Published on *The National Law Review* https://natlawreview.com

NFTs Are Interesting but Fractionalized Non-Fungible Tokens (F-NFTs) May Present Even More Challenging Legal Issues

Article By:

Karen J. Garnett

Jeffrey D. Neuburger

Frank Zarb

Except for the extensive coverage surrounding Coinbase's IPO last week and the volatility in the price of cryptocurrencies, much of the air in the crypto space in the last few months has been taken up by the meteoric rise of non-fungible tokens (NFTs). At this point, we will assume that readers have at least a basic familiarity with NFTs. If not, we suggest a review of this SNL skit, as it is actually a pretty good summary.

It seems like new articles appear on a daily basis addressing some aspect of the legal issues associated with the NFT phenomenon. Interestingly, however, there have been few articles and little attention paid to what ultimately might be the most interesting development in this space, that is, the rise of fractional NFTs (F-NFTs).

F-NFTs Stir Up New Issues

Given that many NFTs are selling for significant amounts of money (in both fiat and digital currencies), the idea of fractionalization is taking shape to allow smaller investors to pool resources to purchase fractional interests of a NFT. Additionally, there is great interest in the opportunity to buy fractional interests of large NFT collections. For example, it was recently reported that a collection of fifty CryptoPunks, which are early, now valuable NFT pixel art collectibles, were fractionalized into millions of tokens. The interest in fractionalization is not surprising given the high sale price of some NFTs and the widespread adoption of crowdfunding in many areas in e-commerce and investing.

Beyond mere entry into the market, purchasers can hold onto an F-NFT in the hope of seeing investment gains or realizing dividends, or else sell the F-NFT (from a technical perspective, referred to as a "shard") to another investor. Several entities have emerged to facilitate the sale of F-NFTs to unlock liquidity in the market and create and trade fractions of NFTs. For example, the NFT trading platform Niftex states that it allows owners to break NFTs into shards for purchase at a fixed price, with the fractions able to be subsequently traded in the market. The site also states that it allows shard owners some local governance rights on the platform with respect to a particular fraction set and provides an investor with a certain percentage of shards who wishes to own the entire digital asset with a method to bid on the remaining shards.

As most anything can be reduced to an NFT, it's interesting to think of the possibilities of fractionalization. Now that the buying and trading of cryptocurrency has become mainstream, with major fintech platforms having begun to allow users to buy, sell or hold crypto and more and more decentralized finance (or DeFi) and decentralized applications (DApps) being developed to offer new digital solutions for various financial transactions, the continued fractionalization of NFTs is almost inevitable.

But is it legal?

F-NTFs bring to bear all of the legal issues that the many articles already published identify with respect to NFTs generally. These include IP issues, contract issues, rights of publicity and other concerns. The most basic NFT sales involving digital collectibles – akin to the sale of sought-after physical artworks at auction – are less likely to be viewed to raise securities law issues. However, the concern that F-NFTs may be securities is more pronounced.

Given the creativity surrounding the NFT market, certain actions, such as any efforts to build up the market and value surrounding F-NFTs, may raise flags with financial regulators (who are fresh off of years of enforcement against unregistered initial coin offerings). Efforts to create fractural interests and related promotional and other arrangements can raise questions about whether such actions begin to sound like an investment product that regulators could classify as a security under the *Howey* test. Compared to more "standard" NFTs, fractional interests tend to be more accessible to a larger number of smaller investors, and could also facilitate the creation of a trading market.

As SEC Commissioner Hester Peirce stated during the recent Security Token Summit 2021 [listen in the 37:00-39:00 min. range], if someone wants to place numerous NFTs into one basket and sell F-NFTs or take one NFT and sell shards, then "you better be careful you're not creating something that's an investment product, that is a security."

Under the Supreme Court's *Howey* test, the standard definition of what is an investment contract, and thus, a regulated security, is where an individual invests money in a common enterprise and reasonably expects profits to be derived from the entrepreneurial or managerial efforts of others. The evaluation of whether NFTs and F-NFTs fit in this context is an issue that may be resistant to easy answers, as it is a case-by-base determination given the economic realities of each transaction.

The SEC and its staff have outlined the agency's position in its statements concerning initial coin offerings (ICOs), in a number of prior enforcement actions, and in its pending enforcement actions against Ripple. The SEC staff have also published a framework for applying the investment contract analysis of *Howey* to digital assets, which identifies a number of characteristics that make a digital asset more or less likely to be viewed as a security. Nevertheless, even the SEC's views are likely to evolve, and uncertainty about whether NFTs or F-NFTs are securities is likely to persist without more specific guidance from the SEC or the courts. One stakeholder recently submitted a petition for SEC rulemaking to clarify when NFTs (and particularly F-NFTs) are securities and, perhaps more importantly, when they are not securities. The new SEC Chair, Gary Gensler, has considerable blockchain expertise and may be open to providing some guidelines to clarify some of the regulatory uncertainty related to digital assets generally and NFTs in particular.

Looking ahead, when the market for NFT collectibles further matures and likely reaches a certain equilibrium, it’s likely that the sharding and creation of F-NFTs representing other types of assets is likely to occur. This should prompt owners and investors in such assets or NFT-related ventures to examine the potential legal issues that might arise. In addition to the myriad other legal issues associated with NFTs, one would be well advised to watch closely for the new administration’s view of the securities laws and enforcement objectives in this emerging area. As Commissioner Peirce reiterated during the Security Token Summit 2021 about the creation of fractional interests NFT products, individuals always have to question whether securities laws are implicated in any new investment opportunity, as “the definition of security can be pretty broad.”

National Law Review, Volume XI, Number 112