, including the name of the artist, the authenticity of the signature, the medium, material or process used, if the artist was deceased at the time the multiple was produced, the kind of reproduction (mechanical, photomechanical, hand-made, etc.), time of production and much more. These disclosure obligations shall enable investors to make a sound (investment) decision. Considering the level of confusion of investors attributable to the infinite production of Rodin's cast, the just enlisted information are indeed of practical relevance and meet a veritable need for protection of potential art buyers. From these rules it clearly emerges that the New York legislator considers buyers in the trade with multiples to be particularly risk exposed. As such, it does not come as a surprise that the statute took the "law governing investments in corporate securities" as its model,[179] precisely to achieve a similar level of transparency and full disclosure as aimed for in the securities market.

In light of the foregoing, the classification of works issued within editions as securities does not seem as far-fetched as one may initially have assumed. However, there still remain two points to be analyzed, namely the negotiability on capital markets as well as the functional comparability with traditional securities.

bb) Negotiability on Capital Markets

Due to the ostensible parallelism between negotiability and tradability, there is a strong indication to demand a surplus compared to the mere capacity of being traded, in that securities are to be traded with ease.[180] In addition to the negotiability, securities would also have to be traded on 2)

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[178] Sec. 602. a VARA (1990) – 17, U.S.C. § 106A.

[179] Holm (n 18) 400 pointing to Memorandum in Support of N.Y.A. 10809, 203d Sess. (1980).

[180] See Commission Delegated Regulation (EU) of 24.5.2016 supplementing Directive 2014/65/EU of the European Parliament and of the Council with regard to technical standards for the admission of financial instruments to trading on regulated markets, Recital (1)

capital markets, including regulated markets or multilateral trading facilities (MTFs), where – as opposed to goods or commodities – equity or debt instruments are dealt with.[181] As this question evidently overlaps in its criteria with the next point to be addressed, namely the functional comparability with securities, it shall be deferred for the time being.

cc) Functional Comparability with Shares or Other Security Standards

When it comes to the functional comparability of artworks with traditional securities, the common traits need to examined with either share or equivalent equity instruments, "bonds and other forms of securitized debt" or "any other securities giving the right to acquire or sell any such transferable securities or giving rise to a cash settlement determined by reference to transferable securities, currencies [...] or other indices or measures."[182] The focus can be laid here on equity instruments. These are characterized by two traits, namely co-participation of investors in key decisions and profit participation.

The latter refers not only to dividends being issued by the entity, but also to indirect participation due to the appreciation of the security that has been issued in exchange for equity. Investments in artworks are generally characterized by the lack of continuous income; simply by owning an artwork, one does not generate cash flow. The possibility of lending the work to exhibitions or depositing it as collateral is not of relevance within the current examination.

At first glance, it seems doubtful whether the price paid for an artwork can be seen as a contribution of equity to a company. One would assume that once the artwork is purchased, it loses its affiliation with the seller. However, a closer look reveals certain parallels within shares in a corporation:

In the first step, one needs to distinguish between the artist and the dealer, who would be given the role of the issuing corporation in traditional share offerings. By contributing capital to the artist, she/he is supported in maintaining her/his business and establishing a recognition, which may at some point have the positive effect of the purchased artwork increasing in value. Indeed,

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<https://ec.europa.eu/finance/securities/docs/isd/mifid/rts/160524-rts-17_en.pdf> accessed 20 October 2022; Christoph Kumpan, 'Financial Instruments', *Max Planck Encyclopedia of European Private Law* (2012).

[181] ThinkBLOCKtank, 'Position Paper on the Regulation of Tokens in Europe (Version 1.0)' (2019) 20; see also CJEU dated 21.10.1999 – C-97/98 (Peter Jägerskiöld vs. Torolf Gustafsson), C-97/98, ECLI:EU:C:1999:515, where the CJEU held that "not every liquid market is to be regarded as a capital market" and made the distinction to goods and commodities markets.

[182] Art. 4(1)(44) MiFID II.

the situation exhibits many similarities to that of an investor believing in the business concept of a company and speculating on its success by contributing capital.

In practice, however, the investor rarely directly interacts with the artist; instead, practically all art deals which are conducted at a price level that would allow to take also investment interests into consideration occur via a dealer or gallery, which takes a (considerable) share of the sales price. The reality shows that with investments in art, not only the artist is attributed a central role in the future "profitability" of the work, but also the gallery to an insignificant level.

It would be naïve to believe that the price development in art is independent from human actors. Instead, disproportionate power in terms of deciding whose works will be requested by collectors and auction houses lies with a very small number of people, especially when it comes to emerging artists who do not have a stable track record yet that solidifies their works' value. Influential galleries function as gatekeepers to the art market, especially with regard to fine art, i.e., paintings and sculptures, as opposed to digital art which is distributed through more open platforms than the traditional art selling channels. Accordingly, investing in an emerging artist being represented by one of the most recognized art galleries in New York often goes hand in hand with the expectation that the works will increase significantly in value in the years to come. Again, this constellation can be compared to trusting the manager of a company in her/his capabilities to making the business profitable, which translates to establishing the artist's recognition in the art world. Having an initial investment increasing tenfold within a short time is a phenomenon which occurs rather only in the primary market, i.e. following the first sale of an artwork directly from the artist and the representing gallery, before it is offered on the market again. This phenomenon can thus primarily be attributed to the (networking) capabilities of the gallery owner. As a consequence to this profitable outlook, investments in early career artist represented by recognized gallerists are particularly interesting for investors. When delving deeper into the opaque correlations of the art market, it emerges that similar to an investment firm manager, also gallery owners exclusively representing an emerging artist apply a business strategy, which consists among others in structuring a marketing strategy around the reputation of an artist, maintaining a stable undersupply of artworks to avoid price collapses, and strategic placing of works with exhibitions and individuals.

In considering the above argumentation, one becomes aware of the strong parallels existing between art and securities investments. Nonetheless, these do not compensate the fact that there are no participation rights conveyed to investors by the purchase of an artwork, which is why the level of comparability between artistic creations and shares will have to be considered insufficient to establish the quality of a security.

Absent the comparability to any other financial instrument, in the end, the conclusion is to be reached that artworks do not constitute financial instruments pursuant to MiFID II. Consequently, the rules of the EU legal framework on markets in financial instruments do not extend their protective scope to the investors of the art market – that is, of the fine art market in its strict sense, limited to the direct investment form in tangible works. Whether the same is true also with regard to other art investment models remains to be seen.

3. Central Findings

The traditional archetype of an artwork, i.e., a unique original painting or sculpture, does not exhibit the necessary characteristics to be considered a security according to MiFID II – or any other financial instrument for that matter. However, on closer examination, the applicability of the securities definition to multiples as a subcategory of art cannot be ruled out entirely. The lack of uniqueness in multiple prints and casts, which due to their large number lose their artistic singularity and instead disintegrate into countable units within a class, may suffice to assume a sufficient level of standardization even in the context of art. The test which can however not be passed by traditional artworks is their function comparability to securities. On that basis, the conclusion is reached that artworks do not constitute financial instruments. From this follows that art market actors do not need to comply with the disclosure obligations, conflicts of interest rules or behavioral duties that firms owe to their investors in the securities market. Nonetheless, a need for the protection of art investors has be discerned and is particularly strong with respect to buyers of multiples.

As we have seen, New York recognized this point. This leads to the question whether under the US federal laws, one may come to a different conclusion regarding the qualification of artworks as securities.

II. REGULATION OF ART INVESTMENTS UNDER US SECURITIES LAW

Interestingly, the US definition of a security is quite different in its terminology and, more importantly, in the emphasis it puts on certain aspects compared to that of MiFID. This provides for the opportunity to illuminate the question of art as a security from a different angle – and with a potentially different outcome.

Together, the Securities Act of 1930, the Securities Exchange Act of 1934, as well as the Investment Company Act and the Investment Advisers Act both of 1940, form the basis of US Securities Laws. What all of these legislative bodies have in common is that their applicability principally revolves around the term "securities", which thus serves as point of departure for the following analysis. A series of responsibilities and duties towards investors as well as towards authorities hinge on the finding that securities are being issued or dealt with. In order to legally sell a security under US regulations, legal subjects need to be registered with the SEC as broker-dealer, absent applicable exemptions.

1. Definition of Securities under US Law

The European term "financial instruments" corresponds in to "securities" in the US' financial markets laws, as defined under the Securities Act of 1933 and the US Securities Exchange Act of 1934.[183] Rather than to provide systematic guidelines on the features by which securities can generally be distinguished, both provisions contain a vast list of financial products, which is concluded by a catch-all phrase. In detail, the Securities Act declares securities to include any kind of "note, stock, treasury stock, security future, security-based swap, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, **investment contract**, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, any put, call, straddle, option, or privilege on any security, certificate of deposit, or group or index of securities (including any interest therein or based on the value thereof), or any put, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency, or, in general, any interest or instrument commonly known as a 'security', or any certificate of interest or participation in,

[183] 15 U.S. Code § 77b (a) (1); §3(a)(10) of the 1934 Act, 15 U.S.C. § 78(a)(10).

temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase any of the foregoing."[184]

This provision is not to be understood as purely formalistic, contrary to what the reference to "any instrument *commonly known* as 'security'" might suggest.[185] Instead, the legislator intended it to be as open as possible in order for the definition to include "virtually any instrument that might be sold as an investment."[186] This legislative intent has been implemented by the courts who assume a functional approach and go beyond the formal denomination in their findings of a security. Indeed, as the Supreme Court noted in *Tcherepnin v. Knight*, "in searching for the meaning and scope of the word 'security' in the Act, form should be disregarded for substance and the emphasis should be on economic reality."[187] The understanding of what is a security has hence meandered throughout the years, adapting to "the countless and variable schemes devised by those who seek the use of the money of others on the promise of profits."[188] What has however emerged as constants in the varying forms of securities, are the right to receive dividends, a factor closely connected to the right of an apportionment of profits, negotiability, the ability to be pledged or hypothecated, to confer voting rights in proportion to the number of shares owned, and to appreciate in value.[189]

An important role in defining securities is also attributed to the US Securities and Exchange Commission ("SEC"), the authority charged with administering the Securities Act. Especially in the context of new technologies being employed for investment models, investment firms regularly turn to the SEC and request a no action letter in order to have at least some legal guidance on unfamiliar terrain. The SEC seems to share the courts' "substance over form" approach by commonly assuming a wide understanding of the securities term,[190] which occasionally leads to unexpected and criticized results.

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[184] Emphasis by the author.
[185] Emphasis by the author.
[186] H.R.Rep. No. 85, 73 Cong., 1st Sess. 11 (1993); "Congress' purpose in enacting the securities laws was to regulate investment, in whatever form they are made and by whatever name they are called", *Reves v. Ernst &Young*, 494 U.S. 56, 61 (1990); see also John C Coffee Jr., Hillary A Sale and Charles K Whitehead, *Securities Regulation* (14th edn, Foundation Press 2021) 273.
[187] 389 U.S. 332, 336 (1967); confirmed in *United Housing Foundation, Inc. v. Forman*, 421 U.S. 837, 95 S.Ct. 2051, 44 L.Ed.2d 621.
[188] *SEC v. W.J. Howey Co.*, 328 U.S. 293 (1946) at 299.
[189] *United Housing Foundation, Inc. v. Forman*, 421 U.S. 837, 95 S.Ct.2051, 44 L.Ed.2d 621; see also Coffee, Sale, Whitehead (n 186) 305.
[190] Coffee Jr., Sale and Whitehead (n 187) 277.

2. Investment Contracts

The sub-category of "investment contracts" enlisted as one of the examples for securities plays an essential role in securities laws, as it encompasses all sorts of investment models that do not neatly fit with any of the other terms. Although it is not legally defined by statutory law, its meaning had been crystallized already prior to the enactment of the federal securities law by State jurisdiction, due to the interpretation of similarly worded State law (blue sky laws).[191] Accordingly, an investment contract is to be understood as a contract, transaction or scheme for "the placing of capital or laying out of money in a way intended to secure income or profit from its employment".[192] The Supreme Court has further narrowed down the conditions under which an investment contract constitutes a security. According to its standard developed in the landmark decision *SEC v. W. J. Howey Co.*,[193] an investment contract is to be assumed where "a person invests his money in a common enterprise and is led to expect profits solely from the efforts of the promoter or a third party, it being immaterial whether the shares in the enterprise are evidenced by formal certificates or by nominal interests in the physical assets employed in the enterprise."[194] This has hence become the "Howey test", which imposes courts to assess a security on the basis of three requirements: 1) whether investors purchase with an expectation of profits arising from 2) a common enterprise that 3) depends on the managerial efforts of others.[195]

3. Application of the Investment Contract Definition to Artworks

The remainder of this chapter will analyze the above-named criteria in detail in order to assess their applicability to artworks as means of investment. The investigation will reveal whether artworks bought at least partially for pecuniary motives can be compared to common enterprises, that promise profit based on their managerial efforts.

[191] These laws derived their name from promoters who 'would sell building lots in the blue sky in fee simple', see Mulvey, 'Blue Sky Law' (1916) 36 Can. L. Times 37.
[192] Coffee Jr., Sale and Whitehead (n 187) 277.
[193] *SEC v. W.J. Howey Co.*, 328 U.S. 293 (1946), 66 S.Ct. 1100, 90 L.Ed. 1244.
[194] Coffee Jr., Sale and Whitehead (n 187) 277.
[195] This test can equally be applied to new technology-driven investment forms, see Hacker and Thomale (n 161) 660.

a) Expectation of Profits

Prospected value increases have always been an essential aspect to collecting art.[196] Absent any continuous interests or dividends resulting from owning art, it needs to be discussed whether mere sales proceeds constitute a relevant element under the profit term.

The primary motive to partake in any investment agreement consists in the expectation of a positive return on investment. In this regard, profit is not only to be understood as "participation in earnings resulting from the use of the investor's funds" but includes also "capital appreciation resulting from the development of the initial investment".[197] Thus, also the appreciation of the initial investment which only accrues at the moment of resale falls within the definition of expected profits.

What generally needs to be disregarded in the context of securities are immaterial advantages such as access to use or consume an item because of the investment. In contrast to the financial nature of profits relevant under the Howey test,[198] acquiring an item for personal consumption or purely emotional gains (such as developing a piece of land, inhabiting an apartment …) accounts for a decisively different incentive for investment than the expectation of economic profits. In this context, the Supreme Court specified that "[t]his principle distinguishes between buying a note secured by a car and buying the car itself."[199] More in detail, "[w]hat distinguished a security transaction […] is an investment where one parts with his money in the hope of receiving profits from the efforts of others, and not where he purchases a commodity for personal consumption or living quarters for personal use."[200]

This clear line between financial and entertainment gain has in the recent past been softened by SEC findings revolving around the issue of digital assets such as utility tokens. An example for

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[196] P. Genco, A. Zorloni even speak of "la finanziarizzazione del mercato dell'arte", '*Struttura e dinamiche evolutive del mercato dell'arte contemporanea*', Economia e Diritto del Terziario (2017) 5; see also with regard to the investment aspect: D. Boll, *Kunst Ist Käufich* (Hatje Cantz) 84.

[197] *United Housing Foundation, Inc. v. Forman*, 421 U.S. 837 (1975) at 852; see also *SEC v. C.M. Joiner Leasing Corporation*, 320 U.S: 344 (1943), where the court rules that the sale of oil and gas leases conditioned on the promoter's agreement to drill exploratory well constituted investment contracts.

[198] *United Housing Foundation, Inc. v. Forman*, 421 U.S. 837 (1975) at 852-853, where the investors were enticed to buy shares of stock which would later entitle them to lease an apartment in a nonprofit housing cooperative. Here the court found that the investment was based on the motivation to acquire a place to live.

[199] *SEC v. Life Partners, Inc.*, US CoA, District of Columbia Circuit, 1996, 87 F.3d 536.

[200] *United Housing Foundation, Inc. v. Forman,* 421 U.S. 837 (1975) at 852, cited in Coffee, Securities, p. 306.

this tendency can be seen in the *Munchee*-case, which dealt with the following issue: Munchee was a restaurants review App, which, in order to incentivize more user-created content, distributed MUN tokens in exchange for any higher quality restaurant review. Reviewers could then, in a next step, redeem these tokens at any participating restaurant for a discount or other benefits. In addition to that, MUN tokens were also marketed to third party investors, outside the user community of the App, with the promise that "MUN tokens would increase in value as a result of Munchee's efforts" to create an MUN "'ecosystem', using the proceeds from the sale of MUN tokens", which could "be traded on secondary markets".[201] In view of the above features, the SEC concluded that the sold MUN tokens were unregistered securities tokens, despite their apparent consumptive use within the App.[202]

This finding prompts the question how situations should be classified where mixed motives underlie the investment decision, i.e., where the expectation of financial return coincides with the at least temporary consumption or use of the item. Indeed, on several occasions, courts have been confronted with this controversy – without ever establishing generally valid guidelines. A tendency can however be denoted according to which courts place an emphasis on the "primary motive" of the purchaser, i.e., determine whether the investor aims rather for profit or for consumption.[203]

In this context, apart from the sales object itself, also the promotional material issued in preparation of the transaction can give an indication as to the crucial motivation of the investor behind an investment. By way of illustration, it may make a difference whether the lots in a development are promoted as "lucrative investment opportunity" or "ideal living space".

Even if the dealt with item does not constitute a security by itself, the assessment of the deal may take a different inclination if the assets are offered in conjunction with managerial services. Such has been proposed by the SEC in its guidelines on offers and sales of condominium units coupled with rental agreements that promise a return investment through the managerial efforts of

[201] Daniel T Stabile, Kimberly A Prior and Andrew M Hinkes, *Digital Assets and Blockchain Technology - U.S. Law and Regulation* (Edward Elgar 2020) 142.
[202] Munchee Inc., Securities Act Release No. 10445 (Dec. 11, 2017), https://www.sec.gov/litigation/admin/2017/33-10445.pdf (order instituting cease-and-desist proceedings)
[203] *Rice v. Branigar Organization, Inc.*, 922 F.2d 788 (11th Circ. 1991); Coffee et al. Securities Law, 307; see also *Aldrich v. McCulloch properties, Inc.*, 627 F. 3d 1036 (10th Circ. 1980).

promoters.[204] In deciding whether the offer of a unit in conjunction with collateral services presents an investment contract, an emphasis is placed on the expected economic benefits to the purchaser. The Act stipulates that "the manner of offering an economic inducements held out to the prospective purchaser plays an important role in determining whether the offers involve securities." In particular, attention shall be awarded to the "advertising, sales literature, promotional schemes or oral presentations which emphasize the economic benefits to the purchaser to be derived from the managerial efforts of the promoter, or a third party designated or arranged for by the promoter".[205] Depending on the content of the marketing material, the association of financial gain rather than personal use may justifiably be evoked to the purchaser and thereby pushed to the foreground as "primary motive" for the investment. If such is the case, investor's protection under securities regulation is called for.

These multi-layered arguments that are to be taken into consideration in the evaluation of profit expectations paint a highly complex picture of this requirement. This is all the more true when it comes to the assessment of artworks as a form of investment contracts. Against pecuniary motives playing an increasing role in buying artworks, there can be drawn no clear line where the appeal of a work to the investor ends, and the financial motive takes over in the decision process. Unless the artwork is purchased merely to be placed in a shielded room in a freeport away from the human eye, it will be difficult to argue that the aesthetics were of minor relevance compared to the financial prognosis. Accordingly, at this point, it cannot be completely excluded nor generally assumed that the first criterion can be met in buying artworks. For a more definite answer, the conditions of each individual case would have to be evaluated.

b) Common Enterprise

In a second step, it is necessary to determine the common enterprise, referring to a common investment pool from which all investors derive shared profits and losses. This does not necessarily require the similitude or coincidence of investment input, some would argue not even the pooling of funds by multiple investors.[206] Indeed, some Circuits, namely the First, Ninth, and Eleventh Circuits, focus on the uniformity of impact of the promoter's efforts.[207] According to

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[204] SEC, Securities Act Release No. 5347 "Guidelines as to the Applicability of the Federal Securities Laws to Offers and Sales of Condominiums or Units in a Real Estate Development", January 4, 1973.
[205] Ibid.
[206] *SEC v. Lauer*, 52 F.3d 667 (7th Cir. 1995).
[207] *SEC and Exchange Commission v. Koscot Interplanetary, Inc.*, US Court of Appeals, Fifth Circuit, 1974, 497 F.2d 473.

this position, a common enterprise can also be found in a vertical alignment,[208] (as opposed to a horizontal one) in that the fortunes of investors are interwoven with the promoter's financial success in such a way that they are both depending on the efforts of the latter and share the financial risk.[209] In order to bar the finding of intertwined profits with the investor and thus, of a common enterprise, there exists the option to agree on flat fees for the promoter instead of profit shares.

This wide understanding of the common investment concept is however not shared by all Circuits; some insist upon the principle of horizontal commonality, which requires a pooling of investor funds, which goes hand in hand with a pro rata participation in profits among all investors.[210] Judge Posner emphasized in this regard in the verdict for the Seventh Circuit:

> ' The [1933] Act is a *disclosure* statute. It requires promoters and issuers to make uniform disclosure to all investors, and this requirement makes sense only if the investors are obtaining the same thing, namely an undivided share in the same pool of assets and profits.'[211]

Whether there can be sufficiently "common ground" among investors in art to be equally affected in their investment is questionable. One could for example identify common ground by focusing on the most restrictive common denominator of artworks, which would have to the authorship of artworks, or even more specific, a certain period within an artist's life. Even among the creations of a single artist, there may be important differences that delineate certain works or phases from another. For example, the different periods of Picasso (e.g. the Blue and Pink Period) may provide for a stronger correlated sub-category and therefore, possibly, for something akin to a common enterprise. Indeed, artworks by the same artist as well as those belonging to the same artistic period, e.g. impressionists, generally experience similar developments in value. The available data on art market prices indicate that as soon as an artist reaches a new all-time high at a public auction, this has a positive effect on all her/his works. The same holds true for when the artist earns international recognition, through prizes or participation in important fairs or

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[208] Mordaunt v. Incomo, 686 F. 2d 815 (9th Circ. 1982) assuming the 'strict vertical commonality' which links not only the efforts of the promoter to the investment outcome, but also the fortune of the promoter – as opposed to the 'broad vertical commonality'; Coffee Jr., Sale and Whitehead (n 187) 293.

[209] See *SEC v. Glenn W. Turner Enterprises, Inc.*,474 F.2d 476 (9th Cir. 1973); *SEC and Exchange Commission v. Koscot Interplanetary*, Inc., US Court of Appeals, Fifth Circuit, 1974, 497 F.2d 473.

[210] Namely the Third, Sixth, and Seventh Circuits, see e.g. Milnarik v. M-S Commodities, Inc., 561 F.2d 274 (7th Cir. 1972); Coffee Jr., Sale and Whitehead (n 187).

[211] *Wals v. Fox Hills Development Corporation* 24 F.3d 1016 (7th Cir. 1994), at 1019; emphasis by the author.

exhibitions. These large-scale effects of essential market events on the value of an artist's work is true not only for surges in prices, e.g., due to a sudden popularity increase, but also in the negative: a collector, whose collection consists to a substantial part of Warhol's works, would have to face a considerable depreciation of her/his assets if at a public auction an essential work by Warhol would not sell, as this would suggest market saturation.[212] Accordingly a certain degree of commonality among owners of artworks by the same artist and to a lesser extent even of the same period can indeed be assumed.

The difficulty in defining commonality in the field of art lies in the fact that works of art are fundamentally unique, therefore equality in between assets can generally not be assumed, but merely similarity. The situation is different when dealing with prints and multiples as we have seen above,[213] where the number of identical prints allows to designate a clear investor group, all of which share reliance upon the investment potential of units of the same edition. A common "enterprise" for investors can under certain conditions thus be detected also in the art context, although the delineation accounts for some difficulty which might ultimately bar the finding of a common enterprise.

c) Efforts of Others

Under the Howey test, the investment needs to be made based on a reasonable expectation of profits to be derived from the entrepreneurial or managerial efforts of others.[214] Profits have to be generated "predominantly" by others,[215] meaning through the managerial or entrepreneurial

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[212] A real-life example for this can be seen in an incident that occurred in 2009: a conversation among Larry Gagosian and Alberto Mugrabi, two influential figures in the art market, which both have heavily invested in Warhol's works (the Mugrabi family owns more than 800 of his artworks, Gagosian has significantly contributed to create the posthumous market for mid- and late career Warhols) was overheard by an associate at the Claridge's Hotel and could thus later be turned into an article by Eric Konigsberg ('The Trials of Art Superdealer Larry Gagosian', *The New Yorker Magazine – Vulture* (20 January 2013) >https://www.vulture.com/2013/01/art-superdealer-larry-gagosian.html > accessed 22 October 2022). In summary, Gagosian had been informed that two out of three works by Warhol, which were part of an auction in the evening of the same day, were probably not going to sell. Not selling these works at a public auction would have induced a detrimental effect on the contemporary art market for Warhols and the collections of Gagosian and Mugrabi. Eric Konigsberg in fact drew the following comparison: "The effect on the Mugrabis' or Gagosian's collection would be like what happens to a hedge fund with a composition overweighed to a given commodity when that commodity's price goes into a sudden free fall." Accordingly, Mugrabi and Gagosian allegedly both attended the aution and kept overbidding each other until Mugrabi was awarded both works for approximately their reserve price.

[213] At 41.

[214] 421 U.S., at 852.

[215] While the wording of the Howey test requires profits to be generated "solely" from the efforts of others, this requirement is not to be "interpreted restrictively" (*US v. Wetherald*, 636 F.3d 1315, 1325 (11th Cir. 2011) according to continuous jurisdiction so as to avoid possible circumvention of securities laws through the involvement of

capacities or care of promoters, rather than through the investors' own efforts. As long as the efforts made by others than the investor are significant in that they "affect the failure or success of the enterprise" and the investor has only minimal control over the investment's performance, exertion of some effort by the investor herself is irrelevant.[216]

The reasoning behind this requirement is to be seen in the typical asymmetrical distribution of knowledge and power among issuer and investor. With the economic fate of an investment being in the hand of another, the typical principal-agent-conflict arises. The inherent risks can be barred by the law, insofar as it comes into application via the qualification of the investment as a security.

The processes behind the creation of value in the art world are highly complex and hardly accessible.[217] Especially with regard to contemporary art, prices are influenced by well-connected intermediaries who push certain names through marketing strategies and public appearances in exhibitions, making sure their represented artists are well established in the art scene and thus, that their clients' investment and their own will be worthwhile. When delving deeper into the market, one may be left with the impression that price developments are very often subject to targeted use of market power and a well-established network, which the purchaser of an artwork can practically not control. Instead, increasing the recognition of an emerging artist is the main task of the representing gallery, which regularly has exclusive contracts with the artists. It is through strategic placements in exhibitions, media, and auctions that the career of an artist can be significantly advanced.[218]

While the role of the art purchaser is a purely passive one, the art dealer and/or gallery is expected by the investor and contractually obliged towards the artist to apply best efforts in establishing the artist's name in the market and increase recognition, in such a way that the artworks increase

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investors and is hence now read by all courts as "predominantly" by the efforts of others (see *SEC v. Turner Enterprises, Inc.* at 482).

[216] *SEC v. Glenn W. Turner Enterprises, Inc.*, at 482; see also Wen v. Willis 117 F.Supp 3d 673, 685 (F.D.Pa. 2015), quoting *Steinhardt Group. Inc. v, Citicorp*, 126 F. 3d 144, 152-153 (§d Cir. 1987)).

[217] See e.g. Bandle, 'Arbiters of Value: The Complexity and Dealers' Liability in Pricing Art' in Gabus and Bandle (n 11) 30.

[218] An example for which can be seen in a strategy described by Hillel "Helly" Nahmad, member of one of the most influential art dealing families in the word. During a panel in 2011, he explained that if he owned "ten examples of an artist ['s work valued at US $ 1 million each], and an eleventh example comes up for auction ... and [he] allow[s that work to trade for] $ 700,000, then theoretically... ten other comparable paintings are all worth $700,000". This insinuates the not an uncommon practice to keep prices (artificially) high as collector of a special artist or period, cited from: Nicole Dornbusch Horowitz, 'Price Fixing the Priceless? Discouraging Collusion in the Secondary Art Market' (2014) 66 Hastings Law Journal 331, 347.

in value over time. It thus seems as if also the third criterion, regarding managerial efforts of others from which profits may derive, can in principle be fulfilled with regard to artworks.

d) Functional Approach

The essential difference in between investing in an artwork and in traditional securities consists in the conferred rights: whereas securities traditionally grant a claim to the investor that she/he is entitled to redeem at a certain point, the contractually owed obligations from the seller of an artwork, even if sold for investment purposes, are fulfilled at the moment that property is passed. The additional prospect of the work appreciating over time is not a term secured by contract. In fact, in order not to expose themselves to liability, dealers will avoid making any concise statements in the negotiations as to the investment potential of artworks. The structure of art investments is therefore substantially different from traditional securities; however, the definition of an "investment contract" offers the opportunity to extend the concept also beyond traditional financial products, if there are sufficient indications for a palpable investment concept.

One of the central objectives pursued through securities laws is the protection of investors from having issuers and distributors of securities exploit the existing gap in knowledge and information. If anything, this reasoning applies even more in the opaque art market where price developments are barely predictable absent objective parameters. This serious deficit in transparency in addition to the increasingly speculative element in art purchases create a need for protection of art investors which in principle could be filled by financial market regulations applying to certain art sales. Of notice, the US understanding of securities does not hinge on the finding of voting rights in applying the Howey test. This constitutes an essential difference to EU law – in particular with regard to the evaluation of art as a security. While under the MiFID II security definition, the qualification of artworks had to be denied, a different picture suggests itself under US Securities laws, since the formal requirements under the Howey standard can be met with regard to certain constellations in the sale of artworks.

What also speaks in favor of this finding is the vast understanding of "investment contracts" established throughout the US jurisprudence. The approach applied by US courts in defining the term is functional rather than formal, in line with the guiding principle that "the securities laws were remedial and should be broadly construed to effect their underlying policy of investor

protection."[219] This is claimed to be valid even to the extent "that the nature of the investment property, that is the subject of the contract, [is] irrelevant."[220] Indeed, the US approach on what assets may be at the underlying of a security is far broader than that assumed in the EU, with landmark cases assuming the presence of an investment contract with regard to investment structures in e.g. unit plots of a Florida citrus grove, whisky gallons, and diamonds.[221] Based on this expansive understanding of the term, it becomes a feasible option for courts to declare an investment-type structure based on tangible property offered by a promoter, whose intent is to maximize the investor's capital, a form of securities which would consequently require SEC registration.[222] Here, again, the factual and contractual predicates of each individual case are decisive. While, in concluding, the simple sale of an artwork does *per se* not exhibit the necessary structure of an investment contract, it might do so in combination with wealth management services offered and a clear focus established by e.g. marketing material on the investment aspect of such works. Given the vague interpretation of "investment contracts" and thus, the wide discretionary powers, it remains to be seen whether a court might follow this line of argumentation; as of today, to the knowledge of the author, there has not yet been issued a holding yet according to which an artwork sold for pecuniary purposes was considered an investment contract under US law.

III. CONCLUSION

Summarizing the above evaluations, it is to be noted that the US assume a by far broader understanding of securities under the term of investment contracts compared the EU perspective, which relies on a rather formal taxonomy that encounters challenges when it comes to assessing new investment types. Nonetheless, under both jurisdictions, artworks are *per se* not considered securities, regardless of their inherent investment aspect and the other strong parallels to financial products disclosed above. However, the broad concept of investment contracts under US law in theory leaves the possibility open that art sales in particular if the works are offered in connection with management services and constitute a sufficiently clearly-defined class may under certain conditions constitute investment concepts that fall within the substance of securities laws.

[219] Holm (n 18) 414.
[220] ibid; see also SEC v. Joiner Leasing Corp., 320 U.S. 344 (1943) where land parcels where found to have been issued in the form of an unregisterd security.
[221] *SEC v. Howey Co.*, 328 U.S.293 (1946); *Glen Arden, Inc. v. Constantino*, 493 F.2d 1027 (2d Cir. 1974): *Matter of Gardner v. Lefkowitz*, 97 Misc. 2d 806, 412 N.Y.S.2d 740 (Sup. Ct., 1978).
[222] Holm (n 18) 424.

CHAPTER III –

REGULATION OF ALTERNATIVE INVESTMENTS IN ART: THE CASE OF ART FUNDS

I. INTRODUCTION

Alternative forms of investment have traditionally attracted greater attention from investors in times of financial instability.[223] The main reasons why the art market draws particular interest are the prospect of favorable risk-adjusted rates of return in combination with a low correlation to traditional investment instruments.. These incentives affect retail and professional investor alike, particularly when the stock markets are volatile and rising inflation rates are to be expected.

Generally speaking, strategic investment in art ownership can occur through any of the following four channels:

1. Direct investment in a traditional artwork
2. Direct investment in an NFT-secured artwork
3. Units of an art fund[224]
4. Tokenized fractions of a single artwork[225]

The latter two options generally do not represent direct investments but occur through the involvement of an intermediate vehicle. All of the above investment possibilities are addressed in detail in the thesis at hand, with the current chapter revolving around one of the rather

[223] See e.g. for an attempted explanation of this phenomenon with regard to art and other tangible assets Gerlis (n 16) 21.

[224] Including fund of funds structures and pooled-funds, see e.g. Eckstein and Willette (n 38) 150; the platform NFTX also provides for the option to create an NFT-Index Fund and sell fractions of it via the platform's own secondary market, see <https://docs.nftx.io/v/v1.0/archive/old-tutorials/how-to-create-an-nft-index-fund> accessed 15 December 2022, see also Barbereau et.al, 'Tokenization and Regulator Compliance for Art Collectibles Markets' 217.

[225] In the various forms that will be revealed in the course of this analysis, including fractional ownership being issued in the form of debt instruments, actual transfers of title on fractional ownership of a tangible artwork or fractional ownership of NFTs.

traditional art investment vehicles, namely art funds, which are currently experiencing a renewed momentum.

Art funds are re-emerging in the current economic situation, precisely with the promise to navigate capital through the impending economic downturn. This phenomenon is evidenced by the fact that the majority of currently active art funds has been inaugurated within the past two years or is still in its initiation phase.[226] Some have even extended their offered portfolio to embrace the latest developments in technology, e.g., by issuing tokenized membership rights[227]. In order to understand the essential role of art funds, the following section will describe the underlying investment concept, the organizational structure as well as the legal framework applicable to closed-end funds in both, the EU and the US.

With art traditionally being an investment class enjoyed by a small group of insiders and HNWIs, art funds aim to demolish this privilege by enabling a larger part of the population to gain access through pooled capital which means that only a fraction of the entire purchase price is financed by each individual investor. What is more, art funds are also set to debunk another factor typically associated with the art market and accounting for a main disincentive for investors: By concentrating the expertise and professional background of the fund's manager and art advisors, realizing financial profits out of art comes within reach even of those who admire art without having the necessary level of knowledge and experience in this sector to make an informed investment decision. As a consequence, the image of a "democratization" taking place in the art market is conveyed, i.e., facilitated access to a wider public. This trend is expected to go as far as rendering art a retail investment opportunity, similar to equities and bonds which have made their way into mainstream portfolio components over the past century.[228]

[226] See Annex I: Overview on Art Funds in the EU and the US, status as of December 2022.
[227] Such as the Artory/Winston art fund, see Annex I.
[228] See on this issue e.g. Taub: "Equities and bonds made this journey over the last century, and funds of funds are now making more non-traditional investment categories (such as hedge funds and private equity investing) accessible to individuals with smaller and smaller amounts of capital to invest. I believe that art is heading down the same road, to the eventual benefit of all investors.", cross-referenced by Horowitz in *Art of the Deal* (n 19) 160 f.

II. CURRENT STATE OF THE ART FUND MARKET

Professional investments in alternative assets is a phenomenon which emerged between the 1980's and 2000's.[229] Ever since, the art market and its various offshoots have experienced ups and downs, together with other investment categories. Generally, it can be said that uncertainty in the stock market fuels art investment trends, as art is a hard-asset, who in general have the reputation of being rather inflation-protected and crisis-resistant.[230] The number of art funds has also undergone some fluctuations, often in response to the general economic climate. As a consequence to the financial crisis in 2008, it could be observed that many funds were liquidated or restructured before maturity.[231] The Fine Art Wealth Management reported that from the estimated 40 art funds in existence before the financial collapse, only 20 endured.[232] There is, however, no absolute number as to how many art funds ceased within the past 15 years. As this type of investment structure has long been outside the regulatory scope and financial supervision, most funds did neither register with public authorities, nor did they seek public appearance, but preferred to address HINWIs privately.[233] Accordingly, the total number of art funds in the world has always been in the unknown.[234] This phenomenon has been described by several authors,[235] one of which endeavored to provide a list of all existing art funds in his publication from 2011: Noah Horowitz rightfully observed that "any summary overview is bound to at least a moderate degree of imprecision" due to "the majority of these funds [...] [being] unregulated and highly discreet – even biased – about the information they reveal."[236] This compilation, being the "most accurate snapshot of these investment vehicles at the time of writing",[237] served as a basis for the collection of data on art funds which is shown in Annex I, that provides for an overview of today's art funds in the US and the EU and their essential business information.

[229] Gerlis (n 18) 27.
[230] ibid 21.
[231] Horowitz (n 19) Introduction to Appendix C.
[232] Referenced by Gerlis (n 18) 133.
[233] In the case of the first Maecenas offer on "14 Small Electric Chairs", a total of 100 investors was invited to bid on fractions of the artwork which together amounted to 31.5 % of the total value, see Anthea Buys, 'The New Fabric of Everyday Life', *Kunstkritik* (7 April 2020), <https://kunstkritikk.com/the-new-fabric-of-everyday-life/> accessed 13 November 2022.
[234] Daniel Grant 'Secrets of the Fine Art Funds' *artnet* (22 November 2011) <http://www.artnet.com/magazineus/features/grant/fine-art-funds-11-22-11.asp> accessed 10 October 2022.
[235] Campbell (n 18) 64; Gerlis (n 18).
[236] Horowitz (n 19) Introduction to Appendix C.
[237] ibid.

Out of the 36 funds that Noah Horowitz listed in his book (10 of which had already terminated their business activity by 2009), only 5 funds respectively their management companies still exist at the time of writing, of which 4 are included in the Annex I due to the geographical restriction of this research. In total, there are 18 art funds in the EU and the US that are still in business or have been dissolved within the past 2 years (since December 2020). The distribution is surprisingly equal, with 9 funds being located in each region. Some belong to the same holding structure which exercises control of more than one fund at the same time, as is the case with the *Anthea* group in Luxembourg or *Yieldstreet Management* in the US.

Naturally, the primary motive for investors to participate in a fund are long-term value preservation, risk diversification with regard to an existing investment portfolio and of course the expectation of a significantly positive, inflation-adjusted rate of return.[238] With regard to art funds, there is however no guarantee on the projected rates of return. In fact, white papers generally include the indication that past price performances in the art market cannot represent predictions for the future. From a historic-empirical view, return rates vary drastically; while some funds have been reported to have generated as much as 17,07% average net annualized return over a 5-year period,[239] many others have failed altogether,[240] especially as a late consequence of economic crises. The sector is ravaged by the loss of trust from investors who were testimony to managers making poor decisions, causing many of the funds to unwind even before the first artwork was bought.[241] The regulation concerning art works has changed, however, since the financial turmoil in 2008. It remains to be seen whether this will also have an impact on the economic performance of this kind of alternative investments. Before the main regulatory instruments under today's financial market law will be outlined, however, the business structure of art funds shall be outlined.

[238] Martin Wilson, *Art Law and the Business of Art* (Edward Elgar 2019) 333.

[239] Such as the Artemundi Global Fund, which was established in 2010 and dissolved with a net return of 85,36% in 2015 (see Artemundi, 'Global Fund's Up-to-Date Information (2010-2015) FINAL' < https://artemundiglobalfund.com/financials/> accessed 10 December 2022).

[240] Alessia Zorloni, *The Economics of Contemporary Art* (Springer 2013) 153; Chiara Zampetti, '"Art Funds". Benefici e Difficoltà' [2007] Analisi Giuridica dell'Economia 187, 191; see also e.g., Fernwood Art Investments, one of the most promising funds in the beginning of the 21st century, was dissolved shortly after its initiation.

[241] E.g. the Castle Apollo Fund, which was launched in 2008 and abandoned as a project in 2009; another quite prominent figure in the art fund landscape which contrary to great expectations of the public had to be dissolved before it could even properly commence operations is the case of the Fernwood Art Investment Fund.

III. BUSINESS CONCEPT OF ART FUNDS

The economic success of an art fund depends primarily on the capability of the acquired assets to increase in value over time. Accordingly, the ultimate objective consists in acquiring high-potential objects that will generate a positive return at resale after the holding period. To achieve this goal, art funds and their managements have to exploit the arbitrage opportunities in the art market, i.e., use the lack of official information and opacity to their own advantage in buying at a below-market price and selling at an opportune moment.

At the outset of each new art fund, the alternative fund manager first has to define the target market and clientele and the company form as well as country where the main business shall be located. Also, the target duration is pre-determined upon initiation of a fund and usually varies between 3-10 years,[242] thereby allowing the artworks to increase in value. The life of the standard art fund can be divided into three phases: the respective periods for raising funds and selecting potential works for the portfolio, the acquisition and holding of artworks, followed by their resale and profit distribution.

1. Company structure

In view of the pre-determined duration of an art fund, most are closed-end funds. Whereas open-ended funds allow for the intake of further investors as well as the withdrawal of existing ones during the life of the fund, in closed-end funds, as the name implies, an admittance freeze for new investors is enforced after the initial capitalization phase. The majority of investment funds worldwide are open-end funds, which can sell as many units to investors as necessary. Conversely, the number of investors – and thus units – in closed-end funds are usually limited. Investors are generally hold to their commitment until maturity of the investment, i.e., until the liquidation of assets and subsequently the dissolution of the fund. With open-end funds, on the other hand, investors are granted the right to redeem their units at any time with the issuing fund.[243]
The exclusion of early redemption by investors does not prevent closed-end art funds from reacting to short-term market variations by selling some of their works and reinvesting the sales

[242] See Column "Target Duration" Annex I; only two of the funds listed have assumed an open-ended approach, both of them representing rather untypical structures.
[243] Exceptions exist for open-ended real estate funds, which due to their illiquid assets may limit the redemption occasions for investors.

proceeds in additional works. Occasionally, also hybrid forms can be observed; while they are generally akin to close-end funds, the possibility to liquidate their invested capital is kept available to investors, although generally contingent on prior notice and often linked to a withdrawal fee.

Art funds are a form of pooled investments under the management of an internal or external management. There is no rigid company structure for art funds. Instead, alternative investment funds are free to adopt any corporate form they want. Private equity, real estate and hedge funds may serve as templates regarding the structuring. The most common form in the US and the EU are limited liability companies as well as partnerships.[244] Art funds in the US are typically set up as a limited partnership (LP) or in the form of a limited liability corporation (LLC). In this regard, art funds possess strong parallels with the traditional hedge fund. In line with this, the structure of the typical art fund consists in a managing general partner or partners on the one hand and the investors as limited partners on the other. As for the general partner, special purpose vehicles (SPVs) are regularly the means of choice. Instead of offering stock, as corporations would do, an LLC offers memberships, an LP interests in their business entity. In variation of a simple two-tiered limited partnership, complex structures can be created to meet the specific requirements for the intended scope of the fund. For instance, so-called master-feeder structures can frequently be observed. This kind of construct is generally employed for funds which intend to pool investment from US and non-US investors into the (master) fund. Accordingly, the feeder caters to US-residents and -tax-eligible investors and buys into the master fund, whose other limited partners consist in overseas investors. An example for a more complex company structure is given below, where the US feeder fund invests in the master fund which is established according to EU-law.

[244] According to each country's national company law; e.g. in Luxembourg, most art funds are constructed as common limited partnership but may in theory also assume the company form of S.à.r.l. and others, see below; in Italy S.p.A, in Germany AG, in Spain SA and SL; in the US LLC.

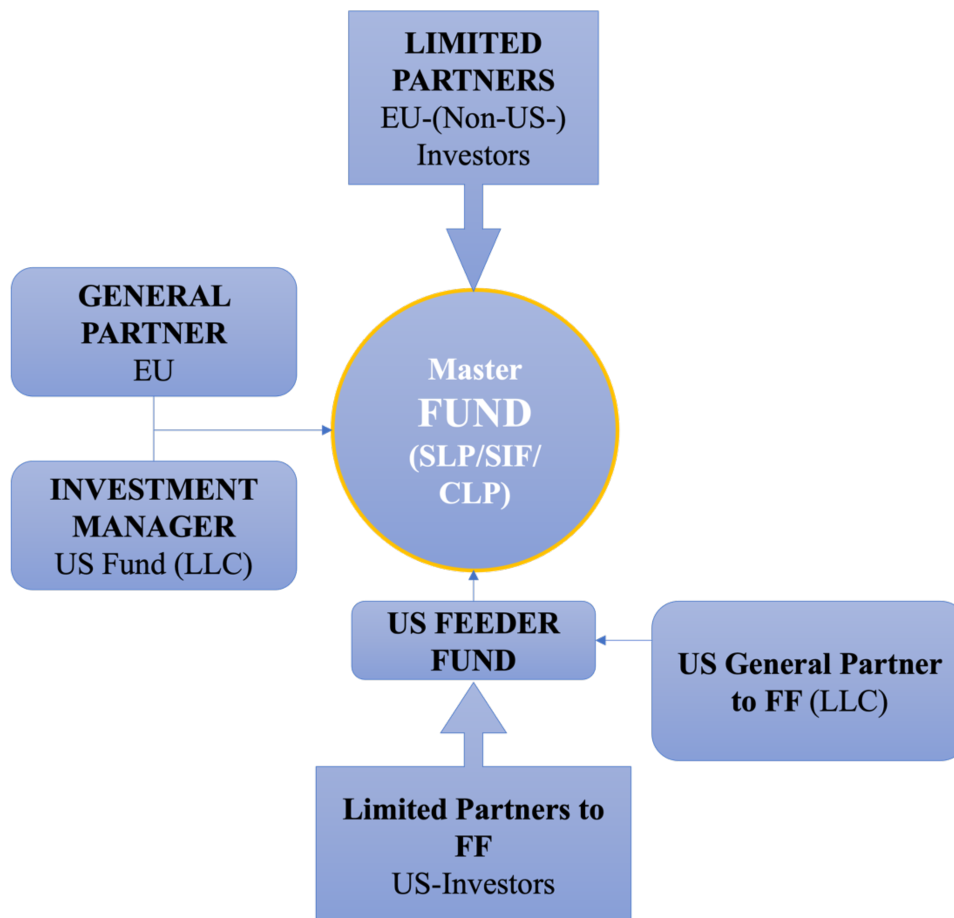

Chart III: Structure of an EU-US Art Fund with Feeder-Fund in the US

It is most common to have external fund managers for each fund, which is usually a legal person associated with the fund or the "umbrella" undertaking that has previously set it up. This structure provides for the advantage of a consistent management organization even throughout the life span of several funds and can hence demonstrate due experience to investors in handling their capital. The art fund manager is often considered an investment adviser to the fund, given that it falls within the manager's discretion to decide which objects to buy and when. Art fund partnerships or memberships are traditionally marketed directly to the investor, without any intermediary involved. Art funds and their management do not act as broker-dealers, but instead investment requests are placed directly through the online platform, which is sought out by potential investors.

What is also of relevance in the context of incorporation is the pertinent legal framework under which the fund is supposed to conduct business and therefore be taxed. Some art funds, despite offering local services at their US or EU offices, are registered in offshore domiciles, e.g. Cayman Islands, the British Virgin Islands and Bermuda. Off-shore funds may adopt various master-feeder

formations, also typically taking the form of a limited partnership but under the offshore country law. The density of art funds domiciled in Europe is particularly high in Luxemburg, where the jurisdiction as well as an attractive tax regime have created a seemingly investor-friendly climate, which allows funds to "optimize their investment returns".[245] In the US, the state of Delaware is chosen by many companies who consider the applicable state laws to be pro-management and where extensive case law has been formed by the local Courts experienced in adjudicating in corporate law matters.

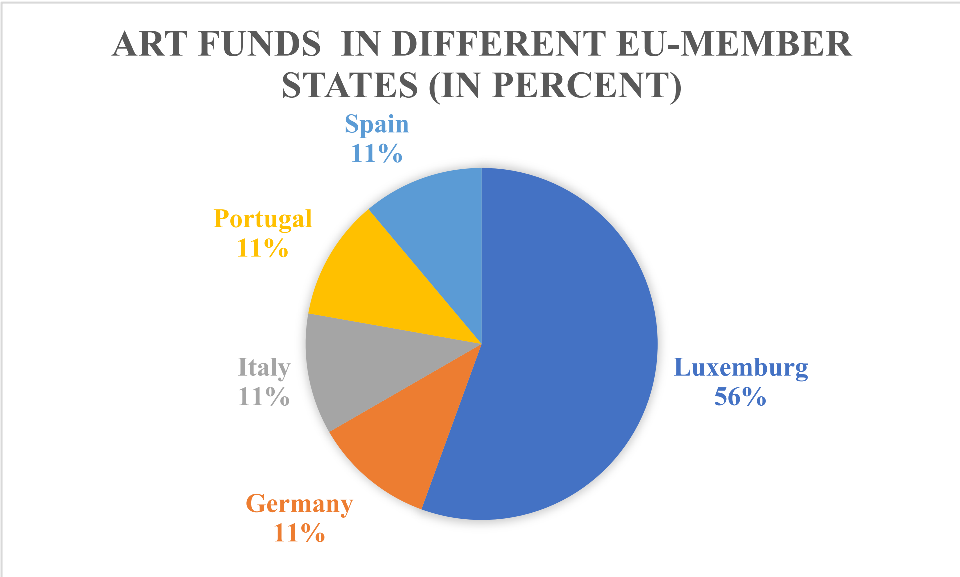

Chart IV: Percentage of Art Funds Established in Different EU-Member States

2. Course of Business

Potential investors are given a rough business plan e.g., in the form of a private placement memorandum, which includes central information on the subject orientation of the fund's portfolio, the requirements for investors as well as targeted annual return rates. As can be detected from Annex I, funds set their potential return rates usually between 10-18% in investment per annum, calculated over the entire timespan of the fund until maturity. These numbers are generally based on art indices and the past market performances of the included artists.

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[245] Horowitz (no 19) 149.

The recruiting process for new investors does not consist in a formal initial public offering (IPO), but is far less accessible to the general investing public. The reason for this can be seen in the legal exemptions provided to certain fund structures, which allow them to evade certain obligations relating to the publishing of a prospectus and disclosure, all aspects of which will be discussed in detail further below.[246] Since the manager does not receive any commission for the sale of interests in the fund, there is no direct incentive to address a large number of investors. However, the more capital is available for investment by the manager, the easier it becomes to purchase high-end artworks that are less volatile.

In general, the window for new members to participate in an art fund extends only to the first year or the first two years of the fund. It is followed by the investment period, when the obtained liquidity is used to purchase promising art works, that correspond in style, sales price, and, most importantly, expected increase in value to the investment strategy of the fund. This phase may take up a period of several years, thereby allowing the fund's management to exploit potential market fluctuations and sector trends. Art funds are commonly prefunded, and thus do not use any leverage. In preparation of the purchase, extensive due diligence on the object of interest can be expected from the fund managers, respectively hired (external) advisors.[247] In an attempt to combine securing values with high potential for profitability,[248] most art funds consider only widely recognized, so-called "blue-chip" artworks. Blue-chip artists are established names in the art scene whose work consistently sells for high values. Although there is no concise threshold as to the price achieved at public sales or the longevity of rising or constant value, blue-chip artists are commonly recognized if their six-figures exceeding prices prove to be resilient for at least over a decade.[249] Other funds however may have a different focus and include mid-career and emerging artists in their portfolio, thereby opening up the fund to higher financial risk but also,

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[246] See below 83.

[247] Horowitz (n 19) 150, 178: "Unlike senior management and administrative support teams, the art buyers tend not to be on the firm's monthly payroll. Instead, they usually receive commissions for placing work with the fund as well as carried interest in the fund's performance. Art advisors may also intermediate between the buyers and management; these are often either critics, academics, or retired art market specialists used to provide objective oversight on trading decisions."; "most art funds – unlike hedge funds and private equity funds – do not have exclusive relationships with their traders. Instead, they tend to buy and sell through dealers who are also active in the market independent of the fund. They then attempt to align the interests of these hired hands by offering them financial incentives to place work with the fund. FAF, for instance, offers its art buyers an undisclosed annual consultancy fee [...] and a portion of the carried interest at the end of the fund's life."

[248] "Securing values" may be a bold term to use against the volatility of the art market; however, art indices who include the last 100 years show that above a certain threshold, values continue to persist in the art world, even throughout decades.

