

CECI N'EST PAS UNE SECURITY: WHEN AND WHY ATTORNEYS SHOULD ADVISE F-NFT CLIENTS TO FILE WITH THE SEC

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ABSTRACT

Non-fungible tokens' (NFTs) market expansion has been both aggressive in scale and unencumbered by effective regulation in recent years. Consumers continue to suffer from regulatory gaps formed by innovations in crypto industries. The applicability and adaptability of the Securities Acts and relevant case law such as SEC v. W.J. Howey Co. to novel technology was already strained by cryptocurrency more generally. NFTs, which are based on the same underlying technology as more familiar cryptocurrencies, present even greater challenges. Howey interprets the "investment contract" portion of the Securities Acts' definition of a security. Unfortunately, Howey requires a fact-intensive analysis that is currently both too ambiguous and too protracted to facilitate efficient market participation in NFT spaces. The SEC's goals of promoting efficient capital markets while also protecting the consumers interacting therein are poorly served in NFT markets by the current regulatory scheme. This Article reviews applicable Securities laws, current actors in the NFT market and how they are using NFTs, abuses present in the market, and a detailed analysis of Howey's application to NFT use cases. Further, this Article provides guidance for securities lawyers advising NFT offering clients.

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I. INTRODUCTION

Non-fungible¹ token (“NFT”) sellers and marketplaces have run forward with reckless abandon in response to incredible increases in market demand, conducting themselves in ways that likely will cause all to look back and ask: “Where were the [NFT] lawyers?”² One such NFT seller, Yuga Labs, recently achieved \$561 million in freshly minted NFT sales in only 24 hours.³ This enormous demand crashed the platform that facilitated the NFT transactions.⁴ The crash cost some purchasers thousands of dollars and increased the transaction fees by 1,000%.⁵ Those purchased NFTs entitled their owners to virtual real estate within Yuga Labs’ upcoming corner of the Metaverse.⁶

Yuga Labs is not the only NFT pioneer experiencing a high volume in sales—one projection estimates that the NFT market will

¹See Jonathan Emmanuel & Gavin Punia, *Non-Fungible Tokens: What’s All the Fuss?*, BIRD & BIRD (Jul 4, 2021), <https://www.twobirds.com/en/insights/2021/uk/nonfungible-tokens-whats-all-the-fuss> (contrasting “non-fungible token,” with *fungible* tokens like Bitcoin).

²Lincoln Sav. & Loan Ass’n v. Wall, 743 F. Supp. 901, 920 (D.D.C.1990).

³Kate Irwin, *Yuga Labs Sees \$561 Million in Otherside Ethereum NFT Sales Within 24 Hours*, DECRYPT (May 1, 2022), <https://decrypt-co.cdn.ampproject.org/c/s/decrypt.co/99156/yuga-labs-sees-561-million-in-otherside-ethereum-nft-sales-within-24-hours?amp=1>.

⁴See *id.*

⁵Alex Hern, *Yuga Labs Apologizes After Sale of Virtual Land Overwhelms Ethereum*, GUARDIAN (May 2, 2022, 11:54 AM), <https://www.theguardian.com/technology/2022/may/02/yuga-labs-apologises-after-sale-of-virtual-land-crashes-ethereum>.

⁶Irwin, *supra* note 3.

experience \$800 billion in transactions in the next two years.⁷ NFTs raise a novel question for securities lawyers and professors. Lawyers must determine what constitutes an NFT and why people are flocking to NFT retailers, like Yuga Labs, to buy them. Most relevant to this Article, securities lawyers must ask: “Are NFTs securities?”

NFTs are the next iteration of a relatively recent technology known as the blockchain.⁸ Blockchain technology, brought to popular attention largely by Bitcoin’s explosive popularization,⁹ was heralded by some to be as significant a disturbance to the market as the internet.¹⁰ However, unlike fungible cryptocurrency like Bitcoin or Ether, NFTs are blockchain-based tokens comprised of unique sequences of code that identify each NFT individually.¹¹ Few attorneys and legal academics have

⁷ Casio Gusson, *The NFT Sector Is Projected to Move Around \$800 billion over Next Two Years: Report*, COINTELEGRAPH (Apr. 28, 2022), <https://cointelegraph.com/news/the-nft-sector-is-projected-to-move-around-800-billion-over-next-2-years-report>.

⁸ Louis DeNicola, *What to Know About Non-Fungible Tokens (NFTs)*, BUS. INSIDER (Feb. 17, 2022, 11:13 AM), <https://www.businessinsider.com/personal-finance/nft-meaning>.

⁹ Vinay Gupta, *A Brief History of Blockchain*, HARV. BUS. REV. (Feb. 28, 2017), <https://hbr.org/2017/02/a-brief-history-of-blockchain>; see also *infra* Section II.B.1. (discussing Bitcoin’s significance is discussed in greater detail).

¹⁰ Carol R. Goforth, *Regulation of Crypto: Who Is the Securities and Exchange Commission Protecting?*, 58 AM. BUS. L. J. 643 (2021) [hereinafter *Regulation of Crypto*] (citing Daniel Lanyon, *Blockchain Will Be “as Transformative as the Internet,”* ALTFI (Apr. 23, 2018), https://www.altfi.com/article/4334_blockchain-will-be-as-transformative-as-the-internet); see also Frances Yue, *Crypto Is Like the 1990s Internet, Nearing a Hyper-Adoption Phase, Wells Fargo Says*, MARKETWATCH (Feb. 8, 2022), <https://www.marketwatch.com/story/crypto-is-like-the-1990s-internet-nearing-a-hyper-adoption-phase-wells-fargo-says-11644354647> (comparing uptake in cryptocurrency engagement with mid-1990s internet use).

¹¹ DeNicola, *supra* note 8.

addressed NFTs specifically, but current academic discussions surrounding cryptocurrency may provide helpful guidance to securities law attorneys working with NFT, crypto, or crypto-adjacent clients.¹²

The innovative nature of NFTs imbue these transactions with uncertainty, causing the SEC to scrutinize NFTs.¹³ According to an anonymous source cited by Bloomberg, the SEC has subpoenaed issuers and exchanges to determine whether NFTs, both fractionalized (“F-NFT”)¹⁴ and otherwise, fall within the SEC’s purview.¹⁵ NFT offerings, like unregistered “initial coin offerings” and “initial public offerings”

¹² See generally Carol R. Goforth, *Cinderella’s Slipper: A Better Approach to Regulating Cryptoassets as Securities*, 17 HASTINGS BUS. L. J. 271 (2021); see generally Yuliya Guseva, *The SEC, Digital Assets, and Game Theory*, 46 J. CORP. L. 629 (2021) (providing an analysis of SEC regulatory activity of cryptocurrency; definitions of “security” and applicability to cryptocurrency; and an assessment of SEC predictability, credibility, and reputation related to cryptocurrency through a game theory lens); Andrew Bull & Tyler Harttraft, *Cryptocurrency and Blockchain Law: SEC’s Heightened Enforcement Against Digital Assets*, 27 RICH. J. L. & TECH. 1 (2021); Kristin N. Johnson, *Decentralized Finance: Regulating Cryptocurrency Exchanges*, 62 WM. & MARY L. REV. 1911 (2021); Wulf A. Kaal, *Digital Asset Market Evolution*, 46 J. CORP. L. 909 (2021); Goforth, *supra* note 10; J. Scott Colesanti, *Sorry, They Were on Mute: The SEC’s “Token Proposal 2.0” as Blueprint for Regulatory Response to Cryptocurrency*, 3.1 CORP. & BUS. L. J. (2022); Jack J. Longley, *The Crypto-Currency Act of 2020: Evaluating First Steps Toward Clarifying the Digital-Asset Regulatory Landscape*, 54 SUFFOLK UNIV. L. REV. 549 (2021); Eric C. Chaffee, *The Heavy Burden of Thin Regulation: Lessons Learned from the SEC’s Regulation of Cryptocurrencies*, 70 MERCER L. REV. 615 (2019); Victoria Chiu & Moin A. Yahya, *The Meme Stock Paradox*, 3 CORP. & BUS. L. J. (2022); Yuliya Guseva, *A Conceptual Framework for Digital-Asset Securities: Tokens and Coins as Debt and Equity*, 80 MD. L. REV. 166, 168 n.9 (2020) [hereinafter *Coins as Debt*] (providing a list of other scholarship related more generally to blockchain accommodation in corporate and securities law).

¹³ Matt Robinson, *SEC Scrutinizes NFT Market over Illegal Crypto Token Offerings*, BLOOMBERG (Mar. 2, 2022), <https://www.bloomberg.com/news/articles/2022-03-02/sec-scrutinizes-nft-market-over-illegal-crypto-token-offerings>.

¹⁴ See *infra* Section II.B.2.c.

¹⁵ Robinson, *supra* note 13.

before them, may simply be a new way for individuals to part people from their money.¹⁶ While popularity has waxed and waned for NFTs,¹⁷ declining steeply from the initial flurry of engagement,¹⁸ consumers are only beginning to explore and exploit the various NFT functionalities. Accordingly, NFT trading topped out at over \$17 billion in 2021, and is expected to increase as additional functionalities are discovered and made accessible.¹⁹

The focus of this Article is to inform securities and business lawyers regarding the way the SEC treats cryptocurrency and NFTs, and provide guidance to attorneys advising NFT and F-NFT-focused clients. Part II of this Article provides the relevant securities law framework and

¹⁶ Jeff Benson, *SEC Targets NFT Creators, Marketplaces over ICO-Like Sales: Report*, DECRYPT (Mar. 2, 2022), <https://decrypt.co/94268/sec-targets-nft-creators-marketplaces-ico-sales-report>.

¹⁷ Musa, *NFTs Outperforming Cryptocurrencies in 2022*, NFT NEWS TODAY (Apr. 14, 2022), <https://nftnewstoday.com/2022/04/14/nfts-outperforming-cryptocurrencies-in-2022/>.

¹⁸ See generally Elizabeth Howcroft, *Cryptoverse: NFT Bubble Gets That Shrinking Feeling*, REUTERS (Apr. 5, 2022), <https://www.reuters.com/technology/cryptoverse-nft-bubble-gets-that-shrinking-feeling-2022-04-05/> (last visited Apr. 5, 2022) (explaining that, while the NFT “bubble” has “shrunk,” innovative uses and social engagement probably will prevent a “pop” comparable to the “dot com” bubble’s “pop”); Matthew Fox, *Weekly NFT sales plunge more than 50% to \$207 million. These were the 5 best-selling digital collections*, BUSINESS INSIDER: MARKETS INSIDER (Apr. 13, 2022), <https://markets.businessinsider.com/news/currencies/weekly-nft-sales-decline-crypto-bored-ape-yeach-2022-4> (illustrating the consistent decline in NFT sales in the first months of 2022); Paul Tassi, *Interest in NFTs and the Metaverse Is Falling Fast*, FORBES (Mar. 10, 2022), <https://www.forbes.com.cdn.ampproject.org/c/s/www.forbes.com/sites/paultassi/2022/03/10/interest-in-nfts-and-the-metaverse-is-falling-fast/amp>.

¹⁹ Ryan Browne, *Trading in NFTs Spiked 21,000% to More than \$17 billion in 2021, Report Says*, CNBC (Mar. 10, 2022), <https://www.cnbc.com/2022/03/10/trading-in-nfts-spiked-21000percent-to-top-17-billion-in-2021-report.html>.

a brief background of blockchain related technology. Part III details recent market abuses, regulatory activity thus far, and how the famous Supreme Court decision in *SEC v. W.J. Howey Co.*²⁰ applies to NFTs and F-NFTs. Part IV details how attorneys should advise clients working in this space.

II. BACKGROUND

A. Securities

1. Statutory Definitions

Economic collapse incited Congress to enact laws and create an agency to regulate securities law.²¹ In the 1920's, a combination of easy-access credit and post-World-War-I optimism spurred U.S. market activity to outpace government regulation.²² Subsequently, half of the new \$50 billion offerings lost all value.²³ In response, Congress passed two Acts in the early 1930s designed to safeguard market participants from both companies issuing securities and brokers or exchanges trading securities.²⁴ Congress established the Securities and Exchange Commission ("SEC") in 1934 to coordinate compliance with the new Acts.²⁵

²⁰ *SEC v. W.J. Howey Co.*, 328 U.S. 293 (1946).

²¹ JAMES D. COX ET AL., *SECURITIES REGULATION* 49 (9th ed. 2020).

²² Annette L. Nazareth, Dir., Div. of Mkt. Reg. U.S. SEC, Speech by SEC Staff: "Come with Me to the SEC" (May 24, 2003) <https://www.sec.gov/news/speech/spch052403aln.htm>.

²³ *Id.*

²⁴ *Id.*

²⁵ *Id.*

The first of these Acts, the Federal Securities Act of 1933 (“’33 Act”), requires issuers of new securities in the public market to register the securities with the SEC. Registration is accomplished by filing a registration statement with the SEC that discloses certain information about the offeror.²⁶ The Securities Exchange Act of 1934 (“’34 Act”) gives the SEC the authority to regulate secondary markets dealing in securities after initial offerings. Markets such as the New York Stock Exchange (NYSE) or National Association of Securities Dealers Automated Quotations (NASDAQ) must comply with certain continuing obligations.²⁷

Congress provided many sweeping regulations to deter corruption in the securities markets; importantly, Congress provided a definition for a security. “Security” is defined by the ’33 Act at 15 U.S.C. § 77b(a)(1), the ’34 Act at 15 U.S.C. § 78c(a)(1), and numerous articles and cases.²⁸ The ’33 Act’s definition of “security” reads as follows:

The term “security” means any 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

²⁶ *Id.* at 6.

²⁷ COX, *supra* note 21, at 10.

²⁸ *See, e.g.*, 15 U.S.C. § 78c(a)(1); 15 U.S.C. § 77b(a)(1); Colesanti, *supra* note 12, at 11.

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, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing.²⁹

While each Act’s definition differs slightly, the U.S. Supreme Court has “treated [them] as essentially identical in meaning.”³⁰ Cryptocurrency is usually evaluated according to the “investment contract” (defined below) portion of these statutory definitions.³¹

Congress sought to provide a very broad meaning to contemplate the “countless and variable schemes devised by those who seek the use of

²⁹ 15 U.S.C. § 77b(a)(1); 15 U.S.C. § 78c(a)(1). For a table with a line-by-line comparison of each statute’s text, see J. Thomas Hannan & William E. Thomas, *The Importance of Economic Reality and Risk in Defining Federal Securities*, 25 HASTINGS L.J. 216, 221 n.13 (1974).

³⁰ SEC, William Hinman, *Digital Asset Transactions: When Howey Met Gary (Plastic)* (June 14, 2018), <https://www.sec.gov/news/speech/speech-hinman-061418>, no. 2 (quoting SEC v. Edwards, 540 U.S. 389, 393 (2004)) [hereinafter Hinman’s Speech].

³¹ Goforth, *supra* note 12, at 277.

the money of others on the promise of profits.”³² However, there are downsides to broad, functional definitions. Namely, functional definitions are often over-inclusive and indeterminate, thereby spurning market expansion where every participant would otherwise be better off.³³ These concerns are exacerbated in the NFT market, where the SEC once again attempts to “ . . . fit nascent, experimental business models into decades-old rules.”³⁴ Here, the decades-old rule in question derives from *Howey* and its progeny.

2. Howey

The now-famous *Howey* test came about when “Howey Company” and “Howey-in-the-Hills Service, Inc.” (collectively “Howey”), both under common control, offered an attractive investment opportunity.³⁵ Howey offered to sell real property and property management in tandem, such that buyers could purchase small portions of an orange grove and recover a commensurate portion of the entire orange grove’s profitability.³⁶ Those buyers depended entirely on the seller’s efforts to

³² *Reves v. Ernst & Young*, 494 U.S. 56, 61 (1990) (citing *SEC v. W. J. Howey Co.*, 328 U.S. 293, 299 (1946)).

³³ Guseva, *supra* note 12, at 636.

³⁴ Ori Oren, *ICO’s, DAO’s, and the SEC: A Partnership Solution Notes*, 2018 COLUM. BUS. L. REV. 617 at 621.

³⁵ *SEC v. W.J. Howey Co.*, 328 U.S. 293, 293–97 (1946).

