# Demystifying NFTs Episode 3

**PLUS Staff:** [00:00:00] Welcome to this PLUS Podcast, Demystifying NFTs, Episode Three. We would like to remind everyone that the information and opinions expressed by our speakers today are their own and do not necessarily represent the views of their employers or of PLUS. The contents of these materials may not be relied upon as legal or financial advice.

And now, I'd like to turn it over to Alice Budge.

**Alice Budge:** Thanks, Tyla. Welcome back, everyone. We're very excited about today's episode in which we're going to tackle several NFT topics, all having to do with money. We're also happy to welcome our very special guest, Meredith Challender, who co-leads the Kissel Straton & Wilmer Emerging Tech team along with Jennifer Stivrins, one of our regular contributors to the podcast.

Their colleague, Vito Marzano, joins us as well, as usual. In what is a very timely episode, today, we will be discussing treatment of NFTs as commodities or securities, how NFTs intersect with anti-money laundering laws, NFTs and sanction issues, and finally, NFTs as virtual [00:01:00] currency and the valuation issues inherit in this.

We'll include discussion on the current turf wars that appear to be coming to a head in the US between the SEC and the CFTC and their views on digital assets as well. I would like to add that the CFTC is the tongue twister for today's episode. We seem to add one every week. That's a lot to grapple with in one episode, so we'll dive straight into the discussion on NFTs as commodities and go from there.

**Vito Marzano:** Thanks Alice, and welcome Merri. I think before we dive in, we should briefly recap what an NFT is as we discussed in Episode One. An NFT is an initialism for non-fungible token, which are truly unique digital assets that are comprised of computer code and hosted on a blockchain ledger. These ledgers confirm ownership and also confirm authenticity.

As we previously discussed, they can be a marker for something digital only or for something physical. And the values will vary widely. So, it's understandable that US regulators are thinking “how should we be treating these things?”

**Jennifer Stivrins:** Yeah, that's right. [00:02:00] And as a bit of a preview, and we've discussed this before, we are US lawyers, so we're going to be focusing on what the US federal regulators and courts are doing in this respect.

Um, as a sneak peek, I think it's safe to say that there's a lean toward considering NFTs to be securities rather than commodities, but it all really depends on how the particular NFT functions. So, in other words, not all NFTs are created equal. I also want to mention that we are not talking today about what the individual states are doing with a couple little exceptions with regard to treatment of NFTs because that just adds a whole other level of complexity.

So, with that, I'll turn it over to our guest today, Merri Challender [née Coleman].

**Meredith Challender:** Hi everyone. Just as we jump into things, I think it's fair to also point out here that the US legislators, aka Congress, have not yet taken a position on what regulatory entities should be in charge of digital assets. So that's left a vacuum in which the two main [00:03:00] US financial regulators, the CFTC and the SEC, are in a turf war, as Alice noted, as it pertains to digital assets.

We've seen a lot of action from both entities over the last couple of weeks, in the SEC *Coinbase* and CFTC *Binance* matters, both of which we'll discuss briefly today. So, much of what we say on this episode is subject to change over the coming months and years as the purview of those regulators is delineated by Congress or the agencies themselves.

**Jennifer Stivrins:** Yeah, that's a great point. So, let's start with the CFTC. What is their role generally?

**Vito Marzano:** I'll jump in here. So, the CFTC, or the Commodity Futures Trading Commission, was established in 1974, and the job at its most basic is to regulate, you might have guessed maybe from the name, the commodity futures and options markets often referred to as derivatives.

Notably, the definition of commodity in the US code includes all kinds of produce and agricultural goods except for onions, apparently. Um… which I guess we'll maybe we'll cover in another [00:04:00] episode. Um, metals and “all other goods and articles . . . and interests in which contracts for future delivery are presented or in the future [dealt with] dealt in.”

Excuse me. Merri, any thoughts?

**Meredith Challender:** Right. And it's this “all other goods and articles” language that would be the basis for the CFTC to say *they* should be the ones regulating crypto assets. Going all the way back to 2015, the CFTC has taken the position that Bitcoin is commodity because it's generally viewed as a decentralized currency.

But they've waffled a bit as to what other digital assets like ETH, Litecoin, and Tether are commodities. For example, in December 2022, in the wake of the FTX collapse, the CFTC chief took the position at a private event that Bitcoin was the only crypto asset that could be viewed as a commodity. Then, in connection with their March 27, 2023, civil enforcement action against Binance, the CFTC took a much broader approach naming Bitcoin, ETH, Litecoin, and two stablecoins, Tether and Binance USD, as well as other “virtual [00:05:00] currencies” as commodities.