[249] Yieldstreet, 'The Differences Between Blue-Chip, Mid-Career, and Emerging Artists', <https://www.yieldstreet.com/blog/article/the-differences-between-blue-chip-mid-career-and-emerging-artists/> accessed 24 October 2022.

offering a different aspect to their investors, since the pecuniary motive is complemented by the endeavor to support the cultural sector and its creators.[250] The terms "mid-career" and "emerging artists" are not used in reference to the artist's productive life, but instead, describe different levels of recognition among art market participants.[251] Mid-career are artists who have received some attention by local or national media and collectors. Their artworks are already a few in numbers and exhibit a personal style recognizable by the well versed and connected part of the audience.[252] Usually, mid-career artists are represented by a gallery and have been part of some solo or group exhibitions. Emerging Artists are the "newcomers" on the market; they have only recently been included in group exhibitions and generally still lack an affiliation with a gallery. Their artworks have entered the art market that recently that they are not yet sold on the secondary market.[253] While price stability increases with the degree of established recognition, the potential for extraordinary price jumps behaves inversely: of course, the ideal scenario for funds would be to buy an emerging artist during her/his early phase at a low price and sell a few years later when the artist has gained popularity and has had a few public breakthrough sales.

Given that contemporary art is particularly fit to reflect sociological changes and respond to current events, some art funds intercept artistic movements and strategically build their investment strategy around emerging market segments, thereby anticipating or responding to the interest of the public. In the 2020's, a strengthening social justice movement has found its expression in drastically increasing demands in works by artists belonging underrepresented minorities in the art scene and has contributed to an exponential increasing in market prices in this sector.[254] As an example, a US-American art fund has recently been established which is

[250] There are a few art funds that do not operate the way describedd above, but instead have put an emphasis on the support of the creative culture and artists. Their primary motive for accumulating funds does not consist in generating positive returns but rather in subsidizing promising new talents who do not yet have a gallery representing them or a platform. Also, there are charity art funds, such as the British "Art Fund" (see <https://bigbangartfund-assets.s3.eu-west-2.amazonaws.com/about-us/annual-report/af_annual-report2018_full_catalogue.pdf> and <https://www.artfund.org>), the Bank of Ireland Begin Together Art Funds (<https://personalbanking.bankofireland.com/campaigns/begin-together/begin-together-arts-fund-webpage/>, all accessed 20 October 2022); these non-profit organizations shall not be subject of the chapter at hand.

[251] See e.g. Yieldstreet, 'The Differences Between Blue-Chip, Mid-Career, and Emerging Artists' (no 249).

[252] ibid.

[253] The art market can generally be divided into the primary and the secondary market. Whereas on the primary market, art works are sold for the first time, i.e., by the artist or the representing gallery, on the secondary market the resale of artworks occurs, e.g., via dealers, auction houses or private sales.

[254] Artprice (n 9) 36, 40.

constituted by works of artists from the Harlem neighborhood of New York, thereby offering a specific platform for younger and underrepresented artists.[255]

The foundation for a positive return rate is laid at the point of purchase. It is essential to strike the right balance between pursuing the lowest possible purchase price while at the same time keeping up a stable market value for the artist so as not to influence her/his market recognition negatively. The preferred "hunting ground" for art fund managers and art advisors are private sales. Conversely, art funds almost never buy at public auction due to the commission that is charged by the auction house, which usually amounts to around 25-30%.[256] Given the incentive to keep profit margins at resale as high as possible, a purchase is best effectuated at discount, e.g. by a "package deal".[257] Most art funds nowadays rely on third-party appraisers who are hired to perform the market and value analysis according to Uniform Standards of Professional Appraisal Practice (USAP) prior to any purchase.[258]

Subsequently to the acquisition period is the holding and consolidation phase. In principle, art funds concentrate their purchases to a period at the very beginning of the fund and engage in resale only close to the termination of the fund. In practice, however, some art funds continue to acquire and sell works throughout their whole existence to balance unfortunate sales or meet redemption requests.[259] In any event, art funds do not generate any liquidity during the holding period which could be yielded to investors in a way similar to dividends. Any proceeds received before the closing period are generally directly re-invested. Thus, investors do not receive any interim payments, but it is only following the liquidation of the fund's property that outstanding obligations are settled, and any remaining profits distributed among investors.

The managers of the fund are entrusted with incessant responsibilities throughout the lifetime of the fund; even the holding period is far from an idle phase. The aspiration to generate profits

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[255] Yieldstreet Art Equity Fund II, see for more Information Annex I; In this context, it shall be pointed out that the Art 4 Africa Fund by KIISA which aimed at promoting African artists could not be included in Annex I as there has been insufficient data available to the set-up of the fund, and several attempts by the author to contact the fund went unanswered.

[256] Although correctly, in proper auction terms, the commission paid by the highest bidder is referred to as "buyer's premium"; for an exemplary chart on the amount of the buyer's premium, see e.g. at Sotheby's: <https://www.sothebys.com/1-february-2021-buyers-premium.pdf> accessed 20 October 2022.

[257] See e.g. Artemundi 'Global Fund's Up-to-Date Information (2010-2015)' < https://artemundiglobalfund.com/financials/> accessed 13 November 2022.

[258] Yuvan Kumar, 'Artemundi: global art fund turned fund manager' *Private Art Investor* (14 February 2020).

[259] See e.g. Yieldstreet art equity funds, according to their promotional material provided to investors.

requires the management to enhance the value of the assets beyond the general projected market growth rates. This is to be achieved through strategic placements in exhibitions, promotion, inclusion in art historic studies, and other strategies that increase the visibility of the works to the public and boost their provenance. In order to exploit trends and predict the best moment for divesture, the market needs to be constantly monitored and sociological developments as well as advancements in provenance research checked. It is during this stage that the art fund manager's understanding of the art world and connections in the art scene can be rendered fruitful e.g. in form of curatorial engagements. Such a practice, in addition to increasing the popularity of the artists, also accounts for the pleasant benefit of the lender assuming permanent expenses that come with storage and insurance.
Alternatively, some art funds allow their investors to take works of the portfolio home during the holding period,[260] often in return for a surcharge. Lastly, it is not uncommon for artworks to be stored safely in high-security compounds with constant control of temperature and humidity (freeports), while waiting for the market to take the predicted upswing.[261] Some funds go as far for their investors as to offer guided visits of the artworks and/or getting to know the artist herself.[262]

It is usually not before the third year after the fund's initiation that divesting is considered, also to allow the work to amortize the not so little transaction costs that usually form part of a sale (e.g., intermediaries' commission).[263] For most funds, the pre-defined lock-in period lasts between 3 to 10 years.[264] This term may be extended for up to two years (or repeatedly for one year), thereby allowing the management to react flexibly to market fluctuations.

As proceeds are realized from the sale of the assets under management, in a first step, the expenses of the fund, management and servicing fees are settled. It is only afterwards that investors will receive their principal, i.e. their capital contributions are returned. Management is awarded an annual handling fee for supervision amounting to 2% of the overall investment. Other than that,

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[260] Such is the case e.g. with The Collectors Fund; also, the very first documented art fund "La Peau d'Ours" allowed its members to take artworks home , see Frye (n 56) 121.
[261] See for more information on the issue of art stored in so-called freeports John Zarobell, 'Freeports and the Hidden Value of Art' (2020) 9 Arts 117, 117.
[262] E.g. Yieldstreet for some of its art equity funds.
[263] Of course, if the market is particularly "enthusiastic" about a certain work or artist among the portfolio, management is generally granted the discretion to seize sale opportunities even before the official liquidation period has started.
[264] See Annex I.

recurring fees include administrative and maintenance costs, costs for insurance, transport and appraisals.[265] If any profit remains at this point, the realized surplus is paid to the investors proportionally to their share and up to the percentage equaling the target margin. Beyond that, the manager is issued the performance fee, which usually accounts for 20% of any profit above the target annual return. As an example, if the target internal rate of return (IRR) was set at 15%, and the total sales proceeds exceeds the target by 5%, one fifth of the remaining 5% would be attributed to the management as additional incentive for structured planning and handling of the assets.
The repayment of the principal is contingent on the sufficient capital influx due to resale. Given the differentiation between the fund and the management company, the insolvency of the latter should not regard the investor's claims. Investors are thus only exposed to the market risk concerning the underlying assets. Accordingly, investors may receive less than their capital contribution if the assets under management perform below expectations.

Investors are in the vast majority of cases required to hold their participation in the fund to its maturity; early redemption rights are generally excluded in the investment contract, as are secondary sales.

3. Business case: Art Funds

As indicated above, it is hard to come up with a definite number on how many art funds are currently in existence in the US and Europe. The overview provided in the Annex I table can only give an estimate, as many art funds prefer to engage privately with investors instead of rendering information available to the general public. In order to illustrate the abstract information given above, two art funds shall be introduced more in detail by outlining their investment structure and portfolio management.

[265] See also Horowitz (n 19) 151: pay a "2 and 20" fee: the fund's management company deducts 2 percent of committed capital per year to cover overhead and operational costs and also takes a 20 percent performance fee on earnings, usually above a hurdle rate of between 6 and 8 percent.

a) The Guernica V. Fund

Artemundi was founded by its current CEO Javier Lumbreras in 1989 as an art-focused investment company.[266] It offers a wide range of investment vehicles, including NFTs on one of Goya's works, co-investment opportunities where several parties may agree to pool their capital to purchase a specific artwork,[267] professional collection building, a non-profit museum fund as well as fractional ownership in art represented by so-called art security tokens.[268] *Artemundi* announced the launch of the *Guernica V. Fund* in April 2021. The target volume for this fund is set at $200 million. The *Guernica V. Fund* is specifically designed to help investors protect values in times of "current health, economic and political crisis".[269] This is significant in two ways: first, artworks are acquired predominantly in "distressed sales driven by the current economic crisis"; second, this fund shall allow investors to "transfer some liquidity into an asset well-suited to preserving and enhancing wealth in times of extreme uncertainty."[270] According to Javier Lumbreras, "museum-quality artworks on the secondary market have a track record of constant appreciation. They are unrelated to financial markets and macroeconomic effects, and their long-term value is invulnerable to financial crises, regardless of their duration or severity. Even in war-like scenarios, art offers wealth protection."[271]

The *Guernica V. Fund* is structured as a closed-end fund, with the master fund being located in Luxemburg (as an SLP) and a feeder fund in the US (as an LP). Each fund consists of a general partner with the investors being attributed the role of limited partners. The Investment Manager is *Artemundi V Funds*, a US LLC. The fund's duration is set at 3 years,[272] with a targeted minimum internal rate of return of 17% (net of fees and expenses).[273] The management will be granted a performance fee of 20% if the profits or realized gains exceed the return benchmark of 6%. The

[266] Interview with Javier Lumbreras, CEO of Artemundi, on 29 September 2022 (transcript with the author).
[267] Artemundi Website, <https://artemundi.com/about-us/> accessed 1 December 2022.
[268] The nature of fractional ownership in artworks will be covered in detail in the next chapter.
[269] Artemundi, Guernica V Fund Partners LLC, 'Pitchbook: The Guernica V. Fund' (2021), <https://artemundi.com/wp-content/uploads/2021/02/pitchbook-the-guernica-v-fund.pdf> accessed 1 December 2022.
[270] Ibid.
[271] Maria Adeliade Marchesoni, 'Artemundi lancia Guernica V. Fund' *Il Sole 24 Ore* (11 April 2021) < https://www.ilsole24ore.com/art/artemundi-lancia-guernica-v-fund-AECvrE?refresh_ce=1> accessed 1 December 2022.
[272] A period which may be extended one additional year.
[273] This number is an assumption of Artemundi and shall, according to the Pitchbook, "not be considered a projection, forecast, guarantee or other indication of future performance."

Guernica V. Fund, and *Artemundi* in general, distinguish themselves from competitors by the selection of artworks: *Artemundi* only invests in blue-chip artworks with a stable track record, which generally excludes new or emerging art. Javier Lumbreras explains this strategy as follows: "I don't consider contemporary art for the following reasons: the artists are alive, production can vary, taste can change, collectors go somewhere else. When you look at masterpieces, they need no introduction, and they already have solid track records. You can take a painting that has sold 5 times over the last 50 years and check on those results that over the course of the years the work has an ROI of e.g., 12% [...] It is not the track record of the manager, it is the paintings own record."[274] In line with this, the *Guernica V. Fund* considers works by the following artists: Picasso, Matisse, Gaugin, Pollock, Rothko, Basquiat, Richter. The average price for a work to be acquired shall be above USD 1 million, with at least USD 250,000 to be spent on a single artwork. The minimum investment for each investor accounts for EUR 170,000 or USD 200,000; only accredited investors are accepted, including family offices. Once the KYC and AML (including UBO) examination have been conducted for each potential investor and the Due Diligence on the work to be acquired is completed, the agreed capital commitment will be drawn and invested, in exchange for limited partner interests being issued to the investors. Interestingly, *Artemundi* envisages to include also institutional investors. This strategy is pursued in particular with regard to fractional ownership investment concepts, since this method is set to provide an increased level of liquidity and traceability compared to other art investment models, such as the long-term art fund involvement, so that it invites even "institutional investors [...] to start looking at this more carefully."[275]

b) The Art Equity Fund II

Yieldstreet is one of the largest online investment platforms in the US with more than 403 offerings and more than USD 3 billion invested in total on the platform. *Yieldstreet* acquired in 2019 what was known before as *Athena Art Finance*, a company founded in 2015 in New York City by the Carlyle Group as an independent specialty finance company, which provided asset-based loans collateralized by high value fine art. *Yieldstreet* offers a broad range of alternative investments – going beyond the art sector to include also investment opportunities relating to real estate, insurance, debt portfolios and many others. The *Athena*-branch continues up until

[274] Interview with Javier Lumbreras, 29 September 2022 (transcript with the author).
[275] ibid.

today to provide investment opportunities based on diversified art-backed loans. What is more, a portfolio of art equity funds allows investors to invest in diversified pools of artworks by contemporary artists. This investment form is in fact a quite recent model within the *Yieldstreet* enterprise, as it was offered on the platform for the first time only in 2021. According to Rebecca Fine, Managing Director and Head of Art Investments at *Athena Art Finance* and *Yieldstreet*, the first offered fund was reappraised six months after the acquisition period and had at this point already increased by 24.3% in fair market value.[276] In order to participate, any potential investor to *Yieldstreet* first needs to register and go through the KYC and AML verification procedures, where also the financial and professional background is established, to allow for a client to be allocated to a certain investor category.

With the *Art Equity Fund II*, *Yieldstreet* in cooperation with *Athena Art Finance* pursue a somehow unusual approach, in that only works made by "artists who have been influenced by a century of experiences in Harlem, NYC" are included,[277] namely Glenn Ligon, Alice Neel, Faith Ringgold, and Norman Lewis. The fund was launched in January 2022 with 4 artworks, one by each of the artists above. In June 2022, its AUM amounted to USD 7.2 million.[278] The fund shall be in existence for 5 years, with the option to extend twice for 1 year. Even before the final period, *Yieldstreet* may sell artworks at a particularly opportune moment. In this context, it is essential to note that in addition to the artwork appreciating over time, there is yet another reason why artworks should be kept for a minimum of a few years, according to Rebecca Fine: "Part of the reason that we've had such success sourcing from the best dealers, galleries, etc. is that they understand that we are not 'flipping' the artworks.[279] It's tough to get collectors to sell artworks to a fund if there's real concern that the artworks are going to be just 'shopped'." Interestingly, *Athena* does not reveal the exact title of the works to its investors.[280] Instead, according to Rebecca Fine, "we show our investors very close comparable works, and there are some very good reasons why that is the case: [there are funds that] are not only exposing the artwork but they're publishing the acquisition price, marking it up and then basically shopping it from the time they buy it.

[276] Interview with Rebecca Fine, Managing Director, Head of Art Investments at Athena Art Finance and Yieldstreet, on 27 September 2022 (transcript with the author).
[277] Yieldstreet, 'Art Equity Fund II – June 2022 Investment Update' (June 2022) <https://cdn2.yieldstreet.com/wp-content/uploads/2022/06/20155759/Art-Equity-Fund-II-June-2022.pdf> accessed 1 December 2022.
[278] Ibid.
[279] "Flipping" is a term used in the art world to describe the quick sale and resale of artworks in an attempt to maximize profits arising from the opacity of the network, see more to this point: Alina Cohen, 'Why "Flipping" Art Is so Controversial', *artsy* (10 February 2020), < https://www.artsy.net/article/artsy-editorial-flipping-art-controversial> accessed 25 October 2022.
[280] With only very limited exceptions, see e.g. 'Last chance to invest in Banksy' (4 May 2022) < https://www.yieldstreet.com/blog/article/last-chance-to-invest-in-banksy/> accessed 2 December 2022.

Provenance really matters and at the moment, it is not considered "sexy" being a part of an investment fund's portfolio, although I think it's increasingly becoming more acceptable. The truth is that if you know that the work is owned by a fund, that has as primary objective investment returns, the conversation revolves automatically about that and about price." Accordingly, not publishing certain information, namely the work's identity, is a way of protecting the investors' interests. On the other hand, investors are kept closely up to date with regard to the economic development of their investment: *Athena* regularly performs re-appraisals of the managed artworks, so that investors receive an update on the fund's performance every 6 months. The target return of the *Art Equity Fund II* lies between 13-17%.[281] Generally speaking, the minimum investment of *Yieldstreet's* investment vehicles starts at USD 10,000, with exceptions like the *Prism Fund* where at least USD 2,500 is requested from each investor. The latter is also the exception in terms of investor qualification: the *Prism Fund* accepts also non-accredited i.e., retail investors; conversely, for the *Art Equity Fund II*, only accredited investors can become involved, if they invest between USD 10,000 - 1 million. According to Rebecca Fine, "typically, [the art equity funds'] investors have not yet invested in physical art" but are generally curious about art and financial diversification.

Due to its experience in art lending, *Athena* has collected an extensive data set on essential information on artworks. On this basis, the manager of the fund "look[s] at the CAGR, the compound annual growth rates of each artist, that we [*Athena*] consider introducing to the fund before we invest. We work with totally independent fine art appraisers; we do not conduct any appraisal internally, although we would have the expertise. It is really important to us that we remain unconflicted. In my opinion, that is was has plagued the industry for so long."[282]

IV. REGULATION OF ART FUNDS

Art funds have for a long time evaded registration duties with financial authorities. It is only since 2013 that managers of art funds marketed in the EU are subject to specific legislation which establishes certain minimal behavioral obligations in terms of reporting, disclosure, and fair treatment of investors. Due to the scarce applicable regulation as well as the complexity of the underlying assets usually dealt with, art funds have traditionally addressed and attracted exclusively HNWIs or financially sophisticated investors. This might however be currently

[281] According to the investor's information material, there is no guarantee that the target return estimated by Yieldstreet will be achieved.
[282] Interview with Rebecca Fine on 27 September 2022 (transcript with the author).

changing principally as a consequence to the use of emerging technologies in the investment context. Art funds have declared their investment model to contribute to the "democratization" of art as an asset class and accordingly, even retail investors may be granted access to this formerly exclusive form of investment.

Art funds, or generally all investment funds who do not concentrate their business on securities and other financial instruments, but instead on non-conventional investment categories such as commodities and collectibles, fall under the category of alternative investment funds (AIFs). The current chapter focuses on art funds whose investment strategy is concentrated on the purchase, holding and resale of individual tangible artworks.[283] These, as we have noted in the previous chapter, are not (yet) recognized as financial instruments.

There are different "layers" to the regulation of alternative investment funds. To assess the exact level, each specific case needs to be analyzed in view of the actual numbers, corporate structures and of course the national law of the home and host state. Only because, as in the case of the European Alternative Investment Managers Directive, there is specific legislation, one cannot simply assume that the respective art funds are bound to comply with the full extent of organizational and protective measures installed through the regulations. Instead, art funds often remain within the confines of statutory exemptions. As we will see, both US and EU regulations stipulate exceptions to the general authorization and disclosure rules for funds that are considered of less relevance with regard to the systemic market risk. The crucial threshold in this matter is attached to the overall assets under management (AUM) and/or the qualification of investors. Given that with art funds, the AUM generally remains at a relatively low value compared to that of hedge funds and venture capital funds,[284] the legislative incentive to regulate art funds is limited, even more so if only financially versed or secured investors are admitted as investors.

The analysis of the respective framework legislation concentrates on the pertinent regulations for art funds,[285] which in the case of the EU means that in addition to MiFID II also the relevant

[283] Although some of the included examples in Annex I also include NFTs in their portfolio.
[284] With a range of AUM generally between EUR/USD 10 and 100 million, see Annex I.
[285] This chapter does not aim to provide a comprehensive treatise on all regulations that may be of relevance for AIF-management but focuses only on the explicitly named legislative acts.

AIFMD is under scrutiny. Indeed, in order to establish the terminology, the AIFMD shall serve as starting point for the following analysis.

In the second subsection, the US regulations will be examined in view of their applicability to national art funds. Absent a specific legislative body that comprises all investment-related provisions on alternative funds, we will consider the relevant statutes within general financial market and securities laws.

1. Regulation of Art Funds in the EU

a) AIFMD

aa) Scope of Application

At an EU level, regulation of alternative fund managers has been harmonized through the AIFMD and the pertaining Level 2-measures according to its Art. 16 para. 11.[286] The AIFMD constitutes the counterpart to the Directive on Undertakings for Collective Investment in Transferable Securities (UCITS-Directive).[287] In line with its "catch-all but UCITS"-nature,[288] the application scope of the AIFMD is as broad as to include in theory all collective investment undertakings, across all market segments, regardless of each undertaking's contractual or corporate set-up and their character as open- or close-ended fund.[289] Examples for AIFs include hedge funds, private equity funds, and real estate funds. [290] This negative delineation from undertakings for collective investments in transferable securities (UCITS) and accordingly the scope of the pertinent Directive occurs primarily through the postulate of the eligible investment assets, which for UCITS consist in transferable securities and defined money market instruments.[291] Another practical difference in UCITS and AIFs consists in the lock-in period for investors: the so-called

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[286] Which consist in detail in the Commission Regulation (EU) N 231/2013; Commission Regulation (EU) No 447/2013; Commission Regulation (EU) No 448/2013; Commission Regulation (EU) No 694/2014; the cited Articles refer to the current version of the AIFMD, version dated 2 august 2021, valid as of September 2022.

[287] Directive 2009/65/EC of the European Parliament and of the Council of 13 July 2009 on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS) (UCITS I-IV: Directive 85/611/EEC UCITS I - 2009/65/CE UCITS IV).

[288] No financial market, no financial product and no player in the global financial markets should remain unregulated in the future, was the central conclusion drawn by policymakers in the aftermath of the global financial crisis of 2007 to 2009.

[289] Art. 4 para. 1 (a) AIFMD.

[290] Together with real estate and private equity funds, art funds form part of the so-called "Grey Market", referring to a whole sector which in the past has rather successfully evaded regulation.

[291] See Art. 50 para. 1 UCITSD, for definitions see Art. 2 para. 1 (n), (o) UCITSD.

"harmonized" investment funds regulated under UCITS provide for greater liquidity by allowing their investors to redeem at their request, at least twice a month.[292] With tangible one-of-a kind assets as traded objects, art funds cannot offer such liquidity on short notice and are indeed outside the regulatory scope of the UCITS directive.

Alternative investment funds are defined under the AIFMD as "collective investment undertakings [...] which: (i) raise capital from a number of investors, with a view to investing it in accordance with a defined investment policy for the benefit of those investors."[293] An entity with a general commercial or industrial purpose is not considered a collective investment undertaking (CIU). As clarified by ESMA guidelines,[294] this refers to entities pursuing a business strategy that includes characteristics such as running predominantly commercial activities, i.e. the purchase, sale, and/or exchange of goods or commodities and/or the supply of non-financial services, industrial activities, comprising the production of goods or construction of properties, or a combination of both activities. The activity of an art funds thus needs to be briefly distinguished from the commercial sale of artworks as goods.[295] While the entire revenue is indeed generated through the difference in price paid at purchase and resale, the business strategy of art funds cannot be reduced to a mere general commercial activity. Management of the assets in between the transactions is detrimental, which is why the lock-in period must last for several years before reselling becomes even an option. In fact, the business strategy of art funds is often considered incompatible with "flipping" the artworks.[296]

The addressee of regulatory obligations under the AIFMD is interestingly enough not the fund itself, also in consideration of the unspecified corporate nature, but the AIF-manager (AIFM), thus the *legal person* whose regular business is managing and marketing alternative collective investment undertakings.[297]

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[292] European Systemic Risk Board (ESRB), 'Recommendation of the European Systemic Risk Board of 7 December 2017 on liquidity and leverage risks in investment funds' ESRB/2017/6 (February 2018) 6, < https://www.esrb.europa.eu/pub/pdf/recommendations/esrb.recommendation180214_ESRB_2017_6_annex_II.en.pdf> accessed 25 October 2022.

[293] Art. 4(1)(a) AIFMD.

[294] ESMA, 'Guidelines on key concepts of the AIFMD' ESMA/2013/611 (13 August 2013) 3, <https://www.esma.europa.eu/sites/default/files/library/2015/11/2013-611_guidelines_on_key_concepts_of_the_aifmd_-_en.pdf> accessed 29 October 2022.

[295] It is partially also argued in academia that artworks belonging to the categories of prints and multiples can be considered commodities, see e.g. Lisa Koenigsberg, 'Art as a Commodity? Aspects of a Current Issue' (1989) 28 Archives of American Art Journal 23.

[296] „Flipping" of artworks is a strongly disincentivized and frowned-upon practice by galleries in the art market. The term refers to loosely buying an swiftly reselling an artwork to make a quick profit, see above n 279.

[297] Art. 4 para. 1(b) AIFMD.

According to the definition, the structure of the fund has to allow for "a number of investors", meaning that binding legal rules or its instruments of incorporation have to foresee the possibility that more than one investor deposits capital – even if in practice there is only one investor actually participating in the undertaking.[298] The capital needs to be raised through the commercial activity of an undertaking or a person or entity acting on behalf of the AIFM taking direct or indirect steps to procure the transfer or commitment of capital by one or more investors.[299] It is irrelevant whether the capital raising activity is conducted only once or on several occasions. What stands inimical to the necessary commercial capital raise however are investments by family-offices. Such "pre-existing groups" investing their private wealth without external capital do not fall within the intended scope of the AIFMD, according to ESMA guidelines.[300] With family funds being a recurring phenomenon in the context of art investments, this presents an important exception for art funds which thereby evade regulation by the AIFMD-transposing rules. The evaluation may however be different in cases of multi-family offices and friends & family structures.

There are further implicit exceptions to the applicability of the AIFMD for certain investment models, e.g., where investors assume ownership or co-ownership of the assets under management. According to ESMA's final guidelines, "a form of direct and on-going power of decision [...] over operational matters relating to the daily management of the undertakings' assets and which extends substantially further than the ordinary exercise of decision or control through voting at shareholder meetings on matters such as mergers or liquidation, the election of shareholder representatives, the appointment of directors or auditors or the approval of annual accounts" suffices to alter the interest and power situation within the entity in a significant way. Since xthe European legislator did not have in mind the investor being directly linked to discretion or control over the assets when drawing up the provisions on investor protection under the AIFMD, any vehicle which transfers property, e.g. a co-ownership share in a real estate property, does not fall within the scope of the Directive.[301] Against this background, the question of fractional ownership comes into the focus, being a quite common model for art investment today. This concept will however be extensively discussed within the next chapter.

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[298] ESMA 'Final Report – Guidelines on key concepts of the AIFMD' ESMA/2013/600 (24 May 2013) VIII.
[299] ibid VII no. 14.; See also recital 7(c) AIFMD.
[300] ESMA 'Final Report – Guidelines on key concepts of the AIFMD' (n 291) VII no. 15 f.; See also recital 7(c) AIFMD.
[301] Jean-Pierre Bußalb and Ferdinand Unzicker, 'Auswirkungen Der AIFM-Richtlinie Auf Geschlossene Fonds' [2012] BKR 309, 310.

The Directive, which represents only the first of the four-levels within the Lamfallussy process, was supposed to be transposed into national law of the Member States by 22 July 2013.[302] On level 2, the framework is supplemented by technical details and advice on implementing measures issued by specialized committees, which apply directly to member states.[303] Furthermore, the European Securities and Markets Authority (ESMA) issues guidelines clarifying the application of the AIFMD. The due execution at a national level is supervised by each Member State's own financial authorities.

Currently the AIFMD as well as the UCITS scope are revised by the Committee on Economic an Monetary Affairs within the European Parliament in the process of amending both directives to align their requirements.[304]

bb) Obligations arising under the AIFMD

As a consequence to the qualification of an investment vehicle as an AIF and the applicability of the AIFMD (respectively the national law it was transposed into), a line of rules and obligations is incumbent on the manager of the fund.[305] The extent of the applicable rules depends primarily upon the assets under management, as the directive does not establish a uniform concept for all AIFs but offers a "lighter regime" based on the inherent market risks associated with different types of funds. According to Art. 3(2), managers of "smaller funds" are exempted from most of the rules established under the Directive; "smaller funds" are those whose assets under management

a) do not exceed a threshold of EUR 100 million, or
b) do not exceed a threshold of EUR 500 million when their portfolio is unleveraged and they do not have redemption rights exercisable during a 5-year period following the initial investment date.

[302] Another exception to the authorization requirement applies to close-ended AIFs that were managed before 22 July 2013 and to which to additional investment was contributed after that date, which according to Annex I can be of relevance to a few European art funds.

[303] See Art. 290, 291 AEUV; Bußalb, Unzicker (n 301) 309.

[304] European Parliament Think Tank 'Amendments to AIFMD and UCITSD: Managing risks and protecting investors' (20 June 2022) <https://www.europarl.europa.eu/thinktank/en/document/EPRS_BRI(2022)729321> accessed 20 October 2022.

[305] Interestingly, the regulation addresses the fund manager, i.e., the legal person whose regular business is managing one or more alternative investment funds, rather than the fund itself with the compliance to the established duties. The reason for this can be seen in the decision-making power of the manager, who decides on the investment strategy, thereby influences the liquidity of the fund and thus the risk it represents to the market, see recital 1.

In practice, this means that most art funds in the EU have to adhere only to the reduced scope of obligations under AIFMD. [306] From the conducted interviews, communications with funds, and online research, it emerges that only two European art fund (aim to) exceed the nominal threshold of EUR 100 million with their AUM, namely the Guernica V. fund by Artemundi and the MAM Fund by Petricca & Co. Capital. Given the generally long holding periods of 3-10 years, and the absence of leverage in this investment form, the relevant threshold for most art funds could indeed be extended to EUR 500 million. The Guernica V Fund with its AUM-target of $ 200 million and an envisaged locked-in period of only 3 years may accordingly not rely on the exemption for small funds. Consequently, the managing company would need to be authorized with the national competent authority (NCA). The MAM Fund does in fact have a CSSF-authorized AIFM.

With regard to the other European art funds, the AUM is between EUR 351,000 and EUR 30 million. The managers of these "smaller" art funds are thus imposed a reduced catalogue of obligations, namely comprehending only the duties arising under Artt. 46, 3(3), and 3(4).[307] Instead of having to file for authorization to start their activities, the corresponding manager is merely required to register with the NCA.[308] The respective valuation of AUM is supposed to occur once a year for assets which do not consist in financial instrument according to the Directive; national valuation standards may state an increased reporting rate. If assets are acquired throughout the fiscal year, an adjustment of the asset calculation can become necessary. Accordingly, AIFMs are required to initially inform the NCA of the value of AUM and provide regular updates.[309] To make sure of their consistent qualification,[310] monitoring measures need to be installed within smaller funds to establish that the AUM are not surpassing the relevant values.

The reason behind the reduction of obligations for the manager of smaller funds is twofold; firstly, these are less relevant in terms of systemic market risk; second, to impose the same level of extensive compliance duties as with larger institutions would probably exceed the resources

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[306] Explicitly stated e.g., in the case of the In Art Fund (Lux.), which according to its website is subject to the AIFMD "light regime", see <http://inartfund.lu/#> accessed 20 October 2022.

[307] See Art. 3(2) AIFMD.

[308] Art. 3 (1), (3)(a) AIFMD; if the marketing to retail clients is permitted by the national legislator, the Directive requires as a minimum standard the level of protection applicable to the marketing to professional investors. The Member States are free to impose stricter requirements on the AIFM or the AIF through the opening clause of Art. 43 (1) sentence 2 AIFM Directive (see in detail below 95).

[309] Art. 3(3)(d) AIFMD.

[310] ESMA does not consider deviations above the threshold for less than 3 months relevant.

available to smaller entities and thus represent a strong disincentive especially for smaller businesses.

The manager of a smaller fund may however choose to comply with the entirety of the regulations by exercising the opt-in right according to Art. 3(4) AIFMD.[311] As a consequence, the manager becomes entitled to the benefits granted through the Directive, which consist primarily in the European passport for funds. Without the pan-European passport, AIFMs of small funds are limited in their capacity to market their shares or units to investors in other Member States, since they would have to check with each pertinent national law for the targeted Member State market.

The extensive set of rules applicable to the managers of larger funds or smaller funds that decided to opt-in include ongoing monitoring, reporting and organizational obligations, risk and liquidity management, valuation, custodian and distribution requirements as well as conflict of interest rules.[312]

(1) Requirements for Authorization under AIFMD

Internally managed AIFs require a minimum initial capital for the AIFM of at least EUR 300,000. For externally managed AIFs, the initial capital is fixed at a minimum of EUR 125,000. [313] These values differ where the portfolios managed by the AIFM exceed EUR 250 million.[314] None of these minimum capital requirements is obligatory for "registration-only" funds; they are merely required to have the minimum capital that corresponds to their chosen corporate form. Investors therefore need to be aware of the significantly lower capital available for liability claims with funds under the lighter regime.

In practice, most art funds are externally managed AIFs. The reason for this consists not only in the lower threshold of capital, but also in the practical advantages of having a long-term AIFM who earns market recognition with each successfully terminated art fund.[315] By contrast, internal AIFMs are tied to the management and time span of their very own AIF.

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[311] Also, Member States are authorized under the Directive to establish stricter rules, especially with regard to the marketing of units to retail investors. It may hence very well be that at least under national law, funds falling below the relevant threshold are still required to receive authorization by the NCA e.g. if they market to retail investor.

[312] In this context, it needs to be remembered that the AIFMD focuses on obligations on proper conduct of the manager; it does not regard the requirement to publish a prospectus, which shall not be subject of this thesis.

[313] Art. 9 para 1, 2 AIFMD.

[314] Art. 9 para. 3 AIFMD.

[315] A point that was confirmed in the interview with Javier Lumbreras from Artemundi from 29 September 2022 (transcript with the author).

AIFMs who require authorization are called upon to apply with the competent authorities of their home Member State.[316] In this context, information on the persons effectively conducting the operations of the AIFM as well as shareholders with qualifying majority and the management set-up have to be provided to the authorities.[317] The individual notification obligations are enumerated in Art. 7 of the Directive and further specified by the Commission Delegated Regulation (EU) No. 231/2013. The authorization is contingent also on the sufficient qualification of the AIFM and the natural persons conducting the business. In particular, their theoretical and practical knowledge in the investment sector, past management experience and reliability are reviewed in the process.[318] Facts that may adversely affect the person's conduct of business or establish doubts with regard to the person's honesty and integrity should be taken into consideration. A business plan must lay down how compliance with transparency and risk management rules is assured (Art. 7 para. 2, 3 AIFMD). A criminal record, judicial or administrative proceedings because of relevant financial offenses will be held inimical to the finding of a "sufficiently good repute" and thus authorization according to AIFM-regulations.[319] With regard to the level of professional competence for the persons behind the AIFM, there are no binding rules that provide for further details.

Of particular interest for art funds and their potential investors is the requirement to supply information about the investment strategies of the AIF (Art. 7 para. 3 (a) AIFMD). A corresponding duty exists also for AIFs under the lighter regime where registration is required under Art. 3(3).[320] This task can be satisfied by providing a general description of the investment strategy or the offering document respectively a relevant extract from the offering document.[321] What needs to be included are at least the following information:[322]

[316] Art. 7 para. 1 AIFMD.
[317] Art. 7 para. 2, 3 AIFMD.
[318] Art. 8 para. 1 AIFMD.
[319] Art. 77 para. 3, Recital 84 of the Commission Regulation 231/2013; see also Bußalb, Unzicker, (n 301) 314
[320] Together with the total value of assets under management calculated in accordance with the procedure set out in Art. 2 of the Commission Regulation 231/2013.
[321] Art. 5 para. 2 of the Commission Regulation 231/2013.
[322] Art. 5 para. 2 (a)-(c) of the Commission Regulation 231/2013.

(a) The main categories of assets in which the AIF may invest;[323]
(b) Any industrial, geographic or other market sectors or specific classes of assets which are the focus of the investment strategy;
(c) A description of the AIF's borrowing or leverage policy.

Investment strategies should be reviewed and provided at least yearly, in any event before a new strategy is installed or a new type of assets assumed.[324] The grade of detail necessary in terms of asset categories and sectors is not defined neither in European legislation and secondary guidelines nor by any national legislator so far. This offers a large extent of flexibility to art funds, where enormous differences exist in terms of value and risk distribution among sectors. In practice, art funds will give themselves and their investors a rough orientation by committing to a certain genre, period and style already during their marketing phase. The majority of art funds includes only classical forms of fine art, thus paintings and drawings, more rarely also sculptures, in their portfolio. Other forms such as photography are rather a niche market, which is why only a few funds decide to dedicate their attention to this sector and build their portfolio around them.[325] From the table in Annex I it clearly emerges that most art funds limit themselves to post-war and contemporary western art.[326] Given the lack of price consistency in contemporary art, which can only be achieved through a larger number of sales, this art class is considered one of the riskier art sectors in terms of investment – but also one with potentially the highest short-term profits.

(2) Excursus: Investment in Contemporary Art

[323] AIFMs are supposed to report their main instruments according to certain subasset-classes, aiming for the highest possible degree of details. In addition to identifying the asset class, also their total value is to be denoted. Art as an asset class is indeed recognized by ESMA and has hence been given a specific denomination in Annex II of the Guidelines on reporting obligations under Articles 3(3)(d), 24(1), (2), and (4) AIFMD, Table 1 and 2, in detail:

Asset macro type		Asset type		Asset sub type	
Code	Label	Code	Label	Code	Label
PHY	Physical (Real / Tangible Assets)	PHY_ART	Phyisical: Art and collectables	PHY_ART_PART	Physical: Art and collectables
PHY	Physical (Real / Tangible Assets)	PHY_ART	Phyisical: Art and collectables	PHY_ART_ART	Physical: Art and collectables

[324] Art. 5 para. 5, Recital 78 of the Commission Regulation 231/2013.
[325] See e.g., in Europe: only the Anthea-CAIF and -CAIO, Annex I.
[326] An art sector which has exhibited great return rates in the recent past is Asian Art, especially Chinese and Indian Art. This trend is reflected in the art fund scene exploding in numbers and investment in these regions. In view of the scope of this work, no detailed analysis of these emerging markets can be given at this point; instead, see Linli Li, 'Art Funds in China: Developments and Limitations' *Arts* 10 (9 January 2021) 4 <https://doi.org/10.3390/arts10010004> accessed 21 November 2022.

Contemporary art is not a strictly defined term; it can however be assumed to refer to all artists born after 1945. One also must not confound contemporary with modern art or post-war art.[327] The market in contemporary art is currently experiencing a rapid buoyancy. There is no other market sector which can compete in terms of growth and price increases. Contemporary turned out to be the most dynamic art segment after the pandemic, as it took a remarkable uplift in 2021 of +49% in terms of value generated at auction, compared to 2019.[328] In line with this, over the past 20 years, the number of contemporary artworks sold multiplied by 10.[329] The primary reason for this consists in the promising growth rates of artist of the 20th and 21st century. Often, the greatest immediate increase in prices paid can be seen at the level between the primary and secondary market, thus within years after the creation of the work. These numbers suggest quick and substantial positive returns after a relatively short holding period, which is why closed-end art funds with a limited duration are attracted to these opportunities and can present a promising investment strategy to investors.

Accordingly, in view of achieving high returns for investors, the contemporary art sector is particularly appealing for art fund managers. At the same time, one needs to be reminded that contemporary art also deserves to be regarded a high-risk investment, some would argue a much higher risk than any other fine art sector among the traditional classes represented at auction.[330] The reasons for this are principally two-fold: first, the track record of a contemporary painting is not long enough to indicate a base value that cannot be shaken, and second, the works by contemporary living artists do not benefit from a condition that is detrimental to the value: rarity. Whereas for any artist of the past, the total number of works is limited, the creators of

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[327] Although there remains some discussion as to the exact scope of "modern art", it is generally agreed that in the art-historic context, the "modern era" started in the second half of the 19th century (see e.g. on the discussion of the term Anne-Marie Bonnet, '"Die Moderne" - Eine Einführung' [2005] 1 Kunsthistorische Arbeitsblätter 51); post-war art is encompasses the period after 1945 between modern and contemporary art and includes e.g. the style category of abstract art.

[328] Artprice, 'The Art Market Report in 2021' (2022) 29 <https://imgpublic.artprice.com/pdf/the-art-market-in-2021.pdf> accessed 21 October 2022.

[329] ibid 30.

[330] Masha Golovina, Head of Art Acquisitions at Masterworks, replied in an interview given in 2021, when asked for investments outside established, i.e. blue chip, art: There's investing in art that's more like blue chip art, and then there's investing in art that's more like investing as a VC [venture capitalist] where if you're going out and looking for young artists, or the hot new thing, I'd say you're playing the numbers. Most of the paintings you buy won't be worth very much in 5 or 10 years. Whereas if you're buying blue chip art, you're limiting your downside risk, much like you would if you're buying blue chip Fortune 500 stock or buying into a company that has a proven track record." (Liz Aldrich, 'Interview with Masha Golovina' *MoneyMade* (28 October 2021) <https://moneymade.io/learn/article-questions-answers/interview-masha-golovina> accessed 21 October 2022.

contemporary art may still create an infinite number of works, thereby decreasing the value of each single specimen.

The controversial question whether there can be assumed a price correlation between past and future sales prices, which was introduced in the first chapter, is only peripherally relevant to the issue of price developments for contemporary art. Even if one were to assume that there is no price correlation and therefore, a prognosis on contemporary works can be rendered just as reliably as that for any older "market-experienced" work, the prices of contemporary artworks are still characterized by their unproven price flexibility. To borrow the phrase employed by Mr. Lumbreras: "[The art market] is a rollercoaster."[331] At the same time, "there hasn't been a point in history where a Leonardo [da Vinci] has been worth zero. For the last 500- 600 years, it has only been going up in prices."[332] But while masterworks have only increased in value over a long time, there is not yet any reliable data that may tell whether the newly discovered artistic star will continue to be appreciated by the public even in 100 and above years from now. The characterizing feature of high-valued contemporary works is precisely that they meet the audience's taste at the moment. This phenomenon is well described in the Art Market Report in 2021, where it reads that: "in just a few months, their works ['red-chip' artists, i.e. 'the new "must haves"' who are born after 1980] have become 'essential' on the international art market. Prodigal artists and symbols of their time, their works have been the subject of fierce competition from American, European and Asian collectors alike."[333] However, without any historic market trajectory, works lack the certainty that the artist will not just be a fashionable ephemera but continue to be appreciated throughout the tangles of taste.

Addressing the second argument for restraint, one needs to be reminded that several of the top-selling artists, whose works are the most expensive and prolific on the market in 2021 overall, not just in the contemporary sector, are still alive and working.[334] It does currently seem that even the potentially unlimited number of works by a certain artist cannot dampen the fascination with her/him. This enthusiasm can ostensibly even cope with proportions that a single person can no longer manage, but where an entire workshop is charged with the production, virtually on a

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[331] Interview with Javier Lumbreras on 29 September 2022 (transcript with the author).
[332] Ibid.
[333] Artprice (n 328) 41.
[334] Among the 10 top-selling artists in 2021, according to the Art Market Report in 2021 (30, 4) are still alive and actively creating art, namely KAWS, Takashi Murakami, Banksy, and Shepard Fairey.

piecework basis. One may think, for example, of Damien Hirst, who recently issued his newest "edition" entitled "The Currency" with 10,000 pieces, to be handed out either in tangible format or as an NFT. Each of the works is created by using machine learning and changing different parameters as to the drips, density, texture, etc.; the products are similar in style, consisting of differently colored dots, but individual in their details. The price for each was set at $2,000.

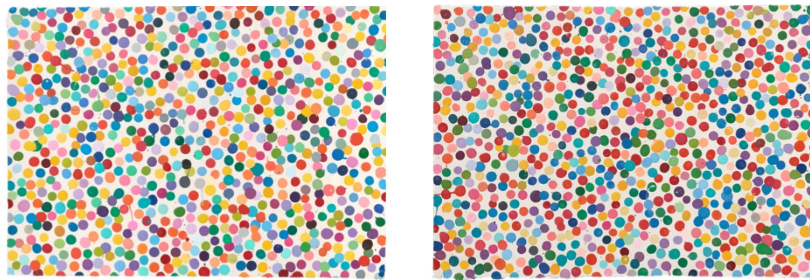

Illustration I: Two examples of works issued as NFTs in the series "The Currency" by Damien Hirst (2022) (left: "While the sun's shining"; right "Totally gonna sell you")

These can be used as a vivid example to put into evidence the indicated market principle: although each single piece of the above edition is unique, their prices would still be subject to substantial fluctuations if Hirst were at some point to decide to issue another 10,000 or 100,000 of these machine-generated artworks. Of course, artists such as Hirst are very aware of this risk and thus have their own motivation not to devaluate their works.

The different risks involved in sector-specific investment strategies could be specifically acknowledged in information materials provided to investors. Instead, however, from the obtainable product information sheets and memoranda, there could not be discerned any graduation in the risk assessment conducted by issuers. Rather, the respective wording was surprisingly consistent in its reference to the fact that no guarantee of future profits could be inferred from past achieved auction prices.

(3) Investment Portfolio

Most art funds employ a diversifying approach with regard to their portfolio as a means of risk management. This includes purchasing works from different artists and market segments. At the same time, this also assures that at the moment of dissolution of the fund, the market is not "flooded" by works of the same style or artist, which could in turn damage the prices.

The AIFMD itself does not provide for a list of eligible or non-eligible assets of AIFMs to manage or specific diversification requirements.[335] There may however be limitations as to permitted assets and the diversification of the associated risks under national law.[336] This is often the case with regard to e.g. real estate funds, where legislative benchmarks are installed stipulating that no single investment shall account for more than 5% of the total assets under management.[337] In the art world, however, the selection of a portfolio is in practice "largely opportunistic and determined less by adherence to a plan than by the availability of appropriately priced investment-quality works." [338]

Most notably, the large majority of art funds explicitly limit themselves to blue-chip artworks.[339] This is in line with the available data processed in the largest art indices and provided in the information material, which generally exclusively takes blue-chip art into consideration. While this top-tier approach on the art market may suggest annual growth rates of 15% and more, one needs to bear in mind that these numbers only reflect around 10% of the overall art market volume and are thus highly biased in that they imply to make a generally valid statement for the whole art world while in fact, they refer only to the example of a few high-performing artists.[340]

cc) Marketing of Units to Investors

If all the conditions are met, the competent authorities of the home Member State of the AIFM issue an authorization that is valid for all Member States.[341] As a consequence, EU-AIFMs may market units or shares of any EU-AIF under management to professional investors in the home Member State of the AIFM and in other Member States upon prior notification of the Member State authority regarding each AIF that is intended to be marketed.[342] Also EU-AIFMs that want

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[335] ESMA, 'Questions and Answers – Application of the AIFMD' ESMA34-32-352 (16 December 2022) Section XI: Scope, Answer to Question 2 < https://www.esma.europa.eu/sites/default/files/library/esma34-32-352_qa_aifmd.pdf> accessed 17 December 2022.

[336] Also, retail alternative investment funds which are generally not targeted by the AIFMD are often subject to diversification requirements under national law, which may vary again depending on the open- or closed-end structure of the fund.

[337] Though this percentage may be raised in the company agreement.

[338] Eckstein and Willette (n 43) 150.

[339] See definition supra on page 64.

[340] There has been extensive research in the economic field on the bias of art indices. See e.g. Arthur Korteweg, Roman Kräussl, and Patrick Verwijmeren, ‚Does it Pay to Invest in Art? A Selection-corrected Returns Perspective', in: Robert L Lewis (ed), *Art as Investment - A Research Anthology From the Past 100 Years* (1st edn, Createspace 2014) 1.

[341] Art. 8 para. 1, 5 AIFMD.

[342] Art. 31 ff. AIFMD.

to market shares of a non-EU AIF can be authorized to do so if they meet the requirements of Art. 35 AIFMD and are therefore issued a Union passport.
Non-EU AIFMs who want to market non-EU AIFs are subject to the national private placement rules of each individual targeted Member State, as they cannot use the AIFMD marketing passport.

As a basic principle, the AIFMD establishes that authorized EU-AIFMs are free to market units and shares of their AIF also cross-border to professional investors.[343] The term 'professional investor' means an investor which is considered to be a professional client, thus referencing to the term implemented through MiFID.[344] By contrast, shares and units of AIFs are generally not to be marketed to retail investors according to the AIFMD, i.e. to investors who are not professional.

(1) Client categorization in the ambit of art funds

The AIFMD presumes that AIFs units can only be marketed to professional investors.[345] It thereby acknowledges the fact that AIF-units are *per se* considered complex financial instruments and therefore adequate only for experienced investors.[346] Marketing is defined as "the presentation of a financial instrument through various means (e.g. advertising, direct marketing, advice) by an investment services provider, a financial investment adviser or a direct marketer of banking and financial services with the aim of encouraging a customer to subscribe for or purchase that instrument."[347] In this context, it is still an open debate how marketing is to be considered different than reverse-solicitation, which occurs when the initiative to purchase units or shares of a fund comes from the potential investor, instead of the fund or third parties approaching the interested party with an offer to invest. Also, mere advertising of an AIF-management company is arguably different from advertising a specific investment in an AIF.[348]

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[343] Art. 31 para. 6 AIFMD.
[344] Art. 4 para. 1 (ag) AIFMD.
[345] Artt. 31(I, VI), 32, 35, 36, 39, 40, 42 AIFMD.
[346] According to the evaluation issued by ESMA, 'Technical Advice to the Commission on MiFID II and MiFIR (Final Report)' ESMA/2014/1569 (19 December 2014) Section 2.18 (13) 159, see also Art. 25(4)(a)(i) MiFID II; see in detail below.
[347] Autorité des Marchés Financiers (AMF), 'AMF Position – Marketing of complex financial instruments' DOC-2010-05 (15 October 2010; amended 8 October 2018) 3 < https://www.amf-france.org/sites/default/files/private/2020-10/20181008-marketing-of-complex-financial-instruments.pdf> accessed 20 October 2022.
[348] Keyword in this context is „pre-marketing"; see for more information on the controversial topic of reverse solicitation and pre-marketing e.g.: Joel El-Qalqili, LL.M. (Fletcher)/ Niclas Winands, Rechtliche Risiken bei Private Equity und Venture Capital Fundraisings, BKR 2019, 231.

A professional client, according to the definition provided by Annex II of MiFID,[349] is a client who possesses the experience, knowledge, and expertise to make its own investment decisions and properly assess the risk that it incurs. Entities which operate in the financial markets, such as investment firms, collective investment schemes, institutional investors, etc. are always considered professionals in their financial activities as well as large undertakings.[350] In addition to that, private individual investors are allowed under MiFID II to be treated as professional investors upon their request, provided that they meet certain criteria.[351] Art. 4(1) (ag) AIFMD refers to this differentiation between professional clients *per se* and those requesting to be treated as such and thereby introduces both categories to the context of AIFs. Given the abatement of protection that goes hand in hand with the recognition as a professional, the investment firm willing to provide a service to the individual needs to make sure that the client is capable of understanding the risks involved in light of the nature of the intended transactions. Therefore, an adequate assessment of the expertise, experience and knowledge of the client needs to be conducted by the investment firm,[352] involving the assessment of at least two of the following conditions:[353]

- The client has carried out transactions, in significant size, on the relevant market at an average frequency of 10 per quarter over the previous four quarters,
- The size of the client's financial instrument portfolio, defined as including cash deposits and financial instruments exceeds EUR 500 000,
- The client works or has worked in the financial sector for at least one year in a professional positions, which requires knowledge of the transactions or services envisages.

Institutional investors are still a quite rare phenomenon in the context of art investments. Whereas the potential of economic benefits from real estate funds has been recognized by institutional investors decades ago, art still seems to be too peculiar an asset, given its general illiquidity and hardly predictable value development, two factors which can hardly be extinguished by art funds investment at well. Conversely, technology-based alternative investment

[349] See Art. 4(1)(10) MiFID II in conjunction with Annex II.
[350] Annex II, I para. 1 MiFID.
[351] Annex II, II.1 MiFID.
[352] Annex II, II.1 MiFID.
[353] Annex II, II.1 MiFID.

structures present more of an opportunity for institutional investors, as tokenized assets promise a higher liquidity due to secondary markets.[354] The British Railway Fund as a pension fund that successfully invested in conventional artworks over a longer period therefore remains an exception up until today.[355]

Member States are left some discretion in their transposal of the Directive, whereby they may allow the marketing of AIF-units also to retail investors in their territory and in this case impose additional, stricter requirements as compared to those applicable to professional investors.[356] Some national legislators have made use of this opening clause by integrating an intermediate investor class into their national financial market laws. The classification of "semi-professional investors" allows for the generalization of certain financial knowledge and/or capital that, despite falling short of that expected from a professional investor, still justifies the accessibility to certain complex investment instruments. This investor category is not explicitly stipulated in the AIFMD; instead, its requirements are determined by national laws (in the case of Germany, e.g., a minimum investment of at least EUR 200 000 in respect of the specific AIF in addition to a firm understanding of the involved risks, or an investment of at least EUR 10,000,000 in an investment fund is required).[357] In line with this, also the requirements with regard to disclosure

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[354] Such is suggested also by Javier Lumbreras in the interview on 29 September 2022; see the following chapters for further explanations of token-based art investments.

