Are sales of nonfungible tokens 'investment contracts' subject to regulation under federal securities laws?

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OCTOBER 23, 2024

The Securities and Exchange Commission (SEC) and private plaintiffs have pursued litigation involving the sale of digital assets over the last several years. Most recently, both have aimed their sights on creators of nonfungible tokens (NFTs) — unique cryptographic tokens that typically provide their owners rights in, or access to, one or more physical or digital assets or entitlements.

Several recent decisions in private securities litigations have addressed whether the plaintiffs adequately pleaded that transactions in certain NFTs satisfied the Howey test.

But whether transactions in NFTs may constitute "investment contracts" and thus "securities" for purposes of the federal securities laws remains an open question subject to an evolving legal landscape.

Legal framework

The Securities Act of 1933 prohibits the purchase or sale of a "security" unless a registration statement has been filed with the SEC or an exemption applies. An "investment contract" is a type of security. Under the Supreme Court's *Howey* test, an investment contract exists where a person (i) "invests … money" (ii) "in a common enterprise" and (iii) "is led to expect profits solely from the efforts of the promoter or a third party."

SEC enforcement actions

Recently, the SEC has taken the position that certain NFT transactions met the *Howey* test.

Impact Theory

For example, in August 2023, the SEC charged Impact Theory, LLC, with conducting an unregistered offering of NFTs called "Founder's Keys." Impact Theory is a content creation company that seeks to "positively impact lives through storytelling." Each Founder's Key contained a digital graphic that features a combination of four (out of 50 possible) symbols. The SEC concluded that Founder's Keys purchasers were led to expect profits from Impact Theory's efforts and that purchasers invested in a "common enterprise" based on public statements in which the company allegedly "invited potential investors to view the[ir] purchase as an investment into the business."

Notably, two of the five commissioners dissented. As they explained: "We do not routinely bring enforcement actions against people that sell watches, paintings, or collectibles along with vague promises to build the brand and thus increase the resale value of those tangible items." The dissenters chastised the Commission for failing to offer "guidance when NFTs started proliferating."

Stoner Cats

Then, in September 2023, the SEC resolved charges against another NFT developer — Stoner Cats 2 LLC, which neither admitted nor denied liability — for allegedly offering and selling "Stoner Cats" NFTs in securities transactions. (The authors' firm represented Stoner Cats 2 LLC in connection with that matter.) Each Stoner Cats NFT was associated with a unique still image of one of the characters in a Stoner Cats web series developed by the respondent, with different expressions, apparel, accessories, and backgrounds.

The SEC focused on a marketing campaign that allegedly "emphasized the respondents' team's expertise as Hollywood producers, its knowledge of crypto projects, and the well- known actors involved in the web series," which, according to the SEC, led "investors to expect profits because a successful web series could cause the resale value of the Stoner Cats NFTs in the secondary market to rise."

The same two SEC commissioners again dissented, emphasizing that the SEC's application of *Howey* to the matter "lack[ed] any meaningful limiting principle."

OpenSea

Finally, late last month OpenSea, the world's largest NFT marketplace, reported that it had received a Wells Notice from the

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SEC — a precursor to an enforcement action — predicated on the theory that NFTs sold on its marketplace are unregistered securities. The report did not disclose whether the SEC has specified which NFTs it views as implicating securities laws. A private securities putative class action was since filed in the wake of this Wells Notice.

Recent decisions

The legal underpinnings of the recent SEC orders have not been tested in court. Several recent decisions in private securities litigations have addressed whether the plaintiffs adequately pleaded that transactions in certain NFTs satisfied the *Howey* test. These decisions turn in part on whether the plaintiff pleaded a "common enterprise" through horizontal or vertical commonality.

In Dufoe, Friel *and* Harper, *the defendants were alleged to have controlled either the blockchain on which the NFTs sat, the marketplace in which they traded, or both. That drove the courts' analysis that the plaintiffs had adequately pleaded securities claims under* Howey.

Horizontal commonality exists where investors' assets are pooled and their fortunes are tied to the success of the enterprise and each other. In terms of vertical commonality, some circuits find vertical commonality can be "broad" such that the fortunes of investors are tied to the efforts of the promoter. Other circuits, including the 2nd U.S. Circuit Court of Appeals, accept only "strict vertical commonality," whereby the fortunes of investors must be tied to the fortunes of the promoter. Another issue in these cases is whether plaintiffs were led to expect profits based on the efforts of others.

Friel

In *Friel v. Dapper Labs, Inc*., Judge Victor Marrero of the Southern District of New York denied a motion to dismiss a putative securities class action arising from Dapper Labs' offer and sale of NFTs called "Top Shot Moments" without a registration statement. A Top Shot Moment is a "digital video clip of highlights from NBA games, such as a spectacular dunk or a game-winning shot."

The court held that, although it was a "close call," the plaintiff had adequately pleaded facts to satisfy *Howey*. The court held that the plaintiffs had adequately pleaded horizontal commonality because the fortunes of each purchaser were allegedly tied to Dapper Labs' overall success.