³⁶ *Id.*

obtain returns on their investments. They could not elect to cultivate their sliver of property themselves.³⁷

The Court held that such an offering constituted an “investment contract” and fell within the purview of § 2(1) of the Securities Act.³⁸ The Court laid down the well-known four-part test for an investment contract. An investment contract is (1) an investment of money; (2) in a common enterprise; (3) with a reasonable expectation of profit; (4) to be derived from the entrepreneurial or managerial efforts of others.³⁹

The *Howey* test seeks to answer whether the transaction being evaluated is the type of capital-transaction that securities law is meant to cover. Thomas Hazen, in his treatise on securities law, provides as diverse a list as one can imagine: scotch whiskey, cosmetics, animal breeding programs, rabbits, recording contracts, and cryptocurrency, *inter alia*—all of which have been found to be securities under the ’33 and ’34 Acts.⁴⁰ A brief survey of the emerging technologies surrounding cryptocurrencies and other tokens may help illustrate why even the broad “investment contract” definition is insufficient to efficiently accommodate NFT transactions.

³⁷ *Id.* at 296.

³⁸ *Id.* at 300.

³⁹ SEC v. Edwards, 540 U.S. 389, 393 (2004); W.J. Howey Co., 328 U.S. at 301.

⁴⁰ THOMAS LEE HAZEN, THE LAW OF SECURITIES REGULATION, 38 (8th ed. 2021).

B. *Tokens*

A general understanding of the technology and its iterations is needed before discussing securities concerns specifically. While an in-depth discussion of blockchain related technology is beyond this Article's scope, an overview of cryptocurrency, NFTs, and the Metaverse is warranted.

1. Cryptocurrencies

The term "cryptocurrency" refers to digital assets that utilize a "decentralized ledger technology" to afford transactors intermediary-entity-free access between accounts.⁴¹ The blockchain serves as the "ledger" recording asset ownership.⁴² A blockchain consists of "blocks," where each block is ordered chronologically and contains processed batches of transactions.⁴³

These transactions occur between keyholders. The owner of cryptocurrency has a "private key," which allows that owner to access their cryptocurrency or to transfer the cryptocurrency to another person.⁴⁴ A "public key" is also generated when transactions occur, and that public

⁴¹ Dennis Chu, *Broker-Dealers for Virtual Currency: Regulating Cryptocurrency Wallets and Exchange Notes*, 118 COLUM. L. REV. 2323, 2326 (2018).

⁴² *Id.*

⁴³ Thomas L. Hazen, *Tulips, Oranges, Worms, and Coins – Virtual, Digital, or Crypto Currency and the Securities Laws*, 20 N.C. J. L. & TECH. 493, 496 (2018).

⁴⁴ Chu, *supra* note 41, at 2327.

key functions like an address and confirms the most recent transfer.⁴⁵ This reassures transferees their new purchase has not been transferred twice.⁴⁶

Bitcoin was the first cryptocurrency to capture popular attention.⁴⁷ In 2008, Bitcoin stepped into the market to provide an immutably transferable, intermediary-free currency.⁴⁸ Bitcoin provided a secure alternative to bank-facilitated payments.⁴⁹ Bitcoin accomplishes this by self-verifying—each transaction records and validates itself for the world to see.

Bitcoins are created by “mining,” which involves a “proof-of-work” validation system that pits network participants against one another to solve difficult algorithm-based problems.⁵⁰ Once someone solves that particular problem, the winner receives the Bitcoin and that transaction is recorded onto the blockchain.⁵¹ This initial recording is significant because

⁴⁵ Hazen, *supra* note 43, at 497.

⁴⁶ *Id.*

⁴⁷ See generally SATOSHI NAKAMOTO, BITCOIN: A PEER-TO-PEER ELECTRONIC CASH SYSTEM, <https://www.bitcoin.org/bitcoin.pdf> (introduces the concept of cryptocurrency).

⁴⁸ Jessica J. Patach, *Blockchain Technology in an Electronic Chattel Paper World, Reducing Transaction Costs and Limiting Fraud*, 54 CREIGHTON L. REV. 411, 422 (2021).

⁴⁹ Hazen, *supra* note 43, at 496. But see John Reed Stark, *10 Axioms that Crypto-Shills Don't Want You to Know*, LINKEDIN (Aug. 8, 2022), <https://www.linkedin.com/pulse/10-axioms-crypto-shills-dont-want-you-to-know-john-reed-stark/> (rebutting the most popular defenses of crypto, including its supposed security for transactors). However, whether cryptocurrency is valuable or feasible for society is beyond the scope of this article.

⁵⁰ Hazen, *supra* note 43, at 497–98.

⁵¹ *Id.*

it creates the new “block” and validates subsequent transactions of that bitcoin.⁵² The algorithm-solving process is called “mining,” and becomes increasingly more challenging as more Bitcoin are “mined.”⁵³ The increase in difficulty raises marginal cost at every new “block,” thereby creating forced scarcity and (purportedly) increasing each bitcoin’s value.⁵⁴

Players began entering the market following Bitcoin’s explosive popularity. New token creation and selling, “initial coin offerings” (“ICOs”)⁵⁵, were possible via the “Ethereum” (“Ether”) blockchain, a counterpart to Bitcoin.⁵⁶ Unlike Bitcoin, Ethereum and its affiliated currencies are gearing up to utilize “proof-of-stake” validation.⁵⁷ Proof-of-stake validation involves individuals “staking” their cryptocurrency as a

⁵² *Id.*

⁵³ Roe Sarel, *Property Rights in Cryptocurrencies: A Law and Economics Perspective*, 22 N.C. J. L. & TECH. 389, 398 (2021).

⁵⁴ For a helpful illustration of how each “block” builds upon previous blocks, see Patach, *supra* note 47 at 424 fig. 1.

⁵⁵ See Chris Prentice, *State Securities Regulators Order Virtual Casino Firm to Stop Selling NFTs*, REUTERS (Apr 13, 2022, 5:19 PM), <https://www.reuters.com/technology/state-securities-regulators-order-virtual-casino-firm-stop-selling-nfts-2022-04-13/>.

⁵⁶ Most new cryptocurrencies fail quickly, but market hazards are insufficient by themselves to place cryptocurrencies under securities law’s purview. See Hazen, *supra* note 43 at 510. However, market hazards accompanied by an absence of regulatory schemes argue in favor of securities classifications. See *id.*

⁵⁷ For a summary of how proof-of-stake operates, see E. Napoletano & Benjamin Curry, *Proof of Stake Explained*, FORBES ADVISOR (Apr. 8, 2022, 3:11pm), <https://www.forbes.com/advisor/investing/cryptocurrency/proof-of-stake/>. For a summary of Ethereum’s switch over from proof-of-work to proof-of-stake, see Amy Castor, *Why Ethereum is switching to proof of stake and how it will work*, MIT TECH. R. (Mar. 4, 2022), <https://www.technologyreview.com/2022/03/04/1046636/ethereum-blockchain-proof-of-stake/>.

sort of collateral for new blockchain entries.⁵⁸ In proof-of-work validation, competitors consume large amounts of energy to “solve” the increasingly challenging algorithms in order to add a block to the blockchain.⁵⁹ By contrast, proof-of-stake validation selects a “validator” to confirm that a new block of data comports with the rest of the blockchain.⁶⁰ Once that validator and a select number of validating “nodes” concur in the new block’s validity, the new block is added to the blockchain.⁶¹ Because of the amount of stake required, “cryptocurrency pooling” is a common way for individuals to put their otherwise inactive cryptocurrency to work under the validator’s discretion.⁶² In exchange for staking currency, the staker receives yields of between 5% to 14% of their staked holdings.⁶³ In this way, proof-of-stake incentivizes consumers like a bank paying interest while investing its account holders’ funds.

⁵⁸ Napoletano, *supra* note 57.

⁵⁹ Castor, *supra* note 57.

⁶⁰ For a concise but clear summary of the proof-of-stake steps, see DELTECBANK, *A Proof of Stake Explanation*, (Jul. 14, 2021), <https://www.deltecbank.com/2021/07/14/a-proof-of-stake-explanation/?locale=en>. This methodology of validation, known as “consensus protocols,” confirms among validators (or, “validation nodes”) that a new block ought be added. *Id.* If those validators validate an inaccurate or insecure new block, the cryptocurrency the validator “staked” is forfeit. *Id.*

⁶¹ DELTECBANK, *A Proof of Stake Explanation*, (Jul. 14, 2021), <https://www.deltecbank.com/2021/07/14/a-proof-of-stake-explanation/?locale=en>.

⁶² *What Is “Proof of Work” or “Proof of Stake”?*, COINBASE, <https://www.coinbase.com/learn/crypto-basics/what-is-proof-of-work-or-proof-of-stake>.

⁶³ Napoletano, *supra* note 57.

Some view Bitcoin as a security, but that conclusion is far from certain. One court has held that Bitcoin can qualify as a security,⁶⁴ but “[t]o the extent that it gains wide acceptance primarily as a unit of exchange, the likelihood of treating Bitcoin as an investment contract diminishes.”⁶⁵ While securities law questions vary based on the facts involved, Bitcoin and Ether are usually used as units of exchange rather than investment vehicles. Swaths of new “coins” necessitated exchanges to connect buyers and sellers, and this need led to the creation of “crypto exchanges.”⁶⁶ Crypto exchanges often provide dual functionality: stock-exchange-esque accessibility and “private key” storage in the form of digital “wallets.”⁶⁷

There are three general types of tokens in the market today: (1) utility tokens, (2) security tokens, and (3) currency tokens.⁶⁸ The first type, utility tokens, confer actual functions upon their holders—some examples include a membership card to an organization or ticket to an event.⁶⁹ The second type, security tokens, function more like debt or equity instruments.⁷⁰ Security tokens can confer voting rights, rights to dividends,

⁶⁴ SEC v. Shavers, No. 4:13-CV-416, 2013 WL 4028182, at *2 (E.D. Tex. 2013); See discussion *infra* Section III.D.1.

⁶⁵ HAZEN, *supra* note 40, at 48.

⁶⁶ Sarel, *supra* note 53, at 400.

⁶⁷ *Id.*

⁶⁸ *Id.* at 403.

⁶⁹ *Id.* at 403–404.

⁷⁰ *Id.* at 404.

or other financial benefits.⁷¹ The third type, currency tokens, function primarily as a means of purchasing goods or services.⁷² However, these three categories act only as general references—many tokens cross category lines and prove more challenging to identify. For example, some tokens might provide both access to a service and a right to receive revenue; such a token might qualify as both a utility token and a security token.⁷³

NFTs blend these domains. NFT transactions have both use and investment-like natures. The versatility of NFTs proves that they may not so easily fall into the supposedly all-encompassing *Howey* definition of a security.⁷⁴

2. NFTs

NFTs represent the most recent emerging asset class to challenge the SEC.⁷⁵ As observed by cryptocurrency commentators, fertile ground

⁷¹ *Id.*

⁷² Sarel, *supra* note 53, at 405 (Adopting cryptocurrency as a unit of exchange, especially a government-sanctioned unit of exchange, has significance in several legal fields); *see generally* Brian McCall, *Now You See It Now You Don't – How the UCC Amendments Will Undo Bitcoin's Brief Status as Money*, ALI ADVISER (Jul. 28, 2022), <https://www.thealiadviser.org/uniform-commercial-code/now-you-see-it-now-you-dont-how-the-ucc-amendments-will-undo-bitcoins-brief-status-as-money/>.

⁷³ Sarel, *supra* note 53, at 407.

⁷⁴ *See* HAZEN, *supra* note 40, at 48.

⁷⁵ NFTs: *Key U.S. Legal Considerations for an Emerging Asset Class*, JONES DAY (Apr. 2021), <https://www.jonesday.com/en/insights/2021/04/nfts-key-us-legal-considerations-for-an-emerging-asset-class>.

exists for fraud when innovation outpaces regulation.⁷⁶ At the very least, the current regulatory landscape ought to cause any practitioner working with clients in this market to feel that “navigating the securities laws in this area is perilous business.”⁷⁷ SEC Director Hinman clearly stated that “simply labeling a digital asset a ‘utility token’ does not turn the asset into something that is not a security.”⁷⁸ The question remains: should an NFT label transform that labeled item into something that *is* a security?

NFTs present a more challenging case than typical cryptocurrency ICOs. Ways in which NFTs are used vary widely, ranging from pure “consumption” in virtual video games to profit-sharing vehicles.⁷⁹ An NFT is a digital asset that is tied to or represents an object in the real world. That object may include art, music, pictures, or in-game items.⁸⁰ The process of associating a real-life object with an NFT is sometimes referred to as “tokenizing.”⁸¹ Virtually anything can be “tokenized.” This

⁷⁶ Goforth, *supra* note 10, at 645.

⁷⁷ SEC Commissioner Peirce expressed the above quoted sentiments regarding cryptocurrency more generally. *See* Hester M. Peirce, Comm’r, *How We Howey*, U.S. SEC. & EXCH. COMM’N (May 9, 2019), <https://www.sec.gov/news/speech/peirce-how-we-howey-050919> [hereinafter Peirce’s Speech].

⁷⁸ Hinman’s Speech, *supra* note 30.

⁷⁹ If people purchase merely for “consumption”, then it is unlikely that such a purchase satisfies the “investment” requirement from *Howey*. *See* discussion *infra* Section II.B.2.a.; *see, e.g.,* United Hous. Found. v. Forman, 421 U.S. 837, 858 (1975).

⁸⁰ Robyn Conti & John Schmidt, *What Is an NFT? Non-Fungible Tokens Explained*, FORBES ADVISOR, <https://www.forbes.com/advisor/investing/nft-non-fungible-token/> (last updated Apr. 8, 2022).

⁸¹ Joshua Caswell & Leigh E. Furtado, *NFTs for Estate Planners: Not Just a Token Concern*, 35 PROB. & PROP. 10, 12 (2021).

is not limited to “real-life items”; songs, in-game items, domain names, and event tickets can be “tokenized” as well.⁸²

NFTs offer a proof of ownership benefit that cause some to suggest that NFT “minting” will become a standard way of proving ownership of a company, a car, or even real property.⁸³ Resale “gas fees” provide creators with unique opportunities to obtain guaranteed, verifiable, and consistent licensing fees for each subsequent sale of any given NFT.⁸⁴ “Gas fees” function like ATM fees or credit card processing fees.⁸⁵ They also cost a minter small fees every time a new NFT is minted in order to offset the “computing energy . . . required to process a transaction on the Ethereum blockchain.”⁸⁶ In this way, they function to prevent “spamming” of NFT marketplaces.

NFTs are regularly purchased with cryptocurrency, especially Ethereum,⁸⁷ and NFT transactions can be stored on the Ethereum

⁸² *Non-Fungible Tokens (NFT)*, ETHEREUM.ORG, <https://ethereum.org/en/nft/> (last visited Mar. 17, 2022).

⁸³ *See generally id.*

⁸⁴ *Id.*

⁸⁵ *What are NFT Gas Fees? How to Calculate Your NFT Gas Fees Like a Pro*, ZIPMEX (Jan. 27, 2022), <https://zipmex.com/learn/what-are-gas-fees/>.

⁸⁶ *Id.*

⁸⁷ *Not Your Standard Orange Grove: Non-Fungible Tokens & Securities Laws*, KING & SPALDING, <https://www.kslaw.com/news-and-insights/not-your-standard-orange-grove-non-fungible-tokens-securities-laws> (last visited June 16, 2022); *see also* Connor Sephton, *Crypto Is No Longer Required to Buy NFTs on OpenSea*, COINMARKETCAP (Apr. 1, 2022), <https://coinmarketcap.com/alexandria/article/crypto-is-no-longer-required-to-buy-nfts-on-opensea> (explaining that OpenSea now permits NFT purchases with

blockchain.⁸⁸ Ordinarily, only one owner can own an NFT at a time. However, “fractionalizing” NFT ownership is possible, and this process implicates securities law more directly than unfractionalized NFT ownership.

a. NFT Functionalities

NFTs have a wide breadth of functionality; understandably, NFTs function similarly to cryptocurrencies as discussed above.⁸⁹ Of particular consequence are the various investment and fractionalization functionalities.⁹⁰ For example, one seller made headlines when it successfully auctioned a home linked with an NFT.⁹¹ There, Haven Real Estate Group sold the NFT for 210 Ether, which is the equivalent of \$653,000.⁹² That NFT ownership included ownership of an LLC, which in turn owned the real property.⁹³ Some herald such a model as the future

more accessible fiat payment methods like traditional debit and credit cards and Apple Pay).

⁸⁸ *Insider Trading Claims Arise, as the NFT Space Starts to Consolidate*, FASHION LAW, <https://www.thefashionlaw.com/insider-trading-claims-are-coming-as-nft-space-starts-to-consolidate/> (last visited Mar. 16, 2022).

⁸⁹ *Non-Fungible tokens (NFT)*, *supra* note 82; *See supra* Section II.B.1.