[355] Frye (n 56).

[356] Art. 43(1) AIFMD; e.g. Germany has made use of this option in §§ 316 ff. KAGB.

[357] See § 1 XIX Nr. 33 KAGB (German Investment Law): Semi-professional investor is

a) any investor,
   aa) who undertakes to invest at least 200,000 euros,
   bb) who states in writing, in a document separate from the investment commitment agreement, that he/she is aware of the risks associated with the intended commitment or investment,
   cc) whose expertise, experience and knowledge are assessed by the AIF management company or the marketing company appointed by it, without assuming that the investor has the market knowledge and experience of the investors listed in Section I of Annex II to Directive 2014/65/EU,
   dd) where the AIF management company or the distributor appointed by it is reasonably satisfied, taking into account the nature of the intended commitment or investment, that he is capable of making his own investment decisions and understands the risks involved and that such commitment is appropriate for the investor concerned; and
   ee) to whom the AIF management company or the marketing company appointed by it confirms in text form that it has carried out the assessment referred to in double letter cc and that the conditions referred to in double letter dd are met,
b) a manager or employee of the AIF management company referred to in section 37(1), provided that he invests in AIFs managed by the AIF management company, or a member of the management or board of directors of an externally managed investment company, provided that he invests in the externally managed investment company,
c) any investor who undertakes to invest at least 10 million euros in an investment fund,
d) any investor in the legal form of
   aa) an institution under public law,
   bb) a foundation under public law, or

and risk-assessment expected from the issuer are generally adapted under national law to reflect the advantage in knowledge and financial capacity of semi-professional investors in comparison to retail investors.

Against the background of the formerly delineated criteria, which are primarily asset-related or hinge on experience in the financial sector, the question emerges whether concepts originally designed for the investment in financial instruments serve a legitimate purpose also when applied to the rather peculiar segment of art funds. Especially in the art world, which eludes rational, material- or past-performance-related assessments of values,[358] a general understanding of market mechanisms seems to be of limited advantage. The pertinent issue which deserves to be discussed is, on the one hand, to which extent finance-related matters shall be taken into consideration when assessing the client category of a potential art fund investor, and on the other, whether in addition to or in lieu of financial knowledge, a background in art should be required to qualify an investor as "professional" or "semi-professional".

The wording of the definition of a "professional client" in MiFID II clearly reveals a focus on the securities market. To simply apply the classification criteria revolving around the "financial instrument portfolio" and "experience in the financial sector" seems however somehow misplaced when it comes to the decision whether an investor in an art-AIF is to be considered a professional, all the more since an AIF by its own definition resorts to alternative investment means compared to conventional securities and other financial instruments.

Price developments in the art market do not follow the same rules as the ones applicable to the financial market. Indeed, what is often used as the central argument for investment in art funds is that the art market exhibits low correlation with the stock market.[359] Some go as far as suggesting that the reason why so many art funds failed in the past lays with the unbalanced approach implemented by managers with a financial background that did not fit well with the

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cc) a company in which the Federal Government or a Land holds a majority interest,

if, at the time of the investment of the establishment, foundation or company, the Federal Republic or the Land invests or has invested in the relevant special AIF.

[358] On the controversial question whether there is a positive price-correlation between past and future performance, see e.g. Péter Erdös, Mihály Ormos, 'Random walk theory and the weak form efficiency of the US art auction prices' Journal of Banking & Finance 34 (May 2010) 5, 1062 < https://doi.org/10.1016/j.jbankfin.2009.11.001> accessed 20 October 2022.

[359] See on this point e.g. Campbell (n 18); Andrew C Worthington and Helen Higgs, 'Art as an Investment: Risk, Return and Portfolio Diversification in Major Painting Markets' (2004) 44 Accounting and Finance 257.

hardly predictable and opaque art market.[360] According to Jeremy Eckstein, a former adviser of the British Railway Pension Fund, "an art fund requires a mix of money-management skills and an intimate understanding of the unique mechanisms of the art market, a balance that is difficult to achieve. Many prospective art funds have failed to achieve funding because they were devised by art experts who had little understanding of the financial structure and mechanisms required by institutional or high-net-worth individual investors. Conversely, other prospective art funds have failed because they were devised by financial people who recognized that superior returns were available in art but through the same disciplines could be applied to the art market as to financial markets. Quite simply, they failed to understand the unique practicalities of operating in the art marketplace."[361]

This suggests that experience in the financial sector is no sufficient basis for understanding investment in art (funds). However, to focus only on professional experience in the art world does not provide for a suitable solution either. While we have seen that the peculiar dynamics of the art market, which are often influenced by networks and socio-economic trends, require the knowledge of an insider to be best brought to use, also for many people working in the cultural sector the price development in the market is a book with seven seals. While their initial interest in the arts may present an incentive to contact an art fund, there cannot be presumed any knowledge as to the risks of investment.

One parameter to be evaluated by investment firms and AIFMs in ascertaining the client's sophistication in this matter is whether the potential investor has experience in investing, which according to the MiFID II-test is exemplified by "significant transactions on the relevant market at an average frequency of 10 per quarter over the previous four quarters".[362] While this benchmark allows in theory to take the individually envisaged fund category into consideration, given the reference to the "relevant market", the exact scope of this term remains unclear. Shall it be understood as to refer generally to AIF-investments or, with regard to art funds, can this in theory also include individual purchases of artworks? In any case, an average frequency of 10 per quarter seems out of proportion when addressing the investment sector of art. Art funds, and in

[360] See e.g. on this point Bruce Taub's statement, the CEO and founder of Fernwood's Art fund which was for a certain time one of the most promising fund on the horizon: "Everyone who has tried this before has either been too financially focused and didn't understand the art, or too art focused – without understanding the financials" cited by Groysberg, Podolny and Keller (n 61).
[361] Eckstein and Willette (n 43) 149.
[362] Annex II, II.1 MiFID.

general all close-ended AIFs, are characterized by longer investment periods which are incompatible with loose and quick transactions within a short period of time.

Of particular interest is the relevance of professional experience in the financial sector. MiFID II as well as several national laws allow to disregard the available total capital of an individual if this can be compensated by a surplus in expertise on the relevant investment form. The pertinent question from an art fund's perspective is: may the AIFM also take the client's career in the art world into consideration? For the acknowledgement of a background in another than the finance sector, an argument can be drawn from ESMA guidelines, according to which it would be considered "good practice for firms to consider non-financial elements when gathering information on the client's investment objectives, and [...] collect information on the client's preferences on environmental, social and governance factors".[363] Although this relates to the investment target rather than the investor her/himself, it still extends the relevant elements to include also non-finance related aspects when assessing the right asset class for the right client.

The requirements established by MiFID II and referenced by the AIFMD seem to be ill-suited to reflect first the alternative investment scope of AIFs in general and second of art funds. Art funds are located at a very special intersection between two seemingly contrasting worlds and thus, knowledge limited to one aspect seems insufficient to prove a comprehensive understanding of the hybrid format. In view of the purpose undergirding the investor classification, it remains uncertain how the criteria can be duly applied in the context of art funds, which bears the risk of reducing the group of potential investors due to insecurity in the interpretation of the term "professional" or "semi-professional" investors. It thus is to be assumed that an in-depth case-by-case assessment which allows to take all relevant aspects of past experience with the finance *and* the art sector into consideration is most likely to meet the parties' interest and duly recognize the investment's inherent risks.

In practice, whether the interested party qualifies as suitable investor is often determined solely on the basis of the size of the investment. Compliance with this criterion is objectively and automatically assessable by installing a corresponding minimum investment threshold. It is therefore easier to handle than vague parameters whose interpretation is not sufficiently

[363] ESMA 'Guidelines on certain aspects of the MiFID II suitability requirements' ESMA35-43-1163 (6 November 2018) 9.

concretized by European institutions. This form of investor assessment therefore also exposes the fund to less liability risks. As a consequence, art funds in the EU (and the US alike) have quite generally assumed the pertinent legal minimum threshold for semi-professional as their personal minimum investment sum. This can very well be illustrated by the overview provided in Annex I. Luxembourg indeed made use of the opening clause in Art. 46 AIFMD and constituted the category of "well-informed" investors within its national laws. The relevant threshold for individuals to be considered a "well-informed investor" under Luxembourg law is legally fixed at EUR 125,000.[364] Not surprisingly, this is taken up by the Luxembourg funds examined. It may also represent yet another reason for the popularity of Luxembourg as state for incorporation among funds, as several other Member States have established higher thresholds thereby reducing the number of potential investors.[365]

(2) The specific case of Luxembourg

The majority of European funds is domiciled in Luxembourg.[366] This is not only true with regard to art funds, but also to AIFs and UCITS in general.[367] The AIFMD was transposed into national law in Luxembourg by the Law of 12 July 2013 on alternative investment fund managers (AIFM Law). Further information on the necessary notification process and other practical details are provided in Circulars (e.g. Circular CSSF 22/810; CSSF 22/795) and Regulations issued by the competent national authority, the Commission de Surveillance du Secteur Financer (CBDF). On 23 July 2016, the Luxemburg Parliament passed yet another relevant law for art funds, namely the Reserved Alternative Investment Fund law (RAIF Law), which combines the advantages of the Specialized Investment Funds Law of 13 February 2007 (SIF Law) with the provisions added by the AIFMD implementing law of 2013.

According to the AIFM Law, marketing units or shares to retail investors in Luxembourg is allowed if the criteria in Art. 46 of the Law are met. In particular, any AIFM – whether established in Luxembourg or in another Member State or third country – is authorized to market shares to retail investors of an (EU or non-EU) AIF under the condition that the AIF is subject to permanent supervision and to a level of investor protection regulation equivalent in its home

[364] Art. 2 Luxembourg law of 23 July 2016.
[365] E.g. Germany with the minimum investment for semi-professional investors amounting to EUR 200,000.
[366] This paragraph claims in no way to be conclusive in the regulation of funds according to Luxembourg Law. Instead, it aims only to provide a short introductory overview, thereby exemplifying the transposal of EU-legislation into national law, using the most prominent and relevant example against the background of total numbers of art funds in the EU.
[367] EC Distribution system of retail investment products, p. 29.

state to that of Luxembourg. Furthermore, a number of arrangements need to be made that shall allow the AIFM to provide investors with information on orders, repurchase and redemption proceeds as well as all the material required in Artt. 22, 23 of the AIFMD.[368] For foreign AIFs, there are additional requirements enlisted in the CSSF Regulation N° 15-03.[369] Most importantly, foreign AIFs need to be authorized by the CSSF. Authorization hinges on the AIFM being established in Luxembourg or authorized in another Member State and consistently complying with the obligations established under AIFMD (Art. 6 CSSF Regulation N° 15-03).

Interestingly enough, the "retail investor" under Luxembourg Law stands not only in distinction to the professional investor, but also needs to be distinguished from the well-informed investor and the eligible investor.[370] The rules on marketing to retail investors do not apply to the other categories, with the consequence that the definition of retail investors under Luxembourg law has a smaller ambit than that of MiFID II and the AIFMD. A well-informed investor is any investor who meets the following conditions:[371]

a) he has confirmed in writing that he adheres to the status of well-informed investor, and
b) (i) he invests a minimum of 125,000 Euro in the specialized investment fund, or
   (ii) he has been the subject of an assessment made by a credit institution within the meaning of Directive 2006/48/EC, by an investment firm within the meaning of Directive 2004/39/EC or by a management company within the meaning of "Directive 2009/65/EC" certifying his expertise, his experience and his knowledge in adequately apprising an investment in the specialized investment fund.

For the definition of eligible investors, the CSSF Regulation points to Regulation (EU) No 345/2013 on European venture capital funds, Regulation (EU) No 346/2013 on European social entrepreneurship funds, and Regulation (EU) No 2015/760 on European long-term investment funds. The term thus refers to professional investors and those requesting to be treated as professionals within the meaning of MiFID II and furthermore to investors who commit to invest

[368] Art. 46-1 AIFM-Law (Law of 21 July 2021: A561).
[369] Mémorial A – No. 224 of 2 December 2015.
[370] Art. 3 para. 2 CSSF Regulation N° 15-03.
[371] Art. 2 para. 1 Law of 13 February 2007 relating to specialized investment funds (amended).

at least EUR 100 000 in the fund and provide a statement in writing assuring that they are aware of the risks involved.[372]

In addition to regulated funds, such as specialized investment funds (SIF), which are subject to the SICAR (Law of 15 June 2004 on the investment company in risk capital law) Law and SIF Law, there is also the possibility to establish an RAIF following the enactment of the RAIF Law. According to this Law, a reserved alternative fund (RAIF) may only be established as an AIF domiciled in Luxembourg and under the management of a Luxembourg AIFM but has the advantage over regulated fund structures that business can be set up quite rapidly, as it does not require authorization by the CSSF. In addition, the new Law also offers flexible operating rules (such as variable capital) and the benefit of a specific tax regime. There are not asset class restrictions for RAIFs, although they are required to observe the principle of risk diversification according to the explanatory memorandum of the Law.

Funds registered in Luxembourg can either be structured as a company, assuming the form of an S.A. (société anonyme), S.à.r.l. (Société à responsabilité limitée), S.C.S. (Société en commandite simple, corresponds to limited partnership), S.C.Sp. (Société en commandite spéciale, corresponds to special limited partnership), S.C.A. (Société en commandite par actions), or contractually as FCP-structure (fonds commun de placement), thus without a proper legal personality.

If chosen to be set up as a company, it is to choose between either SICAV (société d'investissement à capital variable) or SICAF (société d'investissement à capital fixe). In addition, there exists also the SICAR construction, which is dedicated to risk capital investment only.[373]

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[372] Art. 6 para. 1 Regulation (EU) No 345/2013 (EuVECA); Art. 6 Regulation (EU) No 346/2013 on European social entrepreneurship funds.

[373] Lexology GTDT, 'Fund Management Luxembourg' (Oliver Rochmann ed, 2022) 16 <https://www.loyensloeff.com/globalassets/02.-publications-pdf/02.-external/2022/2022-fund-management--luxembourg--lex--gtdt.pdf> accessed 1 December 2022.

bb) Applicable Investor Protection Rules under AIFMD

(1) Distinct Behavioral and Organizational Obligations Towards Investors (Investor Protection Rules)

The AIFMD provides for a number of provisions that aim at protecting investors. Generally speaking, AIFMs shall conduct their activity honestly, fairly and with due skills, which needs to be assessed by the competent national authority.[374] It shall be made sure that members of the management body commit enough time to properly perform their duties and act with integrity and independence of mind.[375] This also includes that adequate and appropriate human and technical resources for the proper management of the fund are in place and maintained on an ongoing basis.[376] In general, AIFMs are required to act in the best interests of the AIF, the integrity of the market and their investors. This entails the prohibition of preferential treatment of an investor – unless such behavior is disclosed in the articles of incorporation.[377] Another essential aspect of fair investor treatment is taking all reasonable steps to avoid conflicts of interest (CoIs).[378] The system relating to conflicts of interest is two-fold: Where they cannot be avoided, it is the AIFM's responsibility to identify, manage and monitor and, where applicable, disclose those CoIs in order to prevent them from adversely affecting the interests of the AIF and investors.[379] These duties towards investors persist even when the AIFM outsources its tasks.[380] Accordingly, the AIFM must demonstrate the qualification of the delegate, that it was duly selected and that the manager is able to monitor and verify the delegated tasks, which must however be withdrawn from the delegate if their outsourcing is no longer in the interest of the investors.

The meaning of the rather vague legal terms is supposed to be concretized by judicial interpretation and guidelines. Further details on how conflicts of interest may arise, and which

[374] Art. 12(1)(a),(f) AIFMD.
[375] Artt. 12 (1)(c) AIFMD; Art. 21 Commission Regulation 231/2013.
[376] Art. 18 (1) AIFMD.
[377] Art.12(1) AIFMD last sentence.
[378] Art. 12(1)(b), (d) AIFMD.
[379] Relevant conflicts of interest may arise specifically between the AIFM and its managers, other employees and associated persons, other AIFs under management or investors or other clients of the AIFM; see for an overview of the relevant provisions for client protection in general: Bußalb, Unzicker (n 301) 309.
[380] Art. 20 AIFMD; the risk of conflicts of interest also needs to be taken into consideration where tasks of the AIFM are delegated. For instance, the carrying out of compliance or audit functions as well as market making or underwriting should be deemed as standing in conflict with portfolio management or/ and risk management, recital 89 AIFMD.

measures are to be taken are provided for example in the Commission Regulation.[381] The adherence to the obligations established under the Directive is to be ensured in day-to-day business by proper monitoring and documentation processes.

(a) Disclosure Rules

Transparency is a central aspect in investor protection. This principle finds recognition in the AIFMD through the obligation to disclose information in the authorization process and continue doing so throughout the existence of the fund, not only to the competent authority but also towards investors. Pursuant to Art. 22 AIFMD, each EU-AIF and AIF marketed in the EU is required to submit an annual report on the business year to the competent national authorities– and upon request also to the investors.[382]

With regard to investors, information and disclosure obligations have to be complied with before the investment decision as well as during the holding period. Art. 23 establishes an extensive list on what needs to be disclosed to investors. With regard to the special focus of art funds, the most relevant points among the disclosure obligations regard the following information:

(a) Description of investment strategy and objectives of the AIF, a description of the types of assets in which the AIF may invest, the employed techniques and all associated risks, as well as any applicable investment restrictions; (a) and (b);
(b) The identity of the AIFM, the depositary, auditor and any other service providers, their provided services, duties and the investors' rights; (d)
(c) A description of any delegated management function such as e.g. valuation and pricing, including tax returns ((f) iVm Annex I);
(d) A description of the AIFs valuation procedure and of the pricing methodology for valuing assets, including the methods used in valuing hard-to-value assets in accordance with Art. 19;
(e) A description of all fees, charges and expenses and of the maximum amounts thereof which are directly or indirectly borne by investors (i);
(f) A description of how the AIFM ensures a fair treatment of investors and, whenever an investor obtains preferential treatment or the right to obtain preferential treatment, a

[381] Commission Regulation 231/2013 Artt. 30 -37.
[382] Art. 22(1) AIFMD.

description of that preferential treatment, the type of investors who obtain such preferential treatment and, where relevant, their legal or economic link with the AIF or AIFM (j);

(g) The identity of the prime broker and a description of any material arrangements of the AIF with its prime brokers and the way the conflicts of interest in relation thereto are managed and the provision in the contract with the depositary on the possibility of transfer and reuse of AIF assets, and information about any transfer of liability to the prime broker that may exist (o);

In addition to the above, AIFMS shall, for each of the EU AIFs that they manage and for each of the AIFs that they market in the Union, periodically disclose to investors (Art. 23 para. 4):

(h) The percentage of the AIF's assets which are subject to special arrangements arising from their illiquid nature (a);
(i) The current risk profile of the AIF and the risk management systems employed by the AIFM to manage those risks (c).

The investment strategy, as indicate above, is to be provided to the NCA as part of the documentation in the process of authorization as well as to investors. The AIFM should be able to prove theoretical as well as practical knowledge in the chosen field of investment, without this being further specified by the AIFMD. The envisaged investment strategy must be in line with the liquidity profile and the redemption policy (Art. 16(2) AIFMD). The authorization by the NCA is only issued with regard to the AIFM managing AIFs with a particular investment strategy.

The Commission has been tasked with defining the actual scope of disclosure necessary with regard to the above points through delegated acts. On 25 November 2021, the EU Commission published a proposal for the new directive amending the AIFMD (AIFMD II), which was answered by a draft report issued by the European Parliament.[383] While the general scope of reform is relatively limited, the Commission's proposal contained a number of provisions relating

[383] European Parliament, 'Draft Report on the proposal for a directive of the European Parliament and of the Council amending Directives 2011/61/EU and 2009/65/EC as regards delegation arrangements, liquidity risk management, supervisory reporting, provision of depositary and custody services and loan origination by alternative investment funds' 2021/0376 (COD) (16 May 2022), < https://www.europarl.europa.eu/doceo/document/ECON-PR-732549_EN.pdf> accessed 1 December 2022.

to additional disclosure obligations towards investors. In detail, the proposal required in Art. 23 the pre-contractual material provided to investors to include:

- Disclosure on fees, costs and expenses to be borne by investors and a list of fees and costs related to the operation of the AIF borne by the AIFM or its affiliates; as well as on a quarterly basis information on all fees and costs charged or allocated directly or indirectly to the AIF and its investments;
- Additional information on the use of liquidity management instruments for open-ended funds.

The proposals were however mostly defused or deleted in the Parliament's responsive report. There is not yet a final version of the AIFMD II.

(b) Valuation of funds

One of the above-mentioned points to be included in the documentation deserves a closer analysis at this point, namely the valuation procedure and pricing methodology.

The objective and duly executed appraisal of the acquired funds is another central aspect of investor protection measures. By this means, investors are given relevant information on the specific fund's strategy to make a well-balanced investment decision. In addition to the valuation procedure, also the net asset value per unit or share needs to be disclosed to the investors.

The relevant regulations on the value of a fund and its assets are quite straightforward, in both US and EU legal frameworks.[384]

The AUM of alternative funds is generally valued in terms of net asset value, which results as a combination of both the acquired assets, i.e. the art, and the cash held by the fund.[385] Absent any official register for the value of artworks, the question becomes pertinent how the value of the fund is to be established.

[384] The valuation rules of the AIFMD are in Art. 19, respectively Arts. 67-74 Commission Delegated Regulation 231/2013.
[385] Wilson (n 239) 336.

In general, there are five key criteria to consider for the valuation of an artwork, which are:

1) Category (e.g. Contemporary vs. Old Masters)
2) Artist
3) Provenance / Authenticity
4) Size
5) Particularity

A point of orientation can be seen in previous auction results and the sales history of a work. However, past auction results are no guarantees on any future price development.[386] The price at which a work can be resold hinges on many conditions, including a number of factors outside the control of the AIFM. The appraisal of the market value of an artwork thus is a difficult task, which has been subject of a vast array of studies.[387] Alternative investment funds are legally required to implement valuation procedures that produce reliable assessments of the fund's assets. The methodologies and systems applied to calculate the net asset value is supposed to be functionally independent from the portfolio management as well as the remuneration policy of the fund.[388] Since the AIFM assumes the central decisive function in the selection of works and usually receives an incentive fee upon successful liquidation, in most cases, the evaluation has to be outsourced. Most alternative investment funds as well as art funds thus appoint independent experts as external appraisers to perform the valuation of assets. By this means, not only do investors receive an objective evaluation of the acquired works, but conflicts of interests are also prevented.[389] According to the AIFMD, the level of proficiency of external appraisers needs to be recognized either by mandatory professional registration or regulatory provisions – both of which do not exist with regard to the profession of art appraisers – or rules of professional conduct.[390] The appointed external appraiser may not delegate his task to a third party.[391] Even if the procedure is outsourced, the AIFM remains responsible for the proper valuation of the assets and

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[386] A fact which is consistently emphasized in the promotion material handed to investors; see also on this issue Jens Beckert, Jörg Rössel, 'The Price of Art – Uncertainty and reputation in the art field' European Societies 15 (2013) 2, 178, <https://doi.org/10.1080/14616696.2013.767923> accessed 13 November 2022.
[387] See e.g. taking also the emotional value into consideration Michael Hutter and Richard Shusterman, 'Chapter 6 Value and the Valuation of Art in Economic and Aesthetic Theory' (2006) 1 Handbook of the Economics of Art and Culture 169; on the relevance of factors external to the artwork Orley Ashenfelter and Kathryn Graddy, 'Auctions and the Price of Art' (2003) 41 Journal of Economic Literature 763.
[388] Art. 19 AIFMD.
[389] Recital 29 AIFMD
[390] De Sanctis (n 66) 58; for the different ethical standards applied by US art appraisers' institutions see Alessandra Dagirmanjian, 'Laundering the Art Market : A Proposal for Regulating Money Laundering Through Art in the United States Laundering the Art' (2019) 29 Fordham Intellectual Property , Media and Entertainment Law Journal.
[391] Art. 19 para. 6 AIFMD.

the publication of the net asset value. The liability towards the fund and the investors can therefore not be precluded by having an external valuer.[392] Nonetheless, this does not exclude the external valuer's liability. Indeed, for any losses suffered by the AIFM as a result of the external appraiser's negligence or intentional failure to duly perform its tasks, the external valuer is to be held liable.

The means by which a proper valuation of assets that are not financial instruments has to be conducted are specified by the Commission's Regulation 231/2013 in Section 7. Given the manifold forms and eligible investment assets of AIFs, valuation policies vary and need to be adapted according to the specific investment strategy. For assets that are particularly complex and illiquid, there is a higher risk of inappropriate valuation. The AIFM should therefore put in place sufficient controls to ensure an appropriate degree of objectivity.[393]

The valuation procedure shall be carried out at appropriate intervals depending on the different fund types (open- or closed-ended), the underlying asset class and capital fluctuations,[394] at least once a year.[395] Additional valuations may be necessary for close-ended funds in case of an increase or decrease of the capital.[396]

(2) Applicable Rules to "Smaller Art Funds"

Pursuant to Art. 3(2) AIFMD, smaller funds call for the application only of Art. 46 as well as Art. 3(3), (4) AIFMD. Accordingly, what can be expected of the manager of a smaller fund is the registration with the NCA, which shall encompass the following information:

a) Identification of the manager as well as the fund with their NCA;
b) Information on the investment strategies of the fund;
c) Information on the main instruments in which the AIFM is trading, on principal exposure and concentrations of the funds under management by the same AIFM;
d) Qualification of the fund as "smaller" AIF.

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[392] Art. 19 para. 10 AIFMD.
[393] Recital 79 Commission Regulation 231/2013.
[394] The details of the assessment procedures and also the time intervals were to be specified by the European legislator, see e.g. Recital 81 Commission Regulation 231/2013.
[395] Indeed, all of the interviewed art funds confirmed to issue an updated appraisal of the underlying artwork to their investors at least once a year.
[396] Art. 19(3) para. 3 AIFMD.

All of the above information is to be reported to the NCA, which may in addition require the AIFM, depositaries or auditors to provide additional material and records (Art. 46); the AIFMD does not explicitly demand the same information to be disclosed to investors.

Consequently to being subject of the lighter regime, smaller alternative investment funds are free to market their units to professional investors without having to comply to the vast list of ongoing duties applicable to "bigger" funds under the AIFMD. The question arises whether the same applies with regard to retail investors. As the AIFMD stipulated that funds managers generally need to be authorized in order to be able to market units to professional investors, this could yield the reverse conclusion that fund which in any case do not need authorization are free not only to market to professionals, but also to retail investors. This is however not the case. Rather, the scope of the Directive is limited to regulate the marketing to professional investors;[397] the marketing to retail investors however is left within the regulation authority of the Member states.[398] This result is in line with the aim of the regulation, which is to increase the protection of investors with regard to alternative investment funds. If small-regime AIFMs were allowed to market to retail investors, properly the most vulnerable group would be "exposed" to the fund structures with the lowest applicable level of disclosure obligations.

As we have seen above, the AIFMD generally provides for transparency rules whose objectives are the protection of investors and avoidance of CoIs. However, given the parallel "light regime" applicable to the managers of smaller funds, in fact, most art funds within the EU are not bound to the majority of rules under the AIFMD. Instead, the applicable provisions only impose the disclosure of essential information to the NCA. In practice, however, art funds in the EU regularly supersede their legal obligations by issuing yearly reports on the value of the AUM and any relevant development in the art market. This may be deemed proportionate in the context of the clientele of art funds being restricted to professional investors, who are assumed to have the sufficient background to calculate the associated risk and cannot not be easily taken advantage of due to limited disclosure.

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[397] Tania Derenzis, 'Retail AIFs – Heterogeneity across the EU' [2019] ESMA Report on Trends, Risks and Vulnerabilities 47, 48.

[398] European Commission, Question and Answer, on the Directive 2011/51/EU of the European Parliament and of the Council of 8 June 2011 on Alternative Investment Fund managers and amending Directives 2003/41/EC and 2009/64/EC and Regulations (EC) No 1060/2009 and (EU) No 1095/2010, 14.

The question to which extent retail investors are protected can however not be conclusively answered merely taking into consideration the AIFMD, as the pertinent rules are established within the national laws of the Member States.[399] As can be deduced from the data included in Annex I, art funds generally pursue a strategy where an invite to participate is only extended to professional or semi-professional clients according to national law (in accordance with Art. 43(1) AIFMD). What remains to be analyzed at an EU level in addition to the AIFMD are the applicable rules to the issuance of art fund units under MiFID. Contrary to the AIFMD, the MiFID-framework does not include an absolute value threshold below which obligations do not have to be followed. Also, MiFID in principle establishes the same rules for catering to any form of investor, regardless of professional or retail, although their extent varies in accordance to the respective need for protection. Accordingly, in determining the minimum European standard with regard to marketing AIF-units to retail investors, one needs to turn to the MiFID framework.

b) MiFID II

With "units in collective investment undertakings" being explicitly named among the list of financial instruments, art funds issuing and marketing their participation rights to investors can be assumed to fall within the remit of MiFID II.[400] Contrary to the AIFMD, MiFID II does not denote any minimum capital threshold, below which its organizational and protective obligations do not apply. Accordingly, art funds would require authorization as an investment firm in order to provide certain financial services. Consequently, they owe their clients fiduciary duties as expressed in the "best interest" obligation under Artt. 24, 27 MiFID II and in this context are in particular required to prevent any CoI.[401]

However, before the MiFID regime can even be applied, its correlation with the AIFMD must be determined. In fact, this is a quite complex issue, since there is not a single solution, but instead, different systems interlock on the basis of the desired outcome.[402] In this context, it is essential to emphasize that an investment firm may not be authorized both under MiFID and as an AIFM

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[399] For an overview on the different applicable regimes in the largest EU industries, see Derenzis (n 397) 48 f.

[400] (3) Section C Annex I MiFID II.

[401] See Art. 23.

[402] See e.g. for an overview Thomas Jutzi and Christoph Feuz, 'MiFID II, AIFMD Und UCITSD: Auswirkungen Des EU-Vermögensverwaltungsrechts Auf Das Grenzüberschreitende Geschäft Schweizer Finanzintermediäre' *Jusletter Next* <https://www.iwr.unibe.ch/e36453/e162340/e172868/e172869/files426879/2016_04_25_Jusletter_ger.pdf>.

under the Directive.[403] Accordingly, a firm that was already authorized under MiFID may opt to become subject to the AIFMD instead.[404] As a consequence of not being a recognized investment firm under MiFID, the entity may however have to face certain restrictions in its scope of activities. If an authorized AIFM intends to offer certain financial services, such as investment advice and individual portfolio management, the manager would have to add a MiFID "top-up" permission. The respective services allowed by the additional permission would hence not be subject to obligations arising under the AIFMD; on the other hand, this leads to most of the MiFID II client protection rules becoming equally mandatory as if a MiFID license was required.

Another controversial point in this matter is the scope of applicable rules with regard to the managers of smaller AIFs. Here, again, one would have to differentiate between small authorized AIFMs (under the opt-in regime) and merely registered small AIFMs. With regard to the former, the applicable system practically parallels that of standard authorized AIFMs, which means that in order to be able to provide investment advice and individual portfolio management, a MiFID top-up permission will be required, which imposes compliance with MiFID rules with regard to the respective services. Taking into account that the regulated activities should not overlap anyway, the same system should apply with regard to smaller funds, especially since MiFID includes retail investors and as such, in view of the intended regulatory gap left by the AIFMD, its rules on portfolio management and advisory services offered to this investor category do not stand in conflict with others.

To what extent does this factually affect art funds? The external managers of art funds usually provide collective portfolio management services – in distinction to individual ones. Only the latter requires a top-up license under MiFID. Where such an authorization may however be needed is in the context of investment advice. In this respect, a distinction must be made on the basis of the facts as to whether the service constitutes merely portfolio management or investment advice. Of relevance in this context is also the differentiation laid down in MiFID between investment advice and corporate finance advice: The latter constitutes a mere "ancillary service", for which no explicit authorization can be requested under MiFID.[405] Corporate finance advice

[403] Collective investment undertakings and their managers are explicitly excluded from the scope of MiFID II, see Art. 2(1)(i).
[404] This practice has been quite frequently employed for a while around the time MiFID II was to enter into force, see Charles Gubert, 'Fund managers abandon MiFID II in shift to AIFMD' *Global Custodian* (31 August 2017) <https://www.globalcustodian.com/fund-managers-abandon-mifid-ii-in-shift-to-aifmd/> accessed 1 October 2022.
[405] Art. 6 (1) MiFID II.

is described in Section B of Annex I of the Directive, according to which advice to undertakings on capital structure, industrial strategy and related matters and advice and services relating to mergers and the purchase of undertakings fall under this term. In its consultation paper on "Understanding the definition of advice under MiFID", the CESR stipulates that the decisive criterion in the assessment should be the nature of the advised-on subject: corporate finance advice does not involve investment in financial instruments.[406] Furthermore, investment advice can only be issued to a person as a potential investor; consequently, advice to an undertaking on it issuing securities shall not be considered investment advice. In applying these standards to the case of art funds, it seems most probable that the advice given by external managers to a fund does not correspond to the concept of investment advice. The primary reason for this can be seen in the nature of the dealt with objects, i.e., artworks. As we have previously established, artworks are generally not considered financial instruments. Accordingly, any advice issued on their profitability can – at least as of now – not be considered investment advice.[407]

Another practical concern arises in the context of investment advice. Given the need for investment firms to provide only financial instruments that are suitable for the client's needs and risk profile, additional requirements arise where the offered product exceeds the "average" complexity.[408] According to an ESMA Technical Advice, all units issued by AIFs are considered complex.[409] Consequently, MiFID II makes the sale contingent on accompanying investment advice which shall render the client aware of the involved risks. In practice, this means that even

[406] CESR, 'Consultation Paper: Understanding the definition of advice under MiFID' CESR/09-665 (14 October 2009) para. 71 f.
[407] The question whether a different result would be obtained if investment advice is given on financial instruments *as well as* artworks, with the consequence that art advisors may be subject to MiFID rules, hints at a controversial issue, the discussion of which would transcend the scope of this work.
[408] Art. 25(4) MiFID II; see above Chapter I.
[409] ESMA, 'Technical Advice to the Commission on MiFID II and MiFIR (Final Report)' ESMA/2014/1569 (19 December 2014), Section 2.18 (13) 159, according to which ESMA understands all investments in non-UCITS collective investment undertakings as complex, "regardless of whether they take the legal form of shares or of units". Whereas for certain financial instruments, complexity it presumed according to MiFID II and ESMA guidelines, in general, it is supposed to be a relative term which requires a case-by-case investigation of the product. In terms of indicators, ESMA has proclaimed that a product should generally be considered complex when, e.g., "they use more opaque indices that are for example set up by the product manufacturer, rather than using standard market indices;", "have a fixed investment term of a number of years with barriers to exit (that are not clearly explained) - whether that is due to the lack of a secondary market, or significant penalties or losses on early exit", or has underlying assets or indices that are not easily valued, or whose prices or values are not publicly available (see ESMA guidelines, e.g. 'Opinion on MiFID practices for firms selling complex products' ESMA/2014/146 (7 February 2014). In light of these parameters, the complexity of units issued by art funds therefore also results from other reasons than the mere distribution of them by AIFs. There is no central art market index but only various private initiatives focusing on certain segments of the market; also, the valuation of the artworks is by itself a highly complex process which needs to be conducted by experts; what is more, the closed-ended structure of most art funds requires investors to leave their capital untouched for the whole life span of the fund.

fund managers that do not provide investment advice but "execution only" services with regard to their funds' units are barred from offering complex products to retail clients, unless these have previously received advice on the investment. This duty accounts for professional clients in a mitigated manner: Due to their experience, professional investors usually need less comprehensive advice on complex financial instruments. Given the costs associated with extensive assessment procedures, this provision may practically exclude retail investors from this kind of investment category – which stands in stark contrast to the legislative intent expressed in recital (71) of the AIFMD, where it calls explicitly on the Member State to "allow the marketing of all or certain types of AIFs manager by AIFMs to retail investors." The Directive reserves the possibility to impose stricter requirements on the marketing of fund's units to retail investors compared to professional investors. Also, the AIFMs themselves are required to "take into account any additional requirements when assessing whether a certain AIF is suitable or appropriate for an individual retail client or whether it is a complex or non-complex financial instrument." This would in theory leave enough discretion to Member States and the issuing entity to decide on the sell-ability on an advised or non-advised basis, taking into consideration the specific circumstances of each product offer. By imposing absolute bars on the availability of execution only services, thereby depriving clients of their autonomous decision-making capacity, ultimately the art (and generally alternative investment) fund sector stands disadvantaged.

c) Central Findings

The primary regulatory bodies specifying duties of conduct and disclosure obligations applicable to art funds and their managers are the AIFMD and MiFID framework. The extent to which these set of rules respectively their national transposing laws apply to art funds depends on the structuring of each individual fund: essential in this regard are the total AUM as well as the addressed client category. Both aspects acknowledge the risk which can be attributed to the different forms of alternative funds: while the volume of assets is indicative for the risk a fund represents in view of macro-economic stability, the targeted investor category reflects the other central objective of financial market regulation, namely investor protection. Taking into consideration the factual predicates of art funds in the EU, it emerges that practically all funds have structured their business concept in such way as not to present great market risks, since their volume is generally much smaller than that e.g., of hedge funds and they market only to professional or sophisticated investors. They therefore often fall within the "lighter" AIFMD

regime, which imposes a drastically reduced set of obligations on the fund manager. In practice, many art funds comply with the annual disclosure obligation towards investors, primarily because of an established custom, thereby exceeding their obligations.

Indeed, notwithstanding art funds being often proclaimed as means to increase accessibility to the art market, the availability of art fund units to retail investors is still extremely limited. Whether AIFs are allowed to market their units to retail investors is subject to national legislation. Currently, the incentive of investment firms to enlarge their clientele is low, given that as a result to accepting retail investors, the manager would have to deal with extensive additional organizational obligations and reporting duties, without there being a corresponding European passport which would allow a transnational business set-up. What is more, the current general classification of AIF-units as "complex" financial instruments in combination with the obligatory investment advice prior to a transaction additionally disadvantages AIFs and renders extending the offer to retail clients simply not profitable enough, for both sides, as the involvement of an intermediary for advice results in extra costs.

In order to increase the availability of alternative and more complex investment forms to other than professional investors, many Member States have installed an interim category of semi-professional investors. Although this investor class is not specifically addressed in the AIFMD, the Directive provides for an opening clause that leaves the necessary discretion to Member States.

Whether also experience and a professional background in the art scene can be taken into consideration in assessing a client's category remains questionable. The AIFMD as well as MiFID generally refer to financial and investment knowledge when requiring a certain level of sophistication. Whether art collectors are allowed to enter the restricted investment segment as "semi-professionals" without prior investment activity in traditional financial instruments in general remains subject to national laws, although no legal system could be discerned where such an asset-specific focus was established. Especially in the art context where there is ostensibly only minimal correlation with the stock market, it would make sense to take account also of an understanding of the cultural sector. On the other hand, conditioning the semi-professional qualification on art investment would also be a too restrictive approach, as it would detrimentally affect the group of potential investors.

The scope of the AIFMD and MiFID framework are not supposed to overlap. Accordingly, an authorization obtained by a manager under MiFID may have to be given up in order to become an authorized alternative fund manager under the Directive's provisions. Certain activities, such as portfolio management, that are not covered by the AIFMD, may however require a top-up permission under MiFID.

2. Regulation of Art Funds under US Securities Laws

Art funds, being almost exclusively private investment vehicles, are not subject to the same level of burdensome regulatory requirements and disclosure obligations as public investment companies. Given their limited exposure to the general public in terms of marketing and sales of interests, the need for investors to be protected is less compelling. The line of argumentation behind this reasoning is principally two-fold: investors in private funds either have the expertise to make informed investment decisions on their own, and thus do not need the information disclosed to retail investors, or they have the financial independence to cope with a higher risk exposure – or a combination of both.[410]

This does however not mean that art funds are unregulated under US Federal securities law: private funds have to comply with the Securities Exchange Act of 1934, the Investment Advisers Act and at the very least the anti-fraud provisions of the Securities Act of 1933. The following chapter is subdivided into three paragraphs, one by one analyzing the relevant provisions under each act.

In order to avoid compliance with US federal securities law altogether, some prefer to establish their fund offshore, whereby the competence of US authorities can be eschewed. Common jurisdictions of choice are Cayman Islands or British Virgin Islands.[411] Consequentially, shares and units may not be marketed or sold to US residents, as this would put the issuer or advisor again within the remit of US laws and SEC rules.

a) Investment Company Act

One of the central legal bodies in financial market regulation is the Investment Company Act of 1940, which targets public companies. In contrast, investment companies who offer their shares and units through "private placements" are exempted under certain conditions laid out in section 3(c):[412] As an exception to the general rule that all issuers which hold themselves out as being engaged primarily in the business of investing or trading securities are investment companies,

[410] SEC, 'Updated Investor Bulletin on Accredited Investors' (investor.gov, 14 April 2021) <https://www.investor.gov/introduction-investing/general-resources/news-alerts/alerts-bulletins/investor-bulletins/updated-3> accessed: 16 September 2022.

[411] See e.g. section 6 (1) of the Investment Company Act, which explicitly excludes companies created in the Virgin Islands and having its principal office and place of business there from the scope of the Act.

[412] See below for further details.

issuing companies offering interests only to a selective group of investors above an individual wealth level fall outside the scope of the Company Act. The most pertinent exemptions to art funds read as follows:[413]

(1) Any issuer whose outstanding securities (other than short-term paper) are beneficially owned **by not more than one hundred persons** [or 250 for venture capital funds] and which is not making and **does not presently propose to make a public offering** of its securities. [...]

(7) Any issuer, the outstanding securities of which are owned exclusively by persons who, at the time of acquisition of such securities, are **qualified purchasers**, and which is not making and **does not at that time propose to make a public offering** of such securities;[414]

The archetype of an art fund meets at least one of the above exemptions. First, art funds generally aim for 100 to 2000 investors. The term "public offering" parallels the one in Sect. 4(2) of the Securities Act of 1933 (see below), according to which the answer to the question whether an offering occurs 'public' or 'non-public' hinges on the classification of the purchasers: in order to fall within the non-public offering exemption, only accredited investors can be admitted, i.e., with a certain income, net worth, or a professional license.

By contrast, the second exemption employs the term "qualified purchaser", whose definition is to be found in Sect. 2(a)(51)(A) of the Company Act:

i. **Any natural person** (including any person who holds a joint, community property, or other similar shared ownership interest in an issuer that is excepted under section 3(c)(7) with that person's qualified purchaser spouse) **who owns not less than $5,000,000 in investments**, as defined by the Commission;
ii. Any company that owns not less than $5,000,000 in investments and that is owned directly or indirectly by or for 2 or more natural persons who are related as siblings or spouse (including former spouses), or direct lineal descendants by birth or adoption, spouses of such persons, the estates of such persons, or

[413] Section 3(c)(1) and 3(c)(7) Investment Company Act of 1940.
[414] Emphasis added by the author.

foundations, charitable organizations or trusts established by or for the benefit of such persons;

iii. Any trust that is not covered by clause (ii) and that was not formed for the specific purpose of acquiring the securities offered, as to which the trustee or other person authorized to make decisions with respect to the trust, and each settlor or other person who has contributed assets to the trust, is a person described in clause (1), (2) or (4); or

iv. Any person, **acting for its own account or the accounts of other qualified purchasers**, who **in the aggregate owns and invests on a discretionary basis, not less than $25,000,000** in investments. [415]

In brief, natural persons willing to invest in art funds must be able to show either a minimum of USD 5 million in investments or equity respectively an investment portfolio of at least USD 25 million in total already at the moment of the sale of units.

Private funds are usually very strict in complying with at least one of the above exemptions in 3(c)(1) or 3(c)(7). While in the first scenario, the number of possible investors is limited to 100, in the second case, theoretically an unlimited number of qualified investors can be catered to. In order to keep the advantage of avoiding registration with the SEC, the total number is however generally kept below 2,000, which is the threshold established by Section 12(g) of the Securities and Exchange Act (see below).

Furthermore, according to Section 6(c), the Commission may exempt any person, security, or transaction from any provision, rule or regulation of the Company Act, if and to the extent that such exemption is necessary or appropriate to the public interest and is consistent with the protection of investors and the purposes of the provisions of the title. This applies in particular to closed-end investment companies, for which Sec. 6(d) explicitly states that the Commission shall exempt them from any or all provisions of that title if, in addition to the earlier prerequisites of appropriateness and necessity to the public interest, the following conditions are fulfilled:

[415] Emphasis added by the author.

(1) the aggregate sums received by such company from the sale of all its outstanding securities, plus the aggregate offering price of all securities of which such company is the issuer and which it proposes to offer for sale, do not exceed $10,000,000, or such other amount as the Commission may set by rule, regulation, or order;

(2) no security of which such company is the issuer has been or is proposed to be sold by such company or any underwriter therefor, in connection with a public offering, to any person who is not a resident of the State under the laws of which such company is organized or otherwise created; and

(3) such exemption is not contrary to the public interest or inconsistent with the protection of investors.

Whether these conditions are fulfilled needs to be decided in consideration of the facts of each individual case.

To summarize what has been established so far, art funds are generally eligible to fall within at least one of the several exemptions provided by the Investment Company Act due to their carefully designed company structure. They are thus exempted from registration as an investment company with the SEC under the Investment Company Act.

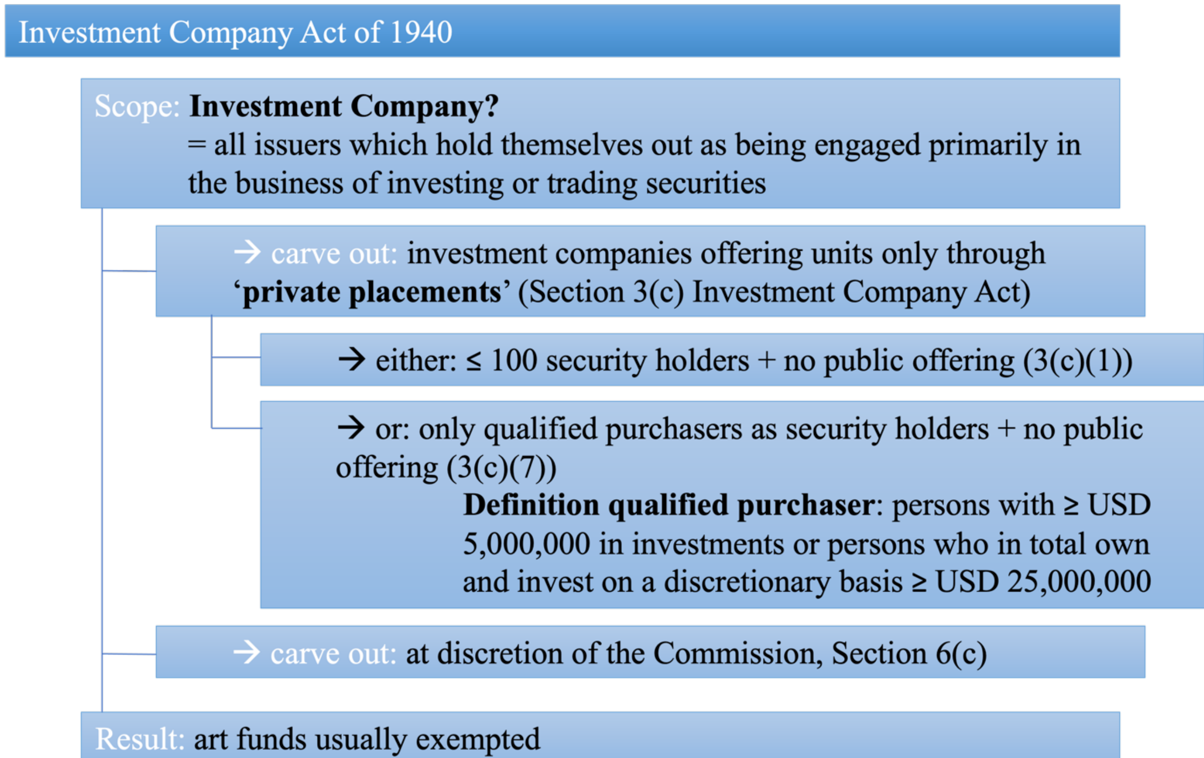

Chart V: Applicability of the Investment Company Act of 1940

b) Securities Act of 1933

The Securities Act determines yet another registration duty with the SEC for the public offer of securities. Art funds, together with other private funds, refrain however from undertaking public offerings. Instead, this type of funds raises its capital almost exclusively through "private placements", for which Regulation D of the Securities Act establishes exemptions to the general registration rule.[416] In detail, Rule 506 provides for two distinct exemptions: The first "safe harbor" refers to the private placement exemption in Rule 506(b) where no "general solicitation" is allowed.[417] To fall within the scope of the exemption, the general public may not be addressed in marketing the fund's units; instead, to win investors, the fund manager has to rely on substantial pre-existing relationships. Importantly, the use of the internet to solicit investors is proscribed.[418]

The second exemption, Rule 506(c), does not stipulate any limitations on the solicitation process ("general solicitation exemption"),[419] but instead constrains the circle of investors that units may be sold to. While marketing information can be shared with the general public over the internet and other long-distance media, only accredited investors are eligible as purchasers of the fund's units.[420] While both options do not put a limit on the number of accredited investors, the private solicitation exemption also allows for admitting up to 35 non-accredited investors. Including non-accredited investors among the limited partners of a fund however goes hand in hand with additional requirements. In case non-accredited investors are involved, disclosure of essential information in a private placement memorandum is mandatory as well as the issuance of a financial statement, the extent of which depends on the amount of the investments.[421] It thus

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[416] "The Rules Governing the Limited Offer and Sale of Securities Without Registration under the Securities Act of 1933", which apply but for so-called "bad actors": if the fund or any relevant involved person has a criminal conviction, a court order exists or a disqualifying event has occurred with regard to a business-relevant issue, the offering is not amenable to the exemptions of Regulation D.

[417] In this case, no Blue-Sky laws apply respectively establish as an additional standard to an offering.

[418] Although online intermediaries may be used.

[419] Which is not to be confused with a public offering; even under this exemption, the marketing and sale of units still occurs as a "private offering".

[420] To name but a few examples: the Artemundi Guernica V. fund files "a 506(c)" ('The Art Fund Inquisition Part II: Guernica V and Artemundi' Artwork Archive < https://www.artworkarchive.com/blog/the-art-fund-inquisition-part-ii-guernica-v-and-artemundi> accessed 20 October 2022; Artory/Winston offer "fund token to investors on Securitize through Reg D 506(c) and Reg S exempt securities offerings" according to their promotional material provided to investors.

[421] SEC, 'Private placements – Rule 506(b)' (28 October 2022) <https://www.sec.gov/education/smallbusiness/exemptofferings/rule506b> accessed 13 November 2022.

does not come as a surprise that in practice, art funds accept only accredited investors as their limited partners (with only a single exception) .[422]

Both constellations, the private as well as the general solicitation exemption, are considered private placements.

aa) Accredited Investors

In order to qualify as an accredited investor, individuals or undertakings must possess a certain level of financial purchasing power or sophistication. Persons belonging to this category are presumed to be in less need for regulatory protection, which is why accredited investors have a wider range of options to choose from compared to retail investors. While for large undertakings, their level of sophistication is generally presumed once their total assets exceed $5,000,000,[423] individuals have to meet at least one of the following conditions:[424]

1) Having a net worth exceeding US$ 1 million, either individually or jointly with a spouse;[425]
2) Having an individual annual income of or exceeding $200,000 or having a joint income with their spouse of at least $300,000 for the last two consecutive years and reasonably expected to maintain the same level of income in the current year.

