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Everything you've ever wanted to know about NFTs and securities regulation (and a few things you didn't)

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Introduction

The Token Economy has arrived. The next iteration of the World Wide Web — frequently referred to as Web3 — introduced new possibilities for data use, protection, and monetization through distributed ledger technology.

Hot on the heels of a massive cryptocurrency boom, the pursuit of new applications for this technology has given rise to a novel class of digital assets called non-fungible tokens. NFTs are allowing people to buy and sell things that could never be bought or sold before, fueling global speculation and enthusiasm. However, with that excitement comes new challenges for law-makers and regulators.

The expectation of profit, alone, is not sufficient to support a determination that an NFT is a security.

Blockchain-mediated crowdfunding mechanisms have long been an area of interest for securities regulators, but the financialization of NFTs is raising the profile of the issue.

Although the U.S. Securities and Exchange Commission (SEC) has yet to make an official ruling on NFTs as an asset class, SEC Commissioner, Hester Peirce, has advised NFT promoters to approach projects with caution, warning: "people need to be thinking about potential places where NFTs might run into the securities regulatory regime."[1]

While it is clear that not every NFT will be considered a security, NFT projects that extract value from investors are likely to attract increased scrutiny from securities regulators, particularly as notable mishaps draw media attention.[2] Despite the superficial appeal of NFT-based investments, in most cases, the compliance costs that would ensue should a token be considered a security would render it unusable.

This article will explore some of the circumstances under which an NFT could be considered a security, and potentially threaten the viability of any related business.

What is an NFT?

An NFT is a unit of data encoded using a cryptographic key, or token, and stored on a blockchain, or digital ledger. Each NFT has a unique identifier and metadata directly linking it to an address on the blockchain network. An NFT is created, or minted, using a "smart contract," which is a self-executing program designed to carry out a defined function based on encoded rules. Smart contracts are stored on the blockchain network and can be used to record, validate, and transfer ownership of an NFT.

NFTs crystalize abstract concepts related to property ownership and control into observable encoded standards. They enable users to create a unique, authoritative version of an intangible asset, capable of bearing verifiable provenance and, if desired, yielding perpetual royalties. An NFT can represent rights related to artwork, music, videos, coupons, land, security credentials, club membership, and much more.

For some, the prospect of using NFTs to extract value directly from the public is an exciting one. NFT evangelists can frequently be heard sermonizing on the merits of raising capital with NFTs, often positioning them as an alternative to the traditional equity model, where businesses give part ownership in exchange for capital.

Inevitably, though, this line of discourse returns to the same familiar refrain: NFT investors are motivated by profit; they hope to resell the token for more than they paid. This hope could implicate federal securities laws.

What is a security?

Any offer or sale of securities in the United States is governed by the Securities Act of 1933 (the Securities Act). The Securities Exchange Act of 1934 (the Exchange Act) created the SEC and vested in it the power to enforce the Securities Act.

The definition of "security" under the Securities Act is expansive, including notes, stocks, treasury stocks, bonds, security-based swaps and futures, debentures, certificates of interest, and transferrable shares, among other things. There are three primary tests that courts apply to determine whether an innovate financial instrument should be regulated as a security.

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The *Howey* test

The U.S. Supreme Court first articulated the prevailing test for determining whether a transaction forms an investment contract under the Securities Act in the seminal case, *SEC v. W.J. Howey Co*.[3]

Under the *Howey* test, an investment contract exists when the following four elements are present:

- An investment of money;
- In a common enterprise;
- With the expectation of profits;
- With such profits to be generated solely from the efforts of the promoter or a third party.

It was the intention of the Court that this flexible definition would be "capable of adaptation to meet the countless and variable schemes devised by those who seek the use of the money of others on the promise of profits."[4]

The family resemblance test

The term "note" also appears in the definition of a security under the Securities Act. The term, which generally covers any legal document evidencing a promise to pay a debt, includes a broad range of financial instruments.

For NFT issuers or promoters, the potential for exposure to new compliance obligations should not be overlooked or dismissed.

Toward the latter part of 20th Century, the term had begun to cause significant disunity among lower courts as they sought to establish appropriate exemptions from the Securities Act requirements for various kinds of promissory notes on a case-by-case basis. The U.S. Supreme Court weighed in on the issue in the case of *Reves v. Ernst & Young*.[5] There, the Court first articulated the "family resemblance" test.

The family resemblance test established a rebuttable presumption that a note is a security, unless it bears a resemblance to one of the following:

- A note delivered in consumer financing;
- A note secured by a mortgage on a home;
- A short-term note secured by a lien on a small business or some of its assets;
- A note evidencing a character loan to a bank customer;
- A short-term note secured by an assignment of accounts receivable; or
- A note that formalizes an open-account debt incurred in the ordinary course of business.