⁹⁰ *Non-Fungible tokens (NFT)*, *supra* note 82.

⁹¹ Marco Quiroz-Gutierrez, *Someone Just Bought a Florida Home for \$653,000 Through an NFT Sale*, FORTUNE (Feb. 12, 2022, 5:17 PM), <https://fortune.com/2022/02/12/nft-florida-home-sale-ether-crypto/>.

⁹² *Id.*

⁹³ *Id.*

of real estate buying and selling.⁹⁴ Haven's real estate agents are already in the process of getting "crypto-certified" to capitalize on the anticipated shift to NFT-linked real property sales.⁹⁵

Additional functionalities further cloud NFT classifications, with most being "static," but others being "dynamic" (dNFT) or "generative."⁹⁶ DNFTs include an NFT created by interactions between the artist and some form of artificial intelligence.⁹⁷ With dNFTs, some artists may upload the algorithms responsible for generating portions of the NFTs, thereby allowing the eventual purchaser to make modifications that will influence the end-product.⁹⁸ DNFTs have certain links built into their smart contracts that enable modification long after it is minted.⁹⁹ A common use case for dNFTs are blockchain-based gaming, where a player's "stats" may change during progression through various challenges.

⁹⁴ Meagan Miller, *Auctioning Homes as NFTs Could Be the Future of Homebuying*, ABC 7 (Mar. 3, 2022, 11:48 pm), <https://abc-7.com/news/cover-story/2022/03/01/auctioning-homes-as-nfts-could-be-the-future-of-homebuying/>.

⁹⁵ *Id.*

⁹⁶ Paola Demichelis, *Beatles, Brands and Blockchain: What Is Possible with the Next Generation of NFTs?*, DRUM (Apr. 13, 2022), <https://www.thedrum.com/opinion/2022/04/13/beatles-brands-and-blockchain-what-possible-with-the-next-generation-nfts>.

⁹⁷ *Id.*

⁹⁸ *Id.*

⁹⁹ *Id.*

However, attorneys ought to heed another interesting dNFT use: a dNFT representing and used to sell real property might update after every sale with the type of information a title examiner or surveyor would need.¹⁰⁰ These are only a few of the myriad potential dNFT uses.¹⁰¹ Regulators need to provide preemptive guidance. As expected due to the complex nature of crypto transactions, treating crypto the same in all cases would be ill advised.¹⁰²

It is easy to imagine ways NFT-linked real property sales could shift into transactions that implicate securities law. For example, fractionalizing those NFTs and appointing another party to manage the property would yield something that looks *Howey*-esque. Indeed, the LABS Group raised \$3,650,000 for its upcoming Kunang Glamping Resort.¹⁰³ The LABS Group touts this project as the “world's first-ever community-owned project fractionalized into Rewarding Timeshare (RTS) NFTs.”¹⁰⁴ RTS NFT purchasers also get “staying rights,” which appear to function

¹⁰⁰ See *infra* Section II.B.2.a.; see *What Is a Dynamic NFT?*, CHAINLINK (Apr. 7, 2022), <https://blog.chain.link/what-is-a-dynamic-nft/>.

¹⁰¹ See generally *16 Ways to Create Dynamic Non-Fungible Tokens (NFT) Using Chainlink Oracles*, CHAINLINK (June 19, 2020), <https://blog.chain.link/create-dynamic-nfts-using-chainlink-oracles/>.

¹⁰² Goforth, *supra* note 12, at 279.

¹⁰³ LABS Group, *LABS Group: The World's First Resort NFT Successfully Raised \$3,650,000 – Live Auction is on 26th July*, TAIWAN NEWS (Jul. 26, 2021), <https://www.taiwannews.com.tw/en/news/4258286>.

¹⁰⁴ *Id.*

like a timeshare.¹⁰⁵ Included with those rights are transportation and discounts on food and drink purchases.¹⁰⁶

NFTs can function as a traditional crowd-funding vehicle, à la Patreon or GoFundMe.¹⁰⁷ Interestingly, the Ukrainian government has initiated talks with a designer to sell its own NFT collection—although, Ukraine’s motivation arises out of war-time financial straits caused by the ongoing Russian aggression.¹⁰⁸ As of April 1, 2022, the Ukrainian government has raised more than \$600,000 through sales of its NFT offerings.¹⁰⁹ These NFT sales represent only a small portion of the total crypto-related donations the government has received, which amount to over \$70 million worth of crypto donations and hundreds of NFTs. Curiously, and related to the focus of this Article, the Ukrainian government plans to auction artwork for which only Ukraine-issued NFT owners may bid.¹¹⁰

¹⁰⁵ *Id.*

¹⁰⁶ *Id.*

¹⁰⁷ Brownstein Hyatt Farber Schreck, *NFTs—The Next Crowdfunding?* JDSUPRA (Jan. 21, 2022), <https://www.jdsupra.com/legalnews/nfts-the-next-crowdfunding-5580146/>.

¹⁰⁸ Abram Brown, *Exclusive: Inside the Ukrainian Government’s NFT Sale—And The 3 Young Entrepreneurs Who Helped Create It*, FORBES (Mar. 26, 2022), <https://www.forbes.com/sites/abrambrown/2022/03/26/exclusive-inside-the-ukrainian-governments-nft-sale-and-the-3-young-entrepreneurs-who-helped-create-it/?sh=4f33ddc2ea6a> (last visited Apr. 5, 2022).

¹⁰⁹ Olga Kharif, *Ukraine Raises \$600,000 Through Museum NFT Sales to Help Rebuild*, BLOOMBERG (Apr. 1, 2022), <https://www.bloomberg.com/news/articles/2022-04-01/ukrainian-government-raises-600-000-through-museum-nft-sales> (last visited Apr. 5, 2022).

¹¹⁰ *Id.*

Sometimes, NFTs function simply to declare affiliation, interest, or engagement with events or culture.¹¹¹ For example, within 24 hours of the now infamous “Will Smith Slap,” an NFT collection bearing that same name listed NFTs for up to \$296,452.79 and had 721 owners.¹¹² Other individuals purchase NFTs strictly as an investment vehicle. Analysts paying attention to the NFT space have even developed volatility classifications, calling certain NFTs “Blue Chip” if they are sufficiently non-volatile.¹¹³ Somewhat humorously for this Article’s purposes, Securities.io published an article titled “Top 8 Upcoming NFTs to Buy Before they Blow Up,” guiding its readers to the NFT collections it deemed most lucrative.¹¹⁴ Sometimes shockingly disappointing results follow. Sina Estavi purchased an NFT of a tweet for almost \$3 million and

¹¹¹ Deborah Lynn Blumberg, *NFTs Can Transform Loyalty: Here Are 6 Things Brands Should Know*, MASTERCARD: NEWSROOM (Apr. 14, 2022), <https://www.mastercard.com/news/perspectives/2022/blockchain-nfts-and-brand-loyalty/>.

¹¹² Karandeep Oberoi, *OpenSea Has a ‘Will Smith Slap’ NFT Collection with 721 Owners Already*, MOBILESYRUP (Mar. 28, 2022), <https://mobilesyrup.com/2022/03/28/opensea-will-smith-slap-nft-collection/> (last visited Mar. 28, 2022). See *Will Smith Slap Dao*, OPENSEA <https://opensea.io/collection/will-smith-oscar-slap-dao> (last visited Mar. 28, 2022).

¹¹³ Ornella Hernandez, *Blue Chip and Metaverse NFTs Propel Growth of NFT Market, says Nansen report*, COINTELEGRAPH (Apr. 11, 2022), <https://cointelegraph.com/news/blue-chip-and-metaverse-nfts-propel-growth-of-nft-market-says-nansen-report>.

¹¹⁴ Ali Raza, *Top 8 Upcoming NFTs to Buy Before They Blow Up*, SECURITIES.IO (Apr. 9, 2022), <https://www.securities.io/top-8-upcoming-nfts-to-buy-before-they-blow-up/>.

put it up for auction the following year, but he received a high bid of only \$3,600.¹¹⁵

Another example of NFTs' multifunctionality is Cloud Yachts. Cloud Yachts has blurred the line between NFTs as a consumable experience and an investment opportunity. It experimented with an NFT that "represents a contract for the build" of custom luxury yachts.¹¹⁶ But, perhaps unsurprisingly, these yachts are (1) Metaverse internal,¹¹⁷ and (2) linked with other benefits such as luxury yacht club membership.¹¹⁸ Cloud Yachts' maiden sale brought in a hefty \$12 million.¹¹⁹

Given the wide swath of potential uses for NFTs, it is little wonder that the SEC is hesitant to shoot from the hip when providing guidance for the public market. However, the enormous amount of damage that abusers can do in the NFT market, and that market is projected to increase

¹¹⁵ Luke Plunkett, *Guy Buys NFT for \$2.9 Million, Asks for \$48 Million, Is Offered \$3600*, KOTAKU (Apr. 14, 2022), <https://kotaku.com.cdn.ampproject.org/c/s/kotaku.com/nft-jack-dorsey-sale-auction-sina-estavi-iran-prison-cr-1848791322/amp>.

¹¹⁶ Micah, *First Superyacht Sold as an NFT for \$12M*, NFT EVENING, <https://nftevening.com/first-superyacht-sold-as-an-nft-for-12m/> (last visited Apr. 17, 2022).

¹¹⁷ The Metaverse is discussed in detail *infra* section II.C.

¹¹⁸ CLOUD YACHTS, <https://cloudyachts.io/> (last visited Apr. 17, 2022). *See also* CloudYachts, OPENSEA, <https://opensea.io/cloudyachts> (last visited Apr. 17, 2022).

¹¹⁹ Micah, *supra* note 116.

by a factor of 1,000 in the next 10 years, requires more proactive regulation.¹²⁰

b. Legal Issues with NFTs

NFTs implicate numerous areas of law. Many of these areas overlap to create a precarious mire of potential liabilities that may befall creators and exchanges.

NFTs represent new departures from the trademark law paradigm—digital and physical production of works continuing to separate “has potentially destabilizing consequences for trademark law, which overwhelmingly has been oriented toward indications of the origin of physical goods.”¹²¹ *Hermès International v. Mason Rothschild*, currently pending in court in New York, involves a trademark infringement and dilution allegation brought by Hermès against Rothschild, who made over \$1 million from selling Birkin-trademark-bearing NFTs.¹²² It is unclear whether consumers ought to presume a mark-bearing NFT’s source is the

¹²⁰ Luke Lango, *Why the NFT Market Could Really Grow by 1,000X*, NASDAQ (Sep. 5, 2021), <https://www.nasdaq.com/articles/why-the-nft-market-could-really-grow-by-1000x-2021-09-05>.

¹²¹ Mark P. McKenna & Lucas S. Osborn, *Trademarks and Digital Goods*, 92 NOTRE DAME L. REV. 1425, 1428 (2017).

¹²² Deborah M. Lodge & Shyloah Daniel, *NFTs: New Frontiers for Trademarks*, THE NATIONAL LAW REVIEW (Mar. 18, 2022), <https://www.natlawreview.com/article/nfts-new-frontiers-trademarks>.

mark-holder, but that presumption may shift as more brands register in NFT and Metaverse trademark classes.¹²³

The purchases themselves do not include the underlying copyright rights to the images associated therewith,¹²⁴ a fact that continues to befuddle some NFT purchasers.¹²⁵ However, contrary to the default state and practice, the Bored Ape Yacht Club (“BAYC”) NFT creators, Yuga Labs, provides broad rights for each BAYC NFT purchaser.¹²⁶ These rights include the right to make derivative works based on the BAYC images associated with each NFT¹²⁷—a right that some have monetized by “licensing” their NFT to other consumers.¹²⁸

¹²³ Kyle Jahner, *Nike NFT Suit Tests ‘New Frontier’ of IP Law In The Metaverse*, BLOOMBERG LAW (Apr. 19, 2022, 5:10 AM), <https://news.bloomberglaw.com/ip-law/nike-nft-suit-tests-new-frontier-of-ip-law-in-the-metaverse>.

¹²⁴ Gregory J. Chinlund & Kelley S. Gordon, *What are the copyright implications of NFTs?*, REUTERS (Oct. 29, 2021, 11:41 AM), <https://www.reuters.com/legal/transactional/what-are-copyright-implications-nfts-2021-10-29/>.

¹²⁵ Ghaith Mahmood, *NFTs: What Are You Buying and What Do You Actually Own?*, THE FASHION LAW (Mar. 18, 2021), <https://www.thefashionlaw.com/nfts-what-are-you-buying-and-what-do-you-actually-own/>. For a wonderful discussion of more nuanced copyright implications of NFTs, see Jake L. Bryant, *Dancing in the Dark: Exploring the Collision of Copyright with NFTs & the Works They Represent*, 17 LIBERTY U. L. REV. 69 (2022).

¹²⁶ Wai L. Choy & Kyle C. Hansen, *Roots of Confusion Over “v1” CryptoPunks NFTs Raise Key Copyright and Practical Considerations for NFT Minters, Acquirers and Platform Operators*, NAT’L L. REV. (Mar. 28, 2022), <https://www.natlawreview.com/cdn.ampproject.org/c/s/www.natlawreview.com/article/roots-confusion-over-v1-cryptopunks-nfts-raise-key-copyright-and-practical?amp>.

¹²⁷ *Id.*

¹²⁸ Brian Quarmby, *Hundreds of Bored Ape Owners Sign Up to Hire out Their NFTs to Brands*, COINTELEGRAPH (Jul. 1, 2022), <https://cointelegraph.com/cdn.ampproject.org/c/s/cointelegraph.com/news/hundreds-of-bored-ape-owners-sign-up-to-hire-out-their-nfts-to-brands/amp>.

NFTs pose problems for the IRS as well. Cryptocurrencies are taxed as capital assets, but few NFT purchasers understand that they are required to report capital gains on appreciated crypto value upon sale of an NFT.¹²⁹ IRS Commissioner Chuck Rettig showed the IRS's cognizance of this, saying that NFTs might become widespread vehicles for tax evasion absent proactive policing.¹³⁰ NFT valuation is challenging enough without including keeping up with the underlying cryptocurrency used to purchase that NFT.¹³¹

Others have examined the business formation and contract drafting implications for NFT-related enterprises.¹³² Using the *Robotos* NFT project, one law firm discussed the potential importance of forming separate entities for different NFT projects and documenting the roles of all parties involved.¹³³

¹²⁹ Robert Frank, *IRS Is Probing the Dark Web to Look for Cryptocurrency and NFT Tax Evasion, Says IRS Commissioner*, CNBC (Apr. 14, 2021), <https://www.cnbc.com/2021/04/14/irs-is-probing-the-dark-web-to-look-for-cryptocurrency-nft-tax-evasion.html>.

¹³⁰ Kelli Maria Korducki, *NFTs Are Proof That Tax Season Can Always Get Worse*, ATLANTIC (Apr. 12, 2022), <https://www.theatlantic.com/technology/archive/2022/04/file-taxes-nft-irs-guidelines/629542/>.

¹³¹ See generally THE NFT TAX GUIDE, <https://www.nfttaxguide.com/> (last visited Apr. 12, 2022).

¹³² See, e.g., Moish E. Peltz et al., *From the Discord Server to the Courthouse: Lessons Learned from Early NFT Lawsuits*, FALCON RAPPAPORT & BERKMAN PLLC (Mar. 25, 2022), <https://frblaw.com/2022/03/25/from-the-discord-server-to-the-courthouse-lessons-learned-from-early-nft-lawsuits/>.

¹³³ *Id.*

NFTs also pose problems for securities law. Whether and when NFTs function as securities has puzzled the SEC—a question that usually results in the answer, “they *might* be.”¹³⁴ In anticipation of greater SEC scrutiny,¹³⁵ National Law Review published a brief article detailing three broad scenarios in which NFTs may implicate securities law: (1) fractionalization; (2) when NFTs represent a right to revenue stream; and (3) pre-sale of NFTs that have no current use.¹³⁶ The first category, fractionalization, is at the center of the debate over whether NFTs are a security.¹³⁷

c. Fractionalized NFTs as a Legally Significant Sub-species

NFTs can be “fractionalized” (F-NFTs).¹³⁸ NFTs usually use the ERC-721 Ethereum standard, which can be “locked” into a “smart

¹³⁴ See, e.g., Hinman’s Speech, *supra* note 30; Gary Gensler, Chairman, SEC, Prepared Remarks of Gary Gensler On Crypto Markets Penn Law Capital Markets Association Annual Conference (Apr. 4, 2022), https://www.sec.gov/news/speech/gensler-remarks-crypto-markets-040422#_ftn3 [hereinafter Gensler’s Speech]; Peirce’s Speech, *supra* note 77.