To give you a further sense of just how broadly the CFTC currently views their role, they claim the *Binance* case “demonstrates that there is no location, or claimed lack of location, that will prevent the CFTC from protecting American investors” and go on to say that the CFTC has been clear that it will “continue to use all of its authority to find and stop misconduct in the volatile and risky digital asset market.”

**Alice Budge:** Okay. That's really interesting. Thank you. But doesn't this all really concern cryptocurrency and not necessarily NFTs?

**Jennifer Stivrins:** Yeah, you're right. You're right. That's true. But again, the CFTC is entrusted to regulate, again, “all other goods and articles.” So, with the CFTC's interest, specifically in cryptocurrencies, you can easily see them interested in other digital assets such as NFTs as well.

**Meredith Challender:** Yeah, and actually, in June 2022, US Senators introduced a bipartisan bill, which squarely put most of the responsibilities for regulating NFTs on the [00:06:00] CFTC. The authors of that proposed bill, entitled The Responsible Financial Innovation Act, believed that cryptocurrency is more likely to operate as a commodity than a security.

The Senate last held meetings on that bill in November 2022 but seemingly took a step back in the wake of the FTX collapse, but we'll certainly be watching closely for it or other similar bills to move forward. Additionally, since the beginning of 2023, Bitcoin “Ordinals,” which are really just the Bitcoin version of NFTs, have been increasingly popular.

And since Bitcoin is a commodity, I think it's safe to assume those would be treated *at least* as commodities. But that's not to say they couldn't also be treated as securities.

**Alice Budge:** So basically, you're saying they could be commodities, but they can also be securities?

**Jennifer Stivrins:** Yeah, that's right. And as we noted earlier, both the SEC and the CFTC, as well as the legislators, are flexing their muscles in this area in terms of who should be handling regulation of NFTs and other digital assets.

But the legal landscape on NFTs as securities is [00:07:00] more developed than that on NFTs as commodities. So, there are some more concrete things to discuss here. Vito, can you help us with who the SEC is and what is a security just generally before we dive in?

**Vito Marzano:** Of course. So, the SEC is the US Securities and Exchange Commission, which Congress established with The Securities Act of 1934 and tasked with regulating securities markets.

"Securities," at their most basic, are financial instruments that can be traded. These are things such as notes, stocks, bonds, and the like.

**Alice Budge:** Okay. Noted. I can see exactly how an NFT would fit there then.

**Meredith Challender:** And the SEC chair, Gary Gensler, has recently said that while he agrees Bitcoin is a commodity, every other digital asset is a security, which is obviously a departure from the CFTC's latest position.

Uh, many of our listeners have likely heard that the SEC recently threatened to sue Coinbase with the issuance of a Wells Notice on March 22, 2023. Although not specified in the Wells Notice, Coinbase believes it was issued in connection with its [00:08:00] "Earn" product, which generates earnings via staking services or DeFi yield, and which presumably the SEC will allege is an unregistered security.

Coinbase has been pretty aggressive in its response saying the company is "right on the law [and] confident on the facts." If any crypto company is going to tangle with the SEC, Coinbase certainly seems prepared to do so, both financially as well as from a policy standpoint. So that's also a case we'll be following closely.

**Jennifer Stivrins:** Okay, so then let's extrapolate that to NFTs. What do you think that means for NFTs?

**Meredith Challender:** The SEC's general position that all digital assets other than Bitcoin are securities would seem to have significant implications for where we see digital asset and cryptocurrency regulation heading. But from a regulatory enforcement perspective, the SEC and the courts hearing these matters have to take each digital asset on a case-by-case facts and circumstances basis.

**Jennifer Stivrins:** Got it. Okay. Yeah, and we'll talk a little bit here about what New York is doing. The New York Attorney General's Office is following that up as well. Just last month on March [00:09:00] 9th, the New York Attorney General Letitia James filed a lawsuit against KuCoin, which is a virtual currency trading platform, which allows investors to buy and sell cryptocurrency, including ETH, Luna, and Terra, which James specifically classifies as "securities and commodities." So, this is one of the first times a regulator has claimed that ETH, which is one of the largest cryptocurrencies, is a security. And as a reminder to our listeners, and as we talked about in the first episode, ETH is on the same blockchain where we see the bulk of NFTs.

**Alice Budge:** Thanks, Jenni. What does the SEC and other regulators look for to determine if a digital asset is a security or not then?

**Vito Marzano:** So far the SEC has used a test from the 1946 US Supreme Court case, *SEC v. W.J. Howey Company*. So, under the *Howey* test, a transaction will qualify as a security under the Securities Act if it meets the following four prongs: (1) an investment of money, (2) into a common enterprise, (3) in [00:10:00] which investors expect to profit, excuse me, and (4) from the efforts of a third party.