The character in commerce test

Even if an asset is not a security at the time it is issued or initially offered, it can still become one through marketing or promotion. In *Gary Plastic Packaging Corp. v. Merrill Lynch*, the U.S. Court of Appeals for the Second Circuit held that the test in defining an investment contract is dependent on the character of the instrument in commerce, as determined by "the terms of the offer, the plan of distribution, and the economic inducements held out to the prospect."[6]

Conversely, an asset that is initially offered as security can evolve over time into something that would no longer be considered a security.

When will an NFT be considered a security?

The first prong of the *Howey* test is typically satisfied in a sale of virtual assets. The word "sale" is just Securities-Act-speak for a "disposition of a security or interest in a security, for value."[7] The distinction between fiat currency, cryptocurrency, or any other unit of valuable consideration is immaterial.

Furthermore, the analysis is not limited to monetary value. Whether a token is issued to incentivize performance of network maintenance activities, or merely to foster a trading market by promoting circulation of that token, any service designed to advance the issuer's economic interests will qualify as valuable consideration.

For most NFT projects, the second prong of the *Howey* test is also easily satisfied. A common enterprise exists whenever an investment causes the fortunes of the investor to become inextricably intertwined with the fortunes of other investors and of the venture itself.

An NFT project will be considered a common enterprise if the value of a token is supported by the success or popularity of an overarching project, such that its value can be expected to decrease if the project is mismanaged or fails to gain popularity. Fractionalized NFTs are also likely to give rise to a common enterprise.

Fractional ownership protocols allow investors to own a share of a high-value NFT, along with any associated revenue rights. Regulators appear to be concerned that dividing an NFT into smaller units removes its non-fungible character and makes it more like a security.

The final two prongs of the *Howey* analysis are less straightforward. In general, the form that an instrument takes is less significant than the manner in which it is sold or promoted. The *Howey* analysis is limited to speculative investments.

In *Marine Bank v. Weaver*, the U.S. Supreme Court pronounced that, in order for an instrument to be considered a security, the investor must bear some risk of loss.[8] An NFT is less likely to be considered a security if the underlying smart contract contains time-limits or event triggers that allow the promoter to absorb all downside risk.

If a purchaser's funds will automatically be returned at a predetermined maturity date or upon the happening of a

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predetermined event, an NFT will look more like a loan or interest-bearing account.

If, however, the prospectus, or "roadmap," for an NFT project suggests or implies that token-holders will receive something of value in the future — something that would support a purchaser's expectation of profiting from their ownership of the token — the likelihood that those tokens could be considered securities increases significantly.

Whether through earnings distributions, secondary market sales, or other forms of economic inducement like exclusive access to events, merchandise, or additional digital assets, the investor's anticipation of a return on their investment is a key element of the *Howey* analysis.

According to the SEC's "Framework for 'Investment Contract' Analysis of Digital Assets" (hereafter, the SEC Framework),[9] to determine whether purchasers have a reasonable expectation of profit, NFT promoters should consider the following:

- Is the NFT offered broadly to potential purchasers, rather than being targeted solely to expected users of the goods or services that token-holders may gain access to, or to those who have a need for the functionality of the network?
- Is the network on which the NFT is intended to function operational at the time the NFT is offered for sale?
- Does the NFT give holders the right to share in the income, profits, or capital gains of the underlying enterprise?
- Can the NFT be traded on a secondary market or platform?
- Is the NFT marketed by emphasizing the future functionality of the network or the digital asset, the potential profitability of the operations of the network, or the potential appreciation of the value of the digital asset?

The expectation of profit, alone, is not sufficient to support a determination that an NFT is a security under the *Howey* test. The expectation must be dependent upon the efforts of a promoter, sponsor, or other closely affiliated third parties (each of whom the SEC refers to as "Active Participants").

Only the essential managerial efforts are relevant to this analysis; that is, efforts impacting the failure or success of the enterprise — especially at the stage where the viability of the project is still uncertain.

When considering whether NFT purchasers expect to generate a profit by relying on the efforts of others, the SEC Framework advises NFT promoters to consider the following:

- Is the NFT marketed by emphasizing the expertise of the Active Participants, or the Active Participants' ability to grow the value of the network or digital asset?
- Is an Active Participant responsible for the development, enhancement, operation, or promotion of the network?
- Are essential tasks or responsibilities necessary to achieve the intended purpose of the network performed by an Active Participant, or are they performed by a decentralized network of users?
- Is an Active Participant primarily responsible for creating or supporting the market for an NFT, performing functions such as creating or issuing of the NFTs, or regulating supply through activities like buybacks or "burning" tokens?
- Does an Active Participant play a central role in decision-making with respect to governance matters, such as transaction validation, network security, participant compensation, asset distributions, and secondary market liquidity?
- Can an Active Participant benefit from its efforts by holding the same class of digital asset as those offered for sale to the general public?