¹³⁵ Clint Rainey, *Report: SEC Has Its Eyes on NFTs, Probing If Some Tokens Are Illegal Securities*, FASTCOMPANY (Mar. 4, 2022), <https://www.fastcompany.com/90727504/report-sec-has-its-eyes-on-nfts-probing-if-some-tokens-are-illegal-securities><https://www.fastcompany.com/90727504/report-sec-has-its-eyes-on-nfts-probing-if-some-tokens-are-illegal-securities> (last visited Apr. 5, 2022).

¹³⁶ *SEC Targets NFTs*, NAT’L L. REV. (Mar. 3, 2022), <https://www.natlawreview.com/article/sec-targets-nfts>, (last visited Apr. 5, 2022).

¹³⁷ *Id.*

¹³⁸ Akash Takyar, *What is a Fractional NFT?*, LEEWAY HERTZ, <https://www.leewayhertz.com/fractional-nft/> (last visited Apr. 20, 2022).

contract” and split the ERC-721 token into several ERC-20 tokens per the instructions drafted into that smart contract.¹³⁹ Fractionalizing NFTs provides minters the opportunity to expedite high-cost NFT sales by dividing it into subparts and enabling multiple purchasers to buy in.¹⁴⁰ Should a minter want to “reconstitute” an F-NFT into a whole NFT, the minter can draft a “buyout auction” reserve price as well, which functions like a tender offer to ensure the end-purchaser owns 100% of the NFT.¹⁴¹

Fractionalization is not new, nor is the SEC ignorant of its securities implications.¹⁴² Indeed, the first judicial interpretation of the statutory security definition involved fractional undivided interests in oil.¹⁴³

SEC Commissioner Hester Peirce specifically addressed NFTs in a discussion with Yahoo Finance, stating that “[w]hether it’s people who are fractionalized in NFTs and selling pieces of them or other types of financialization of NFTs, it’s something that we should be thinking about again and again[.]”¹⁴⁴ One consumer-oriented website explains fractional

¹³⁹ *Id.*

¹⁴⁰ *Id.*

¹⁴¹ *Id.*

¹⁴² *See, e.g., SEC v. C.M. Joiner Leasing Corp.*, 320 U.S. 344 (1943).

¹⁴³ *Id.* at 351–52.

¹⁴⁴ Jennifer Schonberger, *Crypto Regulation Is Coming, Just Not This Year: SEC’s Peirce*, YAHOO! FINANCE (Feb. 3, 2022), <https://finance.yahoo.com/news/crypto-regulation-coming-just-not-this-year-se-cs-pierce-172824069.html>.

ownership NFTs as a relatively innocuous arrangement where one might “become a shareholder in a Picasso NFT, meaning you would have a say in things like revenue sharing.”¹⁴⁵ Such a description, however, should ring warning bells in a securities attorney’s ears.

d. Digital Forums

The Metaverse is the vehicle by which NFTs and F-NFTs will become “household goods” in the coming years.¹⁴⁶ As such, the Metaverse warrants its own brief discussion.

The Metaverse is a virtual environment, like any number of video games in which its players can purchase items, build things, and interact with others.¹⁴⁷ Saying something exists “on the Metaverse” is comparable to saying something exists “on the Internet”—there may be certain servers or systems that facilitate activity, but the consumer’s interaction rarely is concerned about such specifics.¹⁴⁸ However, the Metaverse evades a concrete analogy, as it will probably develop more like early-internet

¹⁴⁵ *Non-fungible tokens (NFT)*, *supra* note 82.

¹⁴⁶ *See generally* Takyar, *supra* note 138.

¹⁴⁷ Mike Snider & Brett Molina, *Everyone Wants to Own the Metaverse Including Facebook and Microsoft. But What Exactly Is It?*, USA TODAY (Nov. 10, 2021, 5:54 AM), <https://www.usatoday.com/story/tech/2021/11/10/metaverse-what-is-it-explained-facebook-microsoft-meta-vr/6337635001/>.

¹⁴⁸ Eric Ravenscraft, *What Is the Metaverse, Exactly?*, WIRED (Apr. 25, 2022, 7:00 AM), <https://www.wired.com/story/what-is-the-metaverse/>.

instant messengers vying for market dominance.¹⁴⁹ Eventually, those disparate platforms developed into agreed-upon protocols and compatible technology that developers use to provide competing *ecosystems*.¹⁵⁰ Businesses can sell products, buy storefronts and “real estate,” invite in customers, and provide environments for socialization and business, all within the digital space made possible by virtual reality and the blockchain.¹⁵¹ “Metaverses” are by no means a new concept, but 2022 saw the most effective centralized effort to manifest ideas that have appealed to consumers for decades.¹⁵²

The widely publicized Metaverse and its NFT integration will likely transform NFTs and their sales into household transactions. “NFT is the product—it’s the *what*,” says Olivier Moingeon, NFT company Exclusible’s CCO, “and metaverse is the *how* and *where*”¹⁵³ One NFT exchange, Portion, showed its confidence in the Metaverse when it

¹⁴⁹ Andrew Morse & Scott Stein, *The Metaverse Is on the Way: Here’s What You Need to Know*, CNET (Mar. 27, 2022, 7:16 AM), <https://www.cnet.com/tech/services-and-software/the-metaverse-is-on-the-way-heres-what-you-need-to-know/>.

¹⁵⁰ *Id.*

¹⁵¹ *Id.*

¹⁵² Ashleigh Hollowell, *Why the Metaverse Must Be Open But Regulated*, VENTUREBEAT (Jan. 26, 2022, 6:00 AM), <https://venturebeat.com/2022/01/26/why-the-metaverse-must-be-open-but-regulated/>.

¹⁵³ Reethu Ravi, *How Exclusible Is Bringing Luxury to the Metaverse*, NFT EVENING (Jan. 31, 2023), <https://nftevening.com/how-exclusible-is-bringing-luxury-to-the-metaverse/>.

purchased a digital “52-parcel plot” of land for \$1.25 million.¹⁵⁴ Portion plans on operating a virtual NFT store, claiming that the plot’s proximity to the “center of Decentraland [, one development in the Metaverse]”¹⁵⁵ justifies the high price tag.¹⁵⁶

Utilizing already owned hardware, like an Oculus headset, provides new users easy access to the Metaverse with relatively low entry costs.¹⁵⁷ Further, while pre-pandemic producers may have doubted consumers’ interest in walking around virtual environments to socialize, COVID-19-mandated quarantine showed businesses how much consumers enjoy virtual worlds and purchases therein.¹⁵⁸ The Metaverse and its NFT utilization, paired with blockchain-based internet’s

¹⁵⁴ Yaël Bizouati-Kennedy, *NFT Auction House Drops \$1.25 Million on Metaverse Property*, GOBANKINGRATES (Feb. 17, 2022), https://www.gobankingrates.com/investing/crypto/nft-auction-house-drops-1-25-million-on-metaverse-property/?utm_campaign=1158344&utm_source=yahoo.com&utm_content=6&utm_medium=rss.

¹⁵⁵ *Id.*

¹⁵⁶ *Id.*; see also Mario Gabriele, *Decentraland: The Metaverse’s Early Mover*, THE GENERALIST (Jan. 9, 2022), <https://www.readthegeneralist.com/briefing/decentraland>. But see Jürgen Geuter, LINKEDIN, https://www.linkedin.com/posts/tante_innovation-metaverse-web3-activity-6948955427543912448-FGM9/?utm_source=linkedin_share&utm_medium=ios_app (last visited Feb. 6, 2023) (responding with skepticism to digital-real-estate assessments that liken the value-add of “location” in the Metaverse to shorter/more memorable URLs being more expensive).

¹⁵⁷ Steven Kovach, *How the Metaverse Won Christmas*, CNBC (Dec. 27, 2021, 3:12 PM), <https://www.cnbc.com/2021/12/27/metaverse-oculus-virtual-reality-headsets-were-a-popular-holiday-gift.html>.

¹⁵⁸ Joanna E. Lewis et al., *New Social Horizons: Anxiety, Isolation, and Animal Crossing During the COVID-19 Pandemic*, FRONTIERS IN VIRTUAL REALITY, Mar. 30, 2021, at 1, 1, 2 (2021).

(“Web3”)¹⁵⁹ impending impact on the market, means that attorneys with clients anywhere close to the technological cutting edge need to equip themselves for entry into this rapidly expanding market space.

Industry leaders are heading to the Metaverse in droves; preemptive trademark registrations for Metaverse internal marks signal their approach.¹⁶⁰ Each company's choice to engage lends an air of legitimacy to what some call merely a scam¹⁶¹ or worse.¹⁶² These entrants

¹⁵⁹ “Web3” or “Web 3.0” represents the newest iteration of the internet. Web 1.0 included early HTML-only internet efforts and Web 2.0 signified developments into user-generated content and interaction, while Web 3.0 includes blockchain innovations and decentralization. See *Web 3.0 Explained, Plus the History of Web 1.0 and 2.0*, INVESTOPEDIA (Oct. 23, 2022), <https://www.investopedia.com/web-20-web-30-5208698>.

¹⁶⁰ Brittany Hainzinger, *NFT Trademark Applications Soar*, APP DEV. MAG. (Mar. 14, 2022), <https://appdeveloper-magazine-com.cdn.ampproject.org/c/s/appdeveloper-magazine.com/nft-trademark-applications-soar/amp/>.

¹⁶¹ Mohamad Hakim, *The (Current) Metaverse Is a Scam*, MEDIUM (Jan. 4, 2022), <https://medium.com/coinmonks/the-current-metaverse-is-a-scam-b577a8b29161>.

¹⁶² Wes Fenlon, *The Metaverse Is Bullshit*, PC GAMER (Oct. 29, 2021), <https://www.pcgamer.com/the-metaverse-is-bullshit/>.

include giants like Chevron,¹⁶³ McDonald's,¹⁶⁴ Skechers,¹⁶⁵ Nike,¹⁶⁶ Walmart,¹⁶⁷ Monster Energy,¹⁶⁸ the NBA,¹⁶⁹ Mastercard,¹⁷⁰ UPS,¹⁷¹ and JPMorgan.¹⁷² Universities are jumping on board, taking "virtual learning"

¹⁶³ Ana Nicenko, *Energy Giant Chevron Files for NFT and Metaverse-Related Trademarks*, FINBOLD (Mar. 7, 2022), <https://finbold.com/energy-giant-chevron-files-for-nft-and-metaverse-related-trademarks/>.

¹⁶⁴ Mason Bissada, *McDonald's Files Trademark for Metaverse-Based 'Virtual Restaurant'*, FORBES (Feb. 9, 2022, 5:43 PM), <https://www.forbes.com/sites/masonbissada/2022/02/09/mcdonalds-files-trademark-for-metaverse-based-virtual-restaurant/>; *see also* Kelly Main, *McDonald's Discovers the Golden Ticket to Making Money in the Metaverse*, INC. (Feb. 15, 2022), <https://www.inc.com/kelly-main/mcdonalds-discovers-golden-ticket-to-making-billions-in-metaverse.html>.

¹⁶⁵ Randall Williams, *Skechers Shapes Up the Metaverse*, BOARDROOM (Feb. 2, 2022), <https://boardroom.tv/skechers-metaverse-trademarks/>.

¹⁶⁶ Jessica Golden, *Nike Is Quietly Preparing for the Metaverse*, CNBC (Nov. 2, 2021, 8:31 PM), <https://www.cnbc.com/2021/11/02/nike-is-quietly-preparing-for-the-metaverse.html>.

¹⁶⁷ Lauren Thomas, *Walmart Is Quietly Preparing to Enter the Metaverse*, CNBC (Jan. 18, 2022, 9:52 AM), <https://www.cnbc.com/2022/01/16/walmart-is-quietly-preparing-to-enter-the-metaverse.html>.

¹⁶⁸ Justinas Baltrusaitis, *Monster Energy Files for Four NFT and Metaverse Trademarks*, FINBOLD (Feb. 24, 2022), https://finbold.com/monster-energy-files-for-four-nft-and-metaverse-trademarks/?related_post.

¹⁶⁹ Sam Dunn, *NBA Signals New NFT Plans With 'The Association'*, BOARDROOM (Apr. 14, 2022), <https://boardroom-tv.cdn.ampproject.org/c/s/boardroom.tv/nba-the-association-nft/amp/>.

¹⁷⁰ Ornella Hernández, *Mastercard Files 15 Metaverse and NFT Related Trademarks*, COINTELEGRAPH, <https://cointelegraph.com.cdn.ampproject.org/c/s/cointelegraph.com/news/mastercard-files-15-metaverse-and-nft-related-trademarks/amp>.

¹⁷¹ U.S. Trademark Application Serial No. 97347016 (filed Apr. 5, 2022); U.S. Trademark Application Serial No. 97347020 (filed Apr. 5, 2022); U.S. Trademark Application Serial No. 97347006 (filed Apr. 5, 2022); U.S. Trademark Application Serial No. 97347013 (filed Apr. 5, 2022).

¹⁷² Yvonne Lau, *JPMorgan Bets Metaverse Is a \$1 Trillion Yearly Opportunity as It Becomes First Bank to Open in Virtual World*, FORTUNE (Feb. 16, 2022, 12:35 PM), <https://fortune.com/2022/02/16/jpmorgan-first-bank-join-metaverse/>; Ron Shevlin, *JPMorgan Opens a Bank Branch in the Metaverse (But It's Not What You Think It's For)*, FORBES (Feb. 16, 2022, 12:00 PM), <https://www.forbes.com/sites/ronshevlin/2022/02/16/jpmorgan-opens-a-bank-branch-in-the-metaverse-but-its-not-for-what-you-think-its-for/?sh=45e29e5e158d>.

even further than what the Covid-19-era required by starting “digital twin campuses” so students can learn inside the Metaverse.¹⁷³ Even attorneys floundering to advise NFT/Metaverse clients could follow Arent Fox’s example and open a law firm office in the Metaverse.¹⁷⁴

JPMorgan projects that the Metaverse will be a \$1 trillion market opportunity in the coming years, which prompted it to open the first virtual bank location in “Decentraland.”¹⁷⁵ Commentators are optimistic about the Metaverse’s future, partly because of the moves companies are making to register Metaverse-related trademarks and hire Metaverse-focused executives.¹⁷⁶ Many registrants may encounter resistance from the United States Patent and Trademark Office, however, as Metaverse/NFT trademarks force examiners to adapt the Trademark Manual of Examination Procedure to ill-fitting specimens.¹⁷⁷

¹⁷³ Sam Sprigg, *VictoryXR Announces Ten ‘Metaversities’ to Launch in the US this Fall*, AUGANIX (Apr. 6, 2022), <https://www.auganix.org/victoryxr-announces-ten-metaversities-to-launch-in-the-us-this-fall/>.

¹⁷⁴ Debra Cassens Weiss, *Major Law Firm Buys Property in the Metaverse and Opens Virtual Office*, ABA J. (Feb. 17, 2022, 9:38 AM), <https://www.abajournal.com/news/article/major-law-firm-buys-property-in-the-metaverse-and-opens-virtual-office>.

¹⁷⁵ Lau, *supra* note 172.

¹⁷⁶ See Hannah M. Mayer, *The Future of The Metaverse: What 2022 Has in Store for the Immersive Digital World*, FORBES (Jan. 24, 2022, 3:26 AM), <https://www.forbes.com/sites/hannahmayer/2022/01/24/the-future-of-the-metaverse-what-2022-has-in-store-for-the-immersive-digital-world/?sh=26b248be335a>.

¹⁷⁷ See *generally Bored Ape Yacht Club Trademark App Sheds Light for Brands*, THE FASHION LAW (Apr. 1, 2022), <https://www.thefashionlaw.com/bored-ape-yacht-club-bayc-trademark-application-sheds-light-for-brands/> (discussing the difficulty faced by NFT offerors to present acceptable specimens of use if their proposed classes include things

NFTs will serve as the backbone of Metaverse functionality. Individual avatars, “real estate,” and all sorts of virtual items are all represented and sold by NFTs.¹⁷⁸

III. PROBLEM

a. Abuses In the Market

The SEC has provided insufficient guidance for NFT issuers and exchanges, resulting in a plethora of abuses. NFTs and NFT consumers are susceptible to the types of abuses that prompted increased securities regulation in the '33 and '34 Acts, such as insider trading and wash trading.¹⁷⁹ Several high-profile examples of abuse have cast a “black cloud over the NFT market . . . [B]ad actors have clearly taken the bloom off the rose.”¹⁸⁰

like “maintain[ing] and record[ing] ownership of digital illustrations represented by non-fungible tokens. . .”).

