New York Law Journal

SERVING THE BENCH AND BAR SINCE 1888

WWW.NYLJ.COM

ALM.

MONDAY, MARCH 28, 2022

What Lawyers Need To Know About Non-Fungible Tokens: Part 1

By Gregory Baker, Anne-Laure Alléhaut and Catherine J. Djang

Non-fungible tokens (NFTs) are the latest trend to sweep markets from the art industry to professional sports leagues. These digital assets have existed for several years but have achieved explosive popularity only recently. In fact, the global market for NFTs reportedly hit over $40 billion in 2021. Despite this, the legal frameworks governing NFTs—which could significantly impact the risks and rewards of buying or selling NFTs—are still catching up. In this series of articles, we will explore the developing legal landscape surrounding NFTs and the increased legal and regulatory scrutiny that lawyers should consider.

What Are NFTs?

If you have not yet familiarized yourself with the basics of blockchain technology, that is the place to start. At its core, a blockchain is meant to be an immutable ledger that records one or a series of transactions, with each transaction verified by a peer-to-peer network rather than a centralized organization. The network constantly checks and validates the accuracy of the blockchain. Once on the blockchain, the record cannot be reversed or erased; one can only add a new blockchain recording the new information. Within that ledger technology, there are (1) fungible tokens, meaning that one token can be replaced by any other token—a typical example is a cryptocurrency, and (2) Non-Fungible Tokens (NFTs).

NFTs are completely unique digital assets and cannot be exchanged for one another. Instead, they primarily serve as digital tokens of ownership rendering the chain of custody more transparent for both NFT creators and purchasers. NFT purchasers can do due diligence by looking at the ledger. NFT creators can not only track the buyers or collectors interested in his or her work, but also benefit from it by, for example, embedding the provision of automatic resale royalties.

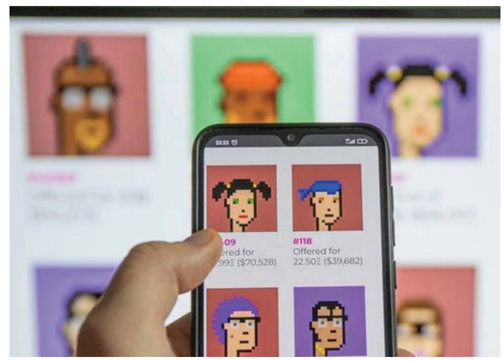
Photo: Rokas Tenys/Shutterstock

A non-fungible token (NFT) is a special type of cryptographic token which represents something unique. NFT blockchain marketplace.

The most well-known NFTs include artwork, such as the record-breaking $69 million auction sale of a digital image created by the artist Beeple, which has been followed by many sales at the major auction houses of native digital artworks. But investors and businesses in other industries have also been lured into launching their own NFTs representing unique collectibles, such as pieces of media content, and other use cases.

Another notable innovation is the emergence of f-NFTs (“fractional non-fungible tokens”). An f-NFT is a fractional piece, or “shard,” of an NFT that can be traded. The value of each shard of a given NFT is tied to the value of the underlying NFT as a whole.

Are NFTs or f-NFTs Securities?

One open—and consequential—question is whether or not an NFT will be considered a security for purposes of U.S. securities laws. As a general matter, subjecting NFTs to securities regulation and enforcement will lead to increased compliance and frictional costs, possibly making NFTs less attractive and constricting the market for NFTs.

Marketplaces and trading platforms may need to register as a securities exchange under the Exchange Act. NFT sellers may similarly need to register as broker-dealers under the Exchange Act, register the NFT as a securities offering, or seek an exemption from registration requirements. Consequences for failure to register include the possibility of private class action lawsuits seeking damages and/or rescission, and regulatory enforcement actions that may seek civil monetary penalties. In instances of fraud, prosecutors may seek to hold issuers of NFTs criminally liable.

Implications for NFT holders are less clear. Insurers, who are still grappling with how to assess the risk NFTs pose, will surely consider the application of securities regulations when deciding whether and how to underwrite coverage. At the very least, should an NFT holder suffer financial losses, they may choose to pursue recovery of damages: rescission, and/or attorney fees.

Legal Landscape

Regulatory Implications. NFTs will not be categorically deemed securities; rather, the analysis is highly fact-dependent. The analysis revolves around the concept of an "investment contract," which is a type of security under federal law. The U.S. Supreme Court's *Howey* case and subsequent case law have found that an investment contract exists when four prongs are met. These prongs are: (1) the investment of money (2) in a common enterprise (3) with a reasonable expectation of profits (4) to be derived from the efforts of others. See *SEC v. W.J. Howey Co.*, 328 U.S. 293 (1946) (*Howey*).

While this framework is well-established and used by the SEC to analyze digital assets, NFTs occupy uncharted territory in the securities world. In the coming months and years, securities regulators (such as the SEC and state agencies) are likely to respond to queries from market participants, issue guidance, and perhaps pursue related enforcement actions. For example, in April 2021, the broker-dealer Arkonis Capital LLC, a subsidiary of Sustainable Holdings Inc., sent a petition to the SEC "encourage[ing] the SEC to publish a concept release on the regulation of NFTs to provide suitable guidance to the industry."