**Jennifer Stivrins:** Right. So, there are a lot of questions in the digital asset community over whether the *Howey* test is really even the right test to be using.

But so far, it's been the test that courts looking at this issue have used, including in the pending *Dapper Labs* case, which I think is the case that we're all watching in connection with this issue. So, in the *Dapper Labs* case, Jeeun Friel filed a class action lawsuit against Dapper Labs for their sale of "NBA Top Shot Moments" NFTs.

So, these were NFTs of basically clips of basketball games, iconic basketball clips. Um, [Ms.] Friel argues that the NFTs sold by Dapper Labs constitute securities, and as a result, their sale in the absence of the required securities registration is illegal. Dapper Labs in their defense argues that the NFTs can't meet the *Howey* test because the [00:11:00] purchasers don't share vertical or horizontal commonality.

And without getting overly technical, the US Circuit Courts, which are the federal intermediary courts, are split on whether the *Howey* test requires “horizontal” or “vertical” commonality, which really just talks about how the parties are related in connection with a given purchase. So, in any event, Dapper Labs’ argument is that these are completely unrelated individuals buying NFTs of basketball video clips, and there's no way that that meets this commonality requirement under the *Howey* test.

**Meredith Challender:** I would just add also that Dapper Labs argues that the NFTs do not come with any reasonable expectation of profits, which is another requirement of the *Howey* test. As you guys have covered in the prior two episodes, both in the *Hermès* case and the *Tarantino* case, the value of NFTs can vary pretty widely, so it's questionable whether one could *expect* a profit from an NFT. On this point, Dapper Labs argues the NFTs are “nothing more than objects of play and not for [00:12:00] investment or speculative purposes.”

**Alice Budge:** So, albeit this is obviously quite a current case, do we have any idea how the court came down on the *Dapper Labs'* issue?

**Vito Marzano:** So, there's been no answer yet, but we have some recent activity in the matter.

On February 22nd of this year, the Southern District of New York denied Dapper Labs’ motion to dismiss, which means that in essence, the court determined that Friel had pleaded allegations sufficient to render the claims facially plausible. In other words, the allegations, if true, [would establish Friel’s entitlement to the relief sought.

The court didn't conclude that it is for sure not a security, but it didn't conclude that it is a security either. Essentially, the parties have to litigate these issues. Dapper Labs filed an answer to the amended complaint shortly thereafter on March 15th.

The parties are working on their case management plan at this stage.

**Alice Budge:** Great. So, I think we need to add this one to our list of court cases we're currently watching throughout the episodes. While that meanders through the court system, are there other suggestions out [00:13:00] there that NFTs should or will be considered securities?

**Meredith Challender:** Sure, yeah. We're keeping tabs on a number of other regulatory matters involving NFTs. For example, we've seen state securities boards issuing cease and desist orders to companies issuing NFTs that fund creation of "virtual casinos" in metaverses in the *Sands Vegas Casino* matter. So far, it does seem that particularly where NFTs represent some kind of fractional ownership similar to owning shares in a company, then the state and federal regulators are going to have a closer eye on it.

We're also watching the *OpenSea* matter where the Department of Justice arrested and charged a former OpenSea product manager with wire fraud and money laundering for alleged trades he made using insider knowledge about which NFT collections were going to be featured on OpenSea's homepage. The DOJ specifically called those trades "insider trading" indicating that they *may* see NFTs as securities as well.

The court in the Southern District of New York denied the defendant's motion to dismiss in October 2022, and the next pretrial conference is set for [00:14:00] April 20th. So we'll be watching this one closely as well.

**Jennifer Stivrins:** And that's a great segue into talking about money laundering issues with NFTs. So, we've established NFTs are *maybe* commodities, *probably* securities, but why do we care?

And this is something that Merri and I were discussing recently. For one thing, these businesses that are impacted by these regulations, the hoops that they need to jump through to comply and the costs attendant to those hoops can vary, but they can be really steep, particularly with the SEC.

I think more relevant to our listening audience is how businesses and individuals who interact with NFTs will ultimately be treated by the law. And of particular interest to Underwriters, what kind of liability a business might be looking at if they deal in NFTs to any extent.

**Alice Budge:** So, I can see this is perfect territory for money launderers then. They're anonymous, they can be relatively low in cost, the valuation is subjective, and, as noted, the regulatory landscape is [00:15:00] largely unclear.

**Vito Marzano:** Yeah, so the regulator we look to here in the US when looking at money laundering is the Financial Crimes Enforcement Network or FinCEN. FinCEN regulates money service businesses that involve "digital currency."

And depending on how a given NFT's classified, may look to enforce The Bank Secrecy Act, or BSA, regulations in connection with the