¹⁷⁸ Oleg Fonarov, *What Is the Role of NFTs in the Metaverse?*, FORBES (Mar. 11, 2022, 8:45 AM), <https://www.forbes.com/sites/forbestechcouncil/2022/03/11/what-is-the-role-of-nfts-in-the-metaverse/?sh=3827a02b6bb8>.

¹⁷⁹ Dan Patterson, *New Tech, Old Scams: Don't Fall for These Crypto and NFT Ripoffs*, CBS NEWS (Mar. 23, 2022, 12:44 PM), <https://www.cbsnews.com/news/cryptocurrency-nft-scams/>.

¹⁸⁰ *Id.*

On February 4, 2022, Reuters reported that “the Department of Justice has yet to bring a criminal case involving NFT markets, but that will change.”¹⁸¹ Reuters further reported that “[i]n the wake of reports about insider trading in NFT marketplaces, manipulation of NFT prices, and NFT creators embezzling funds, the DOJ [was] likely already looking for opportunities to bring prosecutions in [NFT spaces].”¹⁸² The DOJ filed a criminal complaint against the “Frosties” offerors only a month later.¹⁸³ As a result, OpenSea announced a hard limit on how many NFTs minters could create on its platform, apparently in response to widespread abuse.¹⁸⁴

These abuses prompted John Stark, the founder and former chief of the SEC Office of Internet Enforcement, to say that “in the NFT marketplace, market manipulation is not only rampant and tolerated, but also encouraged; fraud not only accepted and rewarded, but also taught.”¹⁸⁵

¹⁸¹ Ian McGinley, *Expect Indictments in the NFT Space Soon*, REUTERS (Feb. 4, 2022, 10:04 AM), <https://www.reuters.com/legal/transactional/expect-indictments-nft-space-soon-2022-02-04/>.

¹⁸² *Id.*

¹⁸³ See *infra* Section III.A.4.

¹⁸⁴ Shanti Escalante-De Mattei, *After Announcing NFT Limit, OpenSea Reverses Course Amid User Uproar*, ARTNEWS (Jan. 28, 2022, 4:04 PM), <https://www.artnews.com/art-news/news/opensea-nft-limit-controversy-1234617074/>.

¹⁸⁵ John Reed Stark, LINKEDIN, https://www.linkedin.com/posts/john-reed-stark-3806866_the-hottest-nft-marketplace-is-mostly-users-activity-6919264333847752704-z5IS?utm_source=linkedin_share&utm_medium=member_desktop_web (last visited Feb. 2, 2022).

1. Issuing Unregistered Securities

As securities lawyers well know, section 5 of the '33 Act requires that transactions offering securities be registered.¹⁸⁶ On May 12, 2021, a class action was filed against Dapper Labs for allegedly violating the '33 Act when it sold NFTs without complying with securities law disclosure requirements (“Dapper Labs Complaint”).¹⁸⁷ Dapper Labs, a platform utilizing the proof-of-stake minting model,¹⁸⁸ started minting NFTs of short video highlights from NBA games. These “NBA Top Shot” NFTs were available in three tiers: (1) common, (2) rare, and (3) legendary, based on the number of NFTs minted in that category.¹⁸⁹ Thereafter, the “NBA Top Shot” Twitter account, hosted by Dapper Labs, began touting the enormous price tags associated with these NFTs.¹⁹⁰ However, much to the chagrin of some purchasers, Dapper Labs held on to consumer funds for months after withdrawal requests—a fact that garnered national attention.¹⁹¹ In its complaint, the SEC worked through *Howey* and explained that the NBA Top Shot NFTs, and the underlying custom-

¹⁸⁶ 15 U.S.C. § 77e(a), (c).

¹⁸⁷ Amended Complaint & Demand for Jury Trial at 1, *Friel v. Dapper Labs*, No. 1:21-cv-05837-VM (S.D.N.Y. Jul. 7, 2021) [hereinafter *Dapper Labs Complaint*].

¹⁸⁸ See *supra* II.B.1.

¹⁸⁹ *Dapper Labs Complaint*, *supra* note 187, at 8.

¹⁹⁰ *Id.* at 9.

¹⁹¹ *Id.* at 15–17.

minted cryptocurrency upon which these NFTs were built, qualified as securities upon their issuance.¹⁹² The SEC considered very significant the way Dapper Labs continually tweeted about the “growth potential” and value increase predictions in the future, and as of this Article’s drafting, the parties are still in dispute.

2. Insider Trading

Insider trading is prohibited under SEC Rule 10b-5, which specifically precludes trading based on material, non-public information.¹⁹³ In its March 16th, 2022 post, “Insider Trading Claims Arise, as the NFT Space Starts to Consolidate,” “The Fashion Law” blog, which has published content at the cutting edge of Metaverse and NFT legal implications, drew attention to allegations of “insider trading” on NFT marketplaces made in September 2021.¹⁹⁴ Reuters echoed these concerns, citing an instance occurring in September 2021 of an NFT marketplace employee buying up certain NFTs immediately before those NFTs were featured on the marketplace’s homepage, only to sell those NFTs after they drastically appreciated in value.¹⁹⁵

3. Wash Trading

¹⁹² *Id.* at 10–15.

¹⁹³ 17 C.F.R. § 240.10b-5 (2000).

¹⁹⁴ *Insider Trading Claims Arise, as the NFT Space Starts to Consolidate*, *supra* note 88.

¹⁹⁵ McGinley, *supra* note 171.

NFT marketplaces are also at risk of “wash trading,” where individuals, either alone or acting in concert, buy and sell NFTs to create the mere appearance of demand. Wash traders will self-finance seemingly independent buyer addresses to increase an NFT’s value, sometimes with exponential gains at the eventual legitimate buyer’s expense.¹⁹⁶ For example, in October of 2021, one individual sold and purchased CryptoPunk #9998, one NFT from a popular collection, just to elicit higher bids.¹⁹⁷

Some marketplaces incentivize as many transactions as the sellers can accomplish. When this is the case, wash trading makes up the majority of these marketplaces’ trading volume.¹⁹⁸ Like other cryptocurrency, NFTs are susceptible to money laundering abuses as well. Wash trading can also be used to launder money via “‘self-financed’ addresses.”¹⁹⁹

4. Rug-pulling

¹⁹⁶ *Crime and NFTs: Chainalysis Detects Significant Wash Trading and Some NFT Money Laundering in this Emerging Asset Class*, CHAINALYSIS (Feb. 2, 2022) <https://blog.chainalysis.com/reports/2022-crypto-crime-report-preview-nft-wash-trading-money-laundering/>.

¹⁹⁷ McGinley, *supra* note 171.

¹⁹⁸ Olga Kharif, *The Hottest NFT Marketplace Is Mostly Users Selling to Themselves*, BLOOMBERG (Apr. 5, 2022, 7:01 AM), <https://www.bloomberg.com/news/articles/2022-04-05/hottest-nft-marketplace-is-mostly-users-selling-to-themselves?sref=62RNSA6Q>.

¹⁹⁹ *What Are Wash Trading and Money Laundering in NFTs?*, COINTELEGRAPH (Apr. 2022), <https://cointelegraph.com.cdn.ampproject.org/c/s/cointelegraph.com/explained/what-are-wash-trading-and-money-laundering-in-nfts/amp>.

NFT “rug pulling” is another form of abuse that can trick purchasers out of millions of dollars. In fact, “rug pulls” represented nearly 40% of crypto-related scams in 2021.²⁰⁰ In a “rug pull,” NFT issuers may sell NFTs that purport to provide value in a system that is not yet operationalized.²⁰¹ Once the issuers have solicited sufficient investment, they “pull[] the rug out from under the victims,”²⁰² abandoning the project and retaining investor funds—thereby defrauding investors.²⁰³

The “Frostie” example is illustrative. Following an investigation, a US Attorney, the IRS, and the Department of Homeland Security charged Ethan Nguyen and Andrew Llacuna (the “Offerors”) with conspiracy to commit money laundering after they were going to “pull the rug” in their second NFT collection sale.²⁰⁴ The Offerors offered a set of NFTs known

²⁰⁰ Benjamin Pimentel, *Anatomy of an NFT Art Scam: How the Frosties Rug Pull Went Down*, PROTOCOL (Feb. 24, 2022), <https://www.protocol.com/fintech/frosties-nft-rug-pull>.

²⁰¹ *Id.*

²⁰² Danny Nelson, *US Justice Dept. Charges 2 in NFT ‘Rug Pull’ Scheme*, COINDESK (Mar. 24, 2022, 8:16 PM), <https://www.coindesk.com/policy/2022/03/24/us-justice-dept-charges-2-in-nft-money-laundering-rug-pull-scheme/?outputType=amp>.

²⁰³ See generally Jeremy Goldman & Zach Lewis, *Arrests for NFT ‘Rug Pull’ Highlight Legal Risks for Creators*, FRANKFURT KURNIT KLIEN SELZ PC (Mar. 29, 2022), <https://ipandmedialaw.fkks.com/post/102hlli/arrests-for-nft-rug-pull-highlight-legal-risks-for-creators> (cautioning NFT offerors that “shar[e] roadmaps or promis[e] or suggest[] future utility”).

²⁰⁴ Press Release, U.S. Att’y’s Off. S. Dist. N.Y., U.S. Dep’t of Just., *Two Defendants Charged In Non-Fungible Token (“NFT”) Fraud and Money Laundering Scheme* (Mar. 24, 2022), <https://www.justice.gov/usao-sdny/pr/two-defendants-charged-non-fungible-token-nft-fraud-and-money-laundering-scheme-0#:~:text=ETHAN%20VINH%20. NGUYEN%2C%2020%2C%20and,in%20violation%20of%2018%20U.S.C.> [hereinafter *Two Defendants Charged*]. See generally Steve Kaaru, *Frosties NFT: 2 Charged*

as “Frosties” and were preparing to offer a set known as “Embers.”²⁰⁵ The Offerors solicited Frosties purchases with the promise of future holder-only rewards, such as “giveaways, early access to a [M]etaverse game,” and first-purchase rights in future Frosties releases.²⁰⁶ After raising over \$1 million, the Offerors abandoned the project, deactivated the website, and transferred the funds to various crypto wallets under their control, allegedly to disguise the funds’ original source.²⁰⁷ The Offerors were charged shortly after advertising a second NFT project—the “Embers” project—which the Department of Justice believed to be a similarly fraudulent enterprise.²⁰⁸ The “Frosties” situation is but one of many.²⁰⁹

b. Examples of NFT Offerings

The following cases provide an interesting yet limited cross section of NFT offerings. While there are many uses of NFTs,²¹⁰ the following are particularly relevant to securities discussions.

in US over \$1.3M Rug Pull, COINGEEK (Mar. 29, 2022), <https://coingeek.com/frosties-nft-2-charged-in-us-over-1-3m-rug-pull/>.

²⁰⁵ Two Defendants Charged, *supra* note 204.

²⁰⁶ *Id.*

²⁰⁷ *Id.*

²⁰⁸ *Id.*

²⁰⁹ See McGinley, *supra* note 171 (describing another “rug-pull” in which NFT purchasers in the “Evolved Apes” virtual fighting game were similarly deceived).

²¹⁰ See generally Jeff Wilser, *15 NFT Use Cases That Could Go Mainstream*, COINDESK (Oct. 14, 2021, 12:52 PM), <https://www.coindesk.com/business/2021/10/14/15-nft-use-cases-that-could-go-mainstream/>.

1. The Bored Ape Yacht Club

The Bored Ape Yacht Club (“BAYC”) NFTs have remained among the most expensive and sought after NFTs available,²¹¹ serving as a status symbol for crypto connoisseurs.²¹² Twitter increased BAYC’s visibility to the average consumer by implementing a verification system²¹³ for BAYC NFT profile pictures, enabling owners to flaunt their NFT to any who visit their feed.²¹⁴

Part of the BAYC’s appeal is that, “[i]n contrast to other NFTs that offer *only investment possibilities*, BAYC NFTs offer additional perks and entertainment opportunities.”²¹⁵ As part of that system of incentives, owners of BAYC NFTs recently received a staggering aggregate \$810 million worth of “ApeCoin,” a freshly minted cryptocurrency.²¹⁶ While such a distribution may have been innocently intended, it represents what might be considered a heavily disguised dividend given to “shareholders,”

²¹¹ Fox, *supra* note 18.

²¹² See generally Namitha Sudhakar, *How BAYC NFTs Become a Status Symbol for Celebrities and Influencers?*, THE CRYPTO TIMES (Mar. 19, 2022, 1:30 PM), <https://www.cryptotimes.io/how-bayc-nfts-become-a-status-symbol-for-celebrities-and-influencers/>.

²¹³ Will Gottsegen, *Twitter Launches NFT Profile Picture Verification*, COINDESK (Jan. 21, 2022, 3:54 PM), <https://www.coindesk.com/business/2022/01/20/twitter-launches-nft-profile-picture-verification/>.

²¹⁴ Sudhakar, *supra* note 212.

²¹⁵ *Id.* (emphasis added).

²¹⁶ Andrew Hayward, *ApeCoin: What is the Bored Ape Ethereum Token and Who Gets it?*, Decrypt (Mar. 17, 2022), <https://decrypt.co/95398/apecoin-what-is-bored-ape-ethereum-token-who-gets-it>.

i.e., BAYC owners.²¹⁷ In a bizarre turn of events, the owner of BAYC NFT #6184 opened a BAYC themed restaurant, which accepted the recently distributed “ApeCoin” as payment.²¹⁸ Unfortunately, in what crypto-skeptics might call poetic, there have been inconsistencies in the restaurant’s acceptance of cryptocurrencies as payment.²¹⁹

2. Home Equity Slice Purchases

“Slices” of home equity are another example of fractionalized NFTs (“FNFTs”) that are almost definitely a security. One offeror appears to understand that risk. Vesta Equity, a real estate startup, has developed a service on the Algorand blockchain for selling fractionalized real estate interests.²²⁰ Interestingly, these fractional ownership interests convey only a right to profits, and do not permit any kind of timeshare-esque residential arrangement.²²¹

²¹⁷ See *id.*

²¹⁸ Jason Nelson, *Bored Ape Yacht Club-Themed Burger Joint Debuts in California*, DECRYPT (Apr. 11, 2022), <https://decrypt.co/97474/bored-ape-yacht-club-themed-burger-joint-debuts-in-california>; see Nicolaus Li, *Bored & Hungry, the First Bored Ape Yacht Club Restaurant Has Officially Opened*, HYPEBEAST (Apr. 11, 2022), <https://hypebeast.com/2022/4/bored-hungry-first-bored-ape-yacht-club-restaurant-officially-opened-info>.

²¹⁹ Brian Contreras, *Inside the Crypto Restaurant After the Crypto Crash*, L.A. TIMES (Jun. 27, 2022, 5:06 PM), <https://www.latimes.com/business/technology/story/2022-06-24/this-restaurant-is-crypto-themed-you-still-have-to-pay-in-dollars>.

²²⁰ Morgan Chittum, *Investors Can Now Buy Home Equity Slices Via Fractionalized NFTs*, BLOCKWORKS (Feb. 23, 2022, 4:13 PM), <https://blockworks.co/investors-can-now-buy-home-equity-slices-via-fractionalized-nfts/>.

²²¹ *Id.*

Other offerors are not being as careful. Jared Kenna, a building owner in California, has started auctioning off NFTs for the rights to an apartment in that building.²²² Interestingly, the same article reporting on that offering recognizes that “[f]ractionalized ownership or a building is already possible without technology. The legal mechanism, whether on paper or through crypto, is for owners to sell securities . . . ‘[b]ut . . . the reporting is too onerous.’”²²³ These burdensome reporting requirements are one of the reasons cited for electronic fractionalization being a more convenient alternative for consumers.²²⁴

3. Casino NFTs

Blue sky laws came to consumers’ rescue in Texas and Alabama in a recent cease-and-desist order.²²⁵ There, Sand Vegas Casino Club offered 11,111 NFTs to raise revenue for a Metaverse casino, assuring consumers that the NFTs they were purchasing were not securities.²²⁶ Included in the deal was a profit-sharing promise once the Metaverse casino was up and

²²² Erik Sherman, *How Crypto and NFTs Could Help Regular People Become Real Estate Tycoons*, FORTUNE (May 20, 2021, 3:00 PM), <https://fortune.com/2021/05/20/real-estate-crypto-nfts-what-is-an-nft-tokenization-non-fungible-token-houses/>.