The fund management must take reasonable steps to make sure that the investor meets the requirement to deserve the "accredited" status. In order to do so, one may rely on primary documents such as tax returns, brokerage statements, etc. In addition to the above, even a signed statement by the investor's lawyer, accountant, or broker shall suffice, accrediting the level of wealth or income. Customarily, a distributor will ask a potential investor to fill out a subscription agreement before making an offer to sell units. It contains essential information about the potential client and the amount to which she/he wants to commit to make sure that the candidate fits the terms of investment. Furthermore, applicants are often asked to confirm that they acquire the membership interest in the fund for their own investment purposes and not to

[422] An exception to this can be seen in the business model employed by Yieldstreet with regard to its Prism fund, which also caters to retail investors (see Annex I).
[423] Provided that the institutional investors and organizations (corporations, partnerships, LLCs, trusts, family offices, etc.) were not just formed for the specific purpose of acquiring the securities offered.
[424] Rule 501(a) of the Securities Act 1933.
[425] Without taking the value of the primary home into consideration.

sell it on in perspective.[426] This obligation is to be fulfilled by the issuer to be able to rely on the exemption under Regulation D, which is why the respectively issued instruments are also referred to as "restricted securities". What is more, the resale of art fund units by investors could impose additional compliance obligations on the issuer: Under Rule 502(d) of Regulation D, securities acquired pursuant to a private placement under one of the exemptions of Regulation D cannot be resold by an investor absent the registration under the Securities Act.[427] Any future transfer is therefore generally also conditional upon the issuer's written consent. Potential investors who are unwilling to provide the necessary information will not be accepted by art funds.[428]

This strictly finance-based understanding of accredited investors has been amended by the SEC in 2020 to include also other groups of individual and institutional investors in view of their knowledge and expertise.[429] Hence, natural persons can achieve the status of accredited investors by showing one of the below qualifications:

- Series 7, 65, or 82 license in good standing (referring to financial profession licenses of the General Securities Representative, Private Securities Offering Representative, Licensed Investment Adviser Representative);
- Directors, executive officers, or general partners (GP) of the company selling the securities;
- Any "family client" of a "family office" that qualifies as an accredited investor;
- "Knowledgeable employees" of a private fund for investments in the fund.[430]

It is not uncommon for funds to incentivize their hired portfolio advisors through participations in the fund's profit. In this context, the question frequently arises whether funds risk to expose themselves to stronger SEC regulation simply because of giving units to their employees. If the employee does not qualify under Rule 501(a) of the Securities Act because of her/his income or

[426] The resale could be in violation of the applicable securities law and impose additional compliance obligations on the issuer, see more in detail below in the Section "Security Exchange Act".
[427] Or in case a registration exemption applies after a certain holding period.
[428] Also, units cannot be offered or sold to prospective investors subject to the Employee Retirement Income Security Act of 1974 and regulations thereunder, as amended ("ERISA").
[429] SEC, 'Release on Accredited Investor Definition' (26 August 2020) <https://www.sec.gov/rules/final/2020/33-10824.pdf> accessed 17 August 2022.
[430] "Knowledgeable employee" as defined in Rule 3c–5(a)(4) under the Investment Company Act of 1940.

net worth, there is yet the option to use the amended definition of an accredited investor.[431] The reason behind the "knowledgeable employee" rule is that no additional safeguards are needed with regard to persons who already have access to the relevant information which would have to be made available as a consequence of registration with the SEC. Hence, the scope of persons who fall under this term encompasses those who participate in the investment activities of the private fund, i.ie. directors, executive officers, or even affiliated persons that manage investment activities ("affiliated management persons"). Their status as "accredited" is limited only to shares and units offered by the private fund.

bb) Legal Obligations Arising under the Securities Act

Most art funds deliberately align their offering structure to the requirements of the safe harbor in order to minimalize legal obligations. Instead of having to register, privately offered funds only file notice with the SEC, respectively also any relevant state authorities. Issuers falling within the remit of Regulation D are not imposed any initial or ongoing SEC reporting requirements, except for filing the Form D. Consequently, investors catered to in a private placement offering may not be provided regularly with financial information on their investment. In practice however, all of the interviewed art funds stated to issue an updated appraisal at least yearly.

Moreover, in contrast to public placements, Regulation D offerings do not have to meet any specific disclosure obligations. Nonetheless, most fund managers provide a certain set of information to their investors through a so-called "private placement memorandum" (PPM), similar to an offering circular but with a restricted scope. This is strictly speaking not legally required if only accredited investors are involved in the fund; it can however be considered a market custom and as such expected by investors. A private placement memorandum is a confidential document provided through the fund manager to potential purchaser of interests who meet the requirements of an accredited or sophisticated investor.[432] It entails among others an outline of the management, the offering procedure, the portfolio under management, and most importantly the risks that the investor exposes her/himself to by taking up the offer. One

[431] Before this exemption was expressed in this explicit language, employers would refer to Section 4(a)(2) of the Securities Act, which provides an exemption from the registration duty for any transaction not involving a public offering, which was arguably the case for interests given directly to a few employees as part of certain benefit plans.

[432] The term "sophisticated investor" is, albeit not being defined by law, commonly used in the context of investment. It is generally understood to complement the "old" accredited investor term, which relied merely on financial thresholds, and refers to persons who have sufficient knowledge and experience in financial and business matters to be capable of evaluating the merits and risks of the prospective investment.

of its primary motives, next to informing the potential investor, is to limit the management's liability. In line with this, the PPM usually explicitly excludes all circumstances that could turn into a risk for the fund, i.e., denies any sale to third and unqualified parties and those outside the chosen jurisdiction, and emphasizes that the offered interests where not registered with the SEC.

By way of illustration, the following exemplary paragraph of a PPM of an art fund shall be provided to show the typical language generally used for disclaimers:

> *Investment in this fund is only available for sophisticated/accredited investors and requires the financial ability and expertise to assess the high risks and lack of redemption rights inherent in an investment in this fund. In making the investment decisions, investors must rely on their own examination of the fund and the terms of this offering, including the merits and risks involved. This Memorandum shall not be construed by investors as legal, tax, investment or accounting advice.*[433]

Irrespective of the above, there is a set of rules within the Securities Act that applies regardless of the registration status of the fund, namely the anti-fraud provisions. Section 12(2) or Section 17 of the Securities Act prohibit funds and fund managers:

(1) to employ any device, scheme, or artifice to defraud, or
(2) to obtain money or property by means of an untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading; or
(3) to engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser.

Examples of acts covered by this provision are false statements of fund managers that are intended to drive up prices artificially.

[433] The model PPMs offered by Assure have been consulted as example for a fund's PPM, see <https://www.assure.co/spvs/fund-documents> accessed 18 August 2022.

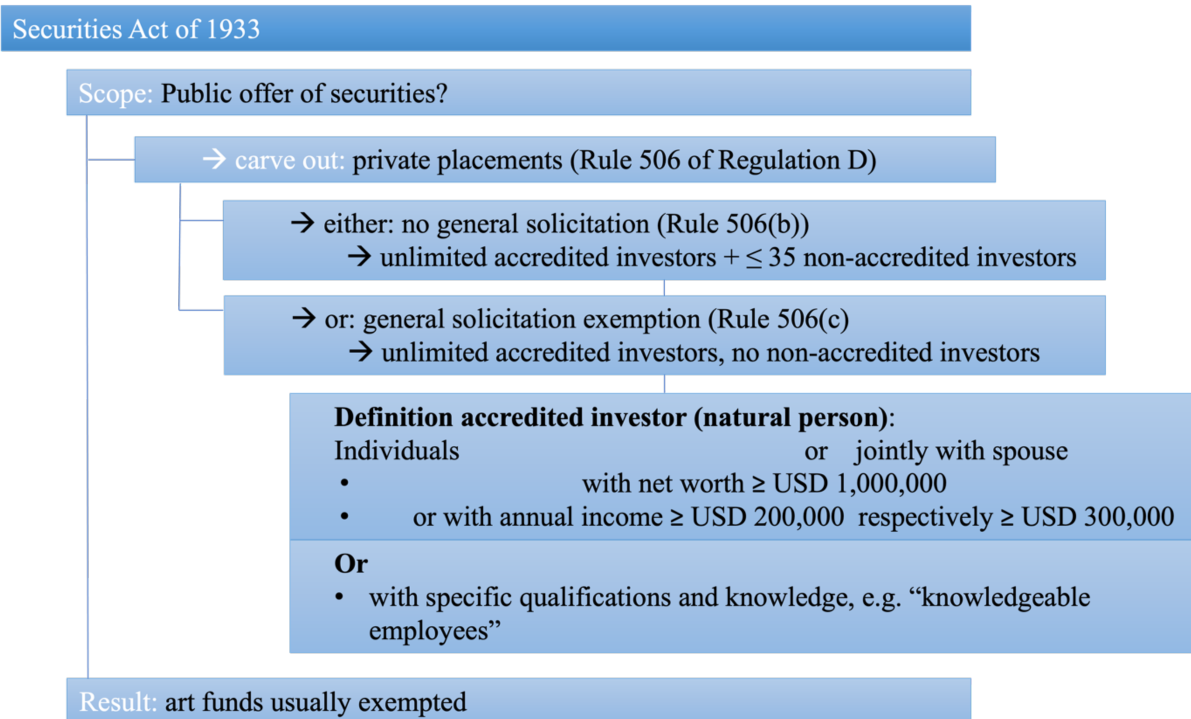

Chart VI: Applicability of the Securities Act of 1933

c) Investment Advisers Act of 1940

The Act from 1940 addresses investment advisers, irrespective of their form as undertakings or individual practitioners. An investment adviser is any person who engages in the business of advising others, for compensation, as to the value of securities or as to the advisability of investing in, purchasing, or selling securities, or who for compensation as part of a regular business issues analyses or reports on securities (section 202 (a)(11)).[434] As we have seen above, whereas art does (for now) not qualify as security under federal law, a membership unit in an art fund evidently constitutes a "participation in any profit-sharing agreement" and therefore comes under the definition of a security.[435]

[434] Further details to the definition are provided by the SEC in its report 'Regulation of Investment Advisers by the U.S. Securities and Exchange Commission' (March 2013), <https://www.sec.gov/about/offices/oia/oia_investman/rplaze-042012.pdf> accessed 1 November 2022; see also SEC, 'Applicability of the Investment Advisers Act of 1940 to Financial planners, Pension Consultants, and Other Persons Who Provide Others with investment Advice as a Component of Other Financial Services', Investment Advisers Act Release No. 1092 (8 October 1987).
[435] See e.g., Section 202 (a) (18) Investment Advisers Act 1940.

The question thus arises whether art fund managers engage in the business of advising their potential clients with regard to the investment.[436] In this regard, it may be of interest to reveal that the SEC has taken a stand on the matter that advice about market trends as well as advice about the advantage of investing rather in securities or other types of investment (e.g. art or real estate) also qualifies as advise about securities.[437] The crucial argument however in this controversy can be found in the above cited paragraph drawn after the template of an exemplary art fund information paper.[438] Here, it is denoted that "*[t]his Memorandum shall not be construed by investors as legal, tax, investment or accounting advice*". In line with this, fund managers generally make sure that their selling activities cannot be construed as advice. Any exchange prior to the sale is to be regarded as a sales pitch without the showing of alternative investments and without taking into consideration the client's individual situation. It is explicitly made clear in the provided information material that investors shall not take any of the therein made statements as investment advice but are instead encouraged to seek independent advice from their own, independent adviser. Consequently, art fund managers do not assume the role of an adviser to the fund's investors.

This does however not mean that the Investment Advisers Act is not applicable to art fund managers. As a matter of fact, art fund managers generally qualify as investment adviser under the Act *towards the fund*.[439] Indeed, the fund manager is expected to concentrate the necessary skill and connections to detect the most profitable purchases and is vested with the discretional power to make investment decisions on behalf of the fund.[440]

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[436] Generally, advice on real estate or commodities does not fall within the scope of the above provision, which is in line with the conclusion of the previous chapter.
[437] SEC, 'Regulation of Investment Advisers by the U.S. Securities and Exchange Commission' (n 434) 3; refers also to the Investment Advisers Act Release No. 1092 (Oct. 8, 1987).
[438] See above (n 433).
[439] See e.g. for illustrative purposes the information provided by Yieldstreet to its investors in the transaction materials for art equity funds: "We are managed by YieldStreet Management, LLC (the "Adviser"), a Delaware limited liability company, which is registered as an investment adviser with the SEC pursuant to the Investment Advisers Act of 1940, as amended, or the "Advisers Act." Our Adviser, which is wholly-owned and controlled by YieldStreet Inc. ("Yieldstreet"), a Delaware corporation, oversees the management of our activities and is responsible for making investment decisions for our portfolio. Both our Adviser and Yieldstreet are considered our affiliates. Our Adviser also serves as our administrator, and in such capacity provides, or arranges for the provision of, the administration services necessary for us to operate. Our Adviser, in its capacity as our administrator, expects to retain one or more sub-administrators from time to time to provide certain administrative services to the Company on its behalf."
[440] There is no clear indication as to whether the Investment Advisers Act applies also if only non-U.S. residents are advised. The SEC has published the standpoint that there is no restriction as to clients being U.S. or non-U.S. persons under the condition that the adviser has his place of business within the U.S. territory (see SEC, 'Regulation of Investment advisors'); on the other hand, non-U.S. Advisors are covered by the Act if they extend their services to U.S. persons (unless a special exemption applies, e.g. the rule of the "foreign private adviser").

Also in the context of investment advisers, family offices assume a particular role, in that an office that manages the wealth of a single family is excluded from the investment adviser's definition if it does not declare itself to be one, if advice is only provided to family members, and the undertaking is exclusively owned and controlled by family members (Rule 202(a)(11)(G)-1(b).

aa) Registration Obligation arising under the Investment Advisers Act

Once the activity falls within the substance of the Investment Advisers Act, the person is required to register with the SEC and/or state authorities according to the law of the State where the investment adviser has the principal place of business.[441] While the SEC is the competent authority for larger advisers,[442] smaller and mid-sized advisers are subject to state regulation and in return prohibited from registering with the SEC (Section (203A).[443] The relevant threshold for small advisers is set at US$ 25 million of assets under management. Nonetheless, if the smaller adviser would have to register in 15 or more states, it may register with the Commission instead. Advisers who manage assets worth between $25 million and $100 million have to report to state authorities if they are registered with the state of the place of business and if they are "subject to examination" by that state's authorities. For example, a mid-sized adviser with principal office in New York is not "subject to examination" there and thus, would have to register with the SEC.[444] Another exceptional case is where advise is provided over the internet, which may require registration with the SEC, regardless of the value of assets under management.[445]

[441] US companies may do so through the Investment Adviser Registration Repository website, IARD (<http://www.iard.com/> accessed 2 December 2022).
[442] If registered with the SEC, state laws are preempted for the advisor.
[443] See SEC, 'Final Rule: Exemption for Certain Investment Advisers Operating Through the Internet' 17 CFR Parts 275 and 279 (modified 16 December 2022) < https://www.sec.gov/rules/final/ia-2091.htm> accessed 1 November 2022.
[444] Unless their principal place of business is in another state and they meet the definition of investment adviser in New York State, in which case they must register with the New York State, see SEC, 'Regulation of Investment ADvisrs by the U.S. Securities and Exchange Commission' (March 2013) <https://www.sec.gov/about/offices/oia/oia_investman/rplaze-042012.pdf > accessed 20 November 2022; see also SEC, 'Instructions for Item 2 of Part 1A of Form ADV; Division of Investment Management: Frequently Asked Questions Regarding Mid-Sized Advisers', <www.sec.gov/divisions/investment/midsizedadviserinfo.htm> accessed 20 November 2022."
[445] See SEC, 'Final Rule: Exemption for Certain Investment Advisers Operating Through the Internet' 17 CFR Parts 275 and 279 (modified 16 December 2022) < https://www.sec.gov/rules/final/ia-2091.htm> accessed 1 November 2022.

With regard to art investment, probably the most relevant exemption from registration is directed at "private fund advisers".[446] For any adviser who has exclusively private funds as clients and less than USD 150 million in assets under management in the US, registration with the SEC is voluntary.[447] The definition of a "private fund" corresponds to that of the investment company in the Investment Company Act, "but for" the exceptions in section 3(c)((1) or 3(c)(7) of that Act. As we have seen above, most art funds fall exactly within this remit, being investment companies *per definitionem* with only qualified purchasers.

In view of the consistency and autonomy of art fund management undertakings, which are not limited to the form of internal managers but instead often in charge of several funds simultaneously, thereby frequently surpassing the threshold of $150 million, many of them are registered investment advisers.[448] This also bears the advantage that SPVs acting under the control and supervision of a registered adviser do not need to register separately as an adviser.[449]
People employed by advisors, who conduct advisory services on their own, do also generally not have to register autonomously with the SEC, if the advisory firm is registered and the registration covers employees and other persons acting on the registered advisor's behalf and under the control.[450]

Investment advisors who fall below the threshold or within another exemption are referred to by the SEC as "exempt reporting advisers" and do not have to comply with registration provisions and associated disclosure obligations. They are however required to file the Form ADV with the SEC annually, which is subject to examination, thereby assuring that the assets under management do not exceed the USD 150 million threshold of the Investment Advisers Act.[451] In this form, information on the fund's organization and the advisor's business practices (especially

[446] Which was added by the Dodd-Frank Act, which replaced the former wider "private adviser" exemption with the narrower current one. Consequently, many advisors who previously acted without registration had to register with the SEC.
[447] Section 203(m) of the Investment Advisers Act (added by the Dodd-Frank Act), 15 U.S.C. § 80b-3 (m).
[448] See e.g. Yieldstreet Inc., which has subsidiaries that include Yieldstreet Management, which is registered as an investment advisor with the SEC.
[449] See SEC Staff Letter, 'American Bar Association, Subcommittee on Hedge Funds' ("ABA Letter 2012") (18 January 2012), Question 3, <http://www.sec.gov/divisions/investment/noaction/2012/aba011812.htm> accessed 20 November 2022.
[450] SEC 'Regulation of Investment Advisers by the U.S. Securities and Exchange Commission' (March 2013) 17, <https://www.sec.gov/about/offices/oia/oia_investman/rplaze-042012.pdf> accessed 1 November 2022.
[451] Ibid 16: "Rule 204-2. The report must be filed within 60 days of relying on the private fund adviser exemption. Only portions of Form ADV must be completed. General Instruction 13 to Form ADV. An exempt reporting adviser is not required to deliver a brochure to its clients. General Instruction 3 to Form ADV."

any involving potential conflicts of interest with clients, but also typical client categories, advisory and non-advisory activities) as well as the offered key services have to be provided. Alternatively, in case the limit of USD 150 million is exceeded, investment advisers have to report extensive information to the SEC using the Form PF, including the types of funds advised, their size, liquidity and leverage, as well as the investor type. With regard to the investors in the fund, no explicit obligations arise under the Investment Advisers Act, given that management firms do not advice the fund's clients. In line with this, the verification of the relevant knowledge and financial background occurs only with regard to ascertaining the accredited investor status, without there being any necessity however to collect information on the investment strategy, risk thresholds and objectives of the investors. The fiduciary duties established under this Act, such as the duty of care and the duty of loyalty, are owed to the fund and have to be observed in the management of the assets. In view of the limited partner status of investors, one may thus assume that they benefit at least indirectly from the owed duties towards the fund.

bb) Anti-fraud

In line with what has been stated with regard to the Securities Act, the anti-fraud provisions of the Investment Advisors Act (Sec. 206) also apply to all advisers regardless of them being registered or exempted.

cc) Performance Fees

Section 205(a)(1) of the Investment Advisers Act prohibit SEC-registered investment advisers from charging clients a share of capital gains on the basis of the adviser's success as remuneration for their advisory service.[452] This general prohibition of performance fees stands in contrast to the common practice of art funds which consists in establishing an incentive fee for the managers upon surpassing the prospected return rates. In fact, art fund advisors are generally not concerned by this prohibition. While for unregistered art funds, the provision is generally not applicable, even funds who are required to register fall for the most part under at least one of the exceptions provided in Section 205(b), namely either by basing the compensation on the total value of a fund averaged over a definite period, by providing investment advice to a company excepted from the definition of an investment company under Section 3(c)(7) of the Investment Company Act, or by having only "qualified clients" (Rule 205-3). In this context, a qualified client means any

[452] See also Rule 205-3 Investment Advisers Act.

client that has at least $1,100,000 in assets under management with the adviser immediately after entering into the advisory contract or if prior to this, the adviser reasonably believes that the client has a net worth of more than $2,200,000.[453]

Parallel to the provision of the Securities Act providing discretionary power to the SEC in exempting any person or transaction where appropriate or necessary and in line with client protection and the aims of the law, also the Investment Adviser Act includes such an entitlement in Sec. 205(e). Accordingly, the Commission can forego the application of subsection (a)(1) if and to the extent that the exemption relates to an investment advisory contract with any person that the Commission determines does not need the protection awarded under that paragraph on the basis of financial sophistication, net worth, knowledge of and experience in financial matters, amount of assets under management, relationship with a registered adviser, etc. It is from this provision that the Commission has drawn the authorization to establish a numerical threshold in an attempt to standardize the exemption process, which is currently set at USD1,100,00 of AUM for companies and USD2,200,00 as net worth for qualified clients.[454] The dollar amount has to be adjusted every 5 years for the effects of inflation.[455]

Investment advisors are free to come to a contractual agreement with their clients on the advisory fees. In general, as we have seen above, these make up a certain percentageof the total value of assets under management as a yearly standard fee, usually between 1% and 2 %. In addition to this, most art fund managers are granted an incentive fee of 15-20% (the term often used in this context is "Two and Twenty" or "2 and 20") in case the realized return in sales exceeds the prospected annual return rates for investors.

[453] These thresholds were only just recently adjusted for inflation by the SEC in June 2021, effective August 2021, see the Order Approving Adjustment at <https://www.sec.gov/rules/other/2021/ia-5756.pdf> accessed 20 November 2022.

[454] SEC, 'Order Approving Adjustment for Inflation of the Dollar Amount Tests in Rule 205-3 under the Investment Advisers Act of 1940' Release No. 5756 (17 June 2021) <https://www.sec.gov/files/ia-5756.pdf> accessed 1 December 2022.

[455] SEC, 'Regulation of Investment Advisers by the U.S. Securities and Exchange Commission' (March 2013) <https://www.sec.gov/about/offices/oia/oia_investman/rplaze-042012.pdf> accessed 20 November 2022.

dd) Evaluation of Assets under Management for Private Funds Advisors

Advisers are required to report the value of all the private funds they manage. In principle, the market value is the decisive factor for the assessment. If no market value is available, the fair value becomes of relevance. The calculation shall be conducted on a gross basis, thus without deducting liabilities such as accrued fees and expenses and any borrowed amounts.[456] Although the majority of advisers calculates the fair value of private fund assets on the basis of the Generally Accepted Accounting Principles ("GAAP"), the SEC does also recognize also other international accounting or fair valuation standards being used in good faith.[457]

ee) Proposed Rules on Private Fund Advisers

Interestingly enough, the SEC voted in February 2022 to propose a new set of rules and amendments under the Investment Advisers Act ("Proposed Rules") that is expected to introduce significant changes to the regulation of alternative investment funds and in particular, the relationship between private funds' advisers and investors.[458] A main goal of the Proposed Rules is to increase investor protection through additional transparency on costs and performance of private funds. As a case in point, the Proposed Rules will impose on registered private fund advisers to provide quarterly statements to investors, including information on fees, expenses, and the fund's performance. What is more, certain sales practices and activities that are contrary to the interest of investors and the public are prohibited, regardless whether registered or not registered. These include charging fees for unperformed services, seeking reimbursement, indemnification, exculpation, or limitation of liability for certain activities, charging fees related to a portfolio investment on a non-pro rata basis, and borrowing or receiving an extension of a credit from a private fund client. Also, conflict of interest rules are established by the prohibition of preferential treatments, unless these are disclosed to current and prospective investors. Certain books and records obligations are also part of the Proposed Rules which shall facilitate the assessment of an adviser's compliance by the SEC.

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456 Form ADV: Instructions for Part1A, instr. 5.b.(1); For non-US advisors, assets by non-US clients can be excluded from the calculation under the premise that all US clients are qualifying private funds and any management at a place of business within the US is only attributed to $150 million of private fund assets, Rule 203(m)-1(b)(1) and (2).

457 For detailed information on the requirements to determine "fair value in good faith" see: SEC Release No. IC-34128 (File No. S7-07-20) (effective 8 March, 2021); Release No. IA-3222 (File No. S7-37-10).

458 SEC, 'Proposed rule: Private Fund Advisers; Documentation of Registered Investment Adviser Compliance Reviews' 17 CFR Part 275, File No. S7-3-22 (9 February 2022) < https://www.sec.gov/rules/proposed/2022/ia-5955.pdf >; see also SEC, Press Release 'SEC Proposes to Enhance Private Fund Investor Protection' (9 February 2022) < https://www.sec.gov/news/press-release/2022-19> both accessed 1 December 2022.

This regime has, as of this writing, not come into force; so far, there have been several comment periods where the public was invited to comment on the published Proposal.

Investment Advisers Act of 1940

Scope: **Investment Adviser?**
= every legal subject who engages in the business of advising others, for compensation, as to the value of securities or as to the advisability of investing in, purchasing, or selling securities, or who for compensation as part of a regular business issues analyses or reports on securities (Section 202 (a)(11))

→ Carve out: for example, among several exemptions:

→ Family offices

→ Lawyer, Accountants, Engineers, and Teachers whose advice is solely incidental to the practice of their profession

→ Registered Brokers and Dealers whose advice is solely incidental to the conduct of their business + no special compensation

Result: art funds fall within scope of Act

→ Consequently: registration obligation with SEC

→ Carve out: e.g. private fund advisers
→ "exempt reporting advisers"

Chart VII: Applicability of the Investment Advisers Act of 1940

d) Securities Exchange Act of 1934

Art fund units are generally marketed directly by the manager to potential investors, without any intermediary involved. The remit of the Securities Exchange Act of 1934 comprises not only rules of conduct of broker/dealers, but also secondary trading of securities. At this point, one might wonder how the Securities Exchange Act may be of relevance for art funds whose units are mostly issued under the condition that no transfer shall be conducted. Indeed, given the long-term financial commitment in line with the closed-ended structure there is hardly any secondary market for interests in art funds. Where units of an art fund were issued under the Regulation D exemption, their transfer is considered "restricted" and as such, they may not be sold again absent

their registration with the SEC or unless an exemption applies. Their restricted nature is in general indicated in the respective transaction documentation (PPM).
Yet, in rare occasions the secondary transfer of interests in an art fund becomes of relevance when units of an art fund pass along to someone else or have to be sold. In the art world, the famous "three D's" are known for being the pushing factor in sales by private individuals, and therefore somehow the market drivers in the art sales and auction scene: these three are debt, death, and divorce.[459] Interests in the limited partnership of an art fund are equally affected by all three realities. It is in these occasions that the Securities Exchange Act becomes of relevance for art funds and their investors, who then have to comply with the rules in any secondary trading. This is the case even in situations where contractual agreements dictate the transferal of the unit back to the fund.[460] What remains however outside the scope of the Investment Advisers Act are cases of involuntary unit transfer, e.g., where a membership right is split up among the heirs after their family member's passing.

It is through the Rule 10b-5 that the Securities Exchange Act extends the anti-fraud provisions of the Securities Act (see above) also to any sale or purchase on the secondary market as well as advisory services. The underlying intent of this rule is primarily to cover any sort of insider trading. Indeed, the language allows to capture any taking advantage of advanced knowledge on profit prospects or other material business facts by withholding this information or making misleading statements about it.

Another provision in the Securities Act that is of relevance to art funds is the earlier mentioned Section 12(g), which establishes that an issuer who is not a bank, bank holding company or savings and loan holding company is required to register a class of securities with the SEC if:[461]

- It has more than $10 million of total assets; and
- The securities are "held of record" by 2,000 persons or more or by 500 persons or more who are not accredited investors.

[459] Horowitz (n 19) 18.
[460] See for the similar constellation of hedge funds: Mark JP Anson, *Handbook of Alternative Assets* (John Wiley & Sons 2002) 149.
[461] Rule 12(g)(1)(A),(B).

Art funds make sure to undercut these thresholds, if not already by their total AUM, at least through limiting the total number of accredited investors to 2,000.

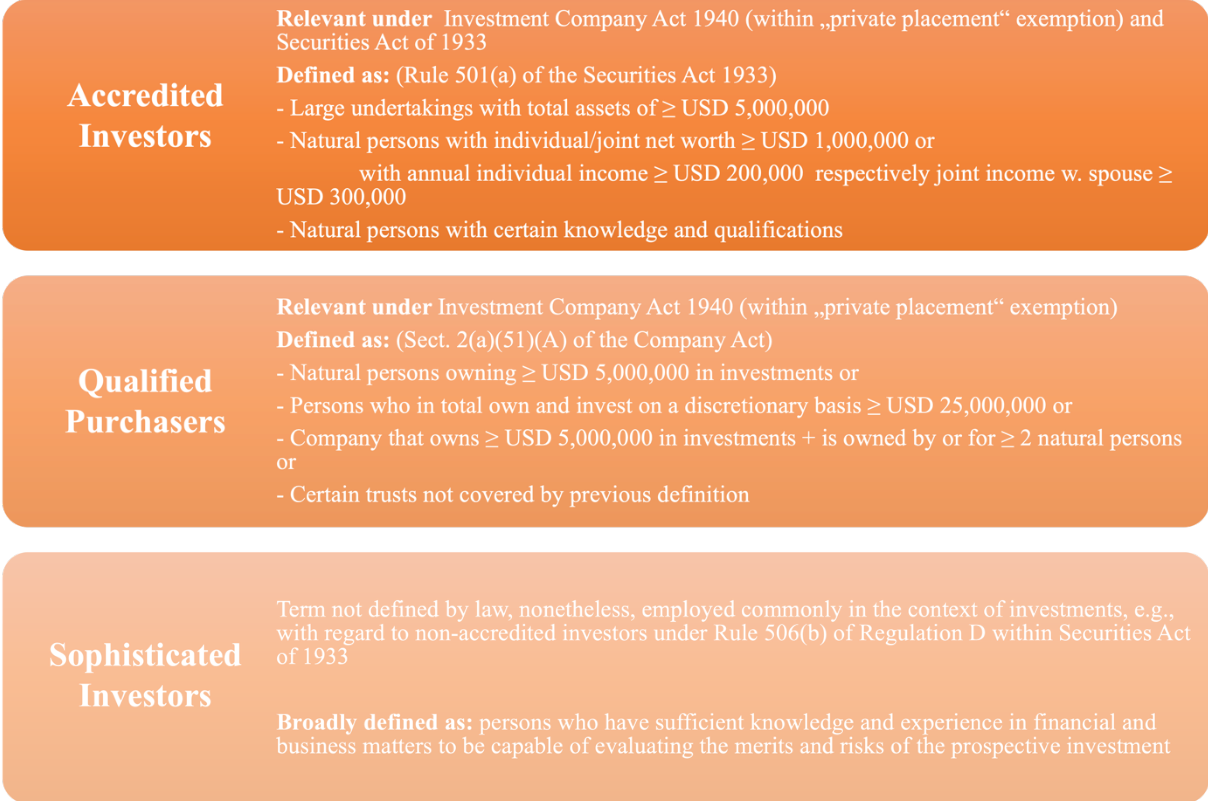

Chart VIII: Overview US Investor Categories

3. Central Findings

Notwithstanding the units issued by art funds being considered securities, their offering is generally not filed with the SEC, nor is the issuer subject to SEC registration. The reason for this is the particular structure of art funds and their investor clientele, which often enough qualify for legal carve outs of registration obligations with the SEC. As a consequence, art funds in the US are usually exempted from the obligations listed under the Investment Company Act of 1940 and the Securities Act of 1933.

Where regulation takes hold however is with investment advisors to art funds. Albeit there being certain exemptions again, some of which are highly relevant for art fund advisors, a significant share of art fund advisers is registered with the SEC. This also accounts for practical reasons, as only the parent structure among several advisers and SPVS would have to register. An essential

regulatory intervention in this sector is however expected if at some point the Proposal on Private Fund Investment Adviser Regulation will enter into force. These rules pay particular attention to the relationship between advisers and investors – a relationship that is so far not concerned by the obligations stipulated under the Investment Advisers Act given that the private fund's adviser does not extend its services to the investors.

Accordingly, the offerings of art fund units are often neither reviewed nor "qualified" by FINRA or the SEC. Against this background, it seems appropriate that participating in art funds investment is only reserved to a small group of sophisticated investors. Out of the nine examined art fund structures in the US enlisted in Annex I, only one in fact presents itself open also to other than accredited investors.[462] Their individually required investment amounts reflect this selection by setting minimum limits of at least USD 10,000 – USD 500,000.

To make sure that the investor meets all the requirements to fall within the category of an "accredited investor" or similar categories that qualify for legal exemptions, the management of an art fund is required to conduct background checks or verify the presented documents. Certain parallels can be drawn with the obligations arising under MiFID and the AIFMD, where depending on the level of sophistication of the client, a different scope of information and risk assessment is expected from the manager.

Although marketing of their shares principally occurs online via a fund's website, the generally available information numbers on the value of the assets under management or the realized return rates is issued only on a restricted basis to investors, through PPMs or White Papers, in following what can best be described a market custom rather than a legal duty, since reporting obligations to investors (as well as financial authorities) are generally reduced to minimum level for art funds.

V. CONCLUSION

The term "art fund" describes an investment vehicle specifically conceived to collect and invest capital in a series of artworks with the aim of making profit from their resale after several years of professional management of the assets. Art funds qualify as alternative investment funds, given that

[462] Namely the Prism Fund by Yieldstreet, see Annex I.

they revolve around non-bankable assets which do not correspond to traditional investment instruments. The issued units or memberships by art funds to their investors qualify however as securities, under EU as well as US securities laws. The details of the participation and profit rights vary, according to each individual structure. Some have moved away from issuing traditional membership or partnership rights to issuing tokenized units instead.[463]

As a consequence to being exempted from most obligations arising for investment firms under financial market laws, the duties that art fund managers owe to their investors are remarkably few. While companies publicly offering their units are encumbered with preparing information sheets and the mandatory disclosure of CoIs to investors, most funds do not need to comply with these obligations and at best do so voluntarily. Given the constellation of many boards, which include dealers, auction house operators, gallery owners and well-connected advisors, the risk of CoI is indeed omnipresent.[464] That CoI-avoidance respectively disclosure rules are not binding for many art funds is due to the often pertinent "lighter" regime of the AIFMD within the EU, while in the US, exemptions often apply for private offerings ("safe harbor"). In order to fall within these regulatory carve outs, funds are structured in a way to only address professional, accredited or semi-professional investors (or an equivalent under national law). This exclusivity is ascertained not only through the KYC-process which precedes each capital contribution by new investors, but also through minimum individual investment sums in the 5-6 figure range. Accordingly, the contribution of art funds to the "democratization" of the art market is to be considered rather small. Nonetheless, most investors would not be able to achieve a comparable positive outcome with direct investments in art, on the one hand because they lack the financial means to buy respective artworks on their own, and on the other hand, because they don't have the time and knowledge to build a broadly diversified art portfolio. The professional art fund management can draw on sources of information and networks that private individuals can often not access or only with unreasonable efforts. Therefore, access to art as an asset class – and where wanted also to knowledge on artists and styles – is definitely facilitated through the investment model of art funds.

[463] See e.g., in the case of the Artory/Winston fund; for a detailed analysis of the tokenization of participation rights in companies, see the next chapter.
[464] Zorloni (n 241) 151.

CHAPTER IV –

REGULATION OF ALTERNATIVE INVESTMENTS IN ART: THE CASE OF FRACTIONAL OWNERSHIP

I. INTRODUCTION

What emerges in light of the previous chapter is the fact that art funds remain an investment form primarily available to high-net-worth investors, a status which is ascertained both by individual minimum investment thresholds and by law, which establishes a two-fold system, whereby only marketing to professional respectively accredited investors corresponds to a limited catalog of reporting and disclosure duties. Thus, the argument that art funds contribute to the "democratization" of art, i.e., to art becoming as an asset class available to a broader public, is to be regarded with some reservation. While it is true that through the pooling of capital, works beyond an individual's financial ability can be acquired, art funds as investment possibility are still far from being accessible to small or mid-tier investors.

There are yet other forms of investment vehicles committed in much the same way to the "democratization" of art as art funds,[465] an example being the business concept of "fractional ownership" in artworks. Unlike traditional art funds, these investment vehicles offer indirect participation in a *single* artwork or other collectible rather than in a portfolio of different works.

One of the main questions to be raised and answered in this chapter is: To which extent do investors in "fractional ownership" constellations actually own the underlying artwork? It is often through catch-phrases implying the possibility to become part of the elitist group of art owners that alternative forms of investment involving fractional ownership of artworks and collectibles

[465] See e.g. "When this technology is applied to non-bankable assets, the face value of these SPVs can also be arranged at low amounts, providing access to luxury or illiquid assets to a much wider audience – and contributing to the democratization of wealth management" (<https://www.avaloq.com/knowledge-hub/blog/monetizing-and-tokenizing-non-bankable-assets>); Maecenas declares that "our aim is to embody the spirit of Maecenas, making Fine Art available to everyone, and not just the ultra-wealthy", <https://www.maecenas.co/whats-maecenas/>, both accessed 10 October 2022.

draw the attention of the public, such as “Have you ever dreamed of owning a painting by Picasso? With blockchain-technology, it becomes possible to own a part of a famous piece of art.”[466] In this context, two aspects are decisive and will hence determine the structure of the following analysis: 1) securitization of rights and 2) tokenization of artworks. The latter is a concept based on the distributed ledger technology (DLT), a technology that has significantly influenced the investment and financial markets in general in the recent past and deserves to be analyzed in view its relevance in the art market.

This chapter is structured as follows: The initial segment outlines the concept and development of “fractional ownership” as an investment form up until today. Secondly, the business model will be presented and critically assessed against the background of investor’s aspirations linked to the terminology employed in this investment model. Subsequently, to fully grasp the innovative approach inherent to the investment form, the concepts of “securitization” and “tokenization” will be delineated before the regulatory relevance of fractional art ownership under EU and US financial market laws will be analyzed.

1. Concept of Fractional Art Ownership

Fractional ownership in the strict sense of the term refers to a division of ownership of a single item between several investors. As a business concept, it originated in the airplane industry, where in 1987, Richard Santulli initiated the NetJets fractional ownership program, which allowed its participants to “combine the flexibility of chartering with the advantages of ownership” of private jets.[467] He extended, streamlined and capitalized the basic concept of co-ownership of airplanes in the following way: interested parties would pool their capital to purchase an aircraft which then was put under the management of the NetJets program. Each individual was consequently granted usage rights not only with regard to the single purchased aircraft, but towards the entire fleet and thereby “round-the-clock access to a private jet” among the various co-owned airplanes.[468] The advantage of drastically reduced individual acquisition costs through capital

[466] This specific statement is formulated by the author, imitating the language commonly employed in this context without copying the exact wording though of any specific offeror.
[467] D. Scott Worrells, David A. NewMyer, Jose R. Ruiz, The Evolution of Fractional Ownership: A Literature Review, Journal of Aviation/Aerospace Education & Research (2001) 10(2), 42, <https://doi.org/10.15394/jaaer.2001.1277> accessed 10 October 2022.
[468] Ibid.

pooling was complemented by management being overtaken by the NetJets company. In exchange, member had to pay fees which were used to pay for maintenance and personnel.

The concept of shared ownership offers considerable advantages especially in the context of high-value assets e.g., jets or yachts, which typically do not have to be at the full-time disposal of a single owner. This way, financial resources can be allocated effectively while granting each party the benefit typically associated with ownership, i.e., access and usage. Each person's share size, determined by the initial down payment on the acquisition, entitles its holders to a certain duration of use in comparison to others and may in addition provide for a profit rate, in case the co-owned asset generates income through rental or charter. In the context of art, at first glimpse the time-sharing concept of "fractional ownership" does not seem to be a perfect fit. Art is not an item to be only temporarily enjoyed and used but a collectible, ideally constantly exposed as an object of affection and décor. Artworks being "shared" among several individuals therefore only evolved as a business concept in view to generating investment returns. As we will see in this chapter, there are a few companies offering their investors the possibility to claim possession of the artwork for a few weeks, as an additional feature to their financial involvement. In most cases, however, the artwork is stored out of sight of the respective "fractional owners" or exported to become part of prestigious expositions in different museums. Therefore, in the context of fractional ownership, the aesthetic and contemplative aspect of art is driven into the background by the primary motive of capital gains. This specific investment category is a rather recent phenomenon with pioneering enterprises testing the waters for this new business concept in the Chinese market only in the 2010`s. The concept was quickly taken up also by European firms, such as SplitArt in Luxembourg and A&F Markets in Paris, which however could not persist over the years and whose discontinuance marked 2014/15 as the end of the first popularity cycle for fractional ownership.[469]

The recent economic developments have spurred investors' interests in fractional ownership again, a tendency that is enhanced by the increased practicability associated with tokenized

[469] Marion Maneker, 'Fractional Art Ownership Scheme Ended in Luxembourg Courts' *Art Market Monitor* (19 May 2013) <https://www.artmarketmonitor.com/2013/05/19/fractional-art-ownership-scheme-ends-in-luxembourg-courts/>, Pierre Sorlut, 'SplitArt licencie tous ses employés' *Paperjam* (8 December 2016), <https://paperjam.lu/article/news-splitart-licencie-tous-ses-employes>; A&F Markets Website (not updated since 2015), < http://artfinance.fr/de/>; see also: Eli Anapur, 'Fractional ownership – A New Model of Art Collecting' *Widewalls* (7 September 2022), <https://www.widewalls.ch/magazine/fractional-ownership-art>, all accessed 10 November 2022.

securities, not only from an issuer's perspective.[470] When confronted with the question, 29% of wealth managers stated in 2021 that they believed fractional ownership and tokenization of artworks would become investment products of interest for their clients, compared to only 19% in 2019.[471] Especially the younger generation of investors, that can be assumed to have previous knowledge of and experience with online financial services, is inclined to try alternative forms of DLT-based investment.[472] Such is suggested by the survey conducted by Deloitte and ArtTactic, where 43% of collectors below the age of 35 expressed an interest in investing in art through fractional ownership, while the corresponding share in overall collectors was significantly lower, namely only 21%.[473] As a response to the increased demand, many art funds as well as art advisors and financial institutes have started exploring the potential of emerging technologies with the aim of addressing a wider investor public. To this aim, "securitization" of shared ownership interests as well as "tokenization" of assets are key in making the market for art and luxury goods in general more accessible.

One among the first companies to professionally offer "fractional ownership" of artworks represented by tokens was Maecenas, a Singapore-based art investment platform whose business concept is built on the blockchain technology.[474] Their pioneering project consisted in the work by Andy Warhol "14 Small Electric Chairs" (1980), which was being "fractionalized" and up to 49% of its ownership interests were issued to investors in the form of tokens. During the ICO in 2018, US$1.7 million were raised equating 31.5% of the artwork.[475] In the case of Maecenas, for each "fraction" or "percentage ownership" of the underlying artwork,[476] an "asset token" was created – or "minted"– and transferred to the investor, who could then trade the token on the Maecenas exchange platform.

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[470] Two essential points would have to be named in this context, namely the facilitated identification of investors and directly in correlation thereto, the easier exercise of shareholder's rights, see for an extensive analysis Florian Möslein, '§ 8 Elektronische Geschäftsanteile' in Sebastian Omlor, Florian Möslein and Stefan Grundmann (eds), *Elektronische Wertpapiere* (Mohr Siebeck 2021) 186.
[471] Deloitte and ArtTactic (n 3) 223.
[472] See for empirical research on this: Braam Lowies and others, 'Fractional Ownership – an Alternative Residential Property Investment Vehicle' (2018) 36 Journal of Property Investment and Finance 513.
[473] Deloitte and ArtTactic (n 3) 24.
[474] Maecenas Fine Art website <https://www.maecenas.co> accessed 1 December 2022.
[475] 'First ever multi-million-dollar artwork tokenized and sold on blockchain', *realwire* Press Release (5 September 2018), <https://www.realwire.com/releases/first-ever-multi-million-dollar-artwork-tokenised-and-sold-on-blockchain> accessed 1 December 2022.
[476] Maecenas Fine Art website <https://www.maecenas.co/whats-maecenas/> accessed 1 December 2022.

The language employed in this context deserves a closer look, as it is exemplary for the marketing strategy thereafter used in this sector. Maecenas answers the question of what asset tokens are in the following way: “Asset Tokens are digital certificates of ownership in real assets. The bearer of the assets tokens becomes the owner of a percentage of the underlying asset.”[477] While ostensibly “buying an asset token is like buying a share in an artwork,”[478] this equation cannot fully explain the underlying concept, which shall hence be outlined in the next section.

a) The Promise of Becoming the Owner of an Artwork

In the current section, we will analyze the legal construction employed in the business model of “fractional ownership”, in particular, to which extent property of the underlying artwork is transferred to investors, whose numbers are often in the hundreds. As can be expected, the transfer of in rem rights offers certain challenges, which will be briefly outlined, before the formal designation of “ownership” is examined in view of its validity.

There can be no doubt that ownership of the same object can be exercised by several legal subjects simultaneously. There is however not a uniform legal concept of ownership and property around the globe. Accordingly, the details of co-ownership are subject to partially substantial variations according to national laws. Especially in confronting common and civil law countries, the existing differences call for pitfalls (e.g. in cross-border transactions), as the constitutive and formal requirements as well as the *numerus clausus* of objects eligible for establishing ownership vary essentially. As such, it is difficult to make a globally valid statement on what “fractional ownership” is.[479] Broadly speaking, it describes the concept of various persons jointly owning e.g. movables or immovables.[480] Fractional ownership of an item must not be confused with each individual

[477] Maecenas Fine Art FAQ <https://www.maecenas.co/faq/> accessed 1 December 2022.
[478] Maecenas Fine Art website <https://www.maecenas.co/whats-maecenas/> accessed 1 December 2022.
[479] Which corresponds to “proprietà frazionaria” in Italian law, “propriété fractionée” in French Law, “Bruchteilseigentum” in German law.
[480] Time-sharing agreements regarding real estate are indeed closely related to the concept of fractional ownership and bring parallels between this investment scheme and traditional securities to the forefront. Co-ownership structures have given rise to discussions on the definition of “investment contracts” on several occasions within US jurisprudence, indicating that the line cannot always be drawn easily between what is or isn’t relevant under US securities laws (see e.g. Wals v. Fox Hills Development Corporation, 24 F.3d 1016 (7th Cir. 1994), see on this issue also Coffee, Sale and Whitehead (n 203) 294; dividing a deed into various fractions, thus “fractionalizing” what can initially be regarded as a unit, bears enormous economic potential, which is why it was properly patented as a business modell by Robert Keith Civino in 2008 (FN: Patent was granted in 2008 to Robert Keith Vicino for a method of selling real estate property through fractional ownership shares, “where the co-owners of property agree on an allocation of hts to use the property and of responsibilities for their respective costs and expenses associated with the ownership of the property”, <https://patents.google.com/patent/US20080154686> accessed 10 October 2022.

being attributed a specific part of the entire unit, which would allow to exclude others from the use of it. Instead, the fractions consist only in ideational constructs or abstract percentages which go hand in hand with participation and co-determination rights to the total. To consider the example of real estate: fractional ownership of a developed plot of land does not grant the "fractional owner" the exclusive use of a certain area in the garden or a room in the house, neither does it assign a specific time as in a timeshare agreement where one may remain on the premise. Instead, it is to be seen as an abstract share. Accordingly, in the context of art, this would mean that there is no clear allocation as to "the upper left corner" of a painting to one of the owners, but rather an abstract sharing of the corresponding rights to ownership. Typically, fractional ownership grants each co-owner the right to transfer her/his interest in the property independently, i.e., without requiring the consent of the other co-owners. It is however established as default principle that administration and management decisions regarding the entire property is subject to the decisional power of the community, which requires a majority of votes by the involved parties. As a consequence, deposing or transferring the item as a whole can only be conducted through an agreement of the co-owners – or by corresponding authorization of one by all the others.

Applying this ownership concept to investments in artworks would lead to significant restrictions in the tradability and liquidity of the co-owned property. Having to coordinate first among all involved parties is simply not compatible with seizing investment occasions which may present themselves on the short run. What is more, given the novelty of the underlying technology, the question whether a title on tangible property can be transferred via on-chain token transfers can still not be uniformly answered.[481] Indeed, many jurisdictions do not yet legally recognize the conjunction between tokens and the underlying off-chain asset.[482] The literal implementation of the fractional ownership concept thus does not only exhibit various practical impediments, but also, it potentially exposes the issuer to liability risks with regard to the rights transferred to investors. Hence, companies offering fractional ownership in the strict sense of the term are the

[481] As a case in point, the investor information issued by the EU-company *Timeless* explicitly states that "the consumer as token-holder is transferred no rights by the Timeless-Token. Timeless-Tokens themselves do not constitute a fractional ownership section of a specific collectible." ("Der Verbraucher als Token-Inhaber hat keinerlei Rechte durch den Timeless-Token. Timeless-Token selbst stellen insbesondere kein Miteigentumsanteil an einem bestimmten Sammlerstück dar." (translated by the author)), see *Timeless* 'Verbraucherinformationen für den Fernabsatz'.

[482] As of the time of writing, the only EU-jurisdiction having recognized the bridge between token and asset is Liechtenstein.

exception. Indeed, only two firms have been encountered during the research process, namely *Timeless* in the EU and *Particle* in the US.[483] What happens instead is that a "mezzanine" structure is generally employed to render participation rights more liquid and management of a property more practicable.[484] This is achieved by having a company holding the title to the valuable item and subsequently issuing debt or equity instruments to investors,[485] a process commonly referred to as "securitization" of an asset. As a consequence to "securitizing" the underlying asset, an ISIN number for the products can be obtained, which again offers practical advantages, especially to asset managers.[486]

b) Securitization and Tokenization of Non-bankable Assets

"Securitization" describes the process of converting assets into marketable financial instruments, most commonly securities.[487] The securitization of non-bankable assets has been an issue of increasing importance in financial markets lately, as it unlocks vast new investment opportunities for previously untradeable assets.[488] Non-bankable assets in this context refer to non-liquid assets, which due to their characteristics are traditionally not part of a financial portfolio, not tradable through an index or exchange-traded fund, and commonly not accepted by financial institutions as a guarantee for a loan – with art being a prime example.[489] The phenomenon of "securitization of art", which can however currently be observed, epitomizes the tendency to render investment in art alike to stock trading. The reasons why instead of purchasing an artwork together as a group of individuals, a company acts as the purchaser with the interest of the involved parties being

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[483] See Annex II.
[484] See e.g., to name but one example: "investors select an Otis asset and acquire fractional interests that represents an *indirect* ownership interest in that asset" [emphasis added by the author] <withotis.com> accessed 10 October 2022.
[485] See with regard to real estate fractional ownership, where similar structures are used: Cyrus de la Rubia, Philipp Sandner and Jonas Groß, 'Studie Zur Tokenisierung von Immobilien' (2021) Frankfurt School Blockchain Center and Hamburg Commercial Bank 6.
[486] ISIN stands for "International Securities Identification Number" and is internationally used to easily identify investment products.
[487] See e.g. on the original definition of securitization of loans: Stuart I. Greenbaum, Anjan V. Thakor, Arnoud W.A. Boot (Eds.), Contemporary Financial Intermediation (Academic Press 2016) 3rd ed., Chapter 11 – Securitization, 249.
[488] OECD (2020), 'The Tokenisation of Assets and Potential Implications for Financial Markets, OECD Blockchain Policy Series', 49 <www.oecd.org/finance/The-Tokenisation-of-Assets-and-Potential-Implications-for-Financial-Markets.htm>, accessed 17 November 2022.
[489] In fact, art lending has been an expanding sector in the art investment segment; one of the first and few cases of art loans where a financial institution has agreed to issue a line of credit accepting an art collection was in 1979 with Christo and Jeanne-Claude being sustained by Citibank; see more on this topic e.g. Deloitte and ArtTactic (n 3) 128.

represented through securities are manyfold, ranging from tax advantages to the simplified transferability of shares instead of tangible property.

Finexity AG is an example for a rather young but nonetheless already established company in the fractional ownership sector. They started out in 2018 with offering "fractional ownership" interests in real estate projects and have expanded their portfolio in 2020 to also include artworks. When asked why the securities-structure was chosen as investment concept over actual ownership in the underlying assets, Paul Huelsmann, Founder and CEO of *Finexity*, replied:[490]

> "At that time [when coordinating the new investment model with the BaFin], we had the ambition to structure everything as equity-like as possible. Coming from the real estate sector, there is one rather central issue when structuring equity, which is the applicability of the AIFM regulations, whose transposing laws under the German KAGB have become extremely complex. Also, in real estate, the question arose: Can we register people directly in the land register? But that would have meant that you would have to register 1,000 people in the land register, and you would also lose liquidity on the secondary market. In addition, we think it makes sense to exclude investors' rights of co-determination. Why? – As a case in point, we recently bought two prints and sold them after about 9 months for about 30% of profits for investors, after cost deduction. If the investors had been involved in the decision to sell, there would certainly have been voices insisting on holding the artwork. And that's where complexity would be added, hence the exclusion, which still leaves options to define exemptions and veto rights. And through the security tokens, we are certain to have regulated securities - which I can export or passport across multiple countries, if we register a distribution license there. And also, I'm a regulated structure. Whereas with equity vehicles, each country is set up quite differently. We on the other hand wanted a scalable structure for the whole of Europe - in order to expand at some point internationally."

Given the numerous practical and regulatory advantages of securities over actual ownership being distributed among investors, for most companies in the art investment sector, "fractional ownership" of artworks is not so much a description of the offered products in the strict legal

[490] Interview with Paul Huelsmann, CEO and Founder of *Finexity* AG, on 5 October 2022; the transcript of the interview is with the author.

sense of the words but should rather be considered a collective term for an investment branch, whereby as a rule of default, financial instruments are marketed to investors.

In this context, the "securitization of art" occurs at the level of each artwork by establishing individual investment vehicles (SPVs). A single artwork is "fragmented" into hundreds or thousands of units i.e., shares or interests in the owning company, which allows for numerous interested individuals to participate in the work's appreciation with a relatively small outlay of capital,[491] in some cases as low as USD 7,[492] thus making it possible for anyone to invest. It is through this concept that individual artworks, which as we have previously seen cannot be considered financial instruments under securities law, become an accessible and tradable means of investment, even for retail investors.

The term "fractional ownership" which is used in this section thus needs to be clearly delineated from co-ownership. By employing this expression "fractional ownership", the author mimics the language commonly employed by distributors of respective interests and thereby intends to draw awareness precisely to the fact that ownership of artworks is transferred only in rare cases,[493] whereas in general, investors are supplied with financial instruments whose value is connected to the artwork owned by the issuing company. "Fractional ownership" of artworks is thus henceforth not the be understood as ownership in the literal sense but rather as a securitized interest in a company's asset.

aa) Consequences of securitization

The "securitization" of expensive assets has proven to have a considerable impact on all concerned parties. Indeed, recent reports and studies demonstrate that fractional trading encourages retail investors by expanding their investment possibilities to include previously out-of-reach securities.[494] This business trend removes barriers to entry especially for individual

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[491] Lowies and others (n 472) 521.

