

## **NFTs: A Flash in the Crypto Pan or Virtual Gold? (Part 1)**

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Non-fungible tokens (“NFTs”) grabbed mainstream attention in 2021 with news of digital art and collectibles selling for millions. But headlines reporting NFTs selling for millions were short-lived. “Crypto winter” cast a chill across the crypto world – prices and interest in the digital art and images that became synonymous with NFTs plummeted. This left many to wonder whether NFTs were nothing more than a flash in the pan.

The “flash” that made so many focus on NFTs was unquestionably the novelty of using this emerging blockchain technology to transact digital art and collectibles. New markets for transacting these digital images seemed to spring up overnight. Just as the masses were drawn to NFT communities like the Bored Ape Yacht Club and CryptoPunks, the legal world also took notice started exploring novel NFT-related legal issues. This early analysis was a helpful introduction, but much of it assumed that NFTs were simply the digital images and collectibles that gave this technology notoriety. What this early analysis failed to appreciate was that innovators in the NFT space were quietly expanding this new blockchain technology.

Crypto winter has undoubtedly cooled the initial NFT frenzy, but it also provides the perfect opportunity to reassess whether NFTs were a passing craze or an innovative technology with staying power. This blog series seeks to explore that question and analyze whether NFTs are set to be an integral part of the fabric of Web3, as many have predicted.

It may be that for all except the most prolific digital art and collectible NFTs, beauty (and value) may only be in the eye of the NFT holder. That being said, the outlook is much brighter for the next generation of NFTs. Over the course of this multi-part series, we will examine the next generation of NFTs and the host of new legal issues on the horizon. Some of the topics covered in future segments will include:

- Real World Property NFTs
- Metaverse and Gaming NFTs

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- Fractionalized NFTs and NFT Funds
  - Staking and Lending NFTs

But first, the series will begin by answering the basic question, “what is an NFT?” We will also examine the equally important question of how federal regulators might answer that question in light of significant innovation in the NFT space.

## **What is an NFT?**

At the most basic level, NFTs are digital tokens that are recorded on a blockchain – the Ethereum blockchain being the most common. These digital tokens are a means to demonstrate the authenticity and ownership of some form of property. The property frequently associated with NFTs is digital art and images. But NFTs can be used to represent an ownership interest in almost any property – digital or physical.

NFTs are referred to as “non-fungible” because each NFT token has a unique digital signature that makes it one-of-a-kind. This means that regardless of the underlying property being represented, each NFT is unique. Contrast this with fungible tokens, like Bitcoin, where any Bitcoin can be swapped for another Bitcoin without any change in value – just like exchanging the dollar in your pocket for one at the bank.

A common misconception has been that the NFT “token” is also the property it represents. But NFTs can be thought of as having two basic components: (1) the digital token that functions as a certificate of ownership and authenticity that is recorded on a blockchain; and (2) the property itself that is linked to the token. These two components are intrinsically linked but usually separate.

The relationship between the token and the property means that while the property at issue is often digital, like a digital image stored on a server, the property can also be tangible, real world, property. By way of analogy, an NFT is like a deed for a piece of real estate. However, where a real estate deed is typically recorded at the county registry of deeds, the NFT “deed” is recorded on the blockchain for all to see.

## **NFTs: Collectibles, Commodities, Securities, or Something Else? It Depends!**

As with most digital assets, the looming issue on the minds of NFT enthusiasts is how federal regulators will classify and regulate NFTs. Much like the uncertainty in the broader crypto world, there is no clear answer to this question. NFT innovation has made these murky waters even more complicated to navigate. As discussed below, given recent enforcement activity in the cryptocurrency world, regulators may be poised to weigh in on these questions – whether by enforcement, regulation, or a combination of the two.