²²³ *Id.*

²²⁴ *Id.*

²²⁵ Chris Prentice, *State Securities Regulators Order Virtual Casino Firm to Stop Selling NFTs*, REUTERS (Apr 17, 2022, 6:04 PM), <https://www.reuters.com/technology/state-securities-regulators-order-virtual-casino-firm-stop-selling-nfts-2022-04-13/>.

²²⁶ *Id.*

running.²²⁷ People could enter the casino at its Decentraland location in the Metaverse and gamble.²²⁸ NFT owners would share in the profits obtained by that casino.²²⁹ Unsurprisingly, OpenSea, which is not registered with the SEC as a securities exchange, delisted the NFTs after the cease-and-desist letters from the state securities authorities were publicized.²³⁰ While this is a small scale and limited example, one commentator expressed hopes that this state action will prompt federal action, as it often does.²³¹

Abuses and examples like those above have prompted at least some reactions from regulatory agencies—the relevant responses and notable absences are detailed below.

c. Recent Regulatory Action (or Inaction)

Because the main applications of NFTs are “founded almost entirely on financial speculation and regulatory arbitrage[.]” the Financial Times implies that there will be little opportunity left once regulators

²²⁷ *Id.*

²²⁸ Bob Mason, *OpenSea Delists Sands Vegas Casino Club NFTs After Cease & Desist Orders*, YAHOO! (Apr. 23, 2022), <https://www.yahoo.com/now/opensea-delists-sands-vegas-casino-035759874.html>.

²²⁹ *Id.*

²³⁰ Barry Fischer, *Think an NFT Is Not a Security? Don't Bet on It. Three Lessons from the Texas and Alabama Cease and Desist Order of Sand Vegas Casino Club*, JDSUPRA (May 6, 2022), <https://www.jdsupra.com/legalnews /think-an-nft-is-not-a-security-don-t-1105763/>.

²³¹ Prentice, *supra* note 225.

“decide it’s time to close the loopholes.”²³² The following sections detail the SEC’s published reactions to crypto thus far.

1. SEC Responses to Cryptocurrency

Cryptocurrency and blockchain technology are remarkably fast moving; regulators have appeared to play catch up in recent years. A string of new developments and abuses has led John Stark, former Chief of the SEC Office of Internet Enforcement, to state that “[w]e may be in the midst of a sudden U.S. crypto-regulatory awakening – and not a moment too soon.”²³³

The SEC first spoke about cryptocurrency in The DAO Report, issued on July 25, 2017, and clarified that “[t]he automation of certain functions through [blockchain] technology, ‘smart contracts,’ or computer code, does not remove conduct from the purview of the U.S. federal securities laws.”²³⁴ “‘The DAO’ project” was a specific decentralized autonomous organization (“DAO”)—wherein DAOs are entities governed by smart contracts and structured on the blockchain, thereby

²³² Richard Waters, *Web3 is Yet to Take Off Despite the Hype*, FIN. TIMES (Apr. 8, 2022), <https://www.ft.com/content/16eaf1b9-08fb-4454-a4eb-ac662cdd8590>.

²³³ John Reed Stark, *A U.S. Financial Regulatory Web3 Awakening (and Not a Moment Too Soon)*, LINKEDIN (Apr. 12, 2022), <https://www.linkedin.com/in/john-reed-stark-3806866/recent-activity/posts/> (follow “Articles” button; then scroll to Apr. 12, 2022 publication).

²³⁴ Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934: The DAO, Exchange Act Release No. 81207 (July 25, 2017), <https://www.sec.gov/litigation/investreport/34-81207.pdf>.

enabling decentralization and automation.²³⁵ Within the DAO project, DAO token ownership granted voting and profit sharing rights.²³⁶ The SEC concluded that the DAO project's tokens were securities offered in violation of the '33 Act, but it did not impose penalties because the DAO project cooperated so readily with the investigation.²³⁷

SEC Chairman Gary Gensler, in his personal remarks to the Penn Law Capital Markets Association, reiterated the SEC's position that "[t]here's no reason to treat the crypto market differently just because different technology is used."²³⁸ Gensler pontificated that "these [crypto exchange] platforms likely are trading securities. While each token's legal status depends on its own facts and circumstances, . . . the probability is quite remote that any given platform has zero securities."²³⁹ Gensler addressed concerns regarding trading and lending platforms, stablecoins, and tokens.²⁴⁰ Regarding tokens, Gensler remarked, "my predecessor Jay Clayton said it, and I will reiterate: Without prejudging any one token,

²³⁵ Goforth, *supra* note 12, at 280 n.45; *See generally* Steven Glaveski, *How DAOs Could Change the Way We Work*, HARV. BUS. REV. (Apr. 7, 2022), <https://hbr.org/2022/04/how-daos-could-change-the-way-we-work>.

²³⁶ Goforth, *supra* note 12, at 280.

²³⁷ *Id.* at 283.

²³⁸ Gensler's Speech, *supra* note 134; *see* Jordan Atkins, *SEC Chair Gary Gensler: 'No reason' to Treat Digital Asset Market Differently Under Securities Laws*, COINGEEK (Apr. 5, 2022), <https://coingeek.com/sec-chair-gary-gensler-no-reason-to-treat-digital-asset-market-differently-under-securities-laws/>.

²³⁹ Gensler's Speech, *supra* note 134.

²⁴⁰ *Id.*

most crypto tokens are investment contracts under the Howey Test.”²⁴¹ Such broad statements have led many to declare that “[Clayton’s] comments. . . reflect[] at least a rebuttable presumption that all ICOs involve[] the sale of securities.”²⁴²

In 2018, the SEC conceded that Bitcoin and Ether are most likely not securities.²⁴³ Director Hinman referenced the decentralized nature of each token, explaining that “purchasers would no longer reasonably expect a person or group to carry out essential managerial or entrepreneurial efforts.”²⁴⁴ SEC Chairman Clayton reiterated Hinman’s sentiment saying “there are different types of cryptoassets” and “[a]s a replacement for currency, [Bitcoin] has been determined by most people to not be a security.”²⁴⁵ Commentators have noted that classifying Bitcoin and other cryptocurrencies as currencies make little practical sense, given

²⁴¹ *Id.*

²⁴² Goforth, *supra* note 12, at 284. Initial Coin Offerings (or, “ICOs”) are the “initial public offering” equivalent for new token offerings and have been treated as such by the SEC on certain occasions; however, such ICOs sometimes more closely mimic a new currency offering than some kind of security, making the analysis challenging in some cases. *Investor Bulletin: Initial Coin Offerings*, U.S. SEC. AND EXCH. COMM’N (July 25, 2017), <https://www.investor.gov/introduction-investing/general-resources/news-alerts/alerts-bulletins/investor-bulletins-16>; see Evelyn Cheng, *The SEC Just Made It Clearer That Securities Laws Apply to Most Cryptocurrencies and Exchanges Trading Them*, CNBC (Mar. 7, 2018, 6:48 PM), <https://www.cnbc.com/2018/03/07/the-sec-made-it-clearer-that-securities-laws-apply-to-cryptocurrencies.html>.

²⁴³ See Hinman’s Speech, *supra* note 30.

²⁴⁴ Goforth, *supra* note 12, at 285 (quoting Hinman’s Speech, *supra* note 30).

²⁴⁵ Neeraj Agrawal, *SEC Chairman Clayton: Bitcoin Is Not a Security*, COIN CENTER (Apr. 27, 2018), <https://www.coincenter.org/sec-chairman-clayton-bitcoin-is-not-a-security/>.

how seldom cryptocurrencies are accepted “in lieu of [traditional] fiat currency.”²⁴⁶ However, several high-profile examples of cryptocurrency being accepted as currency may signal more widespread acceptance and make its non-security classification more sensible.²⁴⁷ Other industry leaders only embrace blockchain technology in a piecemeal fashion—receptive to selling NFTs but not to accepting cryptocurrency as a payment method.²⁴⁸

Cryptocurrency’s volatility poses an interesting problem.²⁴⁹ Some suggest that the entire crypto “bubble” will burst, showing that the cryptocurrency craze was no more than an opportunity for “unlicensed gambling.”²⁵⁰ A particularly glaring example of crypto volatility is the

²⁴⁶ Goforth, *supra* note 12, at 285. Cryptocurrency being classified as “money” also poses problems for other bodies of law. See Lorraine McGowen, 2022 *Is the Year of Sweeping Changes for Cryptocurrency and Other Digital Asset Transfers*, JDSUPRA (Jan. 14, 2022), <https://www.jdsupra.com/legalnews/2022-is-the-year-of-sweeping-changes-9286474/>; Jessica Rizzo, *The Future of NFTs Lies with the Courts*, WIRED (Apr. 3, 2022, 7:00 AM), <https://www.wired.com/story/nfts-cryptocurrency-law-copyright/> (discussing the proposed new category for cryptocurrency in the UCC: “controllable electronic records”).

²⁴⁷ See generally Rosie Perper, *Tesla May Soon Accept Bitcoin as Payment Again*, HYPEBEAST (Oct. 26, 2021), <https://hypebeast.com/2021/10/tesla-bitcoin-payment-returning-sec-filing>.

²⁴⁸ See Chavie Mehta et al., *Amazon CEO Says Not Adding Cryptocurrency as Payment Option Anytime Soon*, REUTERS (Apr. 14, 2022, 9:30 AM), <https://www.reuters.com/technology/amazon-ceo-says-not-adding-cryptocurrency-payment-option-anytime-soon-cnbc-2022-04-14/>.

²⁴⁹ See Guseva, *supra* note 12, at 631 (noting the “robust but highly volatile” cryptoasset demand as seen when Bitcoin traded at record highs in early 2021).

²⁵⁰ See generally BOB SEEMAN & ROGER SVENSSON, BITCOIN: UNLICENSED GAMBLING (7th ed. 2022) (discussing how bitcoin does not operate as currency but instead has all the characteristics of a high-stakes gambling game and enables illegal activities).

incredible fluctuation Bitcoin experienced. An entertaining pastime was to check Bitcoin prices every few days, observe substantial price spikes either up or down, and survey technology and world news reports to speculate about the cause of the spikes. For example, Tesla accepting Bitcoin to purchase vehicles caused a significant jump in Bitcoin prices, followed by a comparable dip when Tesla removed that option citing environmental concerns.²⁵¹

The 2019 “Framework for ‘Investment Contract’ Analysis of Digital Assets” from the “Strategic Hub for Innovation and Financial Technology” (“FinHub Framework”) provides the SEC’s more thorough guidance on evaluating crypto-adjacent securities issues.²⁵² The FinHub Framework defines a “digital asset” as “an asset that is issued and transferred using distributed ledger or blockchain technology, including, but not limited to, so-called ‘virtual currencies,’ ‘coins,’ and ‘tokens.’”²⁵³

²⁵¹ Joe Walsh, *Tesla Will Stop Accepting Bitcoin as Payment Due to Environmental Worries, Musk Says*, FORBES (May 12, 2021, 6:37 PM), <https://www.forbes.com/sites/joewalsh/2021/05/12/tesla-will-stop-accepting-bitcoin-as-payment-due-to-environmental-worries-musk-says/>; Sam Shear, *Elon Musk Says People Can Now Buy a Tesla with Bitcoin*, CNBC (Mar. 24, 2021, 12:09 PM), <https://www.cnbc.com/2021/03/24/elon-musk-says-people-can-now-buy-a-tesla-with-bitcoin.html>.

²⁵² See generally Strategic Hub for Innovation & Fin. Tech., *Framework for “Investment Contract” Analysis of Digital Assets*, SEC. & EXCH. COMM’N (2019), <https://www.sec.gov/files/dlt-framework.pdf> [hereinafter *FinHub Framework*] (discussing the views of the staff of the Securities and Exchange Commission and provides a framework for initial coin offerings).

²⁵³ *Id.* at 1 n.2.

However, even after the FinHub Framework was issued, Commissioner Hester Peirce expressed a sentiment echoing attorneys' probable thoughts: "Pages worth of factors, many of which seemingly apply to all decentralized networks, might contribute to the feeling that navigating the securities laws in this area is perilous business."²⁵⁴ Cryptocurrency adds additional complexity to an already inconsistent and unsettled area of law.²⁵⁵

Recent scholarship provides a useful set of tables in which Professor Guseva, an experienced professor and author in capital markets, details SEC responses to crypto related issues using dollar amounts, actor classifications, and year-by-year comparisons.²⁵⁶ The article posits that the SEC has been more than willing to threaten and bring administrative actions against crypto exchanges and issuers alike.²⁵⁷ Significantly, it points out that almost every action brought against "issuers of digital-asset securities" involved violation of the registration provisions from Section 5 of the Securities Act.²⁵⁸ The author concludes, *inter alia*, that "fear of enforcement alone could be a potent incentive to comply . . . [and] this fear should be magnified twofold due to the scale and scope of the

²⁵⁴ Peirce, *supra* note 77.

²⁵⁵ COX, *supra* note 21, at 47.

²⁵⁶ Guseva, *supra* note 12, at 643-47.

²⁵⁷ *Id.* at 647.

²⁵⁸ *Id.*

Commission's actions and the breadth of the functional *Howey* test.”²⁵⁹ Moreover, attorneys should expect the SEC to pursue enforcement aggressively because reputation and economic damage increases absent active enforcement. Consumers are hyper-aware of SEC action against NFT-related actors while the status of NFTs is unresolved. Uncertainty as to the SEC's perspective on NFTs may provide an open door to people with ill intentions. If NFT actors engage in fraud, lack of enforcement would both harm investors and “make other crypto-projects tainted by association. . . .”²⁶⁰

2. A Proposed New Asset Class

Some have called for a new “class” or “safe harbor” for digital assets, in which NFTs might reside.²⁶¹ Such a “safe harbor” would exempt tokens from securities regulations for an initial growth period, provided their network becomes sufficiently decentralized or functional.²⁶² A new “class” could mimic the proposed “controllable electronic records” UCC classification²⁶³ and function similarly to the hard-and-fast securities

²⁵⁹ *Id.*

²⁶⁰ *Id.* at 652.

²⁶¹ Jacqueline Hennelly, *The Cryptic Nature of Crypto Digital Assets Regulations: the Ripple Lawsuit and Why the Industry Needs Regulatory Clarity Notes*, 27 FORDHAM J. CORP. & FIN. L. 259, 295 (2022).

²⁶² *Id.* at 297.

²⁶³ See Rizzo, *supra* note 246 (discussing the proposed new category for cryptocurrency in the UCC: “controllable electronic records”).

designations for other asset types as laid down by *Landreth Timber Co. v. Landreth*.²⁶⁴

However, Professor Guseva postulates that the ambiguity suffered by the *Howey* functional definition may represent the “Nash equilibrium”²⁶⁵ of the SEC regulatory “game,” as frustrating as that conclusion might be for securities attorneys.²⁶⁶ Despite higher barriers to entry, i.e. players “remain on the sidelines for fear of making the wrong choice,”²⁶⁷ it is unlikely that the SEC will provide the kind of concrete declaration for NFTs hoped for by some no-action letter requests.²⁶⁸ Instead, to use economic language, the issuer/actor “cooperates” by initially over-disclosing through traditionally available means such as no-action letter requests.²⁶⁹

²⁶⁴ See *Landreth Timber Co. v. Landreth*, 471 U.S. 681, 686 (1985).

²⁶⁵ A “Nash equilibrium” exists when parties to an exchange are no longer incentivized to alter their respective positions absent some change by the other party. Guseva, *supra* note 12, at 653 n.130 (citing Ian Ayres, *Playing Games with the Law*, 42 STAN. L. REV. 1291, 1297 (1990)).

²⁶⁶ *Id.* at 653.

²⁶⁷ Robert B. Ahdieh, *The Visible Hand: Coordination Functions of the Regulatory State*, 95 MINN. L. REV. 578, 629 (2010).

²⁶⁸ See *supra* Section III.C.1.

²⁶⁹ Guseva, *supra* note 12, at 663. “Cooperate” is a term widely used by economists to reference interpersonal trust, commerce, psychology, Game Theory, and “Prisoner’s Dilemmas.” See generally Steven Kuhn, *Prisoner’s Dilemma*, in STAN. ENCYC. OF PHIL. (Edward N. Zalta et al. eds., Winter ed. 2019), <https://plato.stanford.edu/archives/win2019/entries/prisoner-dilemma/> (last visited Mar 15, 2023). In some scenarios, parties may be pitted against one another in a “game” (i.e. the marketplace), and each party must determine the optimal choice to make based on predictions of how the opposing party will respond. *Id.* Sometimes the optimal choice involves the parties acting in tandem to accomplish certain goals for

Indeed, the SEC repeatedly has invited communication and engagement with its staff regarding “close calls” like these emerging crypto assets.²⁷⁰ The actor cooperates because it expects the SEC to cooperate by prosecuting noncompliance.²⁷¹ In return, the SEC may afford the actor a chance to escape without civil penalty even if they violated the Securities Acts.²⁷² In order to promote disclosures and communication, the SEC may reward attempted pre- and post-sale cooperation with leniency.²⁷³ This asks the question: how do actors cooperate with the SEC?