[492] Which is the case e.g. with Rally; Otis offers investments starting from USD 14, Masterworks at USD 20, see Annex II.

[493] Anders Petterson, 'Fractional Ownership of Art', *ArtTactic* (22 June 2022,) <https://arttactic.com/editorial/fractional-ownership-of-art-part-i/>; Jeremy Yip, 'A New Fractional Way to Own Artworks' *Luxuo* (7 June 2022) <https://www.luxuo.com/culture/art/a-new-fractional-way-to-own-artworks.html>, both accessed 20 October 2022.

[494] David Gempesaw, Joseph J Henry and Raisa Velthuis, 'Piecing Together the Extent of Retail Fractional Trading' (2022) 54 Global Finance Journal 100757, 2 <https://doi.org/10.1016/j.gfj.2022.100757> accessed 10 October 2022; with regard to residential property, this effect has been shown in a study conducted by Braam Lowies and others, 'Fractional Ownership – an Alternative Residential Property Investment Vehicle' (2018) 36 Journal of Property Investment and Finance 513.

investors with limited capital, which potentially increases the volume of retail investors in the art investment sector, thereby creating new opportunities not only for investors, but also for distributors who can extend their services to larger parts of the population, which is why this phenomenon is often referred to as "democratization" of previously illiquid or inaccessible investment categories.[495]

Having not one but 100-100.000 "co-owners" participating in the value appreciation of a single artwork has opened the market of illiquid assets to a wider public. The costs for participation rights can be arranged at a far lower amount than what we have seen in the last chapter on art funds, given that as little as 0.01% of a single artwork can be acquired, with the result of the market becoming accessible to retail investors and thereby, investment firms tapping into new global pools of capital. This tendency is amplified by constant online access. In the case of *Finexity*, for example, "the investment process is 100% digital and can be concluded within 3 minutes."[496]

In general, the ease with which one can make an investment in this asset class is remarkable compared to its close alternatives. Whereas a tangible artwork requires the owner to take care of its insurance, transportation and storage, investors in fractionalized art have all of these issues taken care of by the issuing entity.[497] Contrary to investing in shares, placement of capital with this business concept does not require to involve any broker, financial institution or stock exchange,[498] but occurs in direct contact with the offeror through its website, which is sought out by potential investors.

In summary, it is through the pooling of capital that benefits from art as an asset class which was typically limited to insiders and HNWIs can also be enjoyed "by a wider group of sophisticated investors, and finally become retail investment opportunities available to all. Equities and bonds

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[495] Horowitz citing Taub, 'New Choices for Sophisticated Investors' 2 in Horowitz (n 19) 160.
[496] Finexity 'Art Guide' (2021) 3 (translation by the author).
[497] Masterworks investor Aaron Shumaker was cited in an interview by Katya Kazakina, 'Robin Hoods of the Art World Lure Scores of Investors in Pandemix' BNN Bloomberg (5 September 2020) summarizing his motivation to invest in the following way: "I don't think I'd feel so comfortable to have one of these works displayed on my wall," said the Washington, D.C.-based entrepreneur, who hasn't laid eyes on any of his holdings. "That seems like a lot of risk." […] Instead, he's happy for Masterworks to store them in a facility with proper security, climate control and insurance, while he hopes to make a financial return on his investment", <https://www.bnnbloomberg.ca/robinhoods-of-the-art-world-lure-scores-of-investors-in-pandemic-1.1489793> accessed 10 October 2022.
[498] The extent to which broker-dealers and exchanges are required to be involved in the secondary market according to US regulations will be discussed in detail below at 167.

made this journey over the last century" and "art is heading down the same road, to the eventual benefit of all investors".[499]

bb) Tokenization of Securities

The tendency of securitization is complemented and propelled by the phenomenon of "tokenization".[500] It is through the tokenization of financial instruments that businesses have been able to simplify and streamline their "fractional ownership" concept. The term "tokenization" refers in short to the representation of rights by digital units.[501] In the specific case of art fractional ownership, it means that the relevant interests in an art-owning SPV are not issued in their certificated form but as tokenized securities, i.e. via an on-chain transfer.[502] The entire system is based on the blockchain technology.

The blockchain, as a subset of DLT, [503] is an append-only distributed (as in opposed to centralized) information chain, whose individual links consist of different data sets that not only build on each other but also assure each other's accuracy. It is thus (almost) immutable and tamper-resistant and can hence be used to create a trustworthy environment for valuable transactions. Especially in the ambit of artworks, where authenticity plays a decisive role in value attribution, this aspect has paved way for DLT to become widely used. [504] The DLT-standards used in the

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[499] Horowitz citing Taub in Horowitz (n 19) 160.

[500] OECD, 'The Tokenisation of Assets and Potential Implications for Financial Markets' OECD Blockchain Policy Series (2020) 49 <www.oecd.org/finance/The-Tokenisation-of-Assets-and-Potential-Implications-for-Financial-Markets.htm> accessed 17 November 2022.

[501] See e.g. ESMA, 'Report on the DLT Pilot Regime On the Call for Evidence on the DLT Pilot Regime and compensatory measures on supervisory data' ESMA70-460-111 (27 September 2022) para. 192; in more technical terms, "tokenization" is the process of creating a singular identifier on a distributed ledger in form of a token, that enables a unique and persistent reference to another off-chain item or unit, see in detail Roger Heines and others, 'The Tokenization of Everything: Towards a Framework for Understanding the Potentials of Tokenized Assets.' [2021] Proceedings of the Pacific Asia Conference on Information Systems (PACIS) 1, 1, <https://widgets.ebscohost.com/prod/customerspecific/ns000290/authentication/index.php?url=https%3A%2F%2Fsearch.ebscohost.com%2Flogin.aspx%3Fdirect%3Dtrue%26db%3Dedb%26AN%3D151674974%26amp%3Blang%3Dpt-pt%26site%3Deds-live%26scope%3Dsite> accessed 1 November 2022.

[502] Tokens are very versatile digital units which in theory can represent everything – including fractional ownership rights in the strict sense to an item or to real estate, if this has been "tokenized" and thereby introduced into the blockchain.

[503] The most common type of a distributed ledger uses a blockchain, therefore, it is often used as a synonym (also by the author henceforth); see also: BaFin, 'Blockchain Technology – Thoughts on Regulation', August 1, 2018, <https://www.bafin.de/SharedDocs/Veroeffentlichungen/EN/BaFinPerspektiven/2018/bp_18-1_Beitrag_Fusswinkel_en.html> accessed 9 July 2022.

[504] Paola Fandella, 'Lo sviluppo dei fondi in arte come opportunità di diversificazione del portafoglio di investimento' (2018) Rivista Bancaria 85.

context of art are usually Ethereum-based, e.g. ERC-20 for fungible tokens, ERC-721 for NFTs, ERC-1155 for either, fungible or non-fungible tokens (NFTs).[505]

Broadly speaking, "tokenization" is the act of equating an on-chain or off-chain asset with a specific token, thereby allowing for a digital individualization of the claim. Indeed, not only items already part of the blockchain (on-chain) may become "tokenized", but practically anything can be represented by a token, ranging from digital assets such as vouchers and computer programs to tangible objects, including real estate, cars, securities, etc. besides artworks. In order to create a token, a smart contract code is inserted in the blockchain.

Smart Contracts refer to the automatization of defined consequences deployed on a blockchain. It is not by itself a legally binding contract but a computer code which permits to auto-execute transactions upon the meeting of pre-defined conditions, including of contractually agreed terms.[506] Smart contracts define the features of a token, such as e.g., its transferability.

To employ the definition presented by the European Securities and Markets Authority (ESMA), the term "[digital] token" refers to "any digital representation of an interest, which may be of value, a right to receive a benefit or perform specified functions or may not have a specified purpose or use." Broadly speaking, a token is the digital representation of claims, rights, or titles, on the blockchain, which can be transferred, stored or traded electronically.
As indicated by the definition of ESMA, there are different types of tokens, with their denomination exhibiting their central characteristics. The functions and rights with which a token is equipped are determined by the issuer through the smart contract. Depending on the inbuilt functions and rights, tokens are traditionally classified into three types:[507] currency

[505] Barbereau and others (n 225) 214.
[506] For an extensive analysis of the scope of application and legal matters of relevance with regard to smart contracts, see Martin Fries, 'Smart Contracts' in Florian Möslein and Sebastian Omlor (eds), *FinTech-Handbuch* (2nd edn, Beck 2021) § 9.
[507] These three types represent the archetypical forms of tokens in consideration of their function; the classification may however also be extended and specified, including e.g. governance token which represent the right to a say in certain matters, games and app tokens (J. Rohr/ A. Wright, 'Blockchain-Based Token Sales, Initial Coin Offerings, and the Democratization of Public Capital Markets' (4 October 2017) Cardozo Legal Studies Research Paper No. 527 12 f., <https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3048104> accessed 5 October 2022), etc., though each of them exhibit, in varying degrees, certain characteristics of the aforementioned types.

tokens,[508] security tokens,[509] and utility tokens.[510] This classification exists in parallel with the division into fungible and non-fungible tokens.

This taxonomy has been widely recognized in legal academia and practice, by ESMA as well as the European Banking Authority (EBA).[511] It thus serves as a basic point of departure for further discussions and regulatory attempts but is in no way conclusive, as several types of tokens do not fall within the established scope (see below). In practice, tokens often assume a hybrid format, since they combine elements of several types, which is why ESMA generally urges caution when it comes to "one size fits all" proposals.[512] ESMA has issued advice on the topic of crypto-assets to the European Parliament, the Council, and the Commission, and continues to monitor the ongoing developments in this sector.[513]

Currency tokens are used as a currency, with the most famous example being bitcoin, which can be used to pay for goods or services external to the token platform (off-chain).[514] The role of currency tokens in the art market is limited and will thus not be analyzed in further detail. Some auction houses as well as online art platforms have however in the past accepted crypto currencies as means of payment, e.g., in the case of the famous Beeple sale at Christie's,[515] where Ether (being the cryptocurrency of the Ethereum network) has for the first time been declared a feasible method of payment by one of the major auction houses.[516]

[508] For an overview, see: Robby Houben, Alexander Snyers, 'Cryptocurrencies and blockchain', Study requested by the TAX3 committee, European Parliament (July 2018), 20, <https://www.europarl.europa.eu/cmsdata/150761/TAX3%20Study%20on%20cryptocurrencies%20and%20blockchain.pdf> accessed 8 July 2022.
[509] Also referred to as investment tokens, in consideration of their principal function.
[510] P. Hacker and C. Thomale, 'Crypto-Securities Regulation: ICOs, Token Sales and Cryptocurrencies under EU Financial Law' [2018] European Company and Financial Law Review 645, 658.
[511] EBA, 'Report with advice for the European Commission on crypto-assets' (9 January 2019) < https://www.eba.europa.eu/sites/default/documents/files/documents/10180/2545547/67493daa-85a8-4429-aa91-e9a5ed880684/EBA%20Report%20on%20crypto%20assets.pdf?retry=1> accessed 8 July 2022.
[512] ibid para. 5.
[513] ESMA, 'Advice on Initial Coin Offerings and Crypto-Assets' ESMA50-157-1391 (9 January 2019) < https://www.esma.europa.eu/sites/default/files/library/esma50-157-1391_crypto_advice.pdf> accessed 9 July 2022.
[514] Philipp Hacker and Chris Thomale, 'Crypto-Securities Regulation: ICOs, Token Sales and Cryptocurrencies under EU Financial Law' (2018) 15 European Company and Financial Law Review 646, 659.
[515] See more in detail below, in the chapter „NFTs as Investment form" at 174.
[516] Tanzeel Akhtar, 'Top Auction House Christie's to Accept Ether Cryptocurrency for Digital Art Sale', *coindesk* (18 February 2021) <https://www.coindesk.com/top-auction-house-christies-to-accept-ether-cryptocurrency-for-digital-art-sale> accessed 8 July 2022.

Utility tokens provide access to certain services or goods that are provided directly by the token issuer.[517]This may also include access to a future product or service that is to be delivered by the defined party (issuer).[518]

Finally, **security tokens** represent the contractual promise of a future inflow of capital (often also in crypto currencies), which stems from an investment in a company or an investment vehicle.[519] Consequently, issuing security tokens typically occurs on the occasion of entities collecting their initial business capital during an Initial Coin Offering (ICO) in parallel to an IPO (Initial Public Offering for shares of a private corporation).[520] In view of the terminology, there is a tendency to specify that registered securities are issued in the forms of tokens, thereby avoiding any uncertainty as to the legal status of coins being issued. Accordingly, the term "Security Token Offering" (STO) is increasingly employed.

ESMA refers to "investment-type" tokens rather than to security tokens, which however is to be understood as a collective term for all forms of tokens that are issued and acquired with a primarily pecuniary motivation, including trading, speculation, and/or hedging, therefore capturing all security tokens and also some utility and payment tokens.[521] In order to avoid any ambiguity, security tokens will be used henceforth in proper delineation to the other two token types. Security tokens represent participation in a network and may be traded at a later point on a secondary market (e.g., a crypto exchange). Through security tokens issued in an STO, investors will participate in the success of a launched project, which is why often similar issues arise as in the context of crowdfunding systems.[522]

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[517] ESMA, 'Advice on Initial Coin Offerings and Crypto-Assets' ESMA50-157-1391 (9 January 2019) para 19; Hacker and Thomale (n 157) 657.

[518] One may further distinguish between utility tokens and pure utility tokens, with the former category of tokens having an investment or speculative component and the latter being assigned a fixed price but the issuer, which can only be exchanged or traded on the platform provided by the issuer.

[519] Y. Chatard and M. Mann, 'Initial Coin Offerings Und Token-Handel im Funktionalen Rechtsvergleich– Entwicklung Deutscher Leitlinien auf Grundlage des Diskussionsstands in der …' [2019] Neue Zeitschrift für Gesellschaftsrecht 567.

[520] The term "ICO" (Initial Coin Offering) was originally most frequently used by authors or regulators whereas more recently the acronym "STO" (Security Token Offering) seems to be predominantly used in order to indicate the regulatory compliance (see OECD, 'The Tokenisation of Assets and Potential Implications for Financial Markets' OECD Blockchain Policy Series (2020) 13).

[521] ESMA, ‚Annex 1 – Legal qualification of crypto-assets – survey to NCAs' ESMA50-157-1384 (January 2019) 2.

[522] Kristian Borkert, `Crowdfunding goes Blockchain – Teil 1' (2018) ITRB 39.

Security tokens, as their name indicates, exhibit strong parallels to traditional securities. Indeed, legislators increasingly recognize security tokens as securities in accordance with national (or supra-national) financial regulations. Malta was among the first countries worldwide to include the concept of tokens in their legislation;[523] Lichtenstein followed by introducing the respective notion shortly afterwards.[524]

Similar to the classification among traditional securities, also security tokens can further be subdivided into the category of equity tokens and debt tokens. While equity tokens entail participation rights typically associated with shares, e.g. profit and voting, the latter are akin to bonds or securitized debt. The International Token Standardization Association has gone beyond this two-tiered categorization by aligning all investment token subcategories with the classification of financial instruments according to the ISO standard 10962.[525]

Interestingly enough, the "tokenization" of rights and interests in an item often has the effect of securitization.[526] While holdings in closed-end investment firms or partnerships as well as co-ownership claims may lack the essential characteristics of standardization and transferability due to their individual structuring, their representation in tokens equips them with all of the above characteristics, thereby subjecting them to securities regulations.[527] Through their tokenization, the corresponding rights can be given a standard format and rendered freely transferable on the blockchain, which may suffice in assessing the quality of a security.

cc) Tokenization of Rights in Artworks

The use of the distributed ledger technology (DLT) is what rendered the fractional ownership business concept practically feasible. In the finance sector, emerging technologies have assumed a groundbreaking role within the past years. The Financial Times predicted that up to $2.7billion per year may be saved by asset managers through the DLT-based market infrastructures that

[523] Malta Virtual Financial Assets Act, 2018.
[524] Liechtenstein Blockchain Act, 2019.
[525] Including Equity Token, Entitlement Rights Token, Debt Token, Derivative Token, Fund Token, and Other Investment Token, see Maximilian Bruckner, Constantin Ketz et. al, 'The International Token Classification by ITSA: A Guidance Tool for the Global Token Markets' *ITSA e.V. Blog* <https://my.itsa.global/blog/the-itc-guidance-tool-for-token-markets> accessed 2 July 2022.
[526] The securitization and tokenization are indeed two sides of the same coin, as both processes manage to convert illiquid financial assets into liquid marketable securities, see on this point also OECD, 'The Tokenisation of Assets and Potential Implications on Financial Markets' OECD Blockchain Policy Series (2020) 15.
[527] See in detail below in the section on Regulation of Fractional Ownership at 143.

enable the digital representation of bankable assets, such as stocks and bonds.[528] This trend goes far beyond the art investment market. As the 2nd Global Alternative Finance Benchmarking Report by the Cambridge Center for Alternative Finance (CCAF) revealed, the Fintech sector is now an indispensable driver of the global alternative finance industry.[529] camb DLT-based investment methods play an essential role in this context, as they enable financial service providers to directly interact with clients, rendering the involvement of intermediaries and any related costs superfluous. This development has enrolled analogously in the art world, where strategic investment opportunities based on the digitalization of art have played a role in decreasing the importance of auction houses and galleries as mediating instance between buyer and seller.

In line with this, the number of offerors for fractionalized ownership in artworks has increased in the last two years.[530] Their common feature is the focus on a strong internet presence, characterized by constant online access to the platform where potential investments and performance rates can be browsed 24/7. This means that the trend is moving away from city-center galleries or prestigious showrooms and increasingly tending towards digital representation in the field of strategic investment in art ownership.[531] Digital representation is also the pertinent dictum with regard to the dealt with items. This goes as far as completely abandoning the tangible aspect of collectibles and creating purely digital values, as is the case for NFTs and them being fractionalized, which shall be covered in detail in the next chapter. Fractional ownership as in the subject of the current chapter offers a middle ground between purely digital values and the physical world by building their business strategy around digitalized interests in tangible artworks, as well as other valuable collectibles such as collection cards (e.g. baseball, Pokémon), sneakers,[532] wine, cars, etc.

Given that tokens are suitable to represent any right or item, there is practically no limit to their use in the artworld. In the case of art investments, the nature of the issued tokens varies according

[528] Attracta Mooney, 'Blockchain "could save asset managers $2.7bn a year"' *Financial Times* (22 February 2018) <https://www.ft.com/content/b6171016-171f-11e8-9e9c-25c814761640> accessed 2 December 2022.
[529] Jason G Allen and others, 'Legal and Regulatory Considerations for Digital Assets' (2020) Cambridge Centre for Alternative Finance.
[530] See initiation years of firms listed in Annex II.
[531] Consumer protection regulations applicable to contracts concluded by means of distance communications will not be subject of the work at hand, as these do not fall within the framework of financial market regulations.
[532] See e.g. the platform "*RARES*" (<https://rares.io/marketplace> accessed 1 December 2022).

to their intended use, in line with the taxonomy outlined above. Whereas for partial or participation rights, e.g., in art funds or SPVs, fungible tokens in the form of security tokens or possibly also utility tokens are the most suitable, the ownership claim on an entire artwork is best represented by an NFT as their integer and unique character corresponds to the full title of the owner of a work. NFTs account for their very own category of tokens, which does not align with the three-tiered system laid out above. It is possible to design tokens in such a way as to represent not only full but also fractional ownership in the strict legal sense. The possibilities of the token and the determination rights of its holders can be defined by the writer of the smart contract. As such, one may allow a group of token holders to exercise rights and duties akin to the manner legally prescribed for co-owners, e.g., render the resale subject to a majority agreement by requiring a certain number of private keys to mimic joint ownership.[533]

Rights and obligations associated with the underlying artwork may also be agreed on between the parties as part of the "conventional" contract, outside the smart contract. One area that in particular requires contractual clarification is the structuring of copyrights relating to the underlying artwork. In addition, the discrepancy between contractual agreement and actual ability with regard to the token needs to be pointed out: Even if the transfer of ownership is contractually excluded (for a certain time), this does not prevent the token from being transferred, potentially in its role as proxy for the underlying asset, unless a corresponding prohibition is also fixed in the smart contract. As the law in this evolving area is still trying to adapt to the upcoming challenges, legal risks arise, e.g., with regard to the acquisition in good faith of the underlying asset, which so far is not yet adequately regulated.

The artworks represented by tokens, fractionally or entirely, are almost never stored on-chain – even if they exist in digital format. The reason for this can be seen in the costs and emissions resulting from large datasets being added to the blockchain,[534] which is why the metadata of a token usually only includes certain descriptive characteristics of the underlying artwork, a link to an online, off-chain stored copy, or a cryptographic hash of the image file in order to facilitate its

[533] Oleksii Konashevych, 'General Concept of Real Estate Tokenization on Blockchain' (2020) 9 European Property Law Journal 21, 35; such a system is employed e.g. by the provider "Particle", where the community of collectors decides on the artworks in a "sub-DAO" manner.

[534] According to Barberau and others, "the storage of large media files on a DL is expensive and impractical" (n 219) 220.

identification. The hash compares in its function to a digital fingerprint, as it can be used to confirm the connection between the tokenized claim and the external file. [535]

(1) The Tokenization-Process

The tokenization of fractional ownership interests in an artwork occurs in the following way: In order to securitize the investors' interests, each debt instrument to be issued by the SPV is equated by a security token on a so-called "private permissioned blockchain" (usually conform to the ERC-20 standard) for which the issuing company is usually the custodian.[536] In primary token offerings, the issuer usually provides access directly through its platform, without the involvement of an exchange or intermediary. The issuer therefor transfers the number of tokens corresponding to the investment to the wallet of the investor. The individual assignment of a token to a rightsholder is assured through the combination of the public key, by which the investor can be individualized on the blockchain, and the private key, which grants access and transfer rights solely known to its holder. In this context, the blockchain serves as a traceable database for all transactions, allowing to trace the ownership of tokens back to their issuance, which is automatically updated and does not need any physical certification or entry with a central national register. Rather, the possibilities linked to the DLT allow for the self-execution of contracts, restriction on transfer rights and an unambiguous assignment of rights to their holders, to name but a few advantages over conventionally issued financial instruments.

According to Artemundi, one of the leading art funds and advisories worldwide, "tokenization lowers the barriers to art investment and opens-up the art market to a broad range of new investors". [537] In fact, this investment format appears to establish a much lower entry level in view of online marketplaces, which grant accessibility to those who cannot make their entry into the close-knitted art market network through personal connections.

(2) The Transfer of Title of Artworks through Tokens

Since the tokenization of assets cannot by itself enforce the continuous link between the tokenized ownership claim and the off-chain physical asset (or its legal recognition), those

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[535] ibid 220 f.

[536] See e.g., in the case of *Finexity*, where the process is described within its issuing conditions at 5; see for the common tokenization strategy of real estate: de la Rubia, Sandner and Groß (n 485) 14.

[537] Sygnum, Press release 'Sygnum Bank and Artemundi tokenize a Picasso on the blockchain' < https://www.insights.sygnum.com/post/sygnum-bank-and-artemundi-tokenize-a-picasso-on-the-blockchain > accessed 20 October 2022.

undertakings offering tokens as a way of reliable ownership prove of artworks are required to provide for a trusted guarantor that officially recognizes the legitimacy of the ownership title and its correspondence to a token, held by the same person.[538] For this reason, companies such as Look Lateral, Petale and Artory have installed a verification procedure, whereby the original artwork is assigned a physical label called a "Signature Tag",[539] which shall not only certify that the asset was correctly pegged into the blockchain, but also the authenticity of the work, assured through a product authentication platform that partners with Look Lateral. Subsequently, the artwork is indexed as to have an online identity in the platform's data set and be able to be traded (entirely or partially) online. Since there is however no uniform legal treatment of ownership claims represented by tokens, the legal consequences of a transfer of title stored on the DL remain as for now mainly subject to the parties' agreement. As Barbereau and his co-authors observed: "Tokenized ownership claims are not necessarily binding, and custodians of physical assets are not liable by default. For art investors, regulatory developments are thus of equal importance to the ongoing technological developments";[540] "if there is no bridge between these two realms [DLT and the physical world], then the investor risks buying a token that represents the ownership of nothing but the token itself"[541]

The technology currently still bears the risk of diverging attribution of asset and token. Without a central institution to accredit the legitimacy of token issuers, practically anybody can mint tokens set to represent a famous artwork and sell them on the blockchain, without having a valid title to the artwork. Incidents like these have indeed occurred in the past especially on NFT-platforms, thereby challenging the often cited "inerrableness" of blockchain technology – not because the blockchain itself was tampered with, but because there is no legally binding and certified bridge between the digital and the original asset. Companies like Look Lateral have put paid to this misuse by assuming themselves or in cooperation with third parties an authentication role. Here, the artwork is subject to an extensive due diligence and provenance check before it becomes listed in the "Fractionalized Market of Art" (FIMART). While this strategy adds to the

[538] OECD, 'Regulatory Approaches to the Tokenisation of Assets' OECD Blockchain Policy Series (2021) 25.
[539] *Look Lateral*, White Paper (with the author); see also *Petale* (FR) <https://www.petale.com/tokenize>, accessed 2 December 2022; these firms do not own the underlying assets but rather offer the service to convert customer's assets into tokenized items and fractionalized interests. Accordingly, they are not among the companies listed in Annex II.
[540] Barbereau and others (n 225) 221.
[541] ibid 222.

credibility of the system, it alone cannot provide for the valid transfer of titles only via the blockchain, but still requires also off-chain change of possession of the tangible artworks.

2. The Business-Set Up of Fractional Art Ownership

For the offering of fractional ownership, each artwork is securitized at an individual level, meaning that the entirety of the issued securities in an STO relates only to one work of art. Usually the "umbrella" investment company sets up a special purpose vehicle (SPV) whose exclusive purpose is the acquisition, holding and management of works of art. Contrary to the practice with conventional art funds, where there is usually only a rough description of future investments communicated to investors, since the artworks will be purchased only after the collection of the capital by investors, in the case of fractional ownership, the investors know exactly what they invest in at the moment of their involvement, as the selection of the asset is upstream of the financing phase. After securing the artwork, e.g., by a pre-emptive right, the target amount is raised, the duration of which depends and may range from a few weeks to in some cases only minutes.[542] The central investment asset is usually acquired by the SPV directly or the supra-ordinated investment company which then transfers ownership to the associated entity.[543]

The tokens issued are so-called "security tokens", i.e., digital units allowing for financial involvement in a common enterprise.[544] The tokens can be assigned various features and associated rights in their smart contracts, such as voting rights, in accordance with the type of security envisaged. Based on the research conducted on the individual providers, the following landscape emerges: most offerors of fractional ownership in artworks issue interests in their company that qualify as securities according to pertinent financial market laws; while in the EU the interests correspond to securitized debt instruments, i.e., bonds, or derivatives, in the US, they represent equity interests.[545] Only 2 out of the 10 examined offering entities have based their

[542] Referring to Finexity's first digital art investment opportunity offered in December 2020, where the offering was completed successfully after only 15 minutes, Finexity Art Guide 2021, 23; in the case of Maecenas, its first offer was open for four weeks, <https://www.realwire.com/releases/first-ever-multi-million-dollar-artwork-tokenised-and-sold-on-blockchain> accessed 20 October 2022.

[543] There are different approaches in how the artwork is paid for; whereas with some funds, the supra-ordinated company advances the capital by purchasing the work itself and subsequently selling it to the fund, others have a right of first refusal granted to them and collect the capital from investors to buy directly.

[544] See for the legal qualification of this kind of security tokens below at 126.

[545] For a detailed analysis of the securities qualification of the issued units, see below the section on Regulation of Fractional Ownership (140)

businesses on the actual fractional *ownership* of the asset in the strict legal sense.[546] There are also other providers, like *Look Lateral*, which offer to convert assets into tokens, allowing also for the possibility to fractionalize one's ownership interest in an asset and provide the secondary market platform for trading of these units. Since they do not own the underlying investment assets, they are not examined further in detail in this Chapter.

Whether the issued products correspond rather to bonds or derivatives is a contentious matter and hinges on the details of each case. The exact denomination of the financial instrument depends to a large extent on the national legislation and assessment of the NCA. Contrary to the common model of bonds in other investment classes, in the artworld there are rarely performance-related current interests cashed out to investors during the holding period. Art ownership does not pay any dividends, which translates into most business concepts based on fractional ownership not generating any considerable interim revenue. It is only in exceptional cases that earnings may be generated e.g., through participation in ticket sales for exhibitions where the artwork is included. The lack of liquidity in this long-term investment model must thus be born in mind by investors, all the more since they may be prevented or disincentivized by contractual agreement from redeeming their debt tokens with the issuer for a certain period.[547] Accordingly, there is no total congruence with the archetype of a bond.

The financial instruments issued to investors are not in a certificated form, but as security tokens. The token, which is often referred to in the marketing context as "digital certificate of ownership", is thus rather to be understood as certification of the indebtedness of the issuing company in the amount of the nominal value to the rightsholder. Investors do not become shareholders or partners of the SPV, but instead, are usually attributed the role of a creditor. In line with this role akin to that of bond holders, they are not awarded any participation rights in the company's business decisions and strategy, which is solely up to the manager's responsibility and evaluation.

The size of each investor's claim reflects their investment per ratio to the total capital and is in detail subject to the contractual agreement. The maturity term for the asset to be resold is set from the beginning and generally lasts between 3-15 years in the artworld, whereas with other

[546] These are emphasized in Annex II by their red underlying color.

[547] Redemption of the issued bonds and similar financial instruments is often excluded for the defined holding period, thus generally for 5-12 years; however, most distributors allow investors to trade their tokens and the respective rights with other investors on the provided secondary market platforms.

collectibles, it may only be weeks.[548] Redemption of the initial investment from the issuer is scheduled only at the moment of resale of the asset. In addition to receiving their originally contributed capital, investors also partake in any surplus generated through the liquidation of the artwork. The net yield which can be expected in this category of investment ranges from 3% to almost 20%.[549] Its size depends to a large extent on whether the expected return shall principally reflect the overall economic development or whether one can reasonably expect an appreciation beyond that due to the strategic placement of the work on the market.
One can generally differentiate between actively and passively managed art as an asset. Passively managed art is simply supposed to be held for a certain period of time in order to let the general art market development play out in favor of the work's value; whereas with actively administered art investments, the management develops and follows a strategy which targets a certain percentage in terms of value increase. Not only does the active observation of market trends and placement of artworks in exhibitions and research projects pertain to this, but also the timing of the final sale is a crucial decision. For its services, the management receives a fixed salary, which amounts to 1-2% of the net purchase price of the co-financed artwork; most offerors foresee an additional success fee in case financial return rates can be exceeded.[550] Administrative costs, such as for transportation, storage, and insurance, are either to be covered by ongoing revenues from lending services or will be deducted from the final sales proceeds.

These ongoing costs as well as management fees are subtracted before the total distribution amount is settled as basis for redemption of the investors. In addition to management fees, the issuer may keep a share of the gross yield for its own expenses (usually around 2%). The group of investors is commonly entitled to 80%-90% of the remaining surplus.[551] In exchange for the payment, bondholders will have to transfer their token back to the issuer.

Due to the structure of the investment, there is no obligation for investors to make any additional financial contributions in case the artwork is resold below its original purchase price; thus, investors in fractional ownership do not directly participate in any loss generated at resale. That is however not to say that a shortcoming compared to the initial sales price paid for the artwork

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[548] E.g. with sports cards, sneakers, NFTs, whose price development is more liquid compared to that of conventional artworks.
[549] See for the different interest rates Annex II; the net yield or annual interest rate to investors is the investment's return after the deduction of a management fee and other expenses, if they exist.
[550] Which is usually at 15-20%, but may in some cases be just under 2%, see Annex II.
[551] According to the Basis-Information Materials provided by *Finexity* and *arttrade*.

by the issuer does not affect the investors' claims. Instead, the subordinate character of the redemption right bears certain risks. As the issuer is only obliged to repayment of investors from funds generated by the resale, in the case of insufficient revenue, investors' claims are redeemed only subsequently to any outstanding third party credit. In terms of investor protection, investors therefore should be alert with regard to the senior ranking or priority of different types of creditors involved. The lower rank of their claims may not only minimize the share in any liquidation surplus, but also reduce investors' claims for restitution of their initial investment.
Certain structures provide for the possibility to sell the underlying asset already during the holding period by concentrating all fractional ownership claims in the hand of a single investor. Such is the case e.g., with the investments offered by Artemundi, that allows not only for the execution of a drag along right but also for a squeeze out. In the first case, token holders are required to vote on the proposed offer within 21 days, after which a minimum of a two-third majority has to have agreed. For the squeeze out, any investor holding a two-third majority of tokens can make a respective call, where the price is calculated on the basis of the retail replacement value plus a 10% premium.[552]

3. Secondary Private Markets

Some issuers have recognized the long-term commitment to be somewhat of a deterrence to investors. Thus, in order to increase liquidity, several platforms have established their own secondary markets,[553] which shall allow investors to trade their tokens during the holding period and thus, extract capital before maturity or realize gains from short-term market developments. In these scenarios, the issuer of the debt instruments generally makes the secondary market available on its own platform or through an associated partner. To sell their bonds, investors can list their offer and wait for other investors to buy at a set rate.

So far, these secondary markets are rather restricted in their group of participants, as access is generally reserved for investors of the specific platform; there is currently no central secondary market for investment instruments issued under the business model of fractional art ownership,

[552] Such an option exists for example with the *Artemundi* security tokens offered in cooperation with *Sygnum*; the fact that the fracitonal ownership offered by these companies is not listed in Annex II is based on the corresponding issuing entity being established outside the scope of EU and US financial market laws, namely according to Swiss law.
[553] Such as *Maecenas, Artemundi, Masterworks*, to name but a few.

neither in the EU nor in the US. The smaller the platform and the number of initial investors, the less trading activity occurs and thus, the aim of increasing liquidity in art investment cannot always be guaranteed. In this regard, there still exist essential shortcomings compared to e.g., the secondary market for real estate fractional ownership units, which is a lot more liquid due to real estate tokens being traded, among others, on large securities trading platforms.[554]

Often, there are restrictions to the trading of fractional ownership tokens on secondary market, which may result either from contractual terms imposed by the issuer, or from legal obligations that emerge due to limited registration obligations or in the context of necessary KYC/AML assessments of investors.[555]

II. Regulation of “Fractional Ownership” in Artworks

1. Regulation of “Fractional Art Ownership” in the EU

There are currently seminal changes taking place in the European regulatory landscape with regard to DLT and finance, only the most important ones of which can be depicted in this thesis which are also of relevance to the art segment. Against the background of an incredibly fast developing investment sector around this technology and the gradual adaption process of legislators around the globe to the challenges presented by it, the regulation of tokens as securities in the EU and the US could stand as a dissertation topic on its own. The legal analysis at hand thus needs to be restrained to the relevancy of tokenized securities and security tokens under MiFID II with a focus on their use for representation of “fractional ownership” of tangible artworks.[556] Further useful readings, especially on the technical conditions, are referred to in the context of the appropriate arguments in the discussion. In view of the topicality and relevance also for the field of art investments, the regulatory system of the Pilot Regime will be outlined in addition to the pertinent MiFID rules.

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[554] As a case in point, SolidBlock listed Real Estate Security Tokens worth USD 150 million on the INX trading platform, see < https://www.sec.gov/Archives/edgar/data/1725882/000121390020045286/ea132438ex99-1_inxlimited.htm> accessed 20 October 2022.
[555] See in detail below at 167.
[556] The issue of regulation of other than security tokens will be topic of the next chapter on NFTs.

a) Regulatory Steps in the EU

In 2020, the EU launched a comprehensive political and legislative program dedicated to the digitalization of finance,[557] which was intended to ensure the competitiveness of the European markets as well as the promotion of digital innovation. To achieve these aims, the Commission proposed various measures, e.g. a legislative act on digital operational stability (Digital Operational Resilience Act, DORA), a proposal on regulation of crypto-assets (Regulation on Markets in Crypto-assets, MiCA),[558] as well as most recently a pilot regime on DLT-based market structures (DLT Pilot).[559] This legislative package was supposed to close a regulatory gap, as DLT-backed financial products and crypto assets outside the MiFID-scope had previously not been specifically addressed by any legal act of the EU, thereby making sure to provide the legislative basis to enhance financial market integration in the EU as banking and capital markets union, while maintaining a harmonized level of investor protection.

b) Regulation of "Fractional Ownership Units" Under MiFID II

As previously established, the designation "fractional ownership" of an artwork in the investment context does not refer to an actual co-ownership structure,[560] but rather to the concept of interests in the art-owning company being issued in the form of most commonly debt instruments. Accordingly, the applicability of the MiFID II-framework needs to be assessed against the qualification of the dealt with debt instruments as financial instruments pursuant to Art. 4(15) and Annex I of MiFID II. Also of relevance with regard to this assessment could be the fact that the debt instruments are not issued in a conventional way, but clients are transferred their rights via the blockchain, obtaining tokens instead of certificates.

[557] The Digital Finance Package was adopted by the European Commission on 24 September 2020 with the objective of adapting the financial regulatory system to the digital transition within the financial industry, remove obstacles for cross-border transactions and establish a common European financial data space to facilitate digital innovation.
[558] Proposal for a Regulation of the European Parliament and of the Council on Markets in Crypto-Assets, and amending Directive (EU) 2019/ 1937 (MiCAR), https://ec.europa.eu/info/sites/info/files/business_economy_euro/banking_and_finance/200924-presentation-proposal-crypto-assets-markets_en.pdf.
[559] The DLT Pilot was published in the Official Journal on 2 June 2022 after being consented to by the European Commission, the European Parliament and the European Council; it will be applicable from 23 March 2023 onwards.
[560] This is the case at least for Member States of the EU; as we have seen, there are exceptions to this where the national law, e.g., in Switzerland, allows for the distribution of tokenized ownership titles for investment purposes.

The MiFID II-framework does not explicitly mention security tokens or other forms of digital assets in its wording. Thus, it was upon the European supervisory authorities and NCA's to issue guidelines on this issue in order to provide clarity in the context of DLT-driven financial services[561] – and in line with their doing,[562] albeit only gradually, a general recognition of tokenized securities has been established throughout the Member States in the recent years. According to a survey conducted by ESMA, most Member States confirmed that they qualify tokenized securities respectively security tokens as transferable securities or another financial instrument in lines with the MiFID II definition as well as according to national transposing laws.[563] Given the lack of a uniform regulatory framework, the uncoordinated approach by single Member States towards the regulation of DLT resulted in national differences as to the details of how DLT-based securities were to be treated.[564] As a consequence, while there is a strong consensus as to the applicability of the MiFID II framework to tokenized securities, Member States' securities laws vary in their definitions, clarity and scope.[565] As a case in point, several countries only recently abolished the requirements for securities to be registered in a central register or deposited in paper form,[566] thereby limiting the accessibility of their investment markets for digital innovation.

[561] See e.g. ESMA, `Report: The Distributed Ledger Technology Applied to Securities Markets` ESMA50-1121423017-285 (7 February 2017) <https://www.esma.europa.eu/system/files_force/library/dlt_report_-_esma50-1121423017-285.pdf>, accessed July 8, 2021; "A key consideration for regulators is the legal status of crypto-assets, as this determines whether financial services rules are likely to apply, and if so, which, and hence the level of protection to investors", in ESMA, 'Advice Initial Coin Offerings and Crypto-Assets' ESMA50-157-1391 (9 January 2019) para 5.

[562] BaFin, ‚Zweites Hinweisschreiben zu Prospekt- und Erlaubnispflichten im Zusammenhang mit der Ausgabe sogenannter Krypto-Token' GZ: WA 51-Wp 7100-2019/0011, IF 1-AZB 1505- 2019/0003, 7 <https://beck-link.de/4d27t> accessed 15 March 2022.

[563] Of course, the qualification depends on features that may vary among security tokens, which is why it is widely assumed that a case-by-case assessment is necessary in order to reliably categorize each token; see BaFIN, 'Blockchain Technology – Thoughts on Regulation' (1 August 2018) <https://www.bafin.de/SharedDocs/Veroeffentlichungen/EN/BaFinPerspektiven/2018/bp_18-1_Beitrag_Fusswinkel_en.html> accessed 8 July 2022, also, "the actual classification of a crypto-asset as a financial instrument is the responsibility of an individual NCA and will depend on the specific national implementation of EU law", ESMA, 'Advice on Initial Coin Offerings and Crypto-Assets' ESMA50-157-1391 (9 January 2019) para 6.

[564] Graham (n 18); Grundmann and Hacker (n 119); Filippo Annunziata, *La Disciplina Del Mercato Mobiliare* (11., Giappichelli 2021); Holland Cotter, 'Bernini, The Man Of Many Heads' New York Times E25; Monika Roth, 'Es Sind Interessenkonflikte, Dummkopf!' (2015) 6 KUR - Kunst und Recht 165.

[565] With one of the first jurisdictions worldwide to recognize the possibility of DLT-assets as financial instruments being Malta, which included the concept of a token in their legislation of the Malta Virtual Financial Assets Act in 2018, Lichtenstein followed by introducing the Liechtenstein Blockchain Act shortly afterwards in 2019; see for an overview on this issue: ThinkBLOCKtank (n 182) 9.

[566] See e.g. for the necessary legal adaptions according to German Securities Law: Zsofia Vig, 'Inhaberschuldverschreibungen Auf Der Blockchain' [2022] BKR 442.

Returning to the supranational level, the MiFID II-framework does not differentiate whether or not a security is represented by a physical certificate.[567] Securities fall within the scope of the Directive even if they only exist in digital format. The prevailing opinion is that securities created on and traded through the DLT are analogous to non-DLT-based securities, given that the form in which they are cast does not materially alter their functions and characteristics, nor does it change their legal nature.[568] According to the recital (2) in the recently issued Pilot Regime,[569] crypto assets may qualify as financial instruments under MiFID II, which is why issuers of such crypto assets and firms conducting activities related to such crypto assets have to comply with the existing legislation on financial markets, as well as with the new Pilot Regime. What is more, the digital representations are assigned the same ISIN as the financial instruments they are representing, given their identical characteristics.[570]

aa) Qualification of Fractional Ownership Units as Financial Instruments

Of relevance with regard to the classification of the "fractional ownership" units as financial instruments is not their tokenized form as much as the characteristics and legal claims that the issued units are supposed to represent. Based on the research conducted on issuers of fractional ownership units within EU Member States, the denomination most commonly employed with regard to the offered products is "debt instruments" or "bonds". [571] However, as we have seen by the example of "fractional ownership", a name is not always to be trusted, which is why an analysis of the nature inherent to the transferred rights is due.

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[567] Kumpan (n 181).

[568] See e.g. ESMA, 'Report on the DLT Pilot Regime On the Call for Evidence on the DLT Pilot Regime and compensatory measures on supervisory data' ESMA70-460-111 (27 September 2022), at para. 39 "While reference data and instrument characteristics are considered to be basically the same, additional (mainly technical) features characterise a DLT instrument, i.e. nature of a digital instrument (digitised format), how it was issued, in which technology, method of recording, the product design, etc", although according to the Report, "[a] few stakeholders called for a distinction between security tokens issued on a DLT that could qualify as a transferable security, and 'tokenised securities', described as financial instruments issued 'traditionally' and introduced on a DLT afterwards.", para. 41.

[569] Regulation (EU) 2022/858 of the European Parliament and of the Council of 30 May 2022 on a pilot regime for market infrastructures based on distributed ledger technology, which also points to MiFID II for the "financial instruments" definition which, to fall within the scope of the Pilot Regime, is adapted to refer to "DLT financial instruments" (Art. 2 (11), (12)).

[570] ESMA, 'Questions and Answers on the implementation of Regulation (EU) 2022/858 of the European Parliament and of the Council of 30 May 2022 on a pilot regime for market infrastructures based on distributed ledger technology' ESMA70-460-189 (16 December 2022) Question 1 – Financial Instruments Reference Data (last update: 16 December 2022) <https://www.esma.europa.eu/sites/default/files/library/esma70-460-189_qas_dlt_pilot_regulation.pdf> accessed 16 December 2022.

[571] The basic information sheets of both European issuers, *arttrade* and *Finexity*, refer to "nachrangige, tokenbasierte ["tokenisierte"] Schuldverschreibungen".

With bonds being the most prominent example of a debt instrument, the question arises whether also fractional ownership units fall under this term.
This finding could be supported by the fact that the capital contribution is structured as a loan, since the investors are formally entitled to repayment of the principal value of their claim, i.e., 100% of their contributed amount, at the end of the pre-determined tenure. This repayment claim is based however on the premise that the issuer has sufficient financial means at the time the payment claim arises. Since typically in the context of art fractional ownership only very limited equity is contributed by the issuer and the SPV is structured around the custody of a single item, the entirety of the repayment claim depends solely on the resales price achieved for the work. In addition, investors' loans are typically attributed a subordinated ranking through contractual provisions, therefore any senior debt is serviced on a preferential basis compared to these investments.
Another reason why the configuration of fractional ownership units occurs as debt instead of equity instruments lays with the possibility to exclude co-determination and voting rights of investors, thereby concentrating decision powers in the hands of the management. This does however not prevent issuers to assign certain co-determination powers to the tokens through their smart contracts,[572] whose terms can be defined in detail, and which may allow a purely digital and self-executing voting procedure.

This is as far as the congruency between the issued instruments and the archetype of a bond goes; in fact, there exist also significant differences regarding fractional ownership units: first of all, no or hardly any accruing interests are paid out to the investor during maturity.[573] While the investment agreement may still provide for a corresponding right of the investors to be issued interests, these interest rates are 100% variable and due to the lack of generated capital throughout the holding phase, in practice, almost never realized.[574] The reason for this consists in the artworks not generating any continuous cash flows profits, and any fees collected from exhibitions etc. are marginal, all the more since they are partially offset by the administrative costs incurred. Instead, the main profit opportunities in this business model are concentrated at the very end when any accrued surplus in sales price is paid out to investors – which in turn accounts

[572] Such as the above explained squeeze-out and drag-along rights stipulated for *Artemundi's* fractional ownership art security tokens.
[573] In their effect, the issued products therefore come close to zero-coupon bonds, all the more since there is no fixed promised success rate.
[574] Interests rates are nonetheless formally part of the transaction agreements in all examined EU fractional art ownership providers, see Basis Information Sheets of *Finexity* and *arttrade*.

for yet another difference compared to bonds: in view of the direct pro rata participation of the investors in the generated resale's price, this form of debt participation has no limited upside; rather, it represents a variable claim to a share of the profit.[575] Contrary to most bond structures, in art fractional ownership there is generally no large equity investor whose profit claim supersedes that of the subordinated loans.

In light of the foregoing, this investment form exhibits strong traits typical for equity investments, while being formally categorized by the issuers as a debt instrument. Hence, one would have to consider the fractional ownership units a hybrid form, which do not fall within the regular definition of a bond.

What is also proposed in this context is the qualification of fractional ownership interests as derivatives. Indeed, as Paul Huelsmann, the CEO of *Finexity*, observed: "These security tokens [fractional ownership tokens of artworks] are similar to derivatives, in that they transmit a claim based on the performance of the underlying. In the end, I am granted a contractual claim to participate in the asset, which qualifies as a security, only that it cannot be considered equity, but debts towards the investors."[576]

In view of the manifold variations of financial instruments, fractional ownership units with an artwork as underlying asset can best be described as a hybrid form, exhibiting different characteristics of securities and derivatives. Given that the definition of financial instruments in MiFID II is intentionally kept open to comprehend also new forms of investment,[577] an assignment to a specific instrument is therefore not necessary, as long as sufficient comparability to known financial instruments can be ascertained, also with regard to the established criteria relevant under the securities definition.[578]

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[575] Or respectively, the limit is set at a very high percentage compared to that generally assumed in bond structures, e.g., at 80% of any generated profit (as is the case in the *Finexity* fractional ownership project "Zermatt (2022)", see Finexity Schuldverschreibungsbedingungen für tokenisierte Schuldverschreibungen mit qualifiziertem Rücktritt [...] der neuart-01 GmbH & Co. KG für die Finanzierung des Erwerbs der Kunstwerke "Zermatt (2022) von Peter Doig", 13 (with the auhtor).

[576] In the interview with Paul Huelsmann on 5 October 2022, he also compared the issued units to "Genussrechte" (profit participation rights), which according to German securities law can be issued in the form of debt instruments (see draft regulation of the German electronic securities law, 41; see also Casper, 'Elektronische Schuldverschreibungen' in Möslein and Omlor (n 506) § 10) (transcript of the interview with the author).

[577] Annunziata (n 564) 107.

[578] See Art. 4(1)(44) MiFID II, according to which "transferable securities" do not only comprise shares in companies but also bonds or other forms of securities debt and any other securities giving rise to a cash settlement

With that being said, the issued units are to be examined against their transferability, standardization, and negotiability in order to establish parallels with traditional securities. In this regard, the tokenization becomes of major relevance: Given the easier transferability of tokenized rights inserted in the DLT as well as their formal alignment as fungible i.e. standardized tokens within the minted class, the tokenization of assets, if anything, *adds* to the qualification of "fractional ownership" units as a security by endorsing the relevant features. Nonetheless, a case-by-case investigation is to be conducted for each STO that allows to take into consideration the precise circumstances and (technical) features of the designed units.

Taking a closer look at the relevant companies within the EU, *arttrade* and *Finexity*, and their contractual terms, a consistent picture emerges, according to which both issue transferable units which are standardized within their class, in that they represent a homogenous class of claims relating to the same asset. The transferability is inherent not only to the very nature of the tokens, but also to their underlying claims, according to the investment terms, where the transferability of the tokenized rights is stipulated (even if subject to certain contractual conditions– which however does not bar the finding of transferability).[579]

The remaining point concerning the negotiability of the respective tokenized rights on capital markets requires a more thorough analysis. As was briefly indicated above, it is quite common practice for fractional ownership token distributors to maintain a secondary market platform where tokens can be exchanged and sold to other investors. Except for the firms offering actual ownership in artworks,[580] all of the companies listed in Annex II offer such an exchange platform or plan to provide one soon.[581] Nevertheless, the liquidity of tokens is limited insofar as they cannot be transferred to another party outside the investors community and in addition, according to the terms of investment issued by the token offerors, the actual numbers of offers may accordingly be that small that trading may not occur on a regularly basis. Whether this is sufficient to assume negotiability on the capital market within MiFID II is doubtful.

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determined by reference to transferable securities, currencies, interest rates or yields, commodities or other indices or measures.

[579] Such has been clarified by ESMA in the context of prospectus regulations, see ESMA, 'Prospectuses. Questions and Answers' (January 2019) 29th updated version, para. 67, p. 56.

[580] Such as e.g. *Timeless*.

[581] See Annex II; also interview conducted with Paul Huelsmann on 5 October 2022, transcript with the author.

The MiFID-texts do not provide a definition of the term "negotiability".[582] Given its apparent parallelism with the prerequisite "transferability", the prevailing opinion reads into it an additional level of "ease" with which the units can be traded, while transferability shall refer merely to the capacity of passing ownership of a security.[583] In line with this, a strong indicative effect is attached to units being traded on regulated markets or a multilateral trading facility (MTF), according to the specifications issued by the European Commission.[584] This applies even to assets that are not actually traded on these venues but only in theory capable of being traded there.[585] The central question that prompts itself in the current trend of DLT-based investment forms is whether token exchange platforms fall within the definition of regulated trading venues, or whether e.g. the fact that company- or broker-provided secondary markets are accessible only to investors in the company account for substantial differences.

In-depth investigations on these issues by legal academia are still rare and often enough, the discussion is evaded by simply pointing to the practice of security tokens effectively being traded on exchanges and platforms.[586] This lack of theoretic and methodological debate deserves remediation.

(1) Exchange Platforms as Regulated Trading Venues

Regulated markets as well as MTFs are trading venues defined by MiFID II and subject to specific rules within the MiFID framework. MTFs are multilateral systems which bring together or facilitate the bringing together of multiple third-party buying and selling interests in financial instruments – in the system and in accordance with its non-discretionary rules – in a way that results in a contract, in respect of the financial instruments admitted to trading under its rules and/or systems, and which are authorized and function regularly (in accordance with Title II of

[582] There are differing opinions as to whether this requirement may be assumed even when transferability hinges on the consent of a third party or a written agreement.

[583] ThinkBLOCKtank (n 558) 19; some legal scholars argue that negotiability in distinction to transferability must be interpreted in a narrower sense, e.g. by allowing for good faith acquisition of the security – an issue to which there is no conclusive solution yet when it comes to security tokens, see e.g. T. Voß, 'Geschlossene Fonds unter dem Rechtsregime der Finanzmarkt-Richtlinie (MiFID)?' (2007) BKR 45 (51); A. Fuchs, in: Fuchs, *Wertpapierhandelsgesetz Kommentar* (2nd ed., 2016), § 2 para. 18.

[584] European Commission, 'Your questions on MiFID (updated version 2008)' Question no. 115.

[585] ThinkBLOCKtank (n 182) 19.

