NFTs and Securities Laws

How to Create and Sell Compliant Non-Fungible Tokens

Robert Heim, Esq. is a partner at Tarter Krinsky & Drogin LLP in New York City and formerly Assistant Regional Director of the U.S. Securities and Exchange Commission

NFTs Are Poised to Revolutionize the Creative Industries

NFTs are extremely hot right now. In March 2021, the digital artist Beeple made history when he sold his NFT of digital art for $69.3 million through Christie's auction house. Jack Dorsey sold his first tweet as an NFT for $2.9 million and Kings of Leon and other musical artists are gearing up to release albums as NFTs. NFTs are poised to upend almost every creative industry from art to music to books to collectibles.

NFTs are also very easy to create (known as "minting" in crypto jargon). ***In fact, this legal article you are reading right now is one of the first ever legal articles to be minted as an NFT.*** Given the immense interest in NFTs and the potential for significant profits to be made by minting, selling or trading NFTs people who work with NFTs must be familiar with applicable securities laws so they don't run afoul of the law.

What is an NFT?

An NFT is a non-fungible token. What does that mean? It means that unlike Bitcoins each NFT is a unique token that can't be exchanged with another NFT. If you are selling a product, service or piece of art it doesn't matter which dollar bill or which Bitcoin you receive from the buyer. In that sense Bitcoins -- just like dollars -- are fungible.

But an NFT token is a unique token that is publicly identified on the blockchain that it was created on. Each NFT also carries its own set of intellectual property rights. In a way, owning an NFT is like owning a limited edition print of an artist's drawing – there are only so many prints that are created and each one is numbered and unique. In a similar way an NFT is a way to authenticate a piece of digital art or a digital collectible and identify its rightful owner and the rights he or she has.

Currently the majority of NFTs are created on the Ethereum blockchain but there are other blockchains that allow NFTs to be created. Almost anything can be turned into an NFT including photographs, paintings, drawings and music.

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Given the enormous profit potential associated with creating and trading NFTs it is only natural for NFTs to bump up against securities laws and regulations. Those who operate in this space must be familiar with how the securities laws will impact NFTs. Failure to comply with the securities laws has severe consequences including stiff fines by federal and state securities regulators, court injunctions and, in egregious cases, criminal charges. Thankfully, these risks can be reduced by consulting a securities lawyer who is familiar with NFTs and their associated regulatory framework.

Whether a particular NFT is deemed to be a security or not will depend heavily on the purpose it was created for and how it is marketed to buyers. A "security" is defined in the Securities Act of 1933 and the Securities and Exchange Act of 1934 and includes many of the types of things you would typically associate with an investment – like shares of common or preferred stock. But the Securities Act also has a catchall term called an "investment contract" that can sweep up NFTs in the definition of a security. If an instrument or digital asset falls under the definition of a security a complex and costly regulatory regime will apply to the creation and sale of such securities – something that most people would rather avoid if possible to do so.

So what is an investment contract? That term was defined by the U.S. Supreme Court in the landmark case *SEC v. W.J. Howey Co.*, 328 U.S. 293 (1946). That case created the *Howey* test to determine whether an instrument or product is an investment contract (and therefore a security) or not. Under the *Howey* Test, an instrument or product will be deemed an investment contract if:

(i) there is an investment of money;

(ii) there is an expectation of profits from the investment;

(iii) the investment of money is in a common enterprise; and

(iv) any profit comes from the efforts of third parties.

While the *Howey* court used the "money," later cases expanded this concept to cover any asset or thing of value and not just cash. The SEC has used the *Howey* test to find various offerings of digital assets and crypto currencies to be securities and, therefore, subject to sanctions when their creators and marketers did not comply with the securities laws by registering their sale and providing full, accurate and fair disclosures. The SEC has also laid out its own framework of how it applies the *Howey* test to digital assets here: https://www.sec.gov/corpfin/framework-investment-contract-analysis-digital-assets

What are Some Features That May Make an NFT a Security?

One of the primary factors that will determine whether an NFT is a security is the purpose it is being created and sold for. If the NFT relates to an already existing asset, like a photograph or piece of digital art, and is marketed as a collectible with a public assurance of authenticity on the blockchain it is unlikely that such an NFT would be deemed a security. However, if the NFT is being created and sold as a way for members of the public to earn investment returns then that type of NFT will be more likely to be considered a security.

And it's not just the creators of NFTs that have to be concerned with whether an NFT is a security. Those who operate NFT exchanges also have to carefully consider this issue. If an NFT exchange is making a market in an NFT that is deemed to be a security that NFT exchange platform could be deemed to be illegally operating an unregistered securities exchange and subject to sanctions by the SEC.

Parting Words

NFTs are in their infancy and are poised to have a significant impact on the worlds of art, photography, music and other creative industries. Working with a securities lawyer who is familiar with the interplay between NFTs and securities laws will help increase the odds of your project's success and make it less likely that you will be deemed to be illegally selling securities.

Contact:

Robert Heim, Esq.
Partner
Tarter Krinsky & Drogin LLP
1350 Broadway
New York, NY 10018
Ph. 212-216-1131
rheim@tarterkrinsky.com

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