3. No-action Letters

Actors cooperate by over-communicating their intentions and requesting guidance before acting.²⁷⁴ The SEC prefers the broad “investment contract” definition and “lack of definitional clarity” for two reasons. First, it “incentivize[s] market participants to request assurances from the SEC concerning which course of action to take to avoid violations.”²⁷⁵ Second, it fosters a “separating equilibrium” which illuminates the quality of assets and developers *before* a sale takes place,

their common good. *Id.* The term, cooperate, refers to the later instance—parties working together to achieve a mutually beneficial goal. *Id.*

²⁷⁰ Finhub Framework, *supra* note 252.

²⁷¹ Guseva, *supra* note 12, at 653.

²⁷² *Id.* at 660 (citing *Munchee Inc.*, Securities Act of 1933 Release No. 10445, 2017 WL 10605969, at *2 (Dec. 11, 2017)).

²⁷³ *Id.* at 660–61.

²⁷⁴ *Id.* at 664.

²⁷⁵ *Id.* at 666.

thereby militating against purchase confusion, future lawsuits, and SEC enforcement.²⁷⁶ The SEC affords market participants this *ex ante* opportunity via no-action letter requests.²⁷⁷

No-action letters serve an important preventative role in the SEC's regulatory framework. In short, no-action letters are a promise from SEC staff to "recommend *no action* to the Commission" against the requester if she follows the guidance detailed in that letter.²⁷⁸ No-action letters are an important *ex ante* mechanism of "cooperation" that furthers the SEC's goals.²⁷⁹ *Ex ante* disclosure mechanics best serve securities law's underlying philosophy: "[s]unlight is said to be the best of disinfectants: electric light the most efficient policeman."²⁸⁰

An SEC response to NFT usage proliferation has been long anticipated. Some are more optimistic than others about how such regulation will impact the market.²⁸¹ One particularly NFT-enthusiastic legal thinker is Brian L. Frye, who has sent not one, or two, but three separate no-action letter requests to the SEC Commissioners, in which he,

²⁷⁶ *Id.* at 666–67.

²⁷⁷ *Id.* at 664.

²⁷⁸ COX, *supra* note 21, at 14–15.

²⁷⁹ Guseva, *supra* note 12, at 664.

²⁸⁰ COX, *supra* note 21, at 6 (quoting L.D. BRANDEIS, OTHER PEOPLE'S MONEY 92 (1914)).

²⁸¹ See Theo, *The SEC Clamps Down on NFTs, Crypto in The US Market*, NFT EVENING (Sep. 21, 2022), <https://nftevening.com/the-sec-clamps-down-on-nfts-crypto-in-the-us-market>.

inter alia, humorously proposes to sell “50 editions of the work of conceptual art ‘SEC No-Action Letter Request 3: Securitized NFTs.’”²⁸²

From the end of 2021 and well into 2022, SEC guidance seemed inevitable. However, the SEC has remained unresponsive to the putative cooperation extended by market participants thus far.

d. Howey applied to F-NFTs

The SEC has begun investigating F-NFTs in particular.²⁸³ While certain use cases fall outside SEC jurisdiction, Jeremy Boldman, co-chair of the Blockchain Technology Group at Frankfurt Kurnit Klein & Selz, states that “[t]he SEC could take the position that these [tens of thousands of NFTs offered up by issuers] . . . are just another way to raise money for a project or venture where people are making an investment.”²⁸⁴ There are arguments for and against SEC jurisdiction over F-NFTs,²⁸⁵ but it is clear that more explicit guidance is needed.

²⁸² Letter from Brian L. Frye, Sec. Art, Inc., to Off. of Chief Couns., SEC (Sep. 5, 2021), <https://ssrn.com/abstract=3917699>; see also Brian L. Frye, *SEC No-Action Letter Request*, 54 CREIGHTON L. REV. 537, 537 (2021).

²⁸³ Robinson, *supra* note 13; see also Aaryamann Shrivastava, *SEC Begins the Investigation of ‘Fractional NFTs’ Suspected to Be Illegal*, YAHOO! (Mar. 3, 2022), <https://www.yahoo.com/video/sec-begins-investigation-fractional-nfts-175108672.html>.

²⁸⁴ *Insider Trading Claims Arise*, *supra* note 88.

²⁸⁵ See Yaël Bizouati-Kennedy, *If Fractionalized NFTs Were Regulated as Securities, How Would It Affect Investors?*, YAHOO! (Mar. 11, 2022), <https://www.yahoo.com/video/fractionalized-nfts-were-regulated-securities-161701535.html>; Philipp Pieper, *Fractionalization Makes NFTs Affordable . . . and Big Targets for Securities Regulators*, THE DEFIANT (Oct. 13, 2021), <https://thedefiant.io/nfts-regulations-fractionalization>. Compare KING & SPALDING, *supra* note 87 (concluding that

The law is settled that “the analysis of whether something is a security is not static and does not strictly inhere to the instrument. Even digital assets with utility that function solely as a means of exchange in a decentralized network could be packaged and sold as an investment strategy that can be a security.”²⁸⁶ The item being offered matters less in this analysis than how it is being presented or received.²⁸⁷ In sum, substance matters over form.²⁸⁸

SEC Director Hinman stressed that, “strictly speaking, the token – or coin or whatever the digital information packet is called – all by itself is not a security . . .,” because “[c]entral to determining whether a security is being sold is how it is being sold and the reasonable expectations of purchasers.”²⁸⁹ The SEC and courts have identified many securities that are fractionalized interests of non-security assets, such as fractional tenancy in common interests, fractional oil and gas interests, and fractional ownership interests in oil wells.²⁹⁰

F-NFTs are probably securities), *with* Thomas Mack & Richard Widmann, *Enabling Nonsecurity Fractional Ownership of NFTs*, LAW360 (May 4, 2021, 4:36 PM), <https://www.law360.com/articles/1381061/enabling-nonsecurity-fractional-ownership-of-nfts> (concluding many F-NFTs are probably not securities and detailing ways market participants can structure deals to avoid securities implications).

²⁸⁶ Hinman’s Speech, *supra* note 30.

²⁸⁷ HAZEN, *supra* note 40, at 41.

²⁸⁸ Hazen, *supra* note 43, at 502.

²⁸⁹ Hinman’s Speech, *supra* note 30.

²⁹⁰ KING & SPALDING, *supra* note 87, at n.17 (citing Complaint, SEC v. Zipprich, (D. Nev. Dec. 20, 2020) (No. 20-cv-02308); Consent Order, In re R. Baker et al., (Mar. 22,

As discussed in Section II.A.2., *Howey* held that an investment contract is (1) an investment of money; (2) in a common enterprise; (3) with a reasonable expectation of profit; (4) to be derived from the entrepreneurial or managerial efforts of others.²⁹¹ This Section details what the SEC has said about F-NFTs so far, and puts F-NFTs through the familiar *Howey* test to determine whether they qualify as investment contracts.

1. Investment of Money

This first element, investment of money, includes more than just fiat currency. The inquiry hinges on whether value is offered.²⁹² *SEC v. Shavers* showed that cryptocurrencies easily satisfy the “money” portion of the *Howey* analysis because those parties treated Bitcoin as a cash-equivalent.²⁹³ Purchasers usually offer Ether or Bitcoin in exchange for their NFTs, so this element is satisfied easily.²⁹⁴

2018) (No. 3-17716); Complaint at 15–16, *SEC v. Green Tree Investment Grp.*, (W.D. Tex. Nov. 17, 2017) (No. 17-cv-1091)).

²⁹¹ Sec. & Exch. Comm'n v. Edwards, 540 U.S. 389, 393 (2004); Sec. & Exch. Comm'n v. W.J. Howey Co., 328 U.S. 293, 301 (1946).

²⁹² See COX, *supra* note 21, at 33.

²⁹³ Colesanti, *supra* note 12, at 19, (citing Sec. & Exch. Comm'n v. Shavers, No. 4:13-CV-416, 2013 WL 4028182, at *1, *6 (E.D. Tex. Aug. 6, 2013) *aff'd on reh'g on other grounds*, No. 4:13-CV-416, 2014 WL 4652121 (E.D. Tex. Sept. 18, 2014)).

²⁹⁴ *Id.* at 14.

2. In a Common Enterprise

Next, *Howey* looks to see whether there is a common enterprise.²⁹⁵

A common enterprise inquiry focuses on the extent to which a purchaser's success is linked with the success of others.²⁹⁶ There are two generally recognized forms: horizontal commonality and vertical commonality.²⁹⁷

Horizontal commonality exists when each investor's success is "pooled" with other investors' success.²⁹⁸ It usually involves multiple investors with a variable rate of return.²⁹⁹ However, horizontal commonality can exist with a fixed rate of return.³⁰⁰ It may even exist in an arrangement with only one investor, provided the offering contemplated multiple investors.³⁰¹

While circuits are divided on the proper description, vertical commonality may be assessed according to either of two standards: broad vertical commonality or strict vertical commonality. Broad vertical

²⁹⁵ *W.J. Howey Co.*, 328 U.S. at 301.

²⁹⁶ Hazen, *supra* note 42, at 503.

²⁹⁷ See Finhub Framework, *supra* note 252, at 2 n.10 (highlighting inconsistency among circuits regarding how to assess commonality).

²⁹⁸ COX, *supra* note 21, at 42.

²⁹⁹ *Id.*

³⁰⁰ SEC v. Infinity Group Co., 212 F.3d 180, 189 (3rd Cir. 2000).

³⁰¹ SEC v. Lauer, 52 F.3d 667, 670 (7th Cir. 1995).

commonality, adopted by the Fifth and Eleventh Circuits, is present when the investment success is linked to the promoter's *efforts*.³⁰² Strict vertical commonality, a more narrow approach adopted by some circuits, requires that the investment success be linked to the promoter's *fortunes*.³⁰³ More plainly, this requires, but is not fully satisfied by,³⁰⁴ some risk-sharing component between investor and promoter.³⁰⁵ The FinHub Framework provided a very limited discussion of this element, saying that "investments in digital assets have constituted investments in a common enterprise because the fortunes of digital asset purchasers have been linked to each other or to the success of the promoter's efforts."³⁰⁶

F-NFTs are susceptible to satisfying this element. F-NFTs almost always represent partial ownership of a larger underlying NFT, thereby satisfying horizontal commonality.³⁰⁷ For example, F-NFTs include fractionalized ownership of blockchain-based videogame items, Metaverse "virtual land" or assets, and real property "minted" as an

³⁰² COX, *supra* note 21, at 42.

³⁰³ *Id.*

³⁰⁴ See, e.g., *Gugick v. Melville Capital, LLC*, 2014 U.S. Dist. LEXIS 12234, at *12–13 (S.D.N.Y. 2014).

³⁰⁵ COX, *supra* note 21 at 42 (citing *Marini v. Adamo*, 995 F.Supp. 2d 155, 186 (E.D.N.Y. 2014), *aff'd on other grounds*, 2016 U.S. App. LEXIS 5611 (2d Cir. Mar. 23, 2016)).

³⁰⁶ FinHub Framework, *supra* note 252, at 2 n.11 (citing *SEC v. Int'l Loan Network, Inc.*, 968 F.2d 1304, 1307 (D.C. Cir. 1992)).

³⁰⁷ Colesanti, *supra* note 12, at 16; see *supra* Section II.B.2.c.

NFT.³⁰⁸ Some minters of particularly inflated NFT collections might opt to fractionalize to raise additional revenue and increase the owner pool.³⁰⁹ Therefore, this element will likely be satisfied.

3. With a Reasonable Expectation of Profit

The expectation of profit requirement from *Howey* requires a showing that investors had a “substantial profit motive,” even if it is only one motive among many for purchasing the asset in question.³¹⁰ Several more nuanced questions help answer the above question,³¹¹ and each will be addressed in turn: “[h]ow do marketing and promotional materials characterize the asset?,” “[h]as the issuer made efforts to increase demand or value?,” “[i]s there a secondary market for the asset?,” and “[w]ho is the target buyer?”³¹²

First, how do marketing and promotional materials characterize the asset? The more an offeror characterizes an F-NFT as an “investment opportunity,” the more likely it is that it satisfies this element.³¹³ For

³⁰⁸ Takyar, *supra* note 139.

³⁰⁹ *The Rise of Fractional NFTs: What Does It Mean for Digital Assets?*, INC4, <https://inc4.net/the-rise-of-fractional-nfts-what-does-it-mean-for-digital-assets/> (last visited Feb. 17, 2023).

³¹⁰ Hazen, *supra* note 42, at 504.

³¹¹ King & Spalding articulated these excellent additional questions when evaluating this *Howey* element. See KING & SPALDING, *supra* note 87.

³¹² *Id.*

³¹³ *Id.*

instance, F-NFT listings that mention how much that F-NFT might appreciate in value or how much the issuer will promote future sales likely indicate a substantial profit motive. Similarly, fractionalization indicates that the offerors may be driven by a substantial profit motive. One need not look far to identify “fractionalization how-to” guides for offerors that cite “[making] NFTs more appealing to *investors*”³¹⁴ and “[making] purchase[s] on secondary markets by a greater number of investors [easier]”³¹⁵ as key reasons to fractionalize. However, it is possible that F-NFTs could be securities in the initial offerings but cease to be securities if their primary uses shift after the fact.³¹⁶

Second, has the issuer made efforts to increase demand or value? Issuers advertising promotional efforts and actually making such efforts are separate questions. The more an issuer has actually made such efforts, the more likely that there is a reasonable expectation of profit with regard to the F-NFT. Such efforts may include attempts to bolster the “ecosystem” in which the tokens operate or are used.³¹⁷ For example, in

³¹⁴ Takyar, *supra* note 139.

³¹⁵ INC4, *supra* note 309.

³¹⁶ Compare Hazen, *supra* note 43, at 510, with Sarel, *supra* note 53 at 410-11 n. 111 (citing Michael J. O'Connor, *Overreaching its Mandate: Considering the SEC's Authority to Regulate Cryptocurrency Exchanges*, 11 DREXEL L. REV. 539, 566 (2018)) (arguing some token offerings qualifying as securities at launch might lose that status once said tokens are subsequently traded on exchanges).

³¹⁷ KING & SPALDING, *supra* note 87.

the now-infamous “Munchee” arrangement, the issuer developed a limited number of tokens that could be used for restaurant purchases and advertising.³¹⁸ Munchee proceeded to advertise aggressively about the inherent scarcity and value in purchasing up these tokens, touting their investment utility.³¹⁹ The SEC issued a cease-and-desist order, citing such activity as grounds for purchasers to “reasonably believe they could profit by holding or trading MUN tokens, whether or not they ever . . . participated in the MUN ‘ecosystem.’”³²⁰

Third, is there a secondary market for the asset? The existence of a secondary markets for purchasers increases the instrument’s liquidity and the investor is more likely to have a reasonable expectation of profit.³²¹ Thus, as the number of NFT exchanges continues to increase,³²² it becomes more likely that the investors have a reasonable expectation of profit.

Fourth, who is the target buyer? A useful “rule of thumb” distinguishes between end-users in the virtual environment in which the NFT may operate and purchasers who have no involvement in whatever

³¹⁸ COX, *supra* note 21, at 49.

³¹⁹ *Id.*

³²⁰ *Id.* (quoting Securities Act Release No. 10445 (Dec. 11, 2017)).

³²¹ KING & SPALDING, *supra* note 87. Secondary markets, such as OpenSea, reduce “search and information costs” for would-be purchasers—*see generally* Sarel, *supra* note 53, at 424 n. 196.

³²² *See* discussion *Infra* Section IV.

environment the NFT operates. For example, some video games operate on the blockchain and issue a limited number of NFTs that function as “characters” or items in-game.³²³ Those NFTs can vary in value based on the rarity or desire for the represented item.³²⁴ So, a gamer purchasing an NFT in a video game for in-game purposes may not be purchasing a security, since the gamer’s purpose is primarily utilitarian. Conversely, an investor purchasing that same NFT via a game-external marketplace like OpenSea may be doing so for possible investment gains, which suggest that NFT may be a security.