[586] According to ESMA's survey, 18 NCAs considered the provided samples of crypto-assets as negotiable on the capital market merely because "they are capable of being traded on an exchange" (ESMA, 'Annex 1 - Legal qualification of crypto-assets – survey to NCAs' ESMA50-157-1384 (January 2019), para. 22; assuming a similar line of argumentation for the negotiability of security tokens on capital markets, see e.g. Valeria Ferrari, 'The Regulation of Crypto-Assets in the EU – Investment and Payment Tokens under the Radar' (2020) 27 Maastricht Journal of European and Comparative Law 325, 332.

the Directive).[587] The essential difference lies with regulated markets being operated and/or managed by a market operator, while MTF can also be run by investment firms.[588] While it is obvious that the secondary markets provided to the rather limited number of investors of the several platforms do not account for "regulated markets" under MiFID II, an example for which are traditional stock exchanges, the delineation with regard to MTFs is more complicated and lacks indeed clear regulatory as well as administrative guidelines. What is of essence in this regard is the level of interaction between investors enabled through the system that is provided by the platform operator.

Common to all types of trading venues under MiFID II is the character of a "multilateral system", which is defined according to Art. 4(1)(19) as any system or facility in which multiple third-party buying and selling trading interests in financial instruments are able to interact.
Basically any set of rules which determines how market participants interact in trading, be it by contractual, standard or (non-) automated procedures, suffices to assume a system or facility.[589] What is more, multiple third party buying and selling interests have to be involved in this system. This relates to parties different from the system operator which bring their various trading interests to interact in the same facility. The question prompts itself whether the aspect of "multiple" party interests implies a certain number of participants or liquidity.
According to ESMA guidelines, also systems where only two trading interests are brought together adhering to the rules of a third-party operator are within the scope of the Directive.[590] ESMA bases this finding on the CJEU Case C-658/15 *Robeco and others vs. AFM*,[591] where the Court denied a bilateral system in a constellation where an investor's trades where always executed by the same investment fund on the other side within its own market system. Accordingly, only systems where any interaction occurs merely between two counterparties, with no third-party involvement, are excluded by the "multiple third-party interests."[592]

[587] Art. 4(1)(21) MiFID II
[588] Art. 4(1)(22) MiFID II.
[589] ESMA, 'Consultation Paper on ESMA's Opinion on the trading venue perimeter' ESMA70-156-4978 (28 January 2022) para. 19.
[590] [590] ESMA, 'Consultation Paper on ESMA's Opinion on the trading venue perimeter' ESMA70-156-4978 (28 January 2022) para. 24.
[591] Court of Justice of the European Union 16 November 2018, Robeco Hollands Bezit NV and Others vs. Stichting Autoriteit Financiële Markten (AFM), <https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:62015CJ0658&from=FR> accessed 29 September 2022.
[592] ESMA, 'Consultation Paper on ESMA's Opinion on the trading venue perimeter' ESMA70-156-4978 (28 January 2022) para. 27.

Although there cannot be given a generally valid number indicating the actual involvement of parties on the provided secondary market platforms allowing trading of fractional ownership units, it can generally be assumed that more than two parties are involved, already from taking the total numbers of investors into consideration, which are often in the hundreds, all of which are generally granted access to the trading platform.

In addition, the parties have to be "able to interact" within the system; the understanding of this term is rather broad, as it merely requires the capacity to react to others' trading interests, not necessarily by concluding a contract, but including e.g., arranging and negotiating the essential terms.[593] The reaction may also consist in an automated mechanism, as is the case e.g. in "an automated match on an order book system."[594] What is however excluded according to the Recital 8 of MiFIR are "bulletin boards used for advertising buying and selling interests, other entities aggregating or pooling potential buying or selling interests", where there is no genuine arranging of orders taking place in the system.[595]

Although the details of the functioning of each market platform are established by the individual custodian, typically, secondary markets in the fractional ownership investment sector are limited in their function so that they only allow investors of a specific platform to publish their buying or selling offers (bids and asks) which can be accepted by other members at a set price. The agreement on the terms is left completely to the discretion of the interested parties of a transaction; conversely, the operator does not play a role in the matching. Instead of establishing the framework e.g., for an automatic matching of corresponding offers and sales, operators may consent themselves with providing the mask for investors who are on their own to scan through the offers to find a transaction partner. If in consistency with the above-described structure, it can be assumed that secondary market platforms for tokens represent mere aggregations of trading interests and accordingly, do not qualify as MTFs. Due to the lack of specific rules

[593] ESMA, 'Consultation Paper on ESMA's Opinion on the trading venue perimeter' ESMA70-156-4978 (28 January 2022) para. 28.
[594] ESMA, 'Consultation Paper on ESMA's Opinion on the trading venue perimeter' ESMA70-156-4978 (28 January 2022) para. 29.
[595] See also ESMA, 'Consultation Paper on ESMA's Opinion on the trading venue perimeter' ESMA70-156-4978 (28 January 2022) para. 30.

governing the matching, arranging or negotiations of the interests, there cannot be assumed a sufficient level of "interaction" occurring through the platform. [596]

More of relevance to the market structure commonly employed in the context of tokens is the category of Alternative Trading Systems (ATS), which is a term established to encompass platforms for securities trading outside the traditional exchanges, which will be assessed in detail below.[597]

(2) Sufficient Level of Negotiability

The finding that art fractional ownership units are generally not traded on a regulated trading venue does however not exclude the inference that they can be considered negotiable on capital markets according to the definition of tradeable securities under MiFID II. As Hacker and Thomale observed in their seminal work on the relevance of crypto assets under EU securities regulation, "the Commission itself points out that even instruments that are incapable of being traded on MTFs or regulated markets may be considered negotiable".[598] In fact, the used platform is merely attributed the role of an indication as to the negotiability of art fractional ownership tokens; the wording of the Directive actually refers to the negotiability "on the capital market", which indicates a broader scope than that of regulated trading venues.[599] Interestingly, there is no legal definition of the "capital market" – neither in the MiFID-framework, nor by any of the EU Member States. [600] By the NCAs of most Member States, "capital market" is simply understood as the place "where buying and selling interests meet."[601] Legal doctrine deduces from the term that the capacity to be traded as equity or debt instrument in any multilateral or bilateral system shall suffice.

[596] See for the distinction further ESMA Consultation Paper on ESMA's Opinion on the trading venue perimeter' ESMA70-156-4978 (28 January 2022) para. 31.
[597] See below at 135; see also Christoph Kumpan, 'Markets for Financial Instruments', *Max Planck Encyclopedia of European Private Law* (2012), who considers ATS' to be an overarching description of trading venues which shall encompass three categories, namely 1) those platforms open to numerous traders defined as MTFs according to MiFID, 2) bilateral systems, which correspond widely to the definition of a systematic internalizer (SI) in MiFID, where the operator is involved as a counterparty in every transaction, and 3) all remaining platforms of various designs. In the following, however, the term ATS is used properly in delineation from MTFs and SIs.
[598] Hacker and Thomale (n 157) 22; referencing the European Commission, 'Your quesitons on MiFID (updated version 2008), question no. 115.
[599] See also on this point Annunziata (n 557) 108.
[600] ESMA, 'Annex 1 - Legal qualification of crypto-assets – survey to NCAs' ESMA50-157-1384 (January 2019), para. 23.
[601] Ibid.

Given the rather broad interpretation of the wording, it is to be assumed that also art fractional ownership tokens being traded (or in theory tradeable) on exchange platforms fulfill the requirement of "negotiability". The tokenized form does in fact represent a significant advantage in terms of tradability, certainly compared to the underlying art as highly illiquid assets, but also compared to other art investment forms, such as the fund units examined in the previous chapter, whose transferability can regularly be excluded due to the personal fixation. Since no comparable limits to the transfer and trade units are established with regard to fractional ownership units, they can be considered tradable with ease in terms of negotiability. This abstract capacity is concretized by there being secondary market platforms dedicated properly to the aim of trade among investors. The fact that there may be practical restrictions due to a smaller potential group of transactional partners on a specific platform cannot play a role insofar as, according to the EC, even the theoretical negotiability can be considered sufficient.[602] An exception to the facilitated negotiability of the assets may apply where trade restrictions are anchored in the smart contract of the tokens. This should indeed be understood as decisive criterion, since circumvention of the smart contract terms is virtually impossible and would therefore represent a significant restriction in a token's tradability.

In this context, also the following needs to be emphasized: As one of the NCAs participating in the survey conducted by ESMA on the qualification of crypto assets rightfully observed, "capital markets [are] not the appropriate venue for crypto assets to be negotiated."[603] Because this is the case and the legal wording is prone to cause more uncertainty than provide useful guidelines in assessing the security quality of a crypto asset, many NCAs do not bother to assess the criterion on its own but treat it as a "self-fulfilling" feature if tokens are actually traded.[604] Often enough, the negotiability on capital markets is denied "because [the assets] do not qualify as securities",[605] which divests this requirements of its delineation function and therefore imposes the conclusion that it is not a useful point to consider in addressing today's challenges of DLT-driven investments.

Concluding what has been established so far, "fractional art ownership" units as in financial products establishing investors' rights towards the art-owning entity and issued in their tokenized

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[602] See also on this differentiation: Annunziata (n 564) 108.
[603] ESMA, 'Annex 1 - Legal qualification of crypto-assets – survey to NCAs' ESMA50-157-1384 (January 2019), para. 22.
[604] Ibid.
[605] ESMA, 'Annex 1 - Legal qualification of crypto-assets – survey to NCAs' ESMA50-157-1384 (January 2019), para. 22.

form correspond in their nature to securitized debt instruments, albeit not to a conventional bond, and fulfill the characteristics typically associated with a security, i.e. transferability, standardization, and negotiability. Therefore, tokenized fractional art ownership can be considered a financial instrument according to MiFID II, subject to specific exceptions in individual cases. As a consequence, the issuer and marketer of such products are subject to the same rules and regulations in terms of investor protection as any investment firm whose services fall within the remit of MiFID II.[606] This encompasses not only the obligations to be observed in an IPO, but also pre- and post-contractual behavioral and transparency duties.

bb) Marketing to retail investors

MiFID II imposes on issuers and investment firms marketing financial instruments to clients the duty to evaluate the target market and assess the client's suitability in accordance to the product. There are exceptions to the appropriateness test where the service provided consists in "execution only" of the client's orders (Art. 25(3),(4) MiFID II). In this case, there is no need to obtain the information on the client's knowledge and experience. However, this reduced scope of pre-sale obligations is premised on the fact that the dealt with products are non-complex financial instruments. Already in light of the product's marketing title, which may create false expectations with the investors, it is questionable whether fractional art ownership tokens should be considered complex financial products.

ESMA has issued guidelines on this topic, including parameters which are decisive in the assessment of a product. Accordingly, certain debt instruments may be considered complex if the "incorporating a structure mak[es] it difficult for the client to understand the risk", which is principally the case if the product in question corresponds to any of the following:[607]

a) Debt instruments, the return of which is dependent on the performance of a defined asset pool, i.e. which depends on the receivables either fixed or revolving generated by the assets in the underlying pool;

[606] Though some would argue that a security issued on the blockchain does not have an identified issuer, but is rather "constituted" than "issued" (see ESMA, 'Report on the DLT Pilot Regime On the Call for Evidence on the DLT Pilot Regime and compensatory measures on supervisory data (27 September 22) para. 40).

[607] ESMA, 'Guidelines on complex debt instruments and structured deposits' ESMA/2015/1787 (4 February 2016) 6, <https://www.esma.europa.eu/sites/default/files/library/2015-1787_-_guidelines_on_complex_debt_instruments_and_structured_deposits.pdf> accessed 10 October 2022.

b) Debt instruments, the return of which is subordinated to the reimbursement of debt held by others;
c) Debt instruments where the issuer enjoys discretion to modify the cash flows of the instrument;
d) Debt instrument having an unusual or unfamiliar underlying for the average retail investor;
e) Debt instruments with complex mechanisms to determine or calculate the return, where the anticipated revenue stream may vary frequently and/or markedly at different points of time over the duration of the instrument;
f) Debt instruments structured in a way that may not provide for a full repayment of the principal amount;
g) Debt instruments issued by a special purpose vehicle (SPV), in which the name of the debt instrument or the legal name of the SPV may mislead the investors as to the identity of the issuer or guarantor.

The average product issued under the denomination of "investment in fractional art ownership" corresponds not only to one but several of the above categories, including being a debt instrument which is subordinated to the reimbursement of senior debt holders as well as having an unusual or unfamiliar underlying to the average retail investor. According to the basic information sheets provided by both issuers in the EU, their products are explicitly declared to be "complex and not easy to be understood".[608] Consequently, the respective investment firms cannot rely on the possible exemption to the obligation to obtain the information or make the determination of the client's knowledge and experience in the investment field under Art. 25(4)(a)(ii),(iii) of MiFID II.

Generally, complex financial instruments are out of the range of average retail investors, unless the latter can prove sufficient knowledge and experience in the field. Indeed, the examined investment firms offering fractional ownership in artworks take consideration of this limitation by declaring their target client group to be retail investors "with substantiated knowledge and experience with financial products as well as token-bases products".[609] The speculative character

[608] The exact wording used is "Sie sind im Begriff, ein Produkt zu erwerben, das nicht einfach ist und schwer zu verstehen sein kann." (You are about to acquire a product that is complex and may be difficult to understand (translated by the author)).
[609] The exact wording is "Anleger mit erweiterten Kenntnissen und Erfahrungen mit Finanzproduktion sowie zu tokenbasierten Produkten", see the basic information materials provided by Finexity and arttrade, e.g. <https://arttrade.io/basis-informationsblatter/> accessed 20 November 2022.

of this form of investment is highlighted by it being rated by the issuers at the risk level 6 (out of 7), which earns the classification of a "higher risk" investment. Also an integral part of the target client description is the ability to bear losses. All potential investors are provided with this information and have to partake in an assessment which shall ensure the suitability of the product with regard to the investment goals. The criteria of "substantiated knowledge and experience" is not standardized and hence requires as adapted investigation process from all offerors.

As a consequence to the additional hurdles installed by MiFID II in selling complex investment products to retail investors, which were intended to work in the best interest of investors who are considered particularly in need of protection, the potential group of investors among those willing to participate in the emerging (art) fractional ownership sector is in practice drastically reduced. Given the general principle, according to which the more complex a product,[610] the harder it is for retail client to ascertain sufficient understanding of the key features, it is to be assumed that the assessment with regard to art-related debt instruments demands an extensive collection of information by investment firms from potential clients. This bears the risk of rendering the marketing to retail investors uneconomical. It also makes an approach like the one followed in the US, where minimum individual investment sums of around USD 20 are quite common, unfeasible. At the same time, it explains while only the entity issuing actual fractional ownership in the strict legal sense – and therefore no securities or other financial instruments – may allow itself to ask for a minimum investment of only EUR 50.[611] This reflects the priorities of the EU legislator, who intended to act for the benefit of smaller investors, but at the same time does not offer an alternative to those who lack the necessary experience but would be willing to invest on a low-budget basis. It is at least questionable whether this approach can contribute to the intended "democratization" of alternative investment opportunities, or whether it actually fosters existing market structures.

Securitized fractional ownership in art is currently only sold to clients by entities acting as broker/dealers, respectively more specifically tied agents to the issuing SPV in the EU.[612]

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[610] See e.g. ESMA, 'Opinion on MiFiD practices for firms selling complex products' ESMA/2014/146 (7 February 2014) 3, < https://www.esma.europa.eu/sites/default/files/library/2015/11/ipisc_complex_products_-_opinion_20140105.pdf> accessed 25 October 2022.

[611] See Annex II.

[612] The precise German term under which both German companies enlisted in Annex II are registered with the BaFin would be „gebundener Vermittler" according to § 3(2) WpIG, which obliges them to act only for the account

Companies selling fractional art ownership security tokens generally explicitly exclude in their transactional documents that they issue any investment advice to investors, thereby significantly limiting their behavioral duties (and liability risk) towards clients.[613] This is the same with regard to EU and US agents/broker-dealers. [614] Accordingly, the product is currently marketed as non-advised complex sales product.

cc) Fractional Ownership Platforms as Alternative Trading Systems

MiFID transparency regulations apply to both, investment firms and trading venues. In addition to the responsibilities imposed by MiFID II on investment firms offering investment services to clients, there may yet be another catalogue of obligations of relevance to fractional ownership companies, on the condition that by offering a secondary market platform to their investors, they also operate what is considered a regulated trading venue under MiFID II, e.g. an MTF or OTF.[615] As established above, the self-custodied secondary exchange platforms currently maintained or planned by fractional ownership issuers in the EU do not qualify as a multilateral trading facility due to the lack of matching the offers.

It should be recalled that the secondary markets for fractional ownership units are limited to investors only of a specific platform, who may publish their bids or asks which can be accepted by other members at a determined price. There is no arrangement occurring in accordance to rules established by the operator.[616] As of today, there exists no central exchange platform for fractional art ownership tokens; given the restricted group of potential market participants, platforms can effectively be maintained according to the bulletin board model, which however does not compare to the accelerated trading possible via automated matching mechanisms and hence, often lacks liquidity.

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of an investment firm, which is fully and unconditionally liable for their actions or omissions (see also Art. 29 MiFiD II).

[613] Extended duties of disclosure resulting from giving investment advice to clients arise in particular under Art. 25 (1, 2, 6) MiFID II; due to the chosen construction, the investment firm which commissions an agent with the marketing of products to customers, is subject to further obligations, see Art. 29 MiFID II.

[614] Consistently can accordingly be recognized in the warnings expressed in the information material provided to EU and US investors.

[615] See e.g., the pre-trade transparency requirements in Art. 3, 8 MiFIR.

[616] Contrary to the case with certain US providers (e.g., *Rally*), whose orders are matched automatically according to a system set up by the operator.

Where secondary markets for fractional ownership tokens fall outside the definition of regulated trading facilities, they may be encompassed by the term "alternative trading system" (ATS).[617] The exact scope of this structure lacks however a clear delineation, as states assume varying interpretations.[618] This terminological uncertainty has already been identified in the year 2000 in a report issued for the EC on the Regulation of Alternative Trading Systems, where the observation is made that "[p]resent European law appears to provide little assistance on this issue. It neither considers the concept of an ATS nor defines with any precision those activities from which ATS activity might be distinguished, and thus potentially carved-out for regulatory purposes."[619] This has not changed ever since. "ATS" provides for a collective term on unspecified structures, which until today are not explicitly defined by any EU regulation, encompassing "bulletin boards, automated trade matching systems, electronic communication networks, proprietary trading systems (broker-run ATSs) as well as for broker-to-client automated linkages."[620] ATSs may serve a variety of purposes, from bilateral to multilateral trading, including also the matching of orders in a similar way to a traditional exchange.[621] The reason for the regulatory blindness on this spot consists, according to Kumpan, on the fact that "transactions are —in general— executed outside the platform", hence "the objectives of the MiFID, to protect investors (investor protection) and secure the functioning of the capital markets, are not affected by these platforms in the same way as by more complex systems which match the respective orders directly within the system."[622]

Against the background of token-based investment forms becoming more and more popular and within reach of retail clients, there is an urgent need for sound and clear substantive guidelines on the question to which extent involvement of the market operator can be compatible with the bulletin board approach, and at which point the regulatory claim to encompass the trading venue

617 Within the FESCO paper for the EC on the Regulation of Alternative Trading Systems, ATS is defined as an entity which, without being regulated as an exchange, operates an automated system that brings together buying and selling interest – in the system and according to rules set by the system's operator – in a way that forms, or results in, an irrevocable contract (para. 11 of the FESCO, 'Paper for the EC on the Regulation of Alternative Trading Systems' Fesco/00-064c (September 2000) < https://www.esma.europa.eu/sites/default/files/library/2015/11/00_064c.pdf> accessed 1 November 2022); conversely, the CESR refers to ATS as "non-exchange trading systems", "developing in the non-standardised OTC derivative markets" (CESR, 'Standards for Alternative Trading Systems', CESR/02/086b (July 2022).

618 The term ATS is often used in US and Canada as an equivalent to the European MTF; as will be, ATS is however used in this section as general term which comprises among others also MTFs, without being limited to this form of trading venue.

619 FESCO, 'Paper for the EC on the Regulation of Alternative Trading Systems', para. 10.

620 ibid para. 4, 9.

621 ibid para. 2, 3.

622 Kumpan (n 596).

under the MTF-term arises. As a case in point: At which point can suggestions to investors be seen as a matching? Can a simple e-mail notification as to relevant offers being published on the so-called bulletin board be of relevance for the regulatory relevance of secondary markets? Does making use of a chat-function constitute sufficient "interaction" on the system?[623] The absence of clear standards in this regard has the potential to confound efforts of businesses in establishing token trading venues, which may consequentially impede investors' access to alternative investments.

While the current structure of secondary markets for fractional art ownership may not correspond to MTFs or other regulated trading venues, this does however not mean that the operators fall outside the regulatory scope of MiFID respectively national implementing laws. Instead, their involvement in establishing the contact among investors may amount to providing investment services or performing investment activities, depending on the specificities of the platform. According to BaFin, for instance, providing a regional structured list of crypto-currency selling or buying persons or firms amounts to brokerage under German national financial market law.[624] It is furthermore argued that also a platform providing a system where offeror and offeree of crypto tokens can get in contact and where the necessary information to conduct the transaction (public key) is disclosed to the parties by the operator is considered brokerage activity that requires authorization – even if negotiations and the closing of the agreement occur outside the provided platform.[625]

The regulatory landscape in the EU on the topic of token trading is currently in transformation,[626] with the Pilot Regime being a recent example of a European approach to addressing evolving

[623] As is the case e.g in the US, according to the SEC (see below at 163).
[624] „Bei dem Angebot regional gegliederter entgeltlicher Web-Verzeichnisse von Personen, die BTC in ihrem Wohnort zum Kauf oder Verkauf anbieten, handelt es sich um Anlage- und Abschlussvermittlung." (translated by the author), BaFin, 'Bitcoins: Aufsichtliche Bewertung und Risiken für Nutzer" (19 December 2013) < https://www.bafin.de/SharedDocs/Veroeffentlichungen/DE/Fachartikel/2014/fa_bj_1401_bitcoins.html> accessed 11 December 2022.
[625] Anika Patz, 'Handelsplattformen Für Kryptowährungen Und Kryptoassets' [2019] Bkr 435, 440.
[626] From the feedback provided to ESMA following its Call for Evidence on the DLT Pilot Regime, it emerged that with regard to DLT financial instruments, OTC is currently still the standard practice. The decisive conditions in this context are yet to be established, with a respondent suggesting e.g. "that the characteristics of the wallet that is used for the custody of the crypto-assets could be a relevant feature. Direct transactions between investors using non-custodial wallets that they control directly, with no interposition of a third-party, could be considered OTC trading, while exchanging an asset between two counterparties through the interposition of an DLT MI, where the infrastructure also offers the custodial wallet to the two counterparties, could be considered on-venue trading", ESMA, 'Report on the Call for Evidence on the DLT Pilot Regime and compensatory measures on supervisory data' ESMA70-460-111 (27 September 2022) para. 44.

market platforms, in this specific case, DLT-based structures. Especially against the background of new technologies calling into question the role of traditional intermediaries in the investment world,[627] it remains to be seen how the EU legislator will address regulatory uncertainties in the context of ATSs.[628] What is more, given the discretionary scope inherent to unspecific terminology, the level of regulation is also subject to the guidance provided by national authorities, whose opinions may come late only as a reaction to an excessive stretching of unclear terms and exploitation of legal ambiguities.

c) The DLT Pilot Regime 2022

In recognition of the increasing importance of online security token exchange platforms, the European Commission has issued the Regulation (EU) 2022/858 of the European Parliament and of the Council of 30 May 2022 on a pilot regime for market infrastructures based on distributed ledger technology ("DLTR" or "Pilot Regime") as new regulatory approach to encompass DLT-based trading within the European legislative framework and achieve consistency in its legal recognition across Member States.[629]

aa) Scope and Aim of the Regulation

The DLTR constitutes a pilot regime, whose purpose is to test the foreseen market infrastructures and allow for temporary exemptions from certain rules under the EU financial market regulations, with the aim of facilitating the development of emerging technology solutions for the trading and settlement system in DLT financial instruments.[630] This testing approach of innovations is supposed to allow EU regulators to understand if any regulatory changes have a sufficiently beneficial effect so that they shall remain permanently.[631] The Pilot Regime has required ESMA

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[627] See for a detailed analysis of the challenges and consequences brought by the development of a return towards private trading networks without the necessary involvement of intermediaries: David C. Donald, 'From Block Lords to Blockchain: How Securities Dealers Make Markets' (2018) 44 Journal of Corporation Law 29.

[628] To keep the analysis focused at this point, the authors refers for any further details on the regulation of ATS' to the book by Matthias Ludwig, *Alternative-Trading-Systems als Zukunftsoption*, Gabler Edition Wissenschaft (2022).

[629] Amending Regulations (EU) No 600/2014 and (EU) No 909/2014 and Directive 2014/65/EU, issued on 2 June 2022 in the Official Journal of the European Union and entered into force on 22 June 2022; the Regime will be applied from 23 March 2023.

[630] ESMA, 'Final Report – draft – Guidelines on standard forms, formats and templates to apply for permission to operate a DLT Market Infrastructure' ESMA70-460-206 (15 December 2022) para. 23 <https://www.esma.europa.eu/sites/default/files/library/esma_70-460-206_final_report_on_dltr_gl_on_application_for_permission.pdf> accessed 16 December 2022.

[631] A regulatory sandbox is usually a legal framework "to allow small-scale, live testing of innovations [...] and operating under a special exemptions, allowance, or other limited time-bound exceptions", see Cristina Poncibò and Laura Zoboli, 'The Methodology of Regulatory Sandboxes in the EU: A Preliminary Assessment from a

to assess whether the regulatory technical standards (RTS, with RTS 1 on shares and UCITS-ETFs, RTS 2 on bonds) on pre- and post-trade transparency and data reporting developed under MiFIR need to be amended in the context of DLT.[632] This has meant in particular that "ESMA should take into account the specificities of those financial instruments issued on a distributed ledger technology and whether they require adapted standards which would allow for their development without undermining the objectives of the rules laid down in the regulatory technical standards adopted in application of Regulation EU No 600/2014."[633] Based on the feedback it received, ESMA does not consider any amendments to the RTS on transparency and data reporting requirements necessary for DLT to be effectively applied to trading financial instruments.[634]

An important milestone of the Pilot Regime consists in the explicit amendment to financial instruments that even those issued, recorded, transferred and stored using DLT are to be considered as such.[635] Admitted to trading on a DLT market infrastructure shall however only be DLT financial instruments that are

a) shares, the issue of which has a (tentative) market capitalization of less than EUR 500 million;
b) bonds or other forms of securitized debt, with an issue size of less than EUR 1 billion, excluding those that embed a derivative or incorporate a structure which makes it difficult for the client to understand the risk involved; or
c) units in UCITS, excluding structures UCITS as referred to in Art.36(1) 2nd subparagraph of Regulation (EU) No 583/2010.[636]

The total market value of DLT-financial instruments admitted to trading on a DLT-MI may not exceed EUR 6 billion at the moment of admission to trading or the initial recording.[637] Corporate

Competition Law Perspective' Stanford-Vienna European Union Law Working Paper No. 61, <http://ttlf.stanford.edu> accessed 15 December 2022.
[632] Recital 54 DLTR.
[633] ESMA, 'Report on the DLT Pilot Regime on the Call for Evidence on the DLT Pilot Regime and compensatory measures on supervisory data' ESMA70-460-111 (27 September 2022) para. 33.
[634] ibid para. 6.
[635] See Art. 2(11), (12) DLTR.
[636] Art. 3(1) DLTR.
[637] Art. 3(2) DLTR.

bonds whose market capitalization did not exceed EUR 200 million at the time of issue are exempted from calculating the threshold under b).[638]

The main change introduced by the DLTR concerns the formal establishment of DLT market infrastructures, i.e., the three categories of a DLT multilateral trading facility (DLT MTF), a DLT settlement system (DLT SS) and DLT trading and settlement system (DLT TSS).[639] Investment firms and market operators as well as central securities depositories are henceforth required to be authorized by their NCA to operate such a market infrastructure. Temporary exemptions to some of the requirements under the general regulatory framework in financial markets (MiFID II, CSDR)[640] may however be granted to these operators under certain conditions. The latter constitute compensatory measures. Generally, both regimes, that of the DLTR and the existing securities regulations, in particular MiFID II and the CSDR, stand independently of each other. This means, that "when a legal person is not authorized as an investment firm or to operate a regulated market and aims to carry out activities under MiFID II in addition to the activity described in DLTR, it should simultaneously apply for the relevant authorization under MiFID II, without the possibility to request any of the exemptions provided by DLTR."[641] Investment firms are thus bound to all applicable rules – unless they qualify for a limited exemption from specific obligations according to Art. 4-6 DLTR.

What is more, the Pilot Regime also provides retail investors direct access to market infrastructures that could previously only be entered by brokers, banks, asset managers and market makers directly, which is why the concerned DLT-platforms may substantially come to differ from traditional trading platforms, with broker-associated costs being only one relevant example.[642] Access by retail investors is constrained to certain conditions applying, such as the natural persons admitted being only those of sufficient good repute and "sufficient level of trading ability, competence and experience, including knowledge of the functioning of distributed ledger technology."[643]

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[638] Art. 3(1) 2nd sentence.
[639] Art. 2 (5) DLTR.
[640] Central securities depository regulation („CSDR"), Regulation (EU) No 909/2014 of the European Parliament and of the Council of 23 July 2014 in improving securities settlement in the European Union and on central securities depositories and amending Directives 98/26/EC and 2014/65/EU and Regulation (EU) No 236/2012.
[641] ESMA, 'Final Report – draft – Guidelines on standard forms, formats and templates to apply for permission to operate a DLT Market Infrastructure' ESMA70-460-206 (15 December 2022) para. 25; see also Art. 4(1) DLTR.
[642] See Recital 26 DLTR.
[643] Art. 4(2) DLTR.

bb) Applicability to Fractional Art Ownership Trading Platforms?

With the scope of the Pilot Regime revolving around DLT-MIs, its relevance for investment firms offering self-custodied exchange platforms for securitized fractional ownership in artworks to investors is questionable. This becomes even more pertinent in view of the opening of trading venues to retail investors according to the DLT-Pilot Regime: A DLT MLT may request to admit natural persons, including retail investors, and legal persons to deal on their own account under certain conditions, which shall assure the proficiency and "sufficient good repute" of the participants.[644] This provision reflects the actual state of the art on many platforms for crypto-asset trading, also for fractional art ownership units, where the advantage appreciated by investors consists precisely in the direct interaction without the necessary involvement of intermediaries.[645] Nonetheless, it is to be assumed that fractional art ownership tokens are not traded on MIs specifically regulated by the DLTR. The reason for this can be seen in the restriction on available financial instruments according to the Regulation: As we have seen earlier, the units issued as fractional art ownership correspond generally to securitized debt instruments, which would have to be considered to "embed a derivative or incorporate a structure which makes it difficult for the client to understand the risk involved"[646] and can thus not be admitted to trading on a DLT-MI.

What is more, in line with the previous reasoning on secondary markets for corresponding tokens, the currently common model of art fractional ownership exchanges does not correspond to any of the market infrastructures named under the DLTR. The definition of a "DLT MI" in Art. 2(5) of the Regulation encompasses the three specific forms of DLT MTFs, DLT SSs and DLT TSSs, with the DLT MTF and the DLT SS corresponding basically to their equivalent in MiFID II and the CSDR,[647] except for addition requirements linked to the DLT-based structure. And the DLT TSS representing a combination of both. In line with what has been established previously on the topic of MTFs, the lack of intervention occurring in the matching of offers and bids on

[644] Art. 4(2) DLTR furthermore requires that the admitted persons "have a sufficient level of trading ability, competence and experience, including knowledge of the functioning of distributed ledger technology"; "are not market markets on the DLT MTF"; "do not use a high-frequency algorithmic trading technique on the DLT MITF"; "do not provide other persons with direct electronic access to the DLT MTF"; "do not deal on their own account when executing client orders on the DLT market infrastructure"; "and have given informed consent to trading on the DLT MTF as members or participants and have been informed by the DLT MTF of the potential risks of using its systems to trade DLT financial instruments".

[645] See also recital (5) of the DLTR.

[646] Art. 3(1) DLTR.

[647] See the definition of the "securities settlement system" in Art. 2(1)(10) of the Regulation (EU) No 909/2014.

fractional ownership platforms is valid to the same extent also with regard to the DLT MIs, thus ruling out their qualification as an DLT MTF. It should be noted, however, that the exact application and interpretation of the provisions of the Pilot Regime is concretized by the NCAs and may therefore vary from Member State to Member State.

d) Interim Result

Contrary to what the wording may suggest, ownership of the underlying tangible asset is, apart from one exception,[648] not transferred to investors in the investment model of fractional art ownership. Investor do not become "the owner" of a masterwork, not even partially. Instead, they are issued a tokenized claim that represents an interest in the company, which owns or plans to buy the artwork. These units are commonly structured as debt instruments, issued in an ICO respectively STO. Since there is however also a certain equity element to the issued instruments, they may qualify as hybrid forms of securities and fall as such within the remit of MiFID II. In particular, the fact that art fractional ownership tokens are not transferred on regulated trading venues does not bar the conclusion that they constitute securities according to Art. 4(1)(44) MiFID II. The secondary markets provided by issuers of this token form equal bulletin boards in their functioning and as such, do not qualify as any of the trading venues recognized under the MiFID framework. In line with this, also the new DLT Pilot Regime which revolves around DLT market infrastructures does not apply to the exchange platforms maintained by the investment firms under scrutiny in this section.

[648] In the EU, the only case where actual art fractional ownership in its strict legal meaning is transferred is with the company "*Timeless*".

2. Regulation of Fractional Ownership under US Securities Laws

The investment structure employed by US firms to provide "fractional art ownership" resembles the European approach in several ways while providing also for its own particularities. The following analysis concentrates on US securities law; in particular, the question will be answered whether tokenized "fractional ownership" units are to be considered investment contracts within the US securities definition. Before we will embark upon the application of substantive securities law, a brief overview will be given on the recent regulatory and supervisory endeavors to address digital assets in the investment context.

a) Recent Developments in the Regulation of Tokens

When the SEC issued its first announcements taking a stand on the issue of tokens being qualified as securities, it assumed an expansive understanding of the securities term which lead to an early disillusionment on the crypto markets: In its first report on the regulatory relevance of cryptocurrencies, issued in 2017, the SEC assumed that the Decentralized Autonomous Organization (DAO) offered tokens in a manner that basically corresponded to the issuance of unregistered securities.[649] Continuing in the vein of this pronouncement, the earlier introduced *Munchee* finding was issued,[650] followed by several other enforcement actions, including against *Ripple* and *Kik*.[651] Corresponding statements made by the SEC Chairman Jay Clayton indicated that against the broad understanding of the prongs under Howey, there could regularly be assumed a risk of non-compliance with securities regulations in scenarios where tokens were issued without registration.[652]

A change in the SEC's approach announced itself with the statement made by William Hinman, Director of Corporation Finance with the SEC, in 2018, where he declared that the SEC would

[649] SEC, 'Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934: The DAO' Release No. 81207 (25 July 2017) 17 f.

[650] See above at 49.

[651] SEC, 'SEC Charges Ripple and Two Executives with Conducting $1.3 Billion Unregistered Securities Offering' Press release (22 December 2020), <https://sec.gov/news/press-release/2020-338>; SEC Charges Issuer with Conducting $100 Million Unregistered ICO' Press release (5 June 2019) <https://www.sec.gov/news/press-release/2019-87> both accessed 10 November 2022.

[652] Jay Clayton (Chairman, SEC), 'Statement on Cryptocurrencies and Initial Coin Offerings' Public Statement, (11 December 2017) <https:// www.sec.gov/news/public-statement/statement-clayton- 2017-12-11> accessed 10 November 2022; see also the investigations against ICO initiators *SEC v. Recoin Group Foundation, LLC*, Complaint (September 29, 2017).

follow a more flexible approach with regard to digital assets.[653] Especially those which had been attributed a strong utility component within a sufficiently decentralized ecosystem could supposedly cease to be classified as securities.

Indeed, it seems that the counter-steering spurred the digital financial market, at least with regard to the art fraction market, where in 2018, Masterworks as pioneering company managed to clear remaining regulatory issues and foster its role in the art investment sector by registering its first fractional ownership product, Andy Warhol's *1 Colored Marilyn (Reversal Series),* with the SEC.

Until today, there is no federal legislative body specifically regulating the qualification of digital assets in financial environments.[654] The calls of the industry for further clarification have long remained unanswered, until on 3 April 2019 the SEC issued its "Framework for 'Investment Contract' Analysis of Digital Assets."[655] Through this publication, additional guidance was given especially on the interpretation and scope of the different requirements applied under Howey in deciding whether a digital asset is an investment contract. In essence, the following arguments were made: with regard to 'common enterprises', this criterion can almost generally be assumed in the context of digital assets "because the fortunes of digital asset purchasers [are] linked to each other or to the success of the promoter's efforts".[656] However, seemingly as counter-movement to this expansive interpretation, the standing of the "common enterprise" condition was reduced by stating that the Commission would not "view a 'common enterprise' as a distinct element of the term 'investment contract'." As a consequence, the criterion of "reasonable expectation of profits derived from the efforts of others" grew all the more important. In this regard, the role of the "Active Promoter" (AP) is emphasized, which means that for the creation of value associated to the digital asset the purchase must reasonably rely on promoters, sponsors and groups of affiliated parties.[657] The efforts undertaken to generate an income or profit have to be "undeniably significant ones", not merely "ministerial."[658] Given that the status of a digital asset

[653] William Hinman, Director of Division of Corporation Finance, SEC, 'Digital Asset Transactions: When Howey Met Gary (Plastics) (Speech)' (14 June 2018).

[654] Pursuant to the OECD Report on Regulatory Approaches to the Tokenisation of Assets, various US-States have introduced legislation relating to Blockchain at a State jurisdiction level; these do however not have any effect "on treatment of digital assets in other states and have no effect on the applicability of the federal securities laws to the digital asset" (36)

[655] SEC, 'Framework for Investment Contract – Analysis of Digital Assets' (2019) < https://www.sec.gov/corpfin/framework-investment-contract-analysis-digital-assets> accessed 1 November 2022.

[656] ibid.

[657] Stephen P Wink and others, 'Digital Asset Regulation: Howey Evolves' (2020) 53 The Review of Securities & Commodities Regulation 1, 7 <https://www.sec.gov/litigation/investreport/34-81207.pdf.>.

[658] Coffee Jr., Sale and Whitehead (n 187) 292.

may change throughout its lifespan, e.g. if the efforts of an AP cease or profit can no longer be reasonably projected,[659] it is expected from the AP of a security issuing entity to actively engage in the managerial role by continuously making decisions and exercising judgment. In the context of profit expectation, promised dividends or alike remuneration is considered a strong indication for the security quality of a token. After all, the evaluation shall be dependent to an essential extent on the factual circumstances of the issuance and marketing of the product, which is why the incentives for the target audience are to be taken into consideration (e.g., whether there is a "consumptive rather than speculative purpose") as well as the token's functionality.[660]

Most of the companies dedicated to the "fractionalization" and thereby "democratization" of artworks were founded after 2017, following the examples set by Masterworks and Maecenas. While the focus is regularly on artworks as assets making up for the companies' portfolio, some firms like Rally or Otis also offer fractional ownership on other valuables and collectibles. In this regard, especially collection cards of sport players or fiction characters from games and series seem to be particularly popular with the audience. The artworks under management reflect a wide range of investment interests, starting from as low as 9,000 USD for a print but include also masterpieces valued millions (e.g., at Masterworks, which acquired for example Banksy's *Agency Job* in 2022 for $10.75 million, see also. e.g., Particle). What is remarkable in this context is the personal minimum investment, which is set distinctively lower than the corresponding level with art funds, with e.g., Masterworks offering shares for as little as 20 USD,[661] or Rally starting its offers at around 7 USD. The highest individual investment sum, according to Annex II, is set by *ArtBnk* with USD 5,000, followed by *Particle* with USD 1,5000. In this context one needs to be reminded that Particle is a very particular example for fractional ownership firms in that it is the only US structure which offers to transfer actual ownership on specific parts of the artwork, "like the lower right corner, for example."[662] It does not aim for selling the acquired work(s) for profit.

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[659] Wink and others (n 653) 8.

[660] ibid 7 f.

[661] Which was the IPO price per share with the initial offering by Masterworks in May 2019, *1 Colored Marilyn* (Reversal Series) by Warhol, see ArtTactic, 'Fractional Ownership Monitor' (August 2022) 13.

[662] According to Particle's website, the tokenized fractions "are created via the Particalization Process which involves taking a painting and dividing it into a grid (in the case of our first acquisition, a 100x100 grid) resulting in 10,000 Particles. Each Particle is unique, allowing the holder to enjoy a personal connection to the artwork within the overarching structure of collective ownership.", <https://support.particlecollection.com/hc/en-us/articles/4416387638669-What-are-Particles->; Eileen Kinsella, 'These 5 Companies Are Betting on Fractional Art Ownership. We Read the Fine Print to Figure Out How Each Deal Actually Works' Artnet (2 June 2022) < https://news.artnet.com/news-pro/these-5-companies-are-betting-big-on-fractional-art-ownership-2123888> accessed 1 November 2022.

Its issued digital means are NFTs. In order to keep the analysis on point and focused, this chapter will not further engage in the details of the structure employed by Particle, but instead draw the relevant conclusions from examining the companies marketing fractional ownership units as securities – which is similar to the EU approach. Accordingly, in continuing with the terminology employed in the general section above, the "fractional ownership" concept scrutinized in the remainder of this chapter corresponds to a participation right in the asset-owing company.

The list provided in Annex II aims to include all fractional ownership providers from the US that include tangible artworks in their portfolio. This is an important point to emphasize, since in the wake of the NFT trend, a large number of companies entered the fractional ownership investment market with a clear focus on NFTs as underlying assets, examples of such firms which offer fractional ownership of digital art and the corresponding NFTs without including tangible art being *Tessera* (formerly fractional.art) and *Liquid MarketPlace* (including also other collectibles such as sports cards in addition to NFTs).

b) Business Set-up of Fractional Art Ownership

In exchange for the contributed capital, investors receive a share or membership rights in the SPV that was established precisely for the purpose to hold and manage the asset. Similar to the process within the EU, these shares are not issued as *certified* securities but instead, are transferred via the blockchain, i.e., using security tokens that are programmed to represent the interest in the company. The standard for tokens representing shares in an art-owning LLC is currently still ERC20, which is used also e.g. by Masterworks.

The essential difference in comparison to EU fractional ownership units consists in the equity nature of the issued instruments in the US. The purchaser becomes a "member" respectively shareholder in the asset-owning sub-company. Accordingly, the investor is not only conveyed profit participation claims but also voting rights. The latter are in practice however reduced to a bare minimum, to the extent possible in line with certain legal limits, by contractual agreement between the issuer and investor. With regard to the profit distribution, from the screening of Offering Circulars and investors' information sheets, it becomes apparent that commonly around 90% of obtained profits from liquidation of the assets are distributed to the investors, in

proportion to their membership or share interests; conversely, only a small percentage (around 5-7%) are assigned to the sponsoring Member, if any exists.

In line with what has been previously established, the preferred form of incorporation among issuers of fractional ownership in art and other collectibles is the limited liability company (LLC) under Delaware state company law. The reason for this consists in the flexibility with which the membership rights associated with shares can be assigned and structured, e.g., in different classes.[663] Contrary to for example a corporation, the form of an LLC allows to distribute profit participation rights differently than on the pro-rata basis and determine the scope of the co-determination rights to the extent intended by the founders. The contractual distribution rights can be mirrored by the token's programming.

Investors are usually given an Offering Circular ("OC") or a Private Placement Memorandum ("PPM") to be made aware of the underlying structures and risks inherent in the investment. In all of the examined OCs respectively PPMs, the issuer explicitly pointed out the extremely speculative investment character of fractional art ownership. Consistent with the high degree of risk, investors should be able to hold their tokens for a longer period of time and cope with a loss of their entire investment.

The issuing SPV is different from the eponym of the platform, with the name of the SPV usually only showing in the OC but not being an essential part of the marketing strategy.[664] This can be attributed to the fact that the issuing SPV is limited in its objective and duration to the 'special purpose' of purchasing the title (from the "parent company"), holding and managing the asset.[665] After its maturity, the SPV will be liquidated – contrary to the superordinated company which ideally persists for a longer time to establish a reputation on the market with clients. The supra-ordinated company may positions itself is a broker-agent to the SPV, assuming the task of marketing the units to investors.

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[663] Stefan Perlebach, 'How Security Tokens enable fractional Ownership' Medium (26 April 2019) <https://medium.com/stocheck/how-security-tokens-enable-fractional-ownership-4900862b6f0a> access 10 November 2022.

[664] See for examples Annex II.

[665] For instance, according to *Artory & Winston*, the primary purposes of Straat100, LLC is to purchase title from Strada, LLC in and to the artwork, hold and manage the artwork for investment and related purposes.

c) Regulation of Fractional Ownership under US Securities Law

The extent to which offers concerning fractional ownership units of artworks are relevant under US securities laws depends on the qualification of such units as securities, or more in detail, investment contracts. In light of the lack of a specific legislative response to DLT market trends, fractional art ownership tokens need to be examined against the standard Howey Test,[666] taking into consideration also the above introduced framework of guidelines, reports, and no-action letters issued by the SEC on digital assets.

Against the background of the earlier outlined broad understanding proclaimed by the SEC of the pertinent criteria, it must be assumed that tokenized rights representing interests in the art-owning company whose goal it is to generate profits from resale and active management of the assets come under the definition of an investment contract, pursuant to the Securities Act of 1933. The fact that no certificated securities are issued to investors does not stand in the way of this in inference; if anything, from the above overview of SEC actions it can be deduced that the Commission tends to affirm the securities quality rather generously in the context of digital assets. Securities regulations are therefore in principle applicable to the issuance of fractional art ownership tokens. This conclusion also finds confirmation in the fact that for all of the scrutinized US-entities listed in Annex II,[667] the offering of fractional ownership units occurs in compliance with the Securities Act and is preceded by SEC filings, the details of which shall be delineated in the following.

Despite fractional ownership units qualifying as securities under the Securities Act and Securities Exchange Act, the legal rules traditionally governing an IPO are generally not applicable to the issuers of the tokens listed in Annex II. The reason for this is to be seen in the various exemptions available under the Securities Act. The relevant ones for fractional ownership offerors are three, namely Regulation D offerings, Regulation A offerings, and Regulation Crowdfunding offerings, all of which allow deviations from the basic principle that the offer and sale of securities must be registered with the SEC.

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[666] See also in detail: Coffee Jr., Sale and Whitehead (n 187) 356.

[667] Except for Particle, whose issued units shall represent non-economic ownership claims and as such, do not qualify as securities under financial market laws.

aa) Regulation D Offerings

The possible exceptions for registering with the SEC under the Regulation D have already been defined in detail in the previous chapter on art funds. While art funds rely almost uniformly on the Regulation D exceptions, the offerors of fractional art ownership resort to them rather provisionally. The reason for this emerges when taking a closer look at the eligible investors for fractional ownership: firms employing this business model usually fix a minimum investment sum far below the relevant individual thresholds for art funds. This goes hand in hand with fractional ownership investments being accessible also to retail investors. By contrast, art funds generally only accept accredited investors,[668] precisely in the effort to fall within the scope of Regulation D exemptions. Since the latter is contingent on investment sums of a considerable amount, the corresponding legal exception to registration is generally not available to issuers of fractional ownership.

Some offerors, such as e.g. Masterworks and Otis, do however occasionally conduct private placements according to Rule 506(c) of Regulation D, where large investments by accredited investors can be expected. Also ARTBnk relies on this "safe harbor", and accordingly has aligned its investor structure so as to only comprise accredited investors including institutions.

bb) Regulation A Offerings

Regulation A complements the Regulation D by providing additional exemptions for small entities. According to a White Paper issued by the SEC, "Regulation A+ can be thought of as an alternative to a small registered IPO and as either an alternative or a complement to other securities offering methods that are exempt from registration under the Securities Act"[669]

The Regulation A adopted under Section 3(b) of the Securities Act in 1936 provided initially exemptions to registration requirements with the SEC for offerings amounting to a maximum of USD 5million.[670] It was amended by the Commission's proposal in 2015 in the context of the implementation of the JOBS Act.[671] The amendments to the Regulation A, referred to as

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[668] Pursuant to Rule 501(a) of the Securities Act of 1933.

[669] Anzhela Knyazeva, 'Regulation A+: What Do we Know So Far?` SEC White Papers (November 2016) 2 < https://www.sec.gov/dera/staff-papers/white-papers/18nov16_knyazeva_regulation-a-plus-what-do-we-know-so-far> accessed 11 December 2022.

[670] Anzhela Knyazeva, 'Regulation A+: What Do we Know So Far?` SEC White Papers (November 2016) 2.

[671] The „Jumpstart Our Business Startups Act" (JOBS Act) of 2012.

"Regulation A+", became effective on 19 June 2015 and were intended to widen the scope of the "small companies" exemption by prescribing different offering thresholds. In detail, under Regulation A+, one needs to differentiate between two tiers: Tier 1 offerings may not exceed USD 20 million in a 12-month period, including not more than USD 6 million offered by all selling securityholders that are affiliates of the issuer; Tier 2 offerings may not exceed USD 75 million in a 12-month period, including not more than USD 22.5 million offered by all selling securityholders that are affiliates of the issuer.[672] Both offerings under Regulation A+ require electronic filing.[673]

Not all issuers are eligible for offerings under Regulation A or A+. Investment companies registered or required to be registered under the Investment Company Act of are excluded from benefitting from this rule,[674] as are issuers seeking to sell fractional undivided interests in oil, gas or other mineral rights, companies that have been subject to any order of the Commission under Section 12(j) of the Exchange Act in the past five years or that have not filed required ongoing reports in the past two years as well as so-called "bad actors", i.e., persons that have certain types of criminal convictions, regulatory or court orders, or other specified unqualifying events.[675]

What needs to be emphasized at this point is that Regulation A offerings are principally open to every investor category, including retail investors. With regard to non-accredited investors, however, Tier 2 offerings are subject to limits in terms of maximum annual investments:[676] non-accredited natural investors must not invest more capital than what represents 10% of the greater of their annual income or net-worth.[677] This is to ascertain that one only invests an amount that one can afford to lose without having to make major adaptions in lifestyle. In order to ascertain compliance with these standards, companies ask potential investors to complete an "on-boarding questionnaire."

[672] 17 CFR § 230.251(a), with Tier 2 being recently amended, see SEC, 'Facilitating Capital Formation and Expanding Investment Opportunities by Improving Access to Capital in Private Markets' (modified 30 November 2022) < https://www.sec.gov/corpfin/facilitating-capital-formation-secg> accessed 11 December 2022.
[673] 17 CFR § 230.251(f).
[674] 1940 (15 U.S.C. 80a-1 et. seq.).
[675] Anzhela Knyazeva, 'Regulation A+: What Do we Know So Far?` SEC White Papers (November 2016) 3.
[676] Conversely, accredited investors are free to invest as much as the like, with limits being installed though by the issuing entities.
[677] For natural persons, whereas for non-natural persons, the limit is at 10% of the greater of annual revenue or net assets at fiscal year-end

Although the registration obligation expires in case of the Regulation A exemption, the offer of securities under this Rule still requires filing an offering statement (offering circular, "OC") with the SEC. After such an offering statement has been filed and before it is qualified, the issuer may already make written offers pursuant to Rule 254 and may initiate so-called "testing-the-waters solicitations", i.e., solicitations of interest and other communications pursuant to Rule 255.[678] In the offering statement, Tier 2 issuers are furthermore required to provide audited financial statements.
In addition to the offering statement, the issuers of securities under Regulation A also need to comply to certain reporting obligations: While Tier 1 issuers must only file an exit report after the completion or termination of the offering, Tier 2 issuers also have to adhere to an ongoing reporting regime, including semi-annual reports, annual reports and current reports.[679]

Out of the analyzed US-fractional ownership companies, three conduct Regulation A offerings with their issuing entities, namely Masterworks, Otis and Rally.[680] They all have in common that their minimum individual thresholds for investment are set low, namely between USD 7-20. Consistent with these small amounts, also the total offering size can easily be kept below the relevant thresholds under Tier 1 and Tier 2. These companies are accordingly not registered as investment companies under the Investment Company Act of 1940, pursuant to the exception provided under Section 3(c)(1) thereunder,[681] and thus, their investors do not benefit from the protections provided by the Act.

cc) Regulation Crowdfunding Offerings

Yet another exemption from registration is provided by the Securities Act Section 4(a)(6) which was added in implementing Title III of the JOBS Act of 2012. Generally, the term "crowdfunding" describes a financing method by which money is raised through the solicitation of relatively small

[678] 17 CFR § 230.254, 255.
[679] Other differences between Tier 1 and Tier 2 obligations include investment limits and state registration.
[680] By way of illustration: the issuing entities of Masterworks usually file offerings pursuant to Tier II of Regulation A, which also marks the point where Masterworks begins marketing the offering through "testing-the-waters" materials (Masterworks, 'Important Disclosures' (January 2022) accessible via the Masterworks website <https://www.masterworks.com> accessed 11 November 2022.
[681] For further details, see above 100 f.

individual investment sums from a large number of people.[682] In order to raise money through the "Regulation Crowdfunding", eligible companies must meet the following requirements: [683]

1) Maximum aggregate amount of USD 5 million raised in a 12-month period
2) Individual investment amounts over the course of 12-month period limited to
   - ⇒ if either the investor's annual income or net worth is less than USD 124,000, then the greater of the following two:
     - o USD 2,500 or
     - o 5% of the lesser of the investor's annual income or net worth;
   - ⇒ if both, the investor's annual income or net worth, are equal to or more than USD 124,000, then the individual limit is 10% of the greater of annual income or net worth;
   - ⇒ in any way, the aggregate amount of securities sold to an investor through Regulation Crowdfunding Offerings during the 12-month period must not exceed USD 124,000.