In the “old days” of NFTs, it seemed that NFTs were simply digital images and collectibles. This first generation of NFTs raised novel legal issues involving Intellectual Property rights, privacy, anti-money laundering concerns, just to name a few. But it seemed difficult to imagine that regulators would classify a work of digital art – or work of computer code art – as a security. If an analog print from the famous artist Banksy is not a security when it is sitting in a frame or spray-painted on a wall, why would converting that same piece of art into a digital art NFT make it one? [[“Banksy Work Physically Burned and Digitized as NFT in Art-World First”](#)].

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## The SEC Begins to Weigh In

Unsurprisingly, the SEC was cautious to make any definitive statements (or provide much guidance) concerning first generation NFTs. The SEC indicated that it would analyze NFTs on a case-by-case basis to determine whether they were securities. This was the same approach the SEC took with cryptocurrencies in general.

In March 2021, SEC Commissioner Hester Peirce warned that innovators in the NFT space could be inadvertently creating and issuing securities depending on the characteristics of the NFT. Although this early warning related to offering fractional interests in NFTs, it foreshadowed how technological innovation in this space could impact the SEC's views of NFTs. Indeed, the SEC's view on NFTs could change depending on how and why the NFT was created or "minted," how the project is marketed, what individuals expect when purchasing an NFT, and the NFT's unique characteristics.

Almost a year after that initial warning, in March 2022, it was reported that the SEC was increasing scrutiny of the NFT market. It was reported that the SEC went as far as issuing subpoenas probing whether some NFT projects were issuing NFTs in a similar way to initial coin offerings ("ICO") – think IPO but with an NFT.

Early warnings to NFT creators were equally applicable to the NFT marketplaces and exchanges listing NFTs for sale. Simply put, if the SEC later concluded an NFT was a security, NFT creators and exchanges could be accused of offering unregistered securities. This concern was not just the hypothetical anxiety expected from the legal world. As discussed below, this is exactly the regulatory surprise that [started to unfold in the cryptocurrency space](#) in July 2022.

## The DOJ and SEC Charge Insider Trading of Ethereum Based Tokens – With Great Utility Comes Potential Regulatory Responsibility?

On July 21, 2022, the U.S. Attorney for the Southern District of New York announced charges against a former Coinbase employee, his brother, and their associate in the "first ever cryptocurrency insider trader tipping scheme." In a parallel action, the SEC filed a related case against the same three defendants charging insider trading based on the same set of facts (the "SEC Complaint"). The key difference between the DOJ and SEC actions was how the "insider trading" scheme was charged. The DOJ charged the former Coinbase employees with wire fraud, while the SEC alleged that the individuals violated federal securities laws by trading certain cryptocurrency tokens that were later listed on Coinbase.

The DOJ's wire fraud charges were nothing remarkable, particularly in the crypto world. The same US Attorney's Office recently brought wire fraud charges against a former employee of OpenSea, a major NFT marketplace, for allegedly using non-public information to purchase NFTs before those NFT collections were featured on OpenSea's marketplace home page. Once the NFT collection was featured on the OpenSea home page, the value of that collection went up, which allegedly enabled the defendant to sell the NFTs he purchased with insider information for a quick profit. As the US Attorney's office put it, "NFTs might be new, but this type of criminal scheme is not."

In comparison to the DOJ actions, the SEC Complaint truly breaks new ground. Unlike wire fraud charges, alleging a violation of federal securities law requires that the bad acts involved a security. The SEC Complaint does exactly that and claims that nine of the nearly twenty-five cryptocurrency tokens at issue are securities. The SEC identified these nine tokens as "crypto asset securities." If

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the term “crypto asset securities” is unfamiliar, that is because this is a term the SEC coined (bad pun intended), suggesting that the SEC is doing a bit of regulating on the fly via this enforcement action.

The SEC Complaint alleges that the tokens at issue are “investment contracts” under the Securities Act of 1933. In alleging this, the SEC applied the well-known (and decades-old) Howey test. An investment contract exists under the Howey test if it involves (1) an investment of money, (2) in a common enterprise, (3) with the expectation of profit, (4) derived from the efforts of others.

