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Are Nonfungible Tokens Securities?

By **Joseph Hall** (April 14, 2021, 5:32 PM EDT)

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An explosion of interest in nonfungible tokens, or NFTs, has led to questions about their status under the federal securities laws, with some debate over whether the uniqueness of a particular NFT is itself enough to mean that it's not a security. It's a bit more complicated.

Like Bitcoin, Ethereum and other cryptocurrencies, NFTs are digital assets created by software code and recorded on a blockchain. NFTs exhibit many of the same characteristics of these more familiar digital assets, including an immutable transaction record that permanently records the provenance of each individual token, as well as undeniable investment appeal.

Anyone reading this article likely knows that an NFT designed by Mike Winkelmann, the artist known as Beeple, fetched over $69 million in a recent Christie's International PLC auction. So like cryptocurrencies, NFTs can be sold and traded for value — and the U.S. Securities and Exchange Commission has explained since 2017 that some digital assets are securities because they are investment contracts under the Howey test, first laid out in the 1946 U.S. Supreme Court decision sharing the name.

The key distinction between NFTs and cryptocurrencies is, of course, their lack of fungibility. When we say two or more items are fungible, we generally mean that they are interchangeable, so that a seller can deliver either item to a purchaser, and the purchaser is obligated to accept either, in satisfaction of a contractual sale and purchase obligation.

For example, if an investor owns Apple Inc. common stock and sells a few shares, the investor is free to settle the trade with shares already owned, or shares borrowed from a third party, because each share of Apple common stock is fungible with all other shares of Apple common stock.

On the other hand, an NFT that links to a JPEG file of a unique piece of Beeple's artwork is nonfungible — provided the artist issues only one such NFT, and grants the holder ownership via contract over the single copy of the file linked to that NFT on the blockchain.

However, ownership of the NFT does not convey ownership of the underlying intellectual property rights in the digital artwork unless such rights are expressly conveyed by contract — similar to the treatment of a physical piece of art.

In fact, in most instances the NFT holder simply obtains a nonexclusive license to the underlying intellectual property rights, and typically only for noncommercial purposes. As a result, the image of Beeple's artwork can still be found all over the internet and can be copied and used by anyone with a license from the IP rights owner.

Despite the apparent online availability of multiple digital copies of the Beeple piece, the Beeple NFT itself is nonfungible because only one token is linked to the original file, and if its new owner agrees to sell it, the buyer won't be obligated to accept delivery of some other NFT — even one linked to another piece by Beeple.

Fungibility is doubtless an extremely useful quality in a security, and generally a precondition to a deep and liquid secondary market. But is nonfungibility enough to be sure an asset isn't a security? No. In fact, while many securities exhibit it, fungibility is not a necessary characteristic of a security.

A bespoke over-the-counter option that references a security, for example, may not be fungible in the slightest with any other instrument, yet still clearly a security. And fungibility is not, on its face, an element of the Howey test.

Howey defines an "investment contract" as a transaction involving an investment of money in a common enterprise where profits are reasonably expected from the efforts of others. The closest to fungibility one gets in Howey is the notion of common enterprise, the test's most confusing and misunderstood element.

One judicial formulation, called horizontal commonality, asks whether the fortunes of investors rise and fall with one another, as would be expected when investors all hold the same fungible asset. But any argument that an NFT can't be a security under Howey because it lacks commonality would have to reckon with the SEC staff's reminder in an April 2019 statement that the commission "does not require vertical or horizontal commonality per se, nor does it view a 'common enterprise' as a distinct element of the term 'investment contract.'"

So something other than mere nonfungibility must be the case for an NFT not to be a security, at least in the SEC's view. Because an investor who purchases an NFT with cash or crypto may well be making an investment of money with a reasonable expectation of profits, the question for NFTs is whether that expectation is based on Howey's efforts of others.

It's clear under the case law and SEC interpretations that these must be future efforts — if no forthcoming and expected third-party efforts are needed to realize an asset's investment potential, the asset is no more a security than a painting hung on an art gallery wall.

It's the same when an investor buys a share of Apple common stock: The investor is banking on the future genius of Apple's designers, engineers, marketers and managers much more than on what they've accomplished to date — that value is already locked into the share price and is unlikely to keep propelling it upward.

Viewed through this lens, it's a safe bet that the Beeple NFT is not a security. The work of art auctioned at Christie's exists in its final state, and even if Winkelmann never creates another artwork, this particular NFT has scarcity value and, for some, aesthetic appeal.

True, many collectors will purchase the work of an obscure or up-and-coming artist in hopes of the work rising in value as the artist becomes more renowned.

But from a Howey perspective this type of appreciation is not due to efforts of others, because the "others" are too diffuse and diverse a crowd of critics, gallerists, museums, collectors and members of the public to pin liability on — the "others," in Howey parlance, being the ones who bear securities law liability.

And the fact that the artwork also has a consumptive use — in this case, aesthetic enjoyment and bragging rights — takes it further from the realm of securities, even if consumptive use alone may not be enough to render it a nonsecurity.

But other NFTs may well have a value that depends on Howey-like efforts of others. For example, if a citrus farmer creates an NFT representing a specific tract of land in a Florida orange grove as well as the net profits deriving therefrom, and the farmer undertakes to raise the crop, that NFT would most assuredly be a security under the Howey test. Spoiler alert: These are essentially Howey's facts.

That such an NFT is unique, and may be worth more or less than an NFT representing an adjacent tract, would not mean it's not a security.

To take another example, if a real estate developer finances construction of an office tower through the sale of NFTs, each representing a single identified floor, or even a single square foot, these NFTs may be securities under the Howey test, depending on factors such as the identity of the purchasers, the representations made by the developer and the project's status at the time of the NFT sale.

If token purchasers are investing before the developer breaks ground, and the purchasers are neither in the commercial real estate business nor prospective tenants, the NFTs may well be Howey securities.

Collectibles may present a trickier question. If NFTs are used to facilitate a trading market in a collectible asset class that is already reasonably liquid and accessible in physical form — think Beanie Babies, if you're old enough — then it seems unlikely that the SEC would try to find a security.

On the other hand, an actively managed enterprise centered on creating liquidity in an otherwise relatively inaccessible asset class might catch the SEC's attention — expensive classic sports cars, perhaps, with NFTs representing distinct auto parts.

Here, the SEC might say there's a Gary Plastic issue, drawing on the 1985 U.S. Court of Appeals for the Second Circuit holding in Gary Plastic Packaging v. Merrill Lynch that illiquid, nonsecurity bank certificates of deposit morphed into securities because of a broker-dealer's active facilitation of a secondary market. In plain English, using NFTs to securitize an investable but difficult-to-trade physical asset might generate a security.

As with so many other assets analyzed under Howey, the bottom line is that an NFT may or may not be a security depending on the particular facts and circumstances. Nonfungibility alone probably will not place an NFT outside the reach of the federal securities laws.

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