Offerings corresponding to the Regulation Crowdfunding must be conducted through an online platform as intermediary that needs to be registered as a broker-dealer or a funding portal with the SEC and FINRA. The corresponding offering statement must be filed electronically on Form C through the SEC's EDGAR system.[684] It must comprise information on the persons in charge of managing the issuer, such as officers and directors, a description of the business and the planned use of proceeds from the offering, the target offering amount and the deadline for the offering, the price of the securities and the method for determining it, as well as certain related-party transactions.[685]

The exemption under the Crowdfunding Offering is not available to all companies; for instance, those that are already subject to Exchange Act reporting obligations as well as "bad actors", which for instance have been convicted of securities fraud or are subject to administrative sanctions, are not eligible.

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[682] SEC, 'Updated Investor Bulletin: Regulation Crowdfunding for Investors' (14 October 2022) < https://www.sec.gov/oiea/investor-alerts-bulletins/ib-crowdfunding> accessed 22 October 2022.
[683] ibid.
[684] The "Electronic Data Gathering, Analysis and Retrieval" (EDGAR) system.
[685] SEC, 'Regulation Crowdfunding: A Small Entity Compliance Guide for Issuers' (13 May 2016, updated 5 April 2017) <https://www.sec.gov/info/smallbus/secg/rccomplianceguide-051316> accessed 11 December 2022.

The financial disclosure obligations arising for issuers under the Regulation Crowdfunding depend on the amount of money raised in the previous 12 months, with several increments between USD 124,000 or less and the maximum aggregate amount of USD 5 million. Apart from the general information listed above about the issuing company and its business structure, also financial statements have to be provided.[686] Further educational material also needs to be provided by the broker-dealer respectively funding portal.

This exemption is employed by Artory & Winston, among the companies included in Annex II, which offer fractions on their acquired artwork by Damien Hirst as equity shares to investors through the platform "Republic",[687] which is a funding portal registered with the SEC and a member of the FINRA.[688]
In order to become involved as investor, a "Crowd Interest Purchase Agreement" needs to be signed.[689]

Once the offering statement has been reviewed by the SEC, the shares can be offered to potential investors and their capital accepted.[690] In the course of time, the issuing entity may file an Offering Circular Supplement with the SEC to add information on the underlying assets, the offering price, and the use of proceeds.[691]

As a consequence to falling within the remit of established legal exemptions, the obligations of the issuers are reduced compared to those in a traditional IPO. The differences consist, among others, in reduced disclosure and reporting obligations. More in detail, disclosure rules incumbent on offerors of securities are limited under Regulation D or A or Crowdfunding

[686] Whereas the financial statements for the lowest threshold of capital raised need to be at least certified by the principal executive, for the highest category, they have to be audited by an independent public accountant and the accountant's audit report.
[687] Conducted by OpenDeal Portal LLC (NY).
[688] See < https://republic.com/artory-winston-hirst>, < https://uploads.republic.com/p/offerings/security_attachments/original/000/001/586/1586-1668812454-bb34dfea05a0c0be58b2e2f34cc897b465ac6a65.pdf> accessed 11 December 2022.
[689] See <https://uploads.republic.com/p/offerings/security_attachments/original/000/001/586/1586-1668812454-bb34dfea05a0c0be58b2e2f34cc897b465ac6a65.pdf> accessed 11 December 2022.
[690] In the review process, the SEC does not endorse or guarantee any securities offering, it does not pass upon the merits of the securities or the adequacy or completeness of the terms of the agreements, offering circulars and other solicitation materials.
[691] RSE Innovation, LLC 'Preliminary Offering Circular (21 May 2020) <https://www.sec.gov/Archives/edgar/data/1812859/000181285920000001/filename2.htm> accessed 11 December 2022.

Offerings which is why the information provided to the SEC and investors in the OC or PPM may be reduced in the context of fractional ownership investments. In the case of Regulation D offerings, there do not exist specific disclosure requirements pursuant to Rule 506(c) of Regulation D. Also, the obligation to provide recurring reports to the SEC is generally alleviated under the regulatory exemptions. For offerings conducted under the Regulation D exemption, there is no obligation for issuers to provide even for an initial report, other than the filing of the Form D.

dd) Secondary Market

It is common standard for fractional ownership companies to operate a platform that facilitates the offer and sale of the tokenized units among investors. Generally, platforms that offer trading of securities, including in their digital format as security tokens, and operate as an exchange, are required to register with the SEC as a national securities exchange ("NSE") unless they are exempt from registration.[692] In view of the securities classification of fractionalized art ownership units, the corresponding secondary market places may have to be considered relevant under the Exchange Act and their operators risk to violate its Section 5 by effecting security transactions without the necessary registration. Indeed, the SEC has targeted several digital asset trading platforms in the past alleging that they have to meet additional regulatory requirements.[693]

An exchange is defined under Section 3(a)(1) of the Exchange Act as a system that brings together the orders for securities of multiple buyers and sellers and uses established, nondiscretionary methods under which such orders interact with each other, with the buyers and sellers agreeing to the terms of the trade. An exemption to the registration obligation as an NSE is provided under the SEC Regulations ATS.[694] According to this rule, alternative trading systems ("ATS"), i.e. systems that match orders for buyers and sellers of securities, may choose in between being treated as an exchange – or a broker-dealer. Accordingly, ATS are free to decide to register with

[692] Sections 5, 6 Exchange Act; see also SEC, ‚Statement on Potentially Unlawful Online Platforms for Trading Digital Assets' (7 March 2018) <https://www.sec.gov/news/public-statement/enforcement-tm-statement-potentially-unlawful-online-platforms-trading> accessed 11 December 2022.
[693] See e.g. SEC, 'SEC Charges Poloniex for Operating Unregistered Digital Asset Exchange' Press release (9 August 2021) <https://www.sec.gov/news/press-release/2021-147>; SEC, 'SEC Charges Dallas Company and Its Founders with Defrauding Investors in Unregistered Offering and Operating Unregistered Digital Asset Exchange' Press release (29 August 2019) <https://www.sec.gov/news/press-release/2019-164>; SEC, 'SEC Charges EtherDelta Founder with Operating an Unregistered Exchange' Press release (8 November 2018) <https://www.sec.gov/news/press-release/2018-258> , all accessed 11 November 2022.
[694] 17 C.F.R. § 240.3a1-1(a)(2).

the SEC according to the Exchange Act as a broker-dealer and become a member of an SRO. The advantage in this scenario consists in evading the host of exchange-related regulatory requirements. In this context, it needs to be emphasized that the US ATS needs to be distinguished from the European ATS model we have previously encountered. The EU establishment that comes closest to US (and Canada) ATS' would be an MTF. Regulations concerning the operation of US ATS are however even more stringent. The matching on the ATS between sellers and buyers occurs through broker/dealers.

There is currently an upheaval concerning the issue of exchanges and ATS in the context of digital assets. On 26 January 2022, the SEC proposed modifications to the existing rules which indicate that significant changes are about to take place in this area.[695] Of relevance for the fractional ownership sector is in particular the widening of the scope of "exchanges", which shall refers not only to system bringing together "orders" but according to the Proposal also "trading interests" as in the mere expression of willingness to buy or sell. What is more, the methods of "bringing together" buyers and sellers of securities is expanded by making available "communication protocols", referring for instance to chat features which may allow potential parties to a transaction to communicate about the price and quantity of a security.[696] The Commission announced that it would take "an expansive view of what would constitute 'communication protocols'."[697] In contrast, with bulletin boards the communication between sellers and buyers would have to occur outside the provided system. Interestingly, also under US law market places structured as bulletin boards constitute a stand-alone institution that does not require registration as such under securities laws. According to the SEC, such systems that only passively display trading interests are not encompassed by the proposed rule amendment. In fact, such systems "would not fall within the criteria of Exchange Act Rule 3b-16(a), as proposed to be amended, because the organization, association, or group of persons would not be considered to be making available established, non-discretionary methods under Rule 3b-16(a)(2).[698] It seems accordingly that if a system continues to unilaterally display trading interests without offering a chance to communicate or bring together buyers and sellers directing within the system, the

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[695] SEC, 'Amendments Regarding the Definition of "Exchange" and Alternative Trading Systems (ATSs) That Trade U.S. Treasury and Agency Securities, National Market System (NMS) Stocks, and Other Securities' File No. S7-02-22, (18 April 2022) <https://www.sec.gov/rules/proposed/2022/34-94062.pdf> accessed 11 December 2022.
[696] ibid, 41.
[697] ibid 42.
[698] ibid.

registration either as an NSE as well as an ATS could be legally avoided. Several no-action letters issued by the SEC in the past to market systems that qualified as electronic bulletin boards.[699] The SEC proclaims in its rule proposal however that "upon the adaption of any final rule, some letters and other staff statements [...] may be moot, superseded, or otherwise inconsistent with the final rule and, therefore, would be withdrawn or modified."[700] To be on the "safe side" and avoid liability as a market operator, registration as an ATS is therefore a considerable option if in doubt as to the extent of communication enabled via the platform.

Reflecting the legal uncertainty when it comes to the qualification of bulletin boards, most of the examined secondary market platforms offering fractional ownership tokens, such as *Otis*, declare indeed to be ATS registered as broker-dealers with the SEC and FINRA. Accordingly, the transactions involving securities and payment on the provided user interface are executed by the broker-dealer.

On the other hand, also one of the probably most vivid and liquid US secondary art fractional ownership markets,[701] which is provided by Masterworks, is structured as peer-to-peer platform where Masterworks itself does not assume an active role in the matching or price discovery of bids.[702] From its website, it could however not be ascertained whether the secondary market platform is structured indeed as a bulletin board, or as an ATS.

Hand in hand with the registration as an ATS go regulatory obligations, comprising books and record keeping requirements and financial safeguarding rules. Whether ATS provide for a suitable solution to the legal classification of digital asset trading platforms, whose number has risen drastically within the recent years, remains to be seen. Interestingly, at the current state, none of the eligible models, i.e., NSE or ATS or over the counter trading, is designed to allow direct access to trading venues by investors – which seems however inconsistent with a particularly

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[699] Without taking the particularities of DLT-based securities into consideration however, *see* Real Goods Trading Corporation, SEC No Act. LEXIS 566 (24 June 1996); PerfectData Corporation, SEC No-Act. LEXIS 700 (5 August 1996); and Flamemaster Corporation, SEC No-Act. LEXIS 972 (29 October 1996); Portland Brewing Co., Federal Securities Law Reporter – Transfer Binders (1993-2001) 77,664 (14 December 1999).
[700] SEC, 'Amendments Regarding the Definition of "Exchange" and Alternative Trading Systems (ATSs) That Trade U.S. Treasury and Agency Securities, National Market System (NMS) Stocks, and Other Securities' (2022), 42.
[701] Given the sheer number of assets under management and the size of the investor community; however, even here, as the ArtTactic Fractional Ownerhsip Monitor 2022 revealed, liquidity is limited due to there being far more selling than buying orders (13).
[702] ArtTactic, 'Fractional Ownership Monitor' (2022) 13.

promising feature of DLT-backed securities, which consists in the fact that intermediaries are no longer a necessary component of transactions.[703]

Whether the tokens can be freely traded on that platform or are a subject to certain restrictions is subject to legal limitations as well as contractual stipulations within the issuing documents. Whereas some companies may have established rights of first refusal (ARTBnk), others like *Rally*, for example, have established a 90-day lock-up period following the asset's initial offering, during which no shares can be bought or sold.[704] After this period, investors are free to publish their offer or bid on the market platform. Similar to a public stock exchange, the website also has "trading windows", during which the investor may place an order which she/he can later revise until the closing of the window, at which point the broker-dealer matches the bids at the market-clearing price per share.[705] These trading windows occur roughly every 90 days with Rally, which made this arrangement in order to prevent thin trading volume against the background of collectibles generally being illiquid assets. There are no market makers or liquidity providers involved in the secondary markets, which means that matching will only occur if a corresponding bit is placed by other investors.

Limitations are also imposed by law: Securities purchased within Regulation Crowdfunding Offerings can generally not be resold for one year, unless certain exemptions apply; these include transfers to the issuer of the securities, to accredited investors, or to a member of the family of the purchaser or the equivalent, to a trust controlled by the purchaser or in connection with the death or divorce of the purchaser or other similar circumstance.[706]

While securities issued under the Tier 2 exemption of Regulation A+ are freely transferable, instruments within a Regulation D offering are considered "restricted" securities since they cannot be resold or transferred absent registration with the SEC or otherwise subject of an exemption. Corresponding restrictions are usually outlined in the OC and terms and conditions

[703] Coinbase, 'Re: Petition for Rulemaking – Digital Asset Securities Regulation' Petition with the SEC (21 July 2022) 17, <https://www.sec.gov/rules/petitions/2022/petn4-789.pdf> accessed 11 December 2022.

[704] Rally, FAQ <https://rallyrd.com/faq/> accessed 11 December 2022.

[705] The final clearing price is established through an algorithm which detects at which level he largest number of transactions can occur. The order of investors willing to pay more will be given priority over those offering less, see Rally.

[706] SEC, 'Regulation Crowdfunding: A Small Entity Compliance Guide for Issuers' (13 May 2016, updated 5 April 2017).

of the sale. What is more, investors may be required to declare that they purchase the units for investment purposes only and not with a view to resell or redistribute them.

III. Conclusion

Fractional Ownership interests in artworks provide for an interesting investment option in alternative assets that has recently drawn growing attention especially by younger and technology versed potential investors. Contrary to the clientele envisaged by art funds, investors in fractional ownership companies are not strictly limited to accredited investors, which is consistent with far lower financial entry levels for investment. Several caveats have however to be emphasized in this context, which investors should be aware of before placing their capital with the issuing entities. First, investors may be disillusioned by the fact that "fractional ownership" of artworks does not convey actual ownership claims regarding the tangible artwork, for the most part of the cases in the EU and the US. The phrasing employed in this context is exemplary of the opacity and complexity of the art investment market. Instead of a title on the artwork, investors are usually transferred interests in the asset-owning company, thereby becoming shareholders, members, or debt holders – all of which bear much less attractiveness than the promise of becoming part of the elite group of "art owners". Second, the increased "liquidity" ostensibly provided to the art world and investments by the design of the issued securities as tokens must be viewed with caution. Redemption of the obtained securities with the issuer is generally only possible at the very end of the planned duration of the SPV, thus regularly after 5-10 years. An additional possibility to realize short-term gains may be presented by secondary markets which are maintained by some of the fractional ownership investment firms. However, especially against the background of restricted accessibility only by investors of the same platform, these market platforms cannot be assumed to provide high liquidity.

In understanding the concept of fractional art ownership investment, one needs to differentiate between the securitization of art as non-bankable assets and the tokenization of the claims. While with the tokenization of artworks, the token is minted in such a way as to represent e.g. the entire artwork or only parts of it, according to the discretion of the issuer, securitization of art means that participation rights in an art-owning entity are issued, often in the form of security tokens. This strategy does not only offer practical advantages in terms of issuance and management of

financial instruments by the investment company, but it also broadens the scope of potential investors, as financial barriers previously limiting investors' access are evaded.

As a consequence to the specific structuring of fractional ownership interests in art, the issued units become relevant under financial market regulations and must in fact be regularly considered securities under EU as well as US securities laws. Albeit the specific details of the issued tokens being subject to the individual structuring of the issuing entity, a general observation can be made which represents an important difference in the EU and US approach to fractional ownership units: while in the EU, the respective units constitute predominantly debt instruments (although often with a hybrid character), in the US, they represent equity interests in the issuing company. This does however not automatically lead to the conclusion that the rules pertinent in traditional IPOs also apply to the issuing of fractional ownership tokens in the US. As has been shown above, the issuer is regularly exempted from registering the fractional art ownership securities with the SEC due to exemptions provided under the Securities Act. Accordingly, investors have to expect a reduced level of applicable rules from which they could benefit, concerning e.g. disclosure and reporting obligations.

In the case of secondary market platforms offering the opportunity to trade art-based fractional ownership tokens among investors, the distinction would principally have to be made between MTFs in the EU respectively ATS' in the US and so-called bulletin boards. Here, too, one can discern a differing approach for each of the scrutinized jurisdictions: Out of the examined EU-secondary markets for fractional art ownership, none conforms to a regulated trading platform under MiFID (and the Pilot Regime); conversely, the rule in the US is that trading platforms also for fractional art ownership tokens qualify as ATS and thus, need to be registered (absent an exemption). The above differentiation rests on the effort of the respective providers of trading platforms in the EU not to become involved in the matching process. Instead, in these constellations, transactions take place only peer-to-peer, with bids and asks being published by the users who are in turn required to act by themselves to find a complementary transaction partner.

CHAPTER V –

REGULATION OF ALTERNATIVE INVESTMENTS IN ART: THE CASE OF NFTS

The trend of NFTs has brought with it a wave of innovation and, probably to a similar extent, confusion in the artworld. Not only has it challenged the definition of art itself but also the legal bedrocks of (intellectual) property law,[707] and last but not least, financial market regulation.

In order to resolve the factual and regulatory challenges riding on the coattails of NFT investment trends in the art context, it is first of all necessary to establish a basic understanding of the underlying technology. This Chapter thus starts with a brief synopsis of the central features of NFTs, in order to lay the groundwork for the following discussions on the applicability of financial market laws. However, this section does not aspire to provide a summary of the existing literature on this topic. Reflecting the overwhelming prominence of the NFT-trend in the media, cultural and investment sector, there has also been extensive coverage of all aspects of NFTs in legal academia.[708] Given this wealth of scientific examinations available to an interested audience, the author refrains from a detailed analysis of the different aspects of NFTs that are not of relevance for the following analysis which focuses on the securities laws of the EU and the US.

I. INTRODUCTION

NFT-related art experienced a rampant buoyancy in the year 2021 and the beginning of 2022, the official starting point of which can be seen in the auction conducted by Christie's N.Y. in March 2021, where the first digital artwork digitally represented by an NFT, with the title "EVERYDAYS: THE FIRST 5000 DAYS" by Beeple, was sold for USD 69 million.[709] What

[707] On the intersection of IP and information technology law see Maria Lillà Montagnani, 'The Interface Between Intellectual Property and Information Technology Law', in Irene Calboli, Maria Lillà Montagnani (eds.) Handbook of Intellectual Property Reserch (OUP 2021) 149.

[708] See e.g. as one of the first articles on NFTs: Tonya M Evans, 'Cryptokitties, Cryptography, and Copyright' (2019) 47 Aipla Quarterly Journal 220; see also e.g. Filippo Annunziata, Andrea Conso (eds), N*FTs - The other side of art* (Montabone 2022), Ferdinand Regner, André Schweizer and Nils Urbach, 'NFTs in Practice – Non-Fungible Tokens as Core Component of a Blockchain-Based Event Ticketing Application', *Fortieth International Conference on Information Systems, Munich* (2019); Antonia von Appen, 'Nifties – The Future of Purchasing Art?' [2021] Osservatorio del diritto civile e commerciale 571.

[709] The online-only auction runs from February 25 until March 11, 2021, https://onlineonly.christies.com/s/first-open-beeple/beeple-b-1981-1/112924, accessed March 15, 2021.

followed was an exponential increase in NFT-related art and a quick surge in prices.[710] In the third quarter of 2021, NFT trading volume increased by 704 percent, compared to the previous quarter.[711] By now, the overreaching enthusiasm has subsided, also as a consequence to the" Crypto-Winter". Nonetheless, NFTs continue as a widely used vehicle for authentication and investment in the digital world,[712] with new business models regularly being developed and marketed to investors, to a large extent without the burden of regulatory restrictions.

Chart IX: Google trends: Interest in the term "NFTs" in the course of time (worldwide google searches, time span: 1 March 2020 until 22 August 2022)[713]

The trend of tokenized digital assets in general is quite young; one of the first decentralized platforms offering NFTs in the format of CryptoKitties was launched only in 2017.[714] Marketplaces focusing on the sale of NFT-artworks, some of which are *OpenSea*, *MakersPlace*, *Rarible* and *SuperRare*, began operating the earliest in 2018. But before entering more into detail on NFT-art, it is important to understand the fundamentals of the technology behind NFTs.

[710] J Damiani, 'From Crypto to Christie's: How Beeple Put Digital Art On The Map – And Then Catalyzed Its Market', Forbes Feb. 16, 2021, https://www.forbes.com/sites/jessedamiani/2021/02/16/from-crypto-to-christies-how-beeple-put-digital-art-on-the-map-and-then-catalyzed-its-market/; accessed March 5, 2021.
[711] 'SEC Peirce says agency guidance on NFTs needed', <https://rollcall.com/2022/01/25/secs-peirce-says-agency-guidance-on-nonfungible-tokens-needed/> accessed 3 November 2022.
[712] See for an extensive analysis on the different usage of tokens in the investment context, Robin Matzke, 'Tokenisierung' in Möslein and Omlor (n 507) § 10.
[713] Relative values: the values indicate the search interest relative to the highest point which corresponds in the chart to 100, with the value 0 meaning that there was not enough data for this term.
*"Hinweis": google data collection system was improved on 1 January 2022.
[714] See in detail: T M Evans, 'Cryptokitties, Cryptography and Copyright: Non-Fungible Digital Creativity on the Blockchain' (2019) 47 Aipla Quarterly Journal 17.

II. Definition and Concept of NFTs

NFT stands for non-fungible token. Like cryptocurrencies, NFTs are blockchain-based tokens,[715] meaning that they are stored on a decentralized (distributed) ledger. However, they differ essentially from crypto currency tokens to one central feature: NFTs are unique (hence: 'non-fungible') and cannot be divided,[716] merged or replicated, whereas cryptocurrencies such as bitcoin require fungible tokens, which can also be transferred in parts (e.g. half a bitcoin).[717] Conversely, fungible tokens are interchangeable and can therefore be used for cryptocurrencies, such as bitcoin. Like dollar bills, bitcoins can be traded one for another and as long as the number of bitcoins corresponds, the transferors will be in the same financial and proprietary situation as before.

NFTs on the other hand are individual and distinguishable crypto items, therefore qualified to represent other assets external to the system (off-chain), whose information can thereby become perpetuated on a blockchain. There are no limits in terms of assets suitable for being represented by NFTs; digital assets, such as a digital artwork or a computer program, can just as easily be "tokenized" as tangible items, for example automobiles, paintings or real estate.[718] Moreover, in view of the unambiguous assignment to a rightsholder, NFTs may also represent IDs, licenses and even debts.

The central idea behind this technology is to establish a sort of online record of title where through the connection with NFTs, ownership of individual assets is traceable for everyone. NFTs fulfill the function of entries into a digital public register. The content of the entry, i.e., the underlying asset, the terms of the transaction, associated rights, information on the issuer etc., is determined by the writer of the corresponding smart contract – i.e., the one who "mints" the NFT.

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[715] By consensus, the Ethereum's ERC721 token standard has been established.

[716] Although there exist so-called "fractionalized NFTs", whose creation process we will take a closer look at below at "F-NFTs as Financial Instruments under MiFID II", 187.

[717] **F Regner, A Schweizer and N Urbach, 'NFTs in Practice – Non-Fungible Tokens as Core Component of a Blockchain-Based Event Ticketing Application', Fortieth International Conference on Information Systems, Munich (2019) 3.**

[718] ibid. More on the point of fractional ownership of artworks: A Whitaker, 'Art and Blockchain: A Primer, History, and Taxonomy of Blockchain use Cases in the Arts' (2019) 8 *Artivate* 21; see for tokens representing real estate: O Konashevych, 'General Concept of Real Estate Tokenization on Blockchain' (2020) 9(1) EPLJ 21.

Most art-NFTs are based on an Ethereum blockchain (ERC721 Standard).[719] In order to integrate the NFT on this DL structure, so-called smart contracts have to be employed, i.e., software embedded in a blockchain, that upon meeting predefined conditions self-executes the defined parameters.[720] Smart contracts are decisive in establishing the features of tokens. Albeit themselves not qualifying as legal contracts, they may stipulate legal responsibilities and, what is especially of interest in the context of art, establish conditions for resale of art on the secondary market.[721] By means of smart contracts, artists can declare themselves to be beneficiaries of any future sale and determine the percentage they consider appropriate. Thus, royalty payments on re-sale can be automatized, thereby assuring compliance with the legislative requirements e.g., under the EU Directive 2001/84/EC or the UK's Artist Resale Rights Regulations 2006. What is more, metadata added to the tokens may include a text, a small image, or in the case of EVERYDAYS: THE FIRST 5000 DAYS the artist's signature.[722] In most cases, the NFT (as in the smart contract on the blockchain) consists only of its token ID and a URL to the relevant information, which includes a description and/or image of the artwork or the attributed IP rights to the purchaser.

In connection with tangible artworks, NFT-technology is generally employed as means of digital certificate of authenticity and trading history: The physical object is equated with a token, thus given a digital representation on a distributed ledger. Importantly, the token is not identical to the artwork, but simply interconnected. This bears the opportunity to render trade with illiquid assets, such as art, faster and much more transparent. By attributing a digital identity to a specific off-chain asset, the respective token can in theory be transferred as proxy for the underlying subject.

Notwithstanding the potential of NFTs in international trading, there remain central issues to be addressed by legislators in order to provide for the legal recognition that is necessary to build

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[719] Nifty Gateway Terms of Use, February 4, 2020, <https://niftygateway.com/termsofuse>, accessed 15 March 2022.

[720] Upon meeting predefined conditions, algorithms enable a trigger to a certain action; see for an extensive analysis: A De Franceschi, R Schulze, '*Digital Revolution – New Challenges for Law*' (2019) 299; P Sirena, F P Patti, 'Smart Contracts and Automation of Private Relationships' (2020) Bocconi Legal Studies Research Paper No. 3662402, https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3662402, accessed March 15, 2021.

[721] Michael D. Murray, 'NFTs Rescue Resale Royalties? The Wonderfully Complicated Ability of NFT Smart Contracts to Allow Resale Royalty Rights' (15 July 2022) (<https://dx.doi.org/10.2139/ssrn.4164029> accessed 15 December 2022).

[722] See the auction website at Christie's <https://www.christies.com/features/Monumental-collage-by-Beeple-is-first-pure- ly-digital-artwork-NFT-to-come-to-auction-11510-7.aspx> accessed July 8, 2021.

trust in this sector. As of today, the bridge between tokenized claims and custodied tangible assets does not receive official recognition by most State authorities yet,[723] which means that the transfer of title on tangible property using only on-chain transfers of NFTs is regularly not legally recognized.[724] This may lead to the risk of investors buying a token which "represents the ownership of nothing but the token itself."[725]

1. Taxonomy of Tokens

Depending on the inbuilt functions and rights, tokens are traditionally classified into three types, which have already briefly been described in the previous chapter:[726] currency tokens, security tokens,[727] and utility tokens.[728] This classification exists in parallel with the division into fungible and non-fungible tokens.

For a brief review: Currency tokens are used as a currency, for example Bitcoins.[729] By contrast, the utility token grants *access* to certain services or goods that are provided directly by the token issuer.[730] This may also include access to a future product or service. Finally, security tokens represent the contractual promise of a future inflow of capital (e.g. in the form of crypto currencies), which may stem from an investment in a company or an investment vehicle.[731] Through security tokens issued in an ICO, investors will participate in the success of a launched project.[732] In practice, tokens often assume a hybrid format, since they combine elements of several types.[733]

[723] With the exception of a few jurisdictions providing this bridge in their national laws, e.g., in Liechtenstein.
[724] Barbereau and others (n 225) 215.
[725] ibid 222.
[726] These three types represent the archetypical forms of tokens in consideration of their function; the classification may however also be extended and specified, including e.g. governance token which represent the right to a say in a certain matter, game and app tokens, etc., though each of them exhibit, in varying degrees, certain characteristics of the aforementioned types.
[727] Also referred to as investment tokens, in consideration of their principal function, see above (n 521).
[728] Hacker and Thomale (n 161) 658.
[729] ibid.
[730] ibid 657.
[731] Chatard and Mann (n 519).
[732] In view of this function, there are certain parallels with crowdfunding vehicles, see e.g. K Borkert, Crowdfunding goes Blockchain – Teil 1, ITRB 2018, 39).
[733] According to Hacker and Thomale, all utility tokens that can be traded on a secondary market can also be sold for profit, which provides for an investment incentive characteristic to security tokens (X) 677.

Tokens compliant with the ERC20 standard for smart contracts, like the majority of art related NFTs, typically include a utility component by providing access to an item via the URL that may lead to an off-chain stored digital artwork. However, whereas utility tokens are usually consumed by their use, similar to a voucher or entry ticket, NFTs incorporating artworks are geared to represent the underlying asset presumably forever, without forfeiting their inherent value. They can therefore not be considered utility tokens but call for an individual "class" in consideration of their specific use and conditions of issuance. [734] This view is shared also by the EU regulator, as can be deduced from the exclusion of "non-fungible" digital assets from the scope of the new MiCA Regulation, which shall encompass utility and currency tokens.[735]

2. NFTs and fractional ownership

The phenomenon of NFTs is still in its infancy with its possible applications currently being experimented with. Accordingly, hybrids of different features are being explored; one of the currently available investment concept involving NFTs allows to represent fractional ownership of tangible artworks.[736] Contrary to the previously analyzed fractional ownership concept, the respective NFTs are not constituted as financial instruments, but supposedly reflect the actual co-ownership in the underlying NFT, which is divided into 10,000 pieces by using a grid, all of which are individually assigned an NFT, which is s unique in its features as each square.[737]

What is more, there has also been developed an alternative investment model based on the fractionalization of NFTs. NFT-associated art can by now be deemed to have become widely popular and in demand. This is also reflected in the prices requested for works by known artists, which may amount to 8-digit figures.[738] With fractionalized NFTs (also referred to as F-NFTs), high-priced NFTs and their respective artworks are brought again within reach of middle-tier investors. The concept is similar to that employed by art-token offering investment firms such as *Masterworks* or *Rally*, where through the ostensible "fractionalization" of a (mostly tangible) asset,

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[734] L Klöhn, N Parhofer and D Resas, 'Initial Coin Offerings' (2018) ZBB 89 (102); see also: K Borkert, 'Crowdfunding goes Blockhain – Teil 2' (2018) ITRB 91 (94).
[735] Art. 2(2a) MiCR Proposal; the parallel system that NFTs do not fit into the breakdown of security, utility and currency tokens becomes evident also from the fact that the preliminary MiCAR Proposal explicitly points out that NFTs may under certain circumstances constitute financial instruments, thereby qualifying as security tokens (Recitcal (6c) MiCAR Proposal).
[736] Particle (E.g. Tessera (formerly fractional.art), Liquid MarketPlace or Dibbs.
[737] See above (n 662).
[738] With probably the most famous example still being the collage "Everydays: the First 5000 Days" by Beeple which was auctioned off by Christies in March 2021 for US$69.3 Million; see also "The Merge" by PAK, which in total earned US$91.8 Million during the public sale.

investors may participate indirectly in the appreciation of e.g., a high-priced artwork, which would usually be beyond the financial means of smaller investors but become attainable precisely because of the large numbers of shares and participants involved.[739]

This concept does however put the earlier made statement that NFTs are not dividable units in question. The technological concept of fractionalized NFTs therefore deserves a closer look.

With fractionalized NFTs, there is not only one token representing ownership of an asset, be it tangible or digital, but a series of tokens, which can be transferred to different token holders. For example, an NFT of the "Doge"-meme was fractionalized by its holder PleasrDAO into 16,969,969,969 F-NFTs.[740]
In order to "divide" an NFT into independently transferable fractions, the unique token needs to be locked into a vault. A single NFT constructed according to the common model of an ERC721 token can thereby be connected to various ERC-20 tokens,[741] which all become unequivocally related to the underlying individual token. The number of fractionalized NFTs (or F-NFTs) as well as their initial price (usually in ETH) and other features is determined in the smart contract by the issuer, i.e., the owner of the holistic NFT and creator of the vault. After the initial issuing of F-NFTs, their price changes dynamically, reflecting supply and demand in the respective liquidity pool where the tokens are offered for sale.[742] As a case in point: The earlier mentioned original Doge-NFT was bought by PleasrDAO in June 2021 for USD 4 million, which then turned it into almost 17 billion F-NFTs in September of the same year.[743] The fractionalized units are currently valued USD 12.6 million in total, based on the market token price at the

[739] A process generally referred to as "democratization", see e.g. on this issue J. Rohr/ A. Wright, '*Blockchain-Based Token Sales, Initial Coin Offerings, and the Democratization of Public Capital Markets*', Cardozo Legal Studies Research Paper No. 527 (October 4, 2017) 12 f., https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3048104, accessed July 8, 2021.
[740] https://fractional.art/vaults/the-doge-nft
Learn.bybir.com , Explained: Fractional NFTs (F-NFTs) and how they work; https://decrypt.co/80337/pleasrdaos-fractionalized-dog-nft-now-worth-336-million
[741] Fractionalization of NFTs is not just possible on the Ethereum blockchain, but on any blockchain where smart contracts can be entered to represent NFTs, such as Cardano, Polygon, and Solana; for a technical analysis which examines this basic principle on Ethereum, see Billy Rennekamp, 'Re-fungible token' *mediun* (26 February 2018) <https://billyrennekamp.medium.com/re-fungible-token-rft-297003592769> accessed 2 December 2022.
[742] Lauren, 'A Beginner's Guide to Buying Fractions on Fractional.art' *Medium* (8 December 2021) < https://medium.com/fractional-art/a-beginners-guide-to-buying-fractions-on-fractional-art-dfa91a355d0f> accessed 11 December 2022.
[743] https://decrypt.co/80337/pleasrdaos-fractionalized-dog-nft-now-worth-336-million

moment (December 2022).[744] There are 11027 F-NFT-owners, with the largest share, namely 48.94%, still being owned by the issuer, PleasrDAO, which decides on the numbers of F-NFTs offered to the public.[745]

In order to realize capital gains from holding an NFT, there are two options: either the token holder may sell the F-NFT without having to ask permission from the other token-holders on a market platform, or wait for the redemption of the NFT. The latter occurs when someone wants to buy the original NFT and is willing to pay the exit or reserve price. While some platforms automatically initiate an auction, which may last for days, upon the disposal of the reserve price, others allow the bidder to directly become the owner. In each way, the holders of F-NFTs will be compensated for their token(s) on a pro-rata basis regarding the achieved sales price. The exit or reserve price is determined by the token holders, by participants holding at least 50% of the total F-NFTs together agreeing on a price.

While the concept of rendering high-priced assets available to a larger audience by splitting the related rights up into "fractions" seems familiar considering the topic of the previous chapter, a significant difference between the recognized investment model and the fractionalized NFTs concept exists:[746] On the one hand, with the traditional "fractional ownership"-businesses, instead of ownership in the artwork, generally a membership in the owning company is transferred to investors;[747] conversely, the distributors of fractionalized NFTs promise their investors to become actual co-owners to the original NFT.[748] Whether and how actual "ownership" towards an NFT can be transferred is subject to national property laws and shall not be at the focus of this Chapter. While some jurisdictions encounter no problem in transferring titles on purely digital assets, others lack behind in the ongoing process of digitalization and may in some

[744] The Doge NFT, sale history and information available at <https://fractional.art/vaults/the-doge-nft> accessed 11 December 2022.
[745] ibid.
[746] For a brief overview on the technical set up and offerors of F-NFTs, see e.g. E. Genç, 'How Can You Share an NFT? Fractional NFTs Explained' *CoinDesk* (23 August 2022) <https://www.coindesk.com/learn/how-can-you-share-an-nft-fractional-nfts-explained/> accessed 20 December 2022.
[747] See with regard to the model employed in the context of real estate C. de la Rubia, P. Sandner and J. Groß, 'Studie Zur Tokenisierung von Immobilien' (2021) Frankfurt School Blockchain Center and Hamburg Commercial Bank 6.
[748] Lauren, 'A Beginner's Guide to Buying Fractions on Fractional.art' *Medium* (8 December 2021) < https://medium.com/fractional-art/a-beginners-guide-to-buying-fractions-on-fractional-art-dfa91a355d0f> accessed 11 December 2022.

cases consider datasets in their intangible form not part of the *numerus clausus* of eligible items to establish ownership of.[749]

The promised co-ownership status transferred via F-NFTs is in line with the ascribed benefits of each tokens, which refer not only to a share in the total value of the associated NFT which can be realized by reselling the token but often also include voting rights for the fractionalized NFT-holders, which grant each participant a saying in essential decisions concerning the underlying holistic NFT, such as the reserve price for a vault, and often access to token-gated communities. What is more, many fractionalized NFTs include a buy-out option which allows an investor to squeeze out the other remaining fractional NFT holders in order to obtain the entire NFT – whose fractionalization can be reversed. Some providers allow to stake the tokens, which means for investors that they can earn continuous fees from holding the NFT.[750]

III. LEGAL IMPLICATIONS OF NFT-TECHNOLOGY

When it comes to technological advancements, the business practice is often a few steps ahead of regulation. Such is the case also with regard to NFTs, that in spite of their vast application in today's markets, still have not been target of sector-specific legislative intervention by EU or US regulators. While the regulatory uncertainty extends far beyond the financial market and the applicability of its rules to issuing and trading with NFTs, the other aspects located in the field of IP and property law shall not be subject of this Chapter. Instead, the following analysis concentrates first of all on the question whether NFTs and F-NFTs qualify as financial instruments and accordingly, whether they invoke the coverage of the MiFID framework and/or of the currently pending MiCAR.[751] A parallel analysis will be conducted subsequently with regard to US securities laws.[752]

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[749] As is the case e.g. with regard to German law, on which property titles may only be transferred with regard to "things" (Sachen, § 90 BGB); NFTs do not qualify as "things" (as long as they are not considered securities), see Michael Denga, 'Non-Fungible Token Im Bank- Und Kapitalmarktrecht' [2022] BKR 288, 288, 290., who also refers to NFTs as "a legal nothing" ("ein rechtliches Nullum"), given their lack of recognition under German law. Nonetheless, tokens may be subject of a sales agreement according to Art. 453 para. 1 phrase 1 2nd Alternative BGB.

[750] See e.g. unic.ly, <https://www.unic.ly> accessed 20 December 2022.

[751] Council of the European Union, 'Proposal for a Regulation of the European Parliament and of the Council on Markets in Crypto-assets, and amending Directive (EU) 2019/1937' (MiCAR) 13198/22 (5 October 2022).

[752] As a preliminary remark: In light of the manifold forms of NFTs, there can hardly be given an absolute answer as to their qualification as financial instruments. Thus, a case-by-case examination is necessary and appropriate for each issuance, where parameters such as the objective of the issuers, circumstances of tokenization as well as the technological standards of the token itself are examined in detail.

Given the manifold forms of NFTs and in order to keep the examination focused, this section concentrates on NFTs representing a work of art ("art-NFTs") – as opposed to collection cards and other valuables. The fact that the concept of art itself is put into question by NFTs, whose underlying subjects often enough are minimalistic depictions resorting to a pixelated style,[753] does not render this analysis any easier. In line with general copyright principles, however, a wide understanding of "art" shall be assumed in the following examination, applying the threshold of at least a modicum of creativity, respectively the "kleine Münze"-standard, which includes also minimalistic creative expressions.[754] What is more, given that the applicability of financial market law is at the heart of this thesis as opposed to copyright-protectability, the author takes the liberty not to make any distinction between human an AI-created artworks represented by NFTs.

1. Regulation of NFTs under EU Law

As on several occasions already denoted, the applicability of MiFID II essentially depends on the qualification of the relevant assets as financial instruments. Accordingly, the analysis starts by assessing the characteristics of art-NFTs against the definition of financial instruments according to Annex I of MiFID II.

a) NFTs as Financial Instruments under MiFID II

From Art. 4(1)(44) MiFID II, one can infer four criteria determining a security, which shall quickly be recalled: In order to qualify as a security, the asset under scrutiny must be 1) transferable, 2) standardized, 3) negotiable on capital markets and 4) correspond in its characteristics and nature to traditional securities.

aa) Standardization of NFTs

What catches the eye at first view is the apparent incompatibility between the second prong and the denomination of the relevant tokens: *Non-fungible* tokens are by their very nature not standardized but unique. This amounts to being their core trait, which distinguishes NFTs from any other token form, and which is decisive in establishing their economic function. NFTs are

[753] See e.g. the examples of Crypto Punks.
[754] This principle from German copyright law stands for the copyrightability of works with minimal creative and artistic value.

issued by artists, galleries and platforms as digital representations of creative works and as such, different from each other in the same way that artworks are. Hence, at least in the case of an NFT representing a unique one-of-a kind artwork, there can be no doubt as to the lack of standardization.[755]

Nevertheless, in taking into consideration what has been previously established with regard to the standardization of tangible artworks, this finding needs to be reassessed in the scenario where NFTs are supposed to represent specimen within an edition. It should be recalled that the uniqueness attributed to each artistic work is arguably offset by the growing number of copies of the same artwork within a larger edition.[756] As a case in point, the US VARA Regulation denies a spiritual bond between the artist and each copy if their total number exceeds 200.[757] With even the strong artistic identification gone, there is no reason to deny standardization to the identical specimen of an edition, even more so if the artworks are actually identical copies of a digital work and the NFTs can be differentiated only by their token IDs and the time of issuance. Digital art, which depending on its file format such as e.g., as .jpeg, .png or in video, can easily be reproduced in an unlimited amount without changing any aspect of the work.[758] From an artist's perspective, it is essential to protect the "original" and thereby one's authorship especially in this digital context, where even technical laymen can create a perfect copy with little effort. An NFT associated with the "original" (digital) artwork by the artist assumes and perpetuates its uniqueness factor, which is precisely the intended objective of using NFTs in the context of digital artworks. Assuming that one authentic digital artwork corresponds to one NFT issued by the artist personally, there is no question as to its lack of standardization. If the artist decides however to issue not one but three NFTs, representing three identical copies of the same digital creation, each with a digital signature by the artist, there would still be three unique NFTs each representing an original artwork, only that the essential difference here consists in the identity of the NFTs, whose enclosed information vary. But are these sufficient to deny standardization within the issued class? One could extend this *Gedankenexperiment* by assuming that the artist decided to issue an edition of 100 – or 10,000 – digital artworks, each being distinguishable from the other only by the token ID of their corresponding NFT. At this point, the unique designation of each NFT can easily be compared in its function to the serial number on banknotes – which

[755] See already above at 41 f.
[756] See above Chapter I.
[757] Sec. 602. a VARA (1990) – 17, U.S.C. § 106A.
[758] Of course, metadata would be different, reflecting the time of origin and property, but even these can be modified in such a way as to imitate the "original".

are not considered unique assets, in spite of being in theory individually identifiable and unique. At this point, the mere fact that each NFT can be distinguished by its metadata does not account on its own for their distinctiveness. In line with this finding is the evaluation expressed in the MiCAR proposal, where it reads that "[t]he sole attribution of a unique identifier to a crypto-asset is not sufficient to classify it as a unique or not fungible."[759] While this specific statement refers to "fractional parts of an unique and non-fungible crypto-asset", there is no reason not to extend its validity to NFTs issued in large editions.

However, in continuing in the vein of what has been said in the first Chapter with regard to traditional artworks within a series, one needs to differentiate between artworks and their associated NFTs being created in form of a varying *sujet* within the same series on the one hand and copies and multiples which lack distinguishing characteristics among themselves. With works which are merely similar to each other, their similarity is to be considered part of the artistic expression and cannot be considered insignificant. The same can however not be said for larger editions, where in contrast to the demarcation and individual traits of individual works, the affiliation to a class is the defining (and value creating) element. The aim of the issuer in these cases is precisely to render the same artistic work available to a larger audience by increasing the numbers of equal copies.[760] Some of the currently most popular and correspondingly valuable NFTs are part of different NFT-image series each with 10.000 pieces, e.g. Cryptopunks or Bored Apes.[761] In these cases, there are strong arguments against assuming standardization, which consist principally in the differing details of the images, e.g. different attributes of each Crypto Punk, which render each one unique – an aspect which is reflected in the differing values that can be achieved on the market.[762]

Other than that, in practice, editions of 5000 NFTs relating to representations of the same digital image are not uncommon; some may reach numbers beyond 80,000.[763] Also, a few editions are

[759] Recital(6c) Proposal MiCAR 5 October 2022.
[760] See on the importance of this aspect for the rise of the Multiple as an art form: Joseph Beuys, *Die Multiples,* Jörg Schellmann (ed.) (Schrimer/Mosel Verlag 1998) Chapter II,15.
[761] Marketed by Larva Labs, <https://www.larvalabs.com/cryptopunks> ; Bored Apres Yacht Club, < https://boredapeyachtclub.com/#/ >, both accessed 22 November 2022.
[762] With differences in prices, in accordance to the different attributes that a digital image combines, amounting to millions of USD. While one of the "rare" combinations may be valued more than USD 20 million in the community, others are currently sold at around USD 88,000 (<https://www.larvalabs.com/cryptopunks>).
[763] See e.g. the NFT 'Otherdeed for Otherside #93452' created by Yuga Labs, which is sold in an edition of 84,384 (<https://www.niftygateway.com/marketplace/item/0x34d85c9cdeb23fa97cb08333b511ac86e1c4e258/93452> accessed 22 November 2022).

kept "open" (as opposed to a "limited edition"), thereby leaving the option to mint more NFTs representing the same image/artwork in case of public demand. This raises the question where the numeric threshold shall be set, so that the individuality of each NFT can be considered "lost" due to the large number of tokens on the same artistic subject. In following VARA, one may set the limit at 200, some market participants propose 10,000; the answer would have to be somewhere in the middle. Standardization requires a class of units which exhibit such similarity among themselves that they can be considered fungible. Whereas with an edition of 3, each of the NFT holders would assumably take some pride in owning #1, #2 or #3, this feature tends to be lost at least after 1000 similar copies,[764] where the impression of "participation" to the collectors' community is stronger than that of being or owning "one of a kind."

Accordingly, standardization among art-NFTs is a practical concern which is prone to put into question the qualification of this token form. Against the background of editions in the 5-digit range, the designation of the medium "non-fungible token" alone cannot prevent the overall evaluation that NFTs belonging to large editions of at least 1000 pieces should be considered enumerable units within their common class and thus, standardized.[765]

bb) Transferability of NFTs

With regard to the transferability of NFTs, there is no doubt from a practical point of view: NFTs can be freely assigned to any other blockchain-user on the secondary market.[766] At most, one could argue that from a legal perspective, transferability requires a change of ownership – which with regard to NFTs is not a recognized option by all EU-jurisdictions.[767] However, there is a circular argument behind this, given that if one were to assume the security-quality of NFTs, the transfer of ownership could consequentially occur in lines with the laws of an increasing number of States recognizing the on-chain transfer of ownership of purely digital securities.[768] Since a

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[764] In any case, the exact order of issued NFTs can be identified by the time stamp perpetuated in the blockchain.
[765] Such is also suggested by the "substance of form approach", which is proclaimed in Recital (6c) of the MiCAR Proposal; see for the interpretation of standardization in the context of tokens: Hacker and Thomale (n 161) 667; CESR's Technical Advice on Possible Inplementing Measures of the Diretive 2004/39/EC on Markets in Financial Instrumentsm CESR/05-290b, BOX 25, 84.
[766] Unless certain restrictions with regard to sales are inherent to the token, e.g. installed by smart contracts, that limit the exercise of owner-attributed rights to the public key of the first purchaser. This can however not generally be assumed.
[767] See Denga (n 58) 290 for a brief analysis on the possibility to establish ownership of an NFT under German law.
[768] As is the case e.g. in Liechtenstein, see Florian Möslein, '§ 8 Elektronische Geschäftsanteile', in Omlor, Möslein and Grundmann (n 470) 184.

broad understanding is to be applied in the context of transferability, in particular in comparison to negotiability, this criterion thus does not stand in the way of assuming the security quality of NFTs.

cc) Negotiability of NFTs on Capital Markets

The argumentation does become more difficult in the context of negotiability on capital markets (Art. 4(1)(44) MiFID II). While the first part of the requirement does not pose a problem with regard to NFTs, since they can easily be transferred, the second half needs further clarification. According to a Q&A document provided by the European Commission,[769] negotiability on capital markets can generally be assumed if the units are traded on regulated venues, such as MTFs.[770] There is however no clear guidance from EU authorities yet on the issue to which extent digital token exchange platforms such as *OpenSea* or *Rarible* may qualify as capital markets. With the new Pilot Regime having only recently been proposed, the possibility comes within reach for token-based platforms to register as a regulated trading venue without being subject to the entire spectrum of regulatory constraints imposed by MiFID. The practical implementation and acceptance can however only be estimated at this time. As we have seen in the previous chapter, providers of tokenized fractional ownership often structure their platforms as "bulletin boards", at least in the EU, which evades further compliance obligations under the specific rules for regulated venues under MiFID II and MiFIR. Although the Pilot Regime provides for a reduced catalog of duties to certain platforms as a consequence to registration, it is questionable whether this will provide for a sufficient incentive for market platforms revolving around NFTs to register e.g., as an MTF. The question whether NFT market platforms constitute regulated trading venues does however not need to be conclusively answered at this point, as the mere capacity of being traded on such a platform or – given the broad understanding to be assumed in defining capital markets – in any "context where buying and selling interest in securities meet" suffices.[771] The earlier shown data on the trade volumes of NFT platforms provide for sufficient practical evidence that NFT-platforms allow a large investor community to meet each other's buying and selling interest. Given how "effortlessly" NFTs can be traded on corresponding trading platforms,

[769] European Commission, Your questions on MiFID (updated version 2008), question n° 115.
[770] Which, accordidng to the Q&A, would be considered a 'conclusive indication that they are transferable securities', ibid.
[771] European Commission, Your questions on MiFID (version 2008), Question no. 115; see also Hacker and Thomale (n 161) 665.

it can be assumed that NFTs can be traded on market structures that fall within the vague term of "capital markets".

dd) Functional Comparability of NFTs with Securities

What remains to be scrutinized at this point is whether NFTs correspond to securities in view of their function.

NFTs and securities share certain features, above all their speculative character. Although the importance of aesthetics in the decision to purchase an NFT cannot be entirely ruled out, it is not the main motivator for the vast majority of investors. Investment has always been an essential aspect to collecting art.[772] With regard to digital artworks, one may argue that the investment aspect becomes even stronger than with conventional artefacts. This becomes particularly evident from the fact that the digital artworks are often freely accessible as digital file,s as they are only attributed a quantifiable value in connection with the NFT. The guiding motive for paying money for such an online available work is therefore frequently the assumption that the NFT will be worth more in the future.[773] Accordingly, buying an NFT can be compared to investing in an NFT-artist.[774]

This parallelism alone is however not sufficient to establish a functional similarity between NFTs and securities.[775] Securities are characterized mainly by two features: the promise of future profits, deriving from the possessorship of the right, and the inherent voting rights with regard to further investment strategies.[776] With NFTs, both aspects do seemingly not fit. Being assigned a potentially "unique" item, the purchaser is granted full determination rights with regard to the token and the underlying artwork. Also, dividend distributions cannot be expected from holding an NFT. Although, in coming back to the earlier employed example of editions, one may argue

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[772] P. Genco, A. Zorloni even speak of "la finanziarizzazione del mercato dell'arte", '*Struttura e dinamiche evolutive del mercato dell'arte contemporanea*', Economia e Diritto del Terziario (2017) 5; see for an overview with regard to newly emerging investment vehicles in art, e.g. art investment funds: Graham; see also for the investment aspect: D. Boll, *Kunst Ist Käufich* (Hatje Cantz) 84 et seqq.

[773] In comparing the bull run of the cryptocurrencies market throughout the same period with prices achieved for NFT-artworks, it becomes obvious that both markets exhibit a strong correlation. Also with regard to other NFT-assets, such as basketball video sequences or Crypto-Kitties, the investment aspect strikes as an essential motivator for investors to enter the markets.

[774] Nonetheless, determining the intrinsic motivation behind a purchase of an NFT to a point that justifies its classification as purely or essentially investment-oriented is not feasible, given that the purchase may also be construed as a way of supporting the artist or gaining access to a community.

[775] See also Valpolicelli (8).

[776] See with regard to the efforts of the issuing entity on achieving profits and the corresponding information asymmetry *see*: Hacker and Thomale, 681.

that the entirety of the issued works represents a unity, with each NFT being comparable to a share in that the token holders benefits from any price increase of the edition as a total, while being exposed to price reductions if the artist's work is no longer requested by the public. But even in this scenario, one does not receive recurring payments as a consequence to an increase in the artist's popularity, nor is one granted a right to participate in any decision-making process of relevance to the edition.
Also, NFTs do not share essential traits with bonds, as they do not transfer any financial claims against the issuer. Eventually, NFTs do not transfer any right to acquire of sell other securities or to a cash settlement, thus not coming close to "any other securities" pursuant to Art. 4(1)(44)(c) MiFID II.