To build its case, the SEC did a deep-dive into each token and the associated project or protocol. Interestingly, the SEC relied heavily on tweets, retweets, and Reddit posts from the founders and developers of the tokens to substantiate its claims. Several factors the SEC emphasized as proving the tokens are securities include:

1. Whether the tokens were issued to fund the development of a related project or protocol – i.e. being used to raise money like a traditional security;
2. The extent to which the developers and founders retained a tranche of tokens;
3. Whether the projects emphasized that the value of the token would increase;
4. Whether the tokens could be traded on secondary markets; and
5. Emphasis on the development team and founders being integral to the success of the overall project, which would increase the value of the token.

In the SEC’s eyes, these tokens were issued to raise money to fund a centralized project or protocol, with a core team of developers/founders, in hopes that when the project itself attained success, the value of the tokens would increase. The SEC also emphasized how the tokens’ success and value were directly dependent on the continued involvement of the developers and founders.

## **Key Takeaways For NFT Creators, Projects, and Exchanges**

Although the SEC Complaint concerns fungible tokens, it provides a helpful demonstration of how the SEC will analyze NFTs when the opportunity arises (if it hasn’t already). There are also significant parallels between the tokens at issue in the SEC Complaint and the newer waves of NFT projects, particularly how and why new NFT projects are initially minted and sold.

Each of the tokens at issue in the SEC’s Complaint was an Ethereum-based token. This is important because most NFTs are also built on the Ethereum blockchain, which gives developers the freedom to create decentralized applications (“dapps”), tokens, and NFTs on the blockchain. The tokens the SEC argues are securities were connected to other applications and projects, which is different from a standalone cryptocurrency like Bitcoin. This might indicate that Ethereum-based projects are in the center of the SEC’s enforcement crosshairs because of the utility and many attributes that make these projects unique compared to cryptocurrencies like Bitcoin.

The SEC’s focus on the functionality of the protocols connected to the tokens at issue is also relevant to the NFT world. The first generation of digital art NFTs were created or minted for the simple purpose of being collected and transacted. The newest generation of NFTs encompasses

property interests reaching far beyond digital images, and often involve greater utility or functionality than a work of digital art that might just collect digital “dust” in the holder’s digital wallet. Moreover, the purpose behind the minting and issuance of an NFT will be a key focus for the SEC.

Many of the next generation NFT projects seek to create a platform where NFTs are a part of a digital ecosystem. To develop these ambitious projects, the creators often mint and sell an NFT that will later integrate into a broader project roadmap. This enables NFT creators to raise money to fund the development of their project.

A key factor in the SEC Complaint was whether the tokens were originally issued to raise money to fund development of a bigger project. For this reason, NFT creators (and the exchanges that list NFTs), should be particularly cognizant of the SEC Complaint. For example, there are a number of projects building metaverse video games where NFTs will one day be incorporated into the game as characters or useable items. Development of these fledgling projects is often funded, at least in part, by minting and selling the NFTs that will one day be incorporated into the game. If the value of the NFTs increases as a result of the successful launch of the game, which was created and driven by the efforts of a core team of developers, will the SEC see view those NFTs as securities?

Understanding these issues is paramount for the teams creating new NFT projects, as well as for the exchanges and marketplaces listing NFTs. And these concerns are not simply hypothetical. Soon after the DOJ/SEC insider trading allegations were released against the former Coinbase employee, reports leaked that the SEC was also probing Coinbase itself for offering unregistered securities by listing the cryptocurrency tokens that the SEC has now deemed are securities via the insider trading Complaint. For Coinbase’s part, its Chief Legal Officer defended the platform, explaining that despite the SEC’s stance on the nine tokens, “[n]one of these assets are securities. Coinbase has a rigorous process to analyze and review each digital asset before making it available on our exchange — a process that the SEC itself has reviewed.” This is obviously not the end of the story, particularly as it relates to NFTs.

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