The court reasoned that Dapper Labs controlled the Flow Blockchain on which the Moments sat and that once Moments were purchased they could be sold only on the Marketplace that Dapper Labs controlled. The Flow Blockchain is Dapper Labs' own private blockchain that uses "Proof of Stake" validation to allow the business to scale more efficiently.

On the other hand, the court held that the plaintiffs had not pleaded strict vertical commonality, which requires that the fortunes of investors be tied to the fortunes of the promoter. The court rejected the plaintiffs' argument that Dapper Labs' collection of a 5% fee on every transaction in the Marketplace could establish strict vertical commonality.

The court further held that the defendants' alleged public statements and marketing materials presenting Moments as an investment opportunity satisfied the requirement to plead that purchasers expected profits from the efforts of Dapper Labs.

Dufoe

Dufoe v. DraftKings, Inc. followed on the heels of *Friel*. In *Dufoe*, Judge Denise Casper of the District of Massachusetts held that the plaintiff had adequately alleged that transactions in DraftKings NFTs were investment contracts under *Howey* based on allegations similar to those in *Friel*, but with a wrinkle: In *Dufoe*, the DraftKings NFTs at issue traded on the Polygon blockchain that "exists independently of [defendant] DraftKings."

The *Dufoe* court held that this was a distinction without a difference for purposes of pleading *Howey* because the plaintiff plausibly alleged that all trading took place through a "Marketplace" controlled by DraftKings.

Harper

Most recently, the court in *Harper v. O'Neal* denied a motion to dismiss a putative class action complaint brought on behalf of purchasers of NFTs called "Astrals" promoted by former basketball star Shaquille O'Neal.

There, Judge Federico Moreno of the Southern District of Florida concluded that the complaint satisfied the 11th U.S. Circuit Court of Appeals' "broad vertical commonality" test where "the creation of the Astrals metaverse," a "virtual reality role-playing game" where purchasers could use their Astrals as virtual avatars, "depended on initial funding from the tokens."

In addition, the court credited the plaintiffs' allegations that the failure or success of the enterprise "hinge[d] on Defendants' managerial efforts" because the defendants allegedly sought to reinvest proceeds to develop and grow the Astrals operation, touted the investment prospects of the NFTs, and controlled the platforms on which the NFTs transacted.

None of the above cases have reached the ultimate merits of the plaintiffs' claims.

Mann v. SEC: art or securities?

Given the unsettled body of case law and a spate of SEC enforcement activity, in *Mann v. SEC*, Jonathan Mann, a musician, and Brian L. Frye, a law professor, pose the question: "[I]n what circumstances does the offer and sale of NFTs constitute securities offerings or sales?"

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Mann and Frye view the answer as simple: NFTs are art, and art is not within the regulatory ambit of the SEC. Echoing the dissents in *Impact Theory* and *Stoner Cats*, the complaint asserts that "the SEC's broad interpretation of the *Howey* test [in NFT enforcement actions] threatens to not only sweep into its jurisdiction all digital art represented by NFTs regardless of the context in which they are offered and sold; it would also sweep into its scope *all* art and collectibles."

The complaint alleges that "[n]o one can confidently say that they know" the "bounds of the SEC's view of its own authority" to regulate NFTs based on existing enforcement activity. The case is still in the early stages, and the SEC has yet to respond to the complaint.

Takeaways

Only a few district courts in various circuits have addressed these issues. Those decisions are far from the last word on whether NFT sales are subject to the securities laws. Each court made clear that its holding was based on the procedural posture of the action and the facts alleged, and thus they were not deciding whether all NFT transactions are investment contracts.

In the absence of greater clarity, NFT creators must continue to navigate the regulatory and legal landscape with caution. But there are guiding principles to derive from the developing body of case law.

For example, in *Dufoe*, *Friel* and *Harper*, the defendants were alleged to have controlled either the blockchain on which the NFTs sat, the marketplace in which they traded, or both. That drove the courts' analysis that the plaintiffs had adequately pleaded securities claims under *Howey*. This aspect of the rulings highlights the potential risks of a "walled garden" model where the NFT issuer creates its own marketplace that serves as the only place for buyers and sellers to trade.

Moreover, the courts in each case considered social media posts and statements by observers and purchasers. This underscores the need for defendants in similar cases to examine and contextualize both pre- and post-offer events and statements, including analyzing how digital asset prices would react to these statements and whether those price reactions were reasonably tied to the promoters' statements or efforts.

Finally, the case law also leaves the door open for NFT creators to establish, on a more complete record, that purchasers acquired NFTs for consumptive rather than investment purposes. Doing so would take transactions in those NFTs outside the reach of securities laws.

As the legal landscape around the offer and sale of NFTs continues to evolve, those involved in the space should consult experienced counsel.

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This article was first published on Reuters Legal News and Westlaw Today on October 23, 2024.

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