Finally, in assessing whether NFTs should be considered similar to financial instrument, also the statutory purpose of the respective laws compelling issuers to disclose and report certain information needs to be taken into consideration. Should the purchase of an NFT invoke the legal protection of investors under financial market laws? At this point, one may raise again the argument of the speculative character of NFTs. Some consider NFTs to be "essentially speculation and investment assets", purchased with the "primary goal to have an increase in value and resell the token on a crypto-platform or peer-to-peer on the blockchain". [777]
However, the argument of extending investor protection rules to NFT sales is not convincing when looking at the other side of the initial offering: Where the issuer of an NFT is an artist, the distribution of power and knowledge is not comparable to that of the offering of traditional securities. In the case of art NFTs, there can hardly be assumed an informational asymmetry, given that all the relevant information, i.e., the artist's name, the work's title, etc., are already available through the NFT. Disclosing the additionally required information under MiFID would not provide for any benefit to the purchaser.
Instead, what matters to investors is the security that the transferor actually corresponds to the authorized rightsholder. The discrepancy between the digital token and the ownership of the represented asset is one of the main concerns of NFT investors.[778] Given the general absence of an authority that controls whether the NFT corresponds to an existing item and that the issuer

[777] See Denga (n 58) 289 (citation translated by the author).
[778] As issuers of NFTs may simply point to digital images that they are not the author of and to which they have no rights, as occurred e.g. with to artist Corbin Rainbolt, <https://twitter.com/CorbinRainbolt/status/1369433485086195717>; see also on this issue Andres Guadamuz, 'Copyfraud and copyright infringement in NFTs' TechnoLlama Blog (14 March 2021) < https://www.technollama.co.uk/copyrfraud-and-copyright-infringement-in-nfts> both accessed 20 October 2022.

or seller has the title to both, the investor is virtually unable to verify the connection between NFT and the item respectively the entailed rights. Any attempt at an efficient investor protection framework would thus have to take up this point. Taking a look at the obligations that arise under MiFID II, enlisted in the first Chapter, a corresponding disclosure duty to reveal any hindrances that the purchaser may encounter with using the connected item, such as e.g. a lack of authorization to transfer corresponding IP rights on the underlying artwork, could be deduced from the "best execution" or "fair treatment" rules.[779] What needs to be remembered in this context, however, is that these provisions concretize a rule that is generally applicable in all contractual relations, namely the principle of good faith. As Denga rightfully observes in his analysis on NFTs against financial market laws, despite NFTs not qualifying as securities, disclosure obligations of the issuer towards the purchaser may still arise from the general principle of good faith or equity applicable in contractual relations.[780] He stipulates that "[i]n the context of an NFT acquisition, the investment interests of the purchaser are central, which depend in particular on the technical qualities of the NFT, but also on its tradability and the intellectual property licenses conveyed. Here, it is obvious to assume an obligation to provide information that relates to the individuality, the actual use of a blockchain, the number of units, if applicable, and also the price development to date."[781] Accordingly, the conclusion is reached that "[t]he technical information gap between the platform and the user just described, as well as the absolute control of the platform over its technical terms of use, speaks in favor of the assumption of information obligations in this regard" that shall arise not from the applicability of securities laws, but general civil law provisions pertinent to all contracts.[782] Such an understanding suggests that there is no practical need to extend the scope of MiFID also to NFT-sales. MiFID II goes far beyond the general valid principles of rightful behavior in civil transactions by stipulating e.g., formality and record keeping obligations or rules to avoid and disclose conflicts of interest. It is hard to imagine a situation where these obligations may indeed be of relevance in the context of an NFT offering. Thus, while appropriate in other investment contexts, the application of MiFID II rules is misguided when it comes to the issuing of art-NFTs.

[779] See above 33 ff.
[780] Denga (n 58) 292, referring to the principle of "Treu und Glauben".
[781] ibid.
[782] Whether the good faith obligations have to be met by the issuer of the NFT or the sales platform results primarily from the pertinent contractual terms, see ibid.

This inference aligns with the current treatment of NFTs by the EU regulator. As of today, NFTs are not recognized as securities or other financial instruments mainly due to a lack of standardization. This evaluation, as we have seen, does however not withstand scrutiny in cases where larger editions of NFTs related to the *same* (and not merely alike) underlying artistic depiction are issued. However, in comparing the essential features of NFTs to securities, it emerges that the involved risks and interests of the parties do not align; while there may be certain relevant information which the purchaser cannot verify with proportionate efforts and hence, has to rely on the seller's representations, this risk is already sufficiently covered by the applicable laws to contractual obligations and thus does not invoke investor protection rules by MiFID. Nevertheless, given the manifold possible arrangements of NFTs, this conclusion does not make a review of individual factual predicates superfluous. In fact, an alternative evaluation of NFTs could be in order when referring to the category of fractionalized NFTs.[783]

ee) NFTs as Derivatives?

In view of NFTs not qualifying as securities under MiFID II, the question prompts itself whether they might constitute another financial instrument. In view of the characteristics of an NFT, derivates emerge as a possible option worth consideration. In particular, commodity derivatives seem to share certain features with NFTs, bearing in mind the pertinent criteria:[784] According to MiFID II and MiFIR, commodity derivatives are to be identified as "financial instruments [...] which relate to a commodity or an underlying referred to in Section C(10) of Annex I to Directive 2014/85/EU; or in points (5), (6), (7) and (10) of Section C of Annex I thereto."[785] To determine the financial nature of an instrument in accordance with the above definition, a three-fold standard has been established by legal academia:[786]

1. The underlying of the derivative instrument: a broad concept of "goods", including not only the typical commodities but also any other asset, i.e., activity, parameter, variable, right, etc.;

[783] See below at 188.
[784] The other form of derivatives, namely financial derivates, can be excluded due to their requirement to have a transferable security or unit of a collective investment scheme as basis.
[785] Art. 4(1)(50) MiFID II, Art. 2(1)(30) MiFIR.
[786] Filippo Annunziata, 'Speak, If You Can: What Are You? An Alternative Approach to the Qualification of Tokens and Initial Coin Offerings' [2019] Bocconi Legal Studies Research Paper Series 42.

2. The "extremely wide notion of "derivative instrument",[787] which goes beyond the traditional forms of options, swaps, and futures, to include also practically any contract, instruments and alike structure;
3. The capacity of the derivative being regulated either in cash and/or being traded on a regulated trading venue.

In consideration of the expansive understanding of the constitutive terms, NFTs seem to fulfill the requirements of a commodity derivative, but for the last one. NFTs derive their value principally from the underlying artwork, which constitutes a collectible asset. However, holding the private and public key to an NFT does not provide the right to a cash settlement. Also, as of now, NFTs cannot be assumed to be traded on an MTF or OTF.[788] Again, the admittance on a regulated trading venue amounts to the decisive obstacle in the recognition of alternative investment forms as financial instrument.[789] Conversely, this yields the assumption that as a consequence to online token platforms becoming MTFs, a fundamental reassessment of alternative investment tokens, in particular NFTs, must be conducted, with the possible result of a litany of newly recognized or recognizable financial instruments.[790] There can thus not be delivered a conclusive answer as to whether NFTs qualify as derivatives, as additional specification in terms of legislative scope and intent are needed.[791] Given the legal grey area surrounding the concept of ATS, platforms providing a set of rules which facilitates the matching process or arrangement of orders on the system should re-evaluate their status in order not to expose themselves to the risk of violating financial market laws by not conforming to the authorization obligation und MiFID II.

In a sidenote: The new Pilot regime addressing DLT-based market structures, including MTFs, does not include the trading with derivates in its scope. As a consequence, platforms aspiring to profit from the lowered regulatory burdens under the Regime may find themselves exposed to the necessity of complying with the entire catalogue of obligations under the MiFID framework with regard to NFTs, under the condition these tokens will be considered commodity derivatives.

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[787] ibid.
[788] See below.
[789] See similarly the recognition of multiples and prints as securities; with regard to fractional ownership units, the problem has also been raised in Chapter IV.
[790] Annunziata (n 781) 43.
[791] For an in-depth analysis of the issue, see also: ibid 41 f.

b) Market Platforms for NFTs as Regulated Trading Venues

NFTs are extensively traded nowadays on various market platforms, including auctions at the three biggest auction houses and their metaverse "branches".[792] Their main trading occurs however through online platforms structured in such a way that NFT-holders can offer their tokens for a certain price or during an auction or accept unsolicited biddings by other platform users. The three largest NFT marketplaces are *OpenSea*, *Magic Eden*, and *X2Y2*, with a total monthly sales volume of almost 400 million.[793]

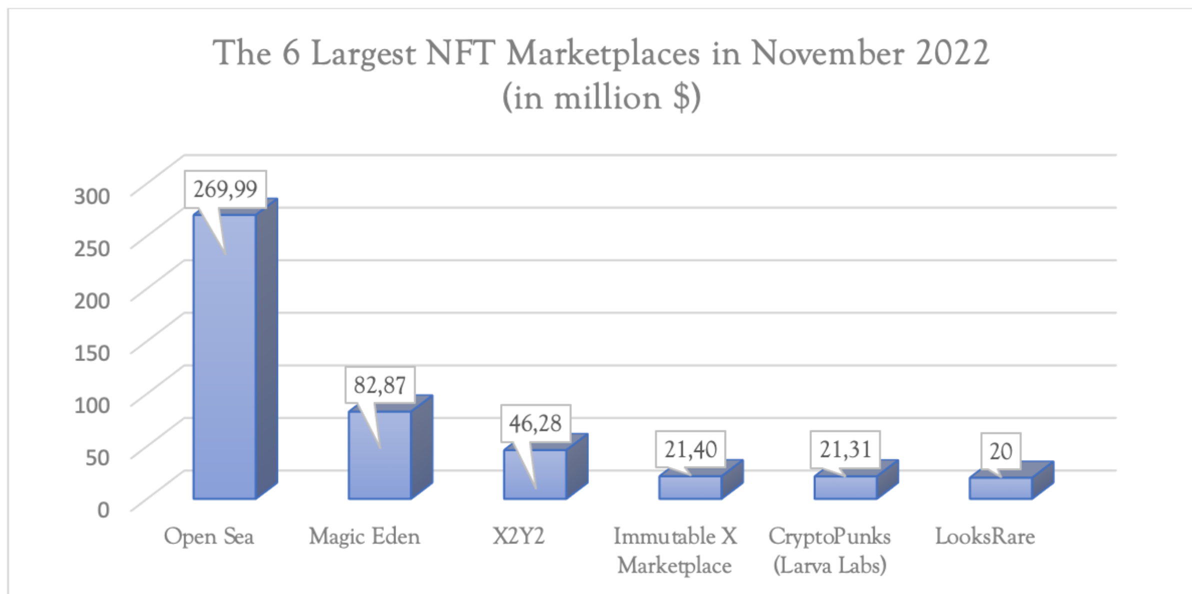

Chart X: The six largest NFT-marketplaces according to total turnover in the 30 days preceding 29 November 2022 (in million US Dollars) (Source: Statista, Largest NFT marketplaces based on all-time sales volume in the previous 30 days as of November 29, 2022, <https://www.statista.com/statistics/1274843/nft-marketplaces-with-highest-volume/>)

These platforms provide for a frequently used alternative to direct, peer-to-peer on-chain transfers of NFTs. Other than these broad NFT-market places, there are also independent project websites, e.g. Larva Labs.

[792] The total turnover on NFTs sold at auction in 2021 amounted to $232.43 million, achieved through the sale of 279 lots; Sotheby's conducted a sale entitled "Natively Digital 1.2" on Sotheby's Metavers, a platform dedicated specifically to NFTs, where works by Pak, Larva Labs and others were auctioned off, see Artprice, 'The Art Market Report in 2021' (2022) 44, 48 <https://imgpublic.artprice.com/pdf/the-art-market-in-2021.pdf>.

[793] Statista 2023, 'Largest NFT marketplaces based on all-time sales volume in the previous 30 days as of November 29, 2022' <https://www.statista.com/statistics/1274843/nft-marketplaces-with-highest-volume/> accessed 14 December 2022.

The primary service offered by the large NFT marketplaces consists in providing a platform for selling and buying-interests to meet. Some also offer their users to assist in the minting process of new NFTs.[794]

The platforms differ in various features, such as the blockchains they are built on and their fee structure. Most are running on the Ethereum blockchain.

Name	Blockchain	Gas Fees	Trading fees on secondary market	Trading fees in per cent
Open Sea	Ethereum, Polygon, Arbitrum	yes	yes	2,50%
Magic Eden	Solana	no	yes	2%
X2Y2	Ethereum	yes	yes	0,50%
Immutable X Marketplace	Ethereum	no	yes	2%
CryptoPunks (Larva Labs)	Ethereum	yes	no	/
LooksRare	Ethereum	yes	yes	2% (excl. private sales)

Table: Features of the largest NFT-marketplaces (blockchain used, gas fees, trading fees)

The business concept of NFT-market places is generally based on trading fees being due for each transaction. These may range from 0 to 2.5% and are generally to be deducted from the obtained sales price. In addition to the provision paid to the platform, also gas fees need to be taken into consideration for each transaction. These are usually paid by the buyers. Their amount does not depend on the price of the token, but on the utilization of the chain and may possibly be even higher than the agreed sales price.
What is more, NFTs may include so-called "creator earnings", which allow the creator of an NFT to benefit economically from any subsequent sale. Whether such fees are due and their amount (of up to 10%) are features decided by the NFT-creator. The other terms of the contracts, governing issues like the included usage and IP rights, means of payment, etc., are stipulated by the market platform. Absent any regulatory interference, these terms and conditions are decisive in defining the scope of owed duties in the fulfillment of the contract. As such, NFT-issuers, buyers and sellers are likewise affected by them without having the negotiating power to modify

[794] Minting refers to the process of creating a token. In order to do so, a command needs to be run on the blockchain that provides the token with a unique hash, containing its metadata, i.e. key contextual information that identifies the NFT.

the standard terms. Against the background of the market powers of NFT-platforms, any attempt at regulation should specifically address them.

There are commonly three ways to acquire an NFT via a token platform:

1) Buying at a price fixed by the current token holder (“Buy now”)
2) Buying an NFT during an auction
3) Making an unsolicited offer that is accepted by the token holder

In order to pursue a sale, the token holder usually has to list the NFT for a certain sales-price, the amount of which is up to the offeror, who may thus go as far as requesting 10 or 100 times the “floor price”, i.e., the lowest price that NFTs of the same collection are currently traded for. As a consequence to using DLT, there are commonly sufficient information available on past trades of the token and similar NFTs being traded, so that the interested investor can actually form a reasonable estimate of the current trading value and trend. Until there is an offer corresponding to the set price, the offeror is generally free to retract the listing. As an alternative to defining a specific price for an NFT, token holders may also initiate an auction, which depending on the structure of the auction may result in achieving a higher price than the “floor price”.[795]

Also unsolicited offers can be extended to token holders to submit a price proposal below the asking price. The potential buyer may set an expiration time and cancel the offer at any time before it is accepted. Such offers can also be extended to the whole collection of NFTs within an edition, which will then be accepted only once by the first seller to agree on the bid. Users owning one of the requested NFTs can be notified by e-mail of the made sales request.

In consideration of the impact that the classification of NFT-platforms as regulated trading venues may have on the legal classification of this token form as financial instruments, the debate is long overdue on the question whether NFT-market platforms fall within the substance of regulated trading venues, or whether they should rather be considered alternative trading systems (ATSs). In light of the above, it becomes evident that the involvement of the platform operator in arranging the sales varies: On the one hand, the acceptance of unsolicited offers, and responding to collection offers or “buy now”-options constitute peer-to-peer transactions where

[795] The OpenSea platform allows for both, English and Dutch auctions, see <https://support.opensea.io/hc/en-us/articles/1500003246082-How-do-timed-auctions-work-> accessed 11 December 2022.

the contact is established and the price stipulated by the parties (except for fees and general terms and conditions, to which the users of the platform consent); on the other hand, the sale of NFTs through an auction follows the rules provided by the system, in that the seller has to accept the highest bid that supersedes the minimum amount. In any case, however, there occurs no "matching" like it typically does on stock exchanges. It remains to be seen whether the NCA will allow this system to operate under the "bulletin board" exemption, or whether they will impose a stricter regime on them under the MiFID framework respectively the DLTR.

c) F-NFTs as Financial Instruments under MiFID II

What has been said earlier in terms of transferability and negotiability with regard to NFTs claims equal validity with regard to F-NFTs.[796] Both shall thus be presupposed at this point.

Also, while the standardization of NFTs may be a controversial topic, the standardized typology of F-NFTs can hardly be argued with. Contrary to the earlier mentioned investment model employed by Particle,[797] where on each artwork a grid system is applied that allows to differentiate between the different fractions, with F-NFTs, there is no correspondence to a specific "square" of the original NFT. Instead, all of the issued F-NFTs are equal in their inherent rights and can be differentiated only by their token ID. The reason why their standardization is however sometimes questioned is because of the denomination as "fractionalized non-fungible tokens"; these do not share the characteristics of the underlying holistic digital asset though. A parallel can be drawn between F-NFTs and the earlier introduced "fractional ownership" interest in the art-owning company, where regardless of the uniqueness of the underlying artwork, the issued company interest represented nevertheless standardized securities.

The most interesting requirement in the context of F-NFTs is their comparability to securities – a criterion which had to be denied taking into consideration the typical structure of art-NFTs. Again, here, one has to examine the common features with equity and debt instruments, being among the traditional securities enlisted as examples within the definition under MiFID II.[798]

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[796] See above 179 f.
[797] See above (n 662).
[798] Art. 4(1)(44) MiFID II.

Equity instruments and shares in particular are characterized by two traits, namely the conveyed right to company profits and the possibility to participate as shareholder in key decisions. A say in essential matters is attributed also to F-NFT holders; for instance, a voting on the setting of a reserve price generally requires a majority representing at least 50% of the tokens.
With regard to the participation in company profits, the issue presents itself more complex. Similar to NFTs, also F-NFTs represent "buy-and-hold investments" as opposed to offering constant cash flow or recurring dividends in the way shares do. F-NFTs do however constitute a profit-sharing claim, which is realized at the moment of resale of the underlying token. What is more, in keeping with the dynamics of shares traded on the stock market, the aggregate F-NFTs' market value may go beyond the book value of the underlying holistic NFT. Thus, from a practical perspective, essential similarities between F-NFTs and shares can be assumed, which outweigh the existing discrepancies.

Last but not least, the rules imposed by financial market regulation also seem appropriate in the context of F-NFTs, as opposed to the trade with NFTs. With F-NFTs, the principal motivation consists in an investment purpose; the aesthetic aspect, which may still deserve consideration with NFT-purchases, becomes virtually insignificant in the case of F-NFTs where no (digital) artworks are transferred as a result of a token purchase. What is more, the investor finds her/himself opposed to an issuer who in the context of F-NFTs can, by mindful placing of tokens on market platforms, ascertain the control over the underlying asset and all relevant decisions. Here lies another detrimental difference compared to the situation with NFTs, which are being entirely transferred to the purchaser. Obligations established by MiFID, such as avoidance or disclosure of CoIs, can realistically become of relevance with regard to F-NFTs, where the issuer's interest may not always align with all the investors'. The risk exposure to the issuer's decision power and informational advantage can indeed be compared to that of investors in traditional shares. Therefore, an examination of the parties' interests typically present in F-NFT investment constellations supports the application of investor protection rules established by MiFID rules to the offering of F-NFTs.

This leads to the conclusion that F-NFTs, subject to variations installed by the factual and contractual predicaments of the concise situation, constitute financial instruments under MiFID II and as such, call for the application of investor protection rules to the offering and trading with this type of tokens.

d) MiCAR

With the Regulation on Markets in Cypto-assets (MiCAR), a "landmark bill" is supposed to come into force in 2023 and be implemented in 2024, that shall provide for a consistent regulatory framework on crypto-assets in the digital European market and bring significant benefits to retail investors and other market participants.[799] Given that the regulation of tokens on a European level is only in its infancy, MiCAR is set to represent an essential step towards clarity and harmonization to the treatments of digital assets within the EU.

Prior to compromising on the current wording, the proposal circulated for roughly two years between the various competent EU institutions. The first proposal on the text of the Regulation was introduced to the European Commission in September 2020. The final consolidated version has not been published yet; following its review by the Council and the Parliament, its full text will be put to vote again in front of the Parliament. Accordingly, the following analysis takes place on the basis of the "compromise text" ("MiCAR Proposal") which was published on 5 October 2022 and which is expected to correspond to the final version,[800] though only time and the official journal of the EU will tell whether the made assumptions are accurate.

MiCAR is intended to encompass not one but three separate but inter-connected regulatory regimes. These consist in the regulation of stablecoins, cryptocurrencies, and what can best be described as utility tokens. In defining its remit, MiCAR establishes four categories of crypto-assets, namely "asset-referenced tokens" (i.e., stablecoins), e-money tokens, utility tokens, and all other crypto-assets which do not correspond to any of the prior categories. The catalogue of obligations, including rules on disclosure, conduct, and governance, is addressed not only to issuers of the above tokens, but also to crypto-asset service providers, including the operators of trading platforms for crypto-assets (Art. 3(1)(9, 11) MiCAR Proposal), who subsequently to falling within the remit require authorization by the NCA.

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[799] Protos Staff, 'Leaked MiCA draft suggests EU sees some NFTs as securities' *Protos* (21 September 2022) <https://protos.com/leaked-mica-draft-suggests-eu-sees-some-nfts-as-securities/> accessed 18 October 2022.

[800] Council of the European Union, ‚Proposal for a Regulation of the European Parliamnet and of the Council on Markets in Crypto-assets, and amending Directive (EU) 2019/1937 (MiCA) – Letter to the Chair' 13198/22 (5 October 2022) <https://data.consilium.europa.eu/doc/document/ST-13198-2022-INIT/en/pdf> accessed 22 November 2022 ("Compromise Text").

MiCAR and the MiFID-framework are mutually exclusive in their scope of application, with MiCAR being intended to capture what has not yet been covered by MiFID II.[801] In particular, MiCAR shall not be applied to financial instruments as defined under Art. 4(1)(15) MiFID II.[802] Although this seems to offer clear guidelines, in practice, it may introduce friction into an already delicate system given that platforms may have to comply not only to one, but several sets of rules if they offer various token forms, such as security and utility tokens, through their system.

Following the current Proposal, MiCAR is going to be the first EU-legislative body that explicitly refers to NFTs as a category of digital assets, even though in this case, the reference intends primarily to exclude "unique, non-fungible crypto-assets" from the remit of the Regulation.[803] Thus, NFTs are *per definitionem* not covered by MiCAR. Amendments to the original draft indicate that there have been some discussion on whether or not NFTs shall be within the scope of the Regulation. While it initially seemed that certain obligations arose also with regard to NFTs, the current state is very clear on generally excluding this token type.[804] were included Importantly, this carve out shall be executed not on the basis of the formal designation of the token by the issuer, but instead, a "substance over form" approach is imposed, requiring a "de facto" examination of the token's features, its use and the inherent rights.[805] In order to qualify as a unique and non-fungible crypto-asset, also the assets or rights being represented by the token need to be unique and non-fungible.[806] "Digital art and collectibles" are explicitly named as examples for underlying assets for unique and not fungible tokens.[807] As an indicator of the fungibility of tokens, the Proposal refers to non-fungible tokens being issued "in a large series or collection."[808] This reference confirms what has been previously established with regard to large NFT-editions, whose individual units can indeed be considered fungible and thus implicitly "standardized" within their class.[809] Unfortunately, the MiCAR Proposal refrains from indicating

[801] Andrea Minto, 'I'd love to help you, but I simply can't… or can I?' (2022) EuZW 986 (988).
[802] Art. 2(3)(a) MiCAR Proposal.
[803] Recital (6b) Proposal Regulation; Art. 2(a) MiCAR Proposal, the latter referring to "crypto-assets that are unique and not fungible with other crypto-assets".
[804] For an overview on the different modifications asserted over time with regard to the NFT treatment under MiCAR, see Filippo Annunziata, 'NFTs and EU Financial Markets Regulation', in Fabiana Di Porto, Oreste Pollicino (Eds.) `*Title to be determined*' (forthcoming, working paper with the author).
[805] Recital (6c) MiCAR Proposal.
[806] Compromise Text Recital (6c).
[807] Recital (6b) MiCAR Proposal.
[808] Recital (6c) MiCAR Proposal.
[809] See above.

a concise number that could provide for a guideline in assessing the fungibility of NFTs within editions.[810]

As another example for tokens being denied the "unique and non-fungible" quality, the Proposal mentions "fractional parts of" NFTs.[811] By including fractionalized NFTs, the EU regulator exhibits surprisingly great awareness of current market trends. It thus subjects fractionalized NFTs, a technology which offers enormous potential in the investment context, to regulation either by MiCAR or MiFID (as well as the prospectus regime and MAR),[812] depending on their qualification as financial instruments. The explicit differentiation can also be construed as an expression of the legislator's assessment that F-NFTs are associated a higher risk compared to their widely popular but nonetheless still unregulated cousins, NFTs. By adding that "[t]he exclusion of crypto-assets that are unique and not fungible from this Regulation is without prejudice to qualification of such crypto-assets as financial instruments", the Regulator deliberately leaves the circumstances undefined under which NFTs may still have to be classified as financial instruments.

What is also left unclear at this point is whether F-NFTs invoke the coverage of MiCAR or MiFID. While some legal scholars and practitioners deduce from the legal assessment of F-NFTs in Recital (6c) that fractionalized NFTs fall within the substance of the MiCAR Proposal,[813] this assessment seems to forget the defined scope of application, which is limited to the area uncovered by laws applicable to financial instruments (Art. 2(3)(a) MiCAR Proposal). In following what has been established earlier with regard to F-NFTs, this token category exhibits strong parallels with traditional securities and as such, can legitimately be subjected to the rules of MiFID and Co.
An essential issue to be kept in mind in this context however is the combination of different features, as may be the case e.g. with F-NFTs, that often do not only exhibit traits similar to that of shares, but are also often equipped with a utility component, in that they provide access to restricted communities. The Proposal addresses this issue implicitly by stipulating that " 'utility token' means a type of crypto-asset which is *only* intended to provide access to a good or service

[810] See on this point also Philipp Maume, 'Die Verordnung Über Märkte Für Kryptowerte (MiCAR)' [2022] RDi 461, 465.
[811] Recital (6c) MiCAR Proposal.
[812] Maume (n 805) 462.
[813] ibid 465; Markus Kaulartz, Benedikt Holl, ‚Der MiCA-Entwurf zu Utility-Tokens, Security-Tokens undd NFTs' CMS Blog < https://www.cmshs-bloggt.de/rechtsthemen/die-neue-mica-verordnung/der-mica-entwurf-zu-utility-tokens-security-tokens-und-nfts/> accessed 21 November 2022.

supplied by the issuer of that token."[814] Accordingly, even a strong utility component of F-NFTs does not suffice to establish the applicability of MiCAR over MiFID.

The Commission is tasked, according to Art. 122b MiCAR Proposal, with issuing a report within 18 months after the date of entry into force of the Regulation, and after consulting with the EBA and ESMA, that reflects the most recent developments on crypto-assets and includes in its considerations in particular areas which are not targeted by the Regulation, such as NFTs.[815] Accordingly, additional guidelines and possibly even regulations can be expected from the EU authorities within the next years. That these are rapidly needed is attributable not only to the speed but also the success of the use of emerging technologies, first and foremost DLT-based, in the investment sector. In this respect, it is important not to let regulatory uncertainties, which may have been initially seen by businesses as opportunity for unhindered growth, degenerate to obstacles in the market.

e) Central Findings

The challenges and opportunities inherent to the NFT trend have so far not been explicitly addressed by the European regulator and supervisory authorities, despite this technology having a wide range of application. NFTs, albeit not qualifying as financial instruments, may be designed in such a way that they exhibit typical features for securities, including a speculative investment purpose and standardized format. This congruence becomes even more evident in the case of F-NFTs, which have been recognized as a controversial issue by the MiCAR Proposal. The author argues that F-NFTs do however not fall within the substance of the proposed Regulation, as they would regularly have to be considered securities pursuant to the definition under Art. 4(1)(44) MiFID II, thereby being subjected to financial market rules outside the MiCAR scope.

[814] Art. 3(1)(5) MiCAR Proposal, emphasis added by the author.
[815] Art. 122b (da) MiCAR Proposal.

2. Regulation of NFTs under US Securities Law

Albeit being recognized by the SEC as a potentially controversial matter, which can be deduced from currently ongoing investigations in this sector,[816] there has not been issued specific guidance in terms of the classification of NFTs as securities under federal securities laws.[817] Absent specific regulations, the Howey test needs to be applied in assessing the legal relevance of this token type. Accordingly, the issuance or resale of tokens falls within the scope of SEC regulations if the digital asset qualifies as a security, which requires an investment of money in a common enterprise with reasonable expectation of profits to be derived from the entrepreneurial or managerial efforts of others, thereby constituting an investment contract.[818]

a) NFTs as Securities Under US Law

Bearing in mind the characteristic uniqueness of NFTs which are destined to represent holistic assets, their affiliation to a common enterprise is a difficult point to argue. However, in view of the extensive interpretation of "common enterprises" assumed by the SEC in the context of digital assets, one may find the link created through common authorship sufficient to affirm this criterion.[819] While in the case of an edition for example one can clearly define the underlying commonalities of a series of NFTs, it is doubtful whether the mere affiliation to an artist shall suffice.[820]

In any case, the SEC places a much higher priority on the following criterion in establishing the security quality of a digital asset: the investor's reasonable expectation of profits must derive from the efforts of others. In this context, the "Active Promoter" (AP) is attributed a decisive role.[821] Whether such a figure can be detected in the context of NFT sales is questionable. NFTs are generally issued by the artists themselves or through project websites, such as *Larva Labs*. This accounts for a decisive difference towards the previous distribution system in the art market, which was founded on the role of dealers and galleries as gatekeepers for artists. Due to the commonly exclusive contracts, the success and recognition of artists relied to a significant extent

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[816] M. Quiroz-Gutierrez, 'Bored Ape Yacht Club creator Yuga Labs part of SEC probe into NFT market' *fortune crypto* (11 October 2022), <https://fortune.com/crypto/2022/10/11/bored-ape-yacht-club-yuga-labs-sec-nfts/> accessed 10 December 2022.

[817] See above fort he „Recent Developments in the Regulation of Tokens under US Law", 184.

[818] SEC v. W.J. Howey Co., 328 U.S. 293, 301 (1946); Dewey (20).

[819] SEC, 'Framework for Investment Contract – Analysis of Digital Assets' (2019) < https://www.sec.gov/corpfin/framework-investment-contract-analysis-digital-assets> accessed 1 November 2022..

[820] On the effect of authorship on establishing strong linkages between works, see above 58.

[821] Wink and others (n 653) 7.

on the efforts of their representing gallery. Conversely, the trend of NFT-driven art renders the role of the intermediary superfluous.[822] Accordingly, each artist is principally her/himself responsible for promoting their work and thereby establishing a reputation in the art market. While this certainly demands some efforts, these cannot be assumed to be undertaken to generate an income or profit for the holders of sold NFTs. Moreover, the interests at stake are not comparable to that of conventional security offerings. Whereas disclosure and CoI obligations make sense in view of an investment that is managed by third parties, the investors in NFTs do not place their future returns in the hands of an agent. NFTs in their archetype can thus be assumed not to invoke SEC regulation.

b) Fractional NFTs as Securities Under US Law

This finding may differ when it comes to F-NFTs, which do exhibit essential differences compared to their underlying tokens. With F-NFTs, a participation in a common enterprise is palpable. The number of fractionalized "parts" is determined by the issuer at the moment of their creation. The respective tokens share a common underlying which cannot be exchanged, and which constitutes the basis for the investors' expectations to gain profits from their investment. The distribution of profits at the moment of resale occurs *pro rata*, on the basis of the resale price for the underlying NFT.[823] Indeed, the investment aspect inherent to F-NFTs is a particularly prominent feature, even more so than with the investment in unique NFTs, where the transfer of or access to the artistic work represented by the NFT is an essential aspect in the sales contract.

What is more, subject to the individual strategy of an F-NFT sale, the creator of the vault is attributed a managing role and accordingly, can exert a strong influence on any potential value increase through strategic placement of offers. This can however only be assumed if the issuer retains a position of power, e.g., by not placing the majority of tokens in the liquidity pool. Otherwise, i.e., with equal distribution of tokens among different owners, the third condition under Howey can hardly be considered satisfied. Given the vast possibilities of structuring F-NFT offerings, attention has to be paid to the individual circumstances: while some offerings may

[822] Although (online) marketplaces where offers and bids are concentrated are still an essential part of the system.
[823] See e.g. A. Vijayakumaran, 'Democratizing NFTs: F-NFTs, DAOs and Securities Law' Richmond Journal of Law and Technology (2021), <https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3964905> accessed 11 December 2022.

resemble an ICO, this structure may also be used on a much smaller scale,[824] by sending parts e.g., to friends or colleagues and conduct polls on what is a common property or project.

The possible relevance of F- NFT-structures under securities regulations has been recognized by the SEC, which can be deduced from the statement made recently by the Commissioner Hester Peirce in an interview with the Financial Times that the "SEC must clarify which NFTs will be regulated."[825] There is reason to believe that over the coming months, the regulatory relevance of F-NFTs will be examined and discerned also by official authorities, which might expose current market participants to liability risks due to unregistered security offerings and trading.[826]

IV. CONCLUSION

The legislative challenges of NFTs have only recently been identified by legislators. Accordingly, so far, there are no clear rules or guidelines, neither in the EU nor in the US, as to how NFTs and F-NFTs shall be treated under financial market law. Instead, the US and EU regulators find themselves in the same boat, navigating on unchartered waters. The apparent reticence by authorities bears the risk of a setback for this burgeoning economic sector, as investment firms and investors find themselves paralyzed due to legal uncertainty. Given the topicality and practical relevance of this matter, additional guidance can however be expected to be issued soon, on both sides of the Atlantic. In any case, there are strong indications of a trend towards bringing the currently still legally "untamed" NFTs back into the regulated space, at least with regard to fractionalized NFTs. The practical consequences of this can only be estimated at this time, as it remains to be seen whether regulated offers will draw more interest from investors in reliance on legal protection, or whether in particular individual issuers and smaller platforms, that are quite common in this business sector, will relinquish due to the additional bureaucratic requirements that go hand in hand with being considered a security trading entity.

[824] Martin Young, 'Going to pieces: Fractionalized NFT projects gather steam' Cointelegraph (18 March 2021) <https://cointelegraph.com/news/going-to-pieces-fractionalized-nft-projects-gather-steam> accessed 11 December 2022.

[825] Stefania Palma, Patrick Temple-West, 'SEC must clarify which NFTs will be regulated, says commissioner' Financial Times (17 October 2022), < https://www.ft.com/content/e8df6ea4-e9fb-4058-9a36-cef9c12f4726> accessed 10 December 2022.

[826] For an extensive analysis on the relevance of token market platforms under US Securities Laws, see Kristin N. Johnson, 'Regulating Cryptocurrency Secondary Market Trading Platforms' (7 January 2020) UChicago Law Review Online, <https://lawreviewblog.uchicago.edu/2020/01/07/298/> accessed 11 December 2022.

KEY FINDINGS

"Investing is more art than science." – This quote, which is attributed to the American investor Howard S. Marks, claims validity especially in the context of art investments, where due to a lack of available information and objective parameters in the establishment of values, investors have to rely on their providers in making an investment decision. The dissertation at hand set out to scientifically assess the legal framework which governs investor protection in the field of art and investment. To this aim, it scrutinizes four different investment models in art, namely 1) direct art investment, 2) art funds, 3) fractional ownership of artworks, as well as 4) NFTs and fractionalized NFTs. The respective central findings are summarized in the following ten key theses:

1) The art market has emerged from the last crisis-ridden years as a rather stormproof investment market. A 5% compound annual growth rate over the past 15 years together with a quick market recovery following the pandemic give evidence to the resilience of the art market, which makes art an attractive alternative investment in current times of inflation and political turmoil.
2) Essential information, e.g., with regard to pricing and the availability of items, are not as readily available in the art market as in securities markets. This goes hand in hand with increased complexity and risk of investments. Market participants have developed their business concepts properly on the basis of the existing lack of available information. Also, hidden incentives and personal interests in transactions continue to be a rather common phenomenon in the art market. While the presented data suggests that the majority of collectors is aware of the lack of transparency, that is characteristic for the art market, a corresponding awareness must also be raised among potential investors.
3) A growing recognition of the investment aspect in art has spurred the trend of alternative investment forms in this sector over the past century. This trend is amplified by the use of modern technology in the last years. Investment models such as fractional ownership and NFTs render the market accessible also to investors who previously could not participate in the benefits that art offers as an asset class.

4) Artworks in the traditional sense, i.e., tangible works belonging to the fine arts sector, do not constitute securities neither under the EU nor under the US securities laws, irrespective of a strong investment aspect inducing the purchase. However, investing in art exhibits strong parallels to securities investments, including the reliance on third party managerial efforts to be able to realize profits.
5) The business concept of art funds is structured in such a way as to principally address accredited/qualified/ professional clients, i.e., subjects with considerable liquid capital at hand to invest and experience in the capital market investment sector. Albeit there being legislative frameworks imposing behavioral and informational duties to the managers of alternative investment funds in the EU and the US, the applicable set of rules to art funds is often reduced to a minimum due to the available statutory exemptions.
6) The investment concept of art fractional ownership encompasses basically two models, namely the actual ownership of an artwork divided among the members of an investors' community, and the indirect participation in an artwork's appreciation over time through (membership) interests issued by the art-owning company. The latter model is by far more common and bears the risk of giving a misimpression to investors who aspire to become the owner of an artwork.
7) Fractional ownership units issued by art-owning companies for investment purposes qualify as financial instruments; whereas in the US, they are exclusively issued as equity instruments (membership rights or shares), companies in the EU structure their products in such a way as to constitute debt instruments. In both jurisdictions, the practicability of the securitized interests is enhanced by the use of DLT, meaning that the products are issued as security tokens to investors.
8) Art-NFTs, which in principle constitute non-fungible digital representations of unique items, may lose their uniqueness component as a consequence to being issued as part of a larger edition. Nevertheless, they do generally not qualify as financial instruments, neither under EU nor US securities laws.
9) A different picture emerges with regard to fractionalized NFTs, which primarily serve an investment purpose. Due to their structuring, which conveys voting and redemption rights to the token holder, F-NFTs can be assumed to fall within the substance of financial instruments in the EU and the US. Official guidelines specifying the relevant conditions have not been issued yet, neither by the EU regulator nor the SEC. There can however

be expected a regulatory intervention soon, given that in both jurisdictions, the issue has been identified as a contentious matter.

10) The progressing digitalization presents itself as an opportunity for the previously exclusive art market to address new investors and thereby create capital inflow. Even though technologic advancements may not be slowed down because of regulatory uncertainty, the reticence of regulators to intervene by providing additional guidelines may have an impeding effect on technology-based businesses who fear exposing themselves to liability. The regulatory digitalization projects currently underway in the EU as well as the practical need for clear guidelines present strong incentives to amend the existing rules and regulations on financial markets to include within their terms and definitions also new DLT-based alternative investment models.

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INDEX LEGAL ACTS AND OFFICIAL REPORTS AND GUIDELINES

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Annex I: Art Funds in the EU and the US

Art Funds in the EU

Name of the Art Fund	Name of the umbrella/ superordinate Entity	Fund Manager	Initiation year	Target Duration	Topical Focus
EU Art Funds					
Anthea - Contemporary Art Investment Fund SICAV FIS (Anthea-CAIF)	(Anthea Art Investments AG)		launched planned for 2010	8 years	Blue chip and emerging artists from post-war and contemporary art
Anthea - Contemporary Art Investment Opportunities CLP (Anthea CAIO)	Anthea CAI S.á.r.l.	Anthea Art Investments AG (Investment Advisor)	2013		Blue chip and emerging artists from post-war and contemporary art
Art Vantage Global	Art Vantage PCC		2011/2012	terminated 2022	Contemporary Art from major developing art markets of the world
Artfonds 21 AG		Rik Reinking, Martin Bouchon	2007	without limited duration	Modern and contemporary art
ArtsGain Alternative Value Fund (AVF)	ArtsGain	ArtsGAin Investments SGEIC S.A.			Blue-Chip Art
Cellini Art Fund*			2022	/	
Guernica V. Fund*	Artemundi Management Limited	Artemundi V Funds, LLC (US)	2021	3 years	Museum-quality artworks from the late XIX Century Impressionism, Post-Impressionism, modernism periods, post-war, early contemporary, ecluding new and emerging artists
In Art Fund	Invictas S.A.	In Art S.A. (Investment Adviser)	2020	5 years	Post-war, contemporary, young emerging artists
Modern Art Masters (Mam) RAIF*	Petricca & Co Capital (LU) S.A.; ltd (UK)	Petricca & Co Capital (ltd., UK)	2016	15 years	Blue-chip modern and contemporary art

Name of the Art Fund	AUM (Target Value)	AUM (Realized)	Target Annual Return (IRR)	Min. individ. investment	Information on Investors (Professional, Retail)	Annual Management + Performance Fee	Company Form Fund	Seat (City)	Country	Additional Information	Terminated	Website
EU Art Funds												
Anthea - Contemporary Art Investment Fund SICAV FIS (Anthea-CAIF)	€ 30-40 mio.		15%	€ 250,000	"Well-informed investors within the meaning of art. 2 of Luxembourg law of Feb. 23, 2007 on Specialized Investment Funds"	2% + 20%	(SIF)		Luxembourg, EU	Portfolio includes also installations, photographs and videos in addition to fine art		http://www.anthea.art/fund/2/9/4/1
Anthea - Contemporary Art Investment Opportunities CLP (Anthea CAIO)							SCS		Luxembourg, EU	Portfolio includes also installations, photographs and videos in addition to fine art		http://www.anthea.art/fund/2/9/5
Art Vantage Global							PCC	Porto	Portugal, EU	Website does not exist anymore; contact via e-mail address provided was not possible	2022	https://www.teakcapital.pt/investments-teak/art-vantage/; http://www.tirochedeleon.com/contact/
Artfonds 21 AG	€ 3 mio.	€ 351,000		€ 3000			AG		Germany, EU			https://artfonds21.de/de/Das-Unternehmen/Vorstand
ArtsGain Alternative Value Fund (AVF)			15-17%	€ 125,000 $ 150,000	accredited investors	2% + 20%	S.A.		Spain, EU			https://www.artsgain.com/en/
Cellini Art Fund*					no specific target client category		SPA	Verona	Italy, EU			https://cellini.io
Guernica V Fund*	$ 20-200 mio.		17%	$ 200,000 USD € 170,000		2% + 20% of returns above 6% return benchmark	SCSp	Luxembourg	Luxembourg, EU			
In Art Fund	€ 50-100 mio.	€ 30 mio. (2021)	10-15%	$ € 125,000		2.5% + 20%	SCS		Luxembourg, EU			http://inartfund.lu/#
Modern Art Masters (Mam) RAIF*	€ 50 - 250 mio.		30%	$ 137,500	"well-informed" investors	2% + 20%	(RAIF)		Luxembourg, EU (UK)	Artworks purchased through Art Houses as a Third Party Guarantor		https://petriccacapital.com/#slide3

Art Funds in the US

Name of the Art Fund	Name of the umbrella/ superordinate Entity	Fund Manager	Initiation year	Target Duration	Topical Focus
US Art Funds					
Alts 1 Fund	Alts Management Co LLC	Alts Management Co LLC	2022	10 years	Various alternative assets across the markets, including artworks by "old masters, modern stars and pop art" artists but also Collectables such as sports cards to vinyl, NFTs, music rights, real estate, wine and whisy, sneakers
American Masters Collection I*	The Collectors Fund	Executive Chairman Alexander Kemper, Chrstine Kemper, Will Conner	2007	10 years	20th Century and contemporary American Artists
Twentieth Century Masters Collection LLC*	The Collectors Fund	Executive Chairman Alexander Kemper, Chrstine Kemper, Will Conner	2012	10 years	20th Century and contemporary American Artists
Art Equity Fund I (YS AEF I LLC)*	Yieldstreet Management, LLC		2021	5 years	Blue-chip and mid-career contemporary and post-war artist
Art Equity Fund II*	Yieldstreet Management, LLC		2022	5 years	Harlem-influenced artists (NYC), Harlem Renaissance to present day
Art Equity Fund IV (YS AEF IV LLC)*	Yieldstreet Management, LLC		2022	5 years	Blue-chip contemporary artists
Artory/Winston	Strada Digital Masterpieces, Ltd.	Apex Group Ltd.	2022		blue-chip, mid-career, and emerging artists (approx. 65 artworks)
Prism Fund*	Yieldstreet Management, LLC		2020	4 years	different asset classes: Art (4,11%), credit instruments such as private credit, legal finance, real esate, transportation, corporates
Salon		/	2022	"holding […] works for decades to come"	acquisitions determined by members (voting procedure), tendency towards emerging and mid-career artists, e.g. artists from Light and Space movement, conceptual art, digitally-mediated works, Black abstraction, women and non-binary artists

* additional information could be collected thanks to the cooperation of the funds e.g. by provided promotion materials.

Name of the Art Fund	AUM (Target Value)	AUM (Realized)	Target Annual Return (IRR)	Min. individ. investment	Information on Investors (Professional, Retail)	Annual Management + Performance Fee	Company Form Fund	Seat (City)	Country	Additional Information	Terminated	Website
US Art Funds												
Alts 1 Fund			40%	$ 20,000	accredited investors (max. 2000 investors)	1%+20%	LLC	Delaware	US	Non-voting membership interests per unit; secondary market planned for		https://alts.co/announcing-the-alts-1-fund/
American Masters Collection I*	$ 50-100 mio.	$ 17 mio.		$ 100,000	accredited investors (<100 members)	2% + 20%	LLC	Kansas City	US	Art Rotation Program, members enjoy a "private museum" – can experience the collected art at their homes	2021	http://thecollectorsfund.com/inquiries/
Twentieth Century Masters Collection LLC*		$ 13 mio.		$ 500,000	accredited investors (ca. 100)	2% +20%	LLC	Kansas City	US	Art Rotation Program, members enjoy a "private museum" – can experience the collected art at their	in the process of being wrapped up	
Art Equity Fund I (YS AEF I LLC)*		$ 15 mio.	15-18%	$ 10,000	accredited investors	2% + 15% of returns above 15%-target	LLC (SPV)		US			https://www.yieldstreet.com/offering/yQ-XWg/art-equity-fund/
Art Equity Fund II*		$ 7.2 mio.	13-17%	$ 10,000	accredited investors	2% + 15% of returns above 13%-target	LLC (SPV)		US			https://www.yieldstreet.com/offering/OiKSnA/art-equity-fund-ii/
Art Equity Fund IV (YS AEF IV LLC)*			15-20%	$ 15,000	accredited investors	2% + 15% of returns above 15%-target	LLC (SPV)		US			https://www.yieldstreet.com/offering/MyBc9A/art-equity-fund-iv/
Artory/Winston	$ 25 mio.			$ 10,000	accredited investors	1.25% + 15%	Ltd.		US	Tokenized art fund with secondary market platform		https://www.artory-winston.com; https://id.securitize.io/#/primary-market/opportunities/247
Prism Fund*		$ 113 mio.	13-17%	$ 2,500	not only accredited, also retail investors	1.5%	Inc.		US	Distributions to the investors are to be made quarterly		https://yieldstreetprismfund
Salon					accredited investors (max. 100)		LLC	Delaware		Members partake in governance decisions regarding the collection (voting rights linked to tokens); relies on blockchain technology		https://salondao.xyz/#/faq; https://medium.com/@jordanhuelskamp/introducing-salon-the-art-worlds-dao-805683698797

Annex II
Fractional Art Ownership Firms in the EU and the US

Maecenas and EU Fractional Art Ownership Firms

Name of the Umbrella Company	Name of (one) issuing SPV	Broker-Dealer	Initiation year	Target holding duration	Scope of Collectibles and Valuables	Investment Volume per asset	Annual Prospective Return (IRR)	Min ind investment
Example								
Maecenas Fine Art Pte. Ltd.			2018		Warhol's "14 Small Electric Chairs"	$ 5,600,000		
EU								
arttrade GmbH	arttrade custody 001		2021	unlimited	Blue Chip Art	15.000-280.000 €	3-12,6%	250 €
Finexity AG	neuart-01 GmbH & Co. KG		2018	2-15 years	Blue Chip Art (Prints and unique artworks)	ca. 20.000-100.000 €	5-7,68%	500 € (additionally prospectively also "Club Deals" starting from 100.000 €)
Timeless (CONCEDDUS GmbH)	New Horizon GmbH			7-12 years	Collectibles, such as art (prints), sneakers, watches	66.400 -94.000 €		50

Annex II
Fractional Art Ownership Firms in the EU and the US

EU Fractional Art Ownership Firms

Name of the Umbrella Company	Information on Investors (professional, retail)	Co-determination rights	Annual management fee/emission fee + share in profit	Company Form SPV	City/ State of Incorporation	Country	Blockchain	Secondary Market	Additional Information	Website
Example										
Maecenas Fine Art Pte. Ltd.	100 invited investors	no	1+8%			Singapore	Ethereum	Yes, partner exchanges (ATEX)	the website is still online, but it is not possible to contact Maecenas via contact form; last news update in 2019	https://www.maecenas.co
EU										
arttrade GmbH		yes, on resale	2% + 10%	GmbH	Düsseldorf	Germany		yes		https://arttrade.io/kunstmarkt/
Finexity AG	retail investors with further knowledge and experience in financial products	no	ca. 1 % + 1,96%	GmbH & Co. KG	Hamburg	Germany	ERC-20 based Finexity Blockchain	not yet		https://finexity.com
Timeless (CONCEDDUS GmbH)		yes, due to fractional ownership rights			Berlin	Germany	/			https://www.timeless.investments/magazine/kunst-als-investment

Annex II
Fractional Art Ownership Firms in the EU and the US

US Fractional Art Ownership Firms

Name of the Umbrella Company	Name of (one) issuing SPV	Broker-Dealer	Initiation year	Target holding duration	Scope of Collectibles and Valuables	Investment Volume per asset	Annual Prospective Return (IRR)	Min ind investment	Information on Investors (professional, retail)	Co-determination rights
USA										
ARTBnk Inc.	GF1 LLC	ABFin	2022	4-5 years	One work by Förg ("Ohne Titel"), 2007	$ 950,000.00	19,85%	$ 5,000	accredited and institutional investors	
Artory & Winston Art Group	Straat100, LLC	Securitize Markets LLC; Republic (OpenDeal Portal LLC)	2022	5 years	Hirst's "Psalm 116: Dilexi, Quoniam"	$ 352,500-375,000 (target)	10-14%	$ 250	retail and accredited investors	no
Masterworks LLC	Masterworks 001-100, LLC		2017	3-10 years	Blue Chip 20th century and contemporary	on average $ 3,626,865.67 (= total vol./ number of assets (134))	16.1%	$ 20	accredited and retail investors	no
Otis	Otis Collection LLC, (Otis Gallery LLC)	Dalmore Group, LLC	2019	3-7 years	all sorts of rare collectibles, including art but also e.g. cards, sneakers, NFTs			$ 14		no
Particle			2021	no limit	Contemporary blue chip art (Banksy)	$ 12,900,000		$ 1,500		yes
Rally (Rd. Entity)	RSE Collection, LLC, RSE Archive, LLC or RSE Innovation, LLC				all sorts of rare collectibles, including art but also e.g. cards, wine, cars, watches	$ 9,000 - 1,800,000		$ 7	retail and accredited investors	no, but investors can buy-out

Annex II
Fractional Art Ownership Firms in the EU and the US

US Fractional Art Ownership Firms

Name of the Umbrella Company	Annual management fee/emission fee + share in profit	Company Form SPV	City/ State of Incorporation	Country	Blockchain	Secondary Market	Additional Information	Regulation A Offerings	Regulation D Offerings	Regulation Crowdfunding	Registered Investment Company	Website
USA												
ARTBnk Inc.	1% + 15%	LLV	Delaware	USA		planned 1 year after offering		(-)	(+)	(-)	(-)	https://www.artbnk.com/gunther-forg-
Artory & Winston Art Group	1,50%	LLC	Delaware	USA		yes	Offers not only investments in single artworks but also a tokenized fund (Strada Digital Masterpieces)	(-)	(-)	(+)		https://www.artory-winston.com; https://republic.com/artory-winston-hirst
Masterworks LLC	1,5 + 20 % (+ 11% upfront payment)	LLC	Delaware	USA	Ethereum (ERC-20 tokens)	yes	When Masterworks purchases a painting, it registers the asset with the Securities and Exchange Commission and then offers shares in the work to investors in an IPO manner	(+)	(+)	(-)	(-)	https://www.masterworks.com
Otis		LLC	Delaware	USA		yes		(+)	(+)		(-)	https://www.withotis.com
Particle			Delaware	USA	Avalanche Mainnet C-Chain (bridge with Ethereum)	yes	Each masterpiece is governed by its community of Particle collectors, in a "sub-DAO" manner; Every piece of art is 'particalized' into a subdivision of unique NFTs called Particles –representing minority ownership in the works in question and a specific piece of an artwork (like the lower right corner, for example) rather than a general part; Buyers get digital certificates with images of the squares they own; the certificates double as tickets to the physical location where the painting is stored.	(-)	(-)	(-)	(-)	https://www.particlecollection.com
Rally (Rd. Entity)		LLC	Delaware	USA		yes		(+)			(-)	https://rallyrd.com