When considering whether an NFT bears a "family resemblance" to one of the categories of exceptions enumerated in *Reves*, NFT promoters should consider the following four factors:

- *The motivations of the seller and the buyer*. If the seller's purpose to raise money for a venture or finance capital investments, and the buyer is interested primarily in the profit they expect the instrument to generate, it is more likely to be considered a security.
- *The instrument's plan of distribution*. If the instrument is commonly traded for speculation or investment, it is more likely to be considered a security.
- *The reasonable expectations of the investing public*. If the investing public would expect the instrument to be considered a security, it is more likely to be considered a security, regardless of the economic circumstances of a particular transaction.
- *Whether some factor renders application of the Securities Act unnecessary*. If some key factor, such as the existence of another regulatory scheme, significantly reduces the risk of the instrument such that application of the Securities Act is unnecessary, an instrument is less likely to be considered a security.

Why does it matter?

The same complex regulatory structures that make traditional capital-raising model cumbersome for a fledgling enterprise are also necessary to protect investors from misrepresentations and fraud. For this reason, the keystone of U.S. securities regulation is its comprehensive disclosure regime.

The Securities Act requires every offer or sale of securities to either be registered with the SEC or conducted under an exemption from the registration requirement. Registrants must make complete and truthful disclosures containing all material information that investors need to make informed investment decisions.

Securities regulations also contain standards for maintaining official ownership records, clearing transactions, certifying ownership,

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voting (for securities that confer governance rights), exchanging or converting securities, and making distributions to holders.

If an NFT is deemed to be a security under *Howey* and its progeny, issuers and promoters would be required to register every offer or sale or seek an exemption from registration requirements from the SEC.

They would also be required to disclose information about their financial condition, management, compensation of principals, business prospects, details about the security to be offered for sale, and risks associated with investing in the security.

Any platform, exchange, or similar marketplace where the NFTs will be offered for sale would also have to consider whether it would need to register as a transfer agent with the SEC.

Practically speaking, this sort of compliance burden would pose a serious threat to the viability of any Web3 business. Indeed, some industry participants have already considered the issue and judged those costs to be too high, opting to halt operations involving NFTs with certain investment-like characteristics.

In one high-profile case, public cryptocurrency exchange, FTX US, decided it would not allow any NFTs that pay royalties on secondary market sales to be listed on its platform, citing potential legal exposure under applicable securities laws.[10]

Conclusion

As the discussion surrounding NFTs becomes increasingly dominated by the potential for greater agency, agility, and liquidity, the likelihood that some NFT promoter will commit a regulatory violation increases. For NFT issuers or promoters, the potential for exposure to new compliance obligations should not be overlooked or dismissed.

According to recent reports, SEC enforcement staff have been sending out subpoenas seeking information about NFT offerings, signaling strong interest in any potential violations of U.S. securities laws that may be occurring through NFT projects.

Regulatory and criminal consequences notwithstanding, a project's principals may also be subject to civil suit by any party who suffers damages as a result of a securities violation.

It is important for NFT issuers and promoters to be circumspect about the business justification for choosing a blockchain- mediated funding model, the utility of the technology itself, and the extent to which those benefits could outweighed by the cost of complying with securities laws.

Furthermore, NFT issuers or promoters harboring a desire to attract public investment while also avoiding the burdens of disclosure and regulatory oversight should seriously reconsider this approach. Of course, any NFT issuer or promoter in doubt about how their instrument will be treated under securities laws should seek the advice of a qualified securities lawyer.

Notes

[1] *First Mover: SEC Commissioner Peirce on 2022 Outlook for Stablecoins, NFTs, Bitcoin ETFs, New Legislation and More* (CoinDesk TV online broadcast Dec. 30, 2021).

[2] *See* John Yoon, *A cryptocurrency inspired by 'Squid Game' crashes. The industry has questions*, N.Y. TIMES, Nov. 2, 2021.

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

[4] 328 U.S. at 299.

[5] *Reves v. Ernst & Young*, 494 U.S. 56, 65 (1990).

[6] *Gary Plastic Packaging Corp. v. Merrill Lynch*, 756 F.2d 230, 239 (2d Cir. 1985).

[7] 15 U.S.C.A. § 77b(a)(3).

[8] *Marine Bank v. Weaver*, 455 U.S. 551, 558–59 (1982).

[9] SEC, Framework for "Investment Contract" Analysis of Digital Assets (2019), available at: https://bit.ly/3plr2DW.

[10] Andrew Hayward, *Solana NFT Projects Cancel Holder Royalties After FTX US Launch*, DECRYPT (Oct. 15, 2021).

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