4. To Be Derived from the Entrepreneurial or Managerial Efforts of Others

This element hinges on whether “the efforts made by those other than the investor are the undeniably significant ones, those essential managerial efforts which affect the failure or success of the enterprise.”³²⁵ *Howey* originally required profits be expected “solely from the efforts of the promoter,”³²⁶ but subsequent case law clarified that the real inquiry is whether the profits are derived “primarily” or “substantially” from the

³²³ Ryan Browne, *Cash grab or innovation? The video game world is divided over NFTs*, CNBC (Dec. 20, 2021), <https://www.cnbc.com/2021/12/20/cash-grab-or-innovation-the-video-game-world-is-divided-over-nfts.html>.

³²⁴ See, e.g., Payton Lott, *15 Video Game NFTs (€ How Much They Sold For)*, GAMERANT (Aug. 16, 2021), <https://gamerant.com/video-game-nft-selling-prices/>.

³²⁵ SEC v. Glenn W. Turner Enters., 474 F.2d 476, 482 (9th Cir. 1973).

³²⁶ SEC v. W.J. Howey Co., 328 U.S. 293, 298-99 (1946) (emphasis added).

efforts of others.³²⁷ The court in *SEC v. Arcturus Corp.* articulated three factors for evaluating this *Howey* element: (1) the extent to which the investors have the power to control the venture, (2) the extent to which investors are inexperienced and lack expertise in the type of business involved, and (3) ‘whether the investors are so “dependent on some unique entrepreneurial of [sic] managerial ability of [the Managers] that [they] cannot replace the manager of the enterprise or otherwise exercise meaningful partnership or venture powers.”’³²⁸

This is a more challenging question than the prior three in the F-NFT context. Per *Arcturus Corp.*’s first question, there are many cases in which the NFT issuer has no control over the venture after minting the NFTs.³²⁹ For example, a fractionalized NFT of a painting may have “gas fees,” royalty distributions, and conditions for a “buyout” clause all drafted into the “smart contract” governing the NFT as a whole.³³⁰ In the case of a smart contract, the fractionalized Mona Lisa would operate as it was minted without any further involvement by the minter. NFTs may

³²⁷ HAZEN, *supra* note 40, at 44.

³²⁸ *Id.* at 45–46 (quoting *SEC v. Arcturus Corp.*, 912 F.3d 786 (5th Cir. 2019) (quoting *Williamson v. Tucker*, 645 F.2d 404 (5th Cir. 1981))).

³²⁹ Mack & Widmann, *supra* note 285.

³³⁰ *Id.*

also have royalty payments built into their smart contracts, which pay out to the issuer or prior owner every time the NFT changes hands.³³¹

Compare the NFT painting to a fractionalized NFT tied to an interest in receiving profits from rental properties.³³² There, the arrangement would undoubtedly require continued involvement by a managing party, and the F-NFT begins to look much more like that familiar grove of orange trees in *Howey*. F-NFTs begin to look less like securities when an F-NFT involves a smart contract governing its future activities, transferability over a ledger that operates independent of the promoter, and the ability of owners to consolidate their ownership via things like buyout clauses drafted into the smart contract.³³³

LLC interests as securities undergo a similar analysis as discussed herein. LLCs can be structured as either member-managed or manager-managed, and that determination often decides whether any membership interest sold qualifies as a security.³³⁴ That governance distinction ordinarily signals a difference in the centralization of the LLC's management.³³⁵ On one hand, a membership interest in a member-

³³¹ James Kelly, *NFT Royalties Explained: What Are They and How Do They Work?*, NFT GATORS (Dec. 26, 2021), <https://www.nftgators.com/nft-royalties-explained/>.

³³² KING & SPALDING, *supra* note 87.

³³³ Mack, *supra* note 285.

³³⁴ HAZEN, *supra* note 40, at 55.

³³⁵ *Id.*

managed LLC likely is not a security. This is because each member necessarily has some form of control over the LLC's activities, thereby failing this "managerial efforts of others" *Howey* element. On the other hand, a manager-managed LLC may significantly distance each member from the LLC's management, thereby turning an otherwise non-security LLC interest into a security.³³⁶

If developers are diligent about their smart contracts, it may eliminate "reliance upon promoters" and remove F-NFTs from the SEC's purview.³³⁷ This is ideal for start-ups and small business clients who may not have the resources to register with the SEC.

IV. PROPOSAL

The SEC has delayed concrete declarations of NFT's classification as securities so far. But the SEC is ideally positioned to issue clearer guidance for NFT exchanges, with new NFT exchanges ever in the works—undue delay will cause considerable expense to exchanges building out frameworks and budgets.³³⁸ OpenSea takes the lion's share of

³³⁶ *Id.* at 55 n. 411, citing *SEC v. Friendly Power Co.*, 49 F. Supp. 2d 1363 (S.D. Fla. 1999) (where LLC interests were securities, since they functioned more like a corporate stock and inured no LCC control to their owners).

³³⁷ Mack, *supra* note 285

³³⁸ Catherine Zhu & Louis Lehot, *United States: Legal Guide to Launching An NFT Marketplace*, MONDAQ (Mar. 22, 2022), <https://www.mondaq.com/unitedstates/fin-tech/1049646/legal-guide-to-launching-an-nft-marketplace>.

NFT trading, but new exchanges are regularly announced.³³⁹ The recent NYSE trademark registration for an NFT marketplace of its own lends an air of legitimacy to NFT marketplaces in general, but other upcoming marketplaces may counteract any good feelings.³⁴⁰ Coinbase, one of the leading cryptocurrency marketplaces, announced a forthcoming standalone NFT exchange arriving in 2022.³⁴¹ A limited-access version of the exchange became available for a small number of users on April 20, 2022, with more waitlisted users to be added in the weeks following.³⁴² Coinbase's CEO, Brian Armstrong, expressed confidence that "[NFTs] are going to be much larger than just digital artwork or something . . . there's citizenship and governance and . . . various novel fundraising mechanisms. So this segment is going to be really big."³⁴³

³³⁹ Sunny Kim, *How OpenSea cornered the \$17 billion market for NFTs*, CNBC: EVOLVE (Apr. 15, 2022), <https://www.cnbc.com/2022/04/15/how-opensea-cornered-the-17-billion-market-for-nfts.html>.

³⁴⁰ Ryan Browne, *Former file-sharing site LimeWire to relaunch as NFT marketplace, more than a decade since shutting down*, CNBC (Mar. 9, 2022, 3:25 am), <https://www.cnbc.com/2022/03/09/limewire-former-file-sharing-site-to-relaunch-as-nft-marketplace.html>.

³⁴¹ Adele Loana, *Coinbase NFT Marketplace Already Has 4M People On The Waitlist*, NFT EVENING (Apr. 13, 2022), <https://nftevening-com.cdn.ampproject.org/c/s/nftevening.com/coinbase-nft-marketplace-already-has-4m-people-on-the-waitlist/amp/>.

³⁴² Elizabeth Howcroft, *Crypto exchange Coinbase launches NFT marketplace for some U.S. users*, REUTERS (Apr. 20, 2022, 9:09 AM), <https://www.reuters.com/article/fintech-nft-coinbase-idUSKCN2MC12U>.

³⁴³ Luc Olinga, *Coinbase Wants to Expand, But...*, THESTREET (Apr. 6, 2022), <https://www.thestreet.com/investing/cryptocurrency/coinbase-wants-to-expand-into-nfts-but>.

SEC Chairman Gay Gensler addressed exchanges like Coinbase and Blockfi, saying that “[i]t’s a question of whether they’re registered or they’re operating outside of the law . . .”³⁴⁴ Mr. Gensler implored these marketplaces to voluntarily register with the SEC, pointing to the widely publicized \$100 million Blockfi settlement.³⁴⁵

There, Blockfi was charged with failing to register security offerings in violation of the Investment Company Act of 1940.³⁴⁶ Blockfi operated a crypto-based lending company, where individuals could lend crypto assets to Blockfi for a high interest rate.³⁴⁷ However, that enterprise was cut short when the SEC instigated a lawsuit against the company, alleging that Blockfi sold unregistered securities under both an investment contract analysis and a notes analysis.³⁴⁸ Without conceding liability, Blockfi agreed to pay \$50 million in fees to the SEC, another \$50 million to settle related investigations by 32 different state attorney generals, and

³⁴⁴ Ben Werschkul, *Crypto platforms that don’t register with the SEC do business ‘outside the law’*: Gensler, YAHOO! FINANCE (MAR. 4, 2022, 11:42 AM), <https://finance.yahoo.com/news/crypto-platforms-dont-register-with-sec-outside-the-law-gensler-164215740.html>.

³⁴⁵ *Id.*

³⁴⁶ *BlockFi to Pay \$100 Million to Settle with SEC and 32 States Over Crypto Lending Business*, PAUL WEISS (Feb. 17, 2022), <https://www.paulweiss.com/practices/litigation/cryptocurrency-blockchain/publications/blockfi-to-pay-100-million-to-settle-with-sec-and-32-states-over-crypto-lending-business?id=42408>.

³⁴⁷ *Id.*

³⁴⁸ *Id.*

promised to avoid selling unregistered securities in the future.³⁴⁹ Coinbase planned to offer a service comparable to Blockfi's lending program, but subsequently cancelled that plan once the SEC threatened Coinbase with a punishment similar to Blockfi's.³⁵⁰ The Blockfi settlement should serve as a cautionary tale to institutions that, absent more concrete SEC guidance, flippantly disregard securities concerns.

Despite repeated pleas from attorneys and businesses alike,³⁵¹ SEC Commissioner Hester Peirce does not expect the commission to provide clearer guidance.³⁵² In the interim, she suggested that a traditional *Howey* analysis is the proper guide for crypto sellers to avoid suffering a fate similar to Blockfi.³⁵³ However, others have observed that overly-broad regulatory schemes involving crypto result not in protection for consumers but in out-sourcing offerings to other countries instead.³⁵⁴ Particularly enthusiastic crypto/NFT purchasers might just use VPNs to buy from unsecure overseas marketplaces instead of regulated US markets,

³⁴⁹ *Id.*

³⁵⁰ *Id.*

³⁵¹ See Frye, *supra* note 282; Vincent R. Molinari, *Re: Rulemaking Regarding Non-Fungible Tokens*, SECURITIES AND EXCHANGE COMMISSION, <https://www.sec.gov/rules/petitions/2021/petn4-771.pdf> (last visited Apr. 12, 2021).

³⁵² Werschkul, *supra* note 344.

³⁵³ *Id.*

³⁵⁴ Ben Strack & Casey Wagner, *Crypto Industry Will Move Offshore If Congress Doesn't Act, Executives Warn*, BLOCKWORKS (Dec. 8, 2021, 6:00 PM), <https://blockworks.co/crypto-industry-will-move-offshore-if-congress-doesnt-act-executives-warn/>.

thereby foiling the SEC's goal of protecting consumers via the *ex-post* enforcement discussed in Section III.C.1.³⁵⁵

One guide for business executives provides useful advice for community engagement, digital wallet infrastructure, and Web3 integration.³⁵⁶ However, in its section on legal positions, it says only that “[r]egulatory guidance is still sparse in this field. Major organizations have taken a variety of different internal stances and positions on their appetite for participation and their tolerance for ambiguity. My (non-legal) advice, is to convey the commercial opportunity to your lawyers ASAP and put them to work in developing your organization’s position.”³⁵⁷ For the attorneys, the question is clear: what ought the company’s position be?

Attorneys representing NFT or NFT-adjacent clients, such as issuers, exchanges, artists, investors, etc., ought to be particularly diligent about recommending SEC registration to their clients. As observed, most SEC proceedings involving digital-asset securities relate to registration violations.³⁵⁸ If there is any question regarding why potential customers will purchase or the goal of any particularly NFT collection sale, clients

³⁵⁵ Septimiu-Vlad Mocan, *Do You Need a VPN for Crypto Trading?*, TECHNADU (Oct. 6, 2021), <https://www.technadu.com/do-you-need-a-vpn-for-crypto-trading/98801/>.

³⁵⁶ Chris Liquin, *VaynerNFT’s Head of Strategy: An Executive’s Guide to NFTs*, BUILTIN (Apr. 5, 2022, updated April 6, 2022), <https://builtin.com/blockchain/guide-to-NFT-VaynerNFT>.

³⁵⁷ *Id.*

³⁵⁸ Guseva, *supra* note 12, at 647.

would be well-advised to err on the side of caution and register. However, registration implicates additional issues, such as the challenges associated with valuing³⁵⁹ some of the most volatile commodities in recent years.³⁶⁰ Market abuses like the wash trading and rug pulling discussed above only exacerbates NFT volatility.³⁶¹

Alternatively, developing smart contracts correctly may eliminate “reliance upon promoters” sufficiently and remove F-NFTs from the SEC’s purview, as discussed above in Section III.D.4.³⁶² Resolution in the Dapper Labs case may provide sufficient guidance for issuers in the coming months, depending on how thoroughly the court discusses each *Howey* element.³⁶³ If the NFT market responds comparably to the crypto market’s response, then SEC enforcement against a few first movers such as Dapper Labs should be sufficient to spur offerors and exchanges alike to preemptive “cooperation.”³⁶⁴

In summary, trying to sneak NFT projects past the SEC is asking for trouble. NFT exchanges or offerors with any F-NFTs should register

³⁵⁹ 17 CFR § 270.2a-5.

³⁶⁰ Maria L. Murphy, *NFTs come with big valuation challenges*, JOURNAL OF ACCOUNTANCY (July 15, 2021), <https://www.journalofaccountancy.com/news/2021/jul/nft-nonfungible-token-valuation-challenges.html>.

³⁶¹ *Id.*

³⁶² Mack, *supra* note 285.

³⁶³ Dapper Labs Complaint, *supra* note 187.

³⁶⁴ Guseva, *supra* note 12, at 660.

with the SEC. Attorneys working at the cutting edge of FinTech should specialize in compliance with securities regulation, not avoidance.³⁶⁵ Lastly, attorneys should keep an ear to the ground for any resolution in the Dapper Labs case, the numerous no-action letter requests, or published results from the SEC's investigations.

V. CONCLUSION

The NFT market moves quickly. Sections of this Article were written and re-written dozens of times over a span of a few weeks as new market information came to light. Lawsuits were filed, massive amounts of money changed hands, market crashes impended,³⁶⁶ and offerors made a fortune artificially inflating the price of offerings.³⁶⁷

“[I]t is important that we start providing clear and timely answers,” says SEC Commissioners Peirce and Roisman.³⁶⁸ The Commissioners also recognized that the persistent ambiguity in the crypto and NFT markets causes significant hardships for issuers. Providing guidance via punishing

³⁶⁵ John Reed Stark, *Where Are the (Crypto) Lawyers?*, LINKEDIN (Nov. 10, 2021), <https://www.linkedin.com/pulse/where-crypto-lawyers-john-reed-stark/>.

³⁶⁶ See generally Ruholamin Haqshanas, *Sales of Blue-NFTs Plunge Amid Crypto Market Crash*, CRYPTONEWS (May 11, 2022), <https://cryptonews.com/news/sales-of-blue-chip-nfts-plunge-amid-crypto-market-crash.htm>; Paul Vigna, *NFT Sales Are Flatlining*, THE WALL STREET JOURNAL (May 3, 2022), <https://www.wsj.com/articles/nft-sales-are-flatlining-11651552616>.

³⁶⁷ See *supra* Section III.A.

³⁶⁸ Roslyn Layton, *The SEC's Fair Notice Farce, Starring William Hinman*, FORBES (July 19, 2021), <https://www.forbes.com/sites/roslynlayton/2021/07/19/the-secs-fair-notice-farce-starring-william-hinman/?sh=7c93da7d2f4f>.

noncompliance after the fact greatly inhibits early movers, which is particularly harmful in a market as fast moving as NFTs.³⁶⁹ The Commissioners recognize that laying down clear rules *ex ante* is better for the market than the “clue-by-enforcement approach that [the SEC] ha[s] embraced to date.”³⁷⁰ The *Howey* test’s lack of “crystal [clarity]”³⁷¹ reduces the usefulness of both it and its progeny in resolving NFT securities concerns.

While NFT market participants await additional guidance, this Article provides an overview of the technology, the applicable law, the abuses that showcase the need for more thorough SEC guidance, and how the *Howey* test ought to be applied to F-NFTs. Despite the likelihood that regulatory uncertainty will continue to dominate crypto markets,³⁷² this Article attempts to clear the muddy regulatory waters.

³⁶⁹ *Id.*

³⁷⁰ *Id.*

³⁷¹ *Id.*

³⁷² Bull, *supra* note 12, at 34.