While NFTs have "tremendous potential to revolutionize industries," they also "present[] a unique challenge to SEC's ability to protect investors from products that may be illegally offered securities." It can be expected that further calls for clarity from market participants will continue until the agency issues regulatory guidance on this subject.

Securities Litigation Risk. A bellwether case may soon provide a data point on NFTs in this otherwise untested frontier. In a lawsuit filed in New York Supreme Court on May 13, 2021, putative class action plaintiffs seek to bring claims stemming from defendant Dapper Labs' sale of NFTs. See *Friel v. Dapper Labs* (N.Y. Sup. Ct., Index No. 653134/2021, filed May 13, 2021). The NFTs at issue are called NBA Top Shot Moments (Moments). These Moments depict video clips of NBA basketball game highlights. What's more, Moments can be bought, sold, and traded on a blockchain-based digital collectibles platform, called the NBA Top Shot marketplace. Moments have been promoted by their creators as the "next generation of basketball cards."

The central allegation is that defendants are liable for "significant" damages caused by the sale of unregistered securities, i.e., the Moments NFTs. Thus, the case centers on whether the Moments are properly considered securities under the *Howey* test. The first prong of the *Howey* test is easily met here and not in dispute: Plaintiffs all invested money when they purchased Moments.

Plaintiffs plead the second prong, the existence of a "common enterprise," in two ways. First, they argue that vertical commonality—i.e., that the fortunes of plaintiffs and defendants are linked so that they rise and fall together—is met. Plaintiffs point out that Dapper takes a percentage of all transactions that occur in its secondary marketplace. Defendants counter that there is no interdependence of profits and losses between a Moments collector and Dapper: A collector cannot vote in Dapper corporate matters or receive any of Dapper's profits.

Alternatively, plaintiffs argue that horizontal commonality is met, i.e., the fortunes of each investor in a pool of investors are tied to one another and to the success of the overall venture. Defendants disagree, noting, among other things, that each Moment is unique and the value of each Moment is independent of every other Moment.

Next, plaintiffs argue that the third and fourth prongs are met because Moments collectors reasonably expected profits based on the efforts of Dapper. According to plaintiffs, investors were lured to purchase Moments with the hope that the tokens' value would increase in the future as the project grew in popularity, based upon the managerial efforts of the issuer of the token, Dapper, and those working to develop the Top Shots project. Defendants maintain, however, that Moments have consistently been marketed as collectibles, not as profit-driven investments. Moreover, defendants argue that any collector gains are influenced by market and other forces—such as the collectors themselves, culture, and game results—not Dapper.

Dapper Labs was removed to federal court on July 7, 2021, No. 1:21-cv-05837-VM (S.D.N.Y.), and the case is still in the pleadings stage. Plaintiffs filed an amended complaint on Dec. 27, 2021, and defendants have filed a letter with the court in support of a proposed motion to dismiss the amended complaint. The eventual outcome of this case will be closely watched by NFT investors and sellers alike.

Other Legal Risks. NFTs present several other legal risks: as with other much-hyped cryptocurrency-related offerings, the NFT space has been plagued by fraud, scams (including phishing theft), and market manipulation (including the practice of "wash trading"). The U.S. Department of Justice has taken note, and has established a specialized National Cryptocurrency Enforcement Team (NCET), tasked with addressing the criminal misuse of cryptocurrencies and other digital assets.

The DOJ has recently doubled down on these efforts, and announced the appointment of NCET's first Director, Eun Young Choi, on Feb. 17, 2022. The Commodities Futures Trading Commission may also be contemplating the application of U.S. commodities laws to NFTs. The CFTC has taken the position that it has jurisdiction over several virtual currencies, such as Bitcoin and Either, and may also oversee other digital asset-related activities.

NFTs also pose unprecedented legal challenges in other contexts. The implications of NFTs in contract disputes, intellectual property, tax, and AML and OFAC compliance all merit further in-depth exploration.

Conclusion

Media coverage of NFTs thus far has painted a picture of exorbitant returns, on the one hand, and serious risks on the other. Although NFTs are currently operating in a legal grey area, this may soon change as the burgeoning market for NFTs comes under further scrutiny from regulators and the courts. Market participants of all stripes who wish to proceed should do so with an appreciation for the legal complexities that NFTs present.

Gregory Baker *is a partner in Patterson Belknap Webb & Tyler's litigation department and chair of its securities litigation group, and is also a member of the white-collar defense and investigations group. He is a former senior counsel for the SEC's Enforcement Division.* **Anne-Laure Alléhaut** *is counsel in the firm's art and museum law practice and formerly was a senior vice president with Sotheby's legal transactional team.* **Catherine J. Djang** *is an associate in the firm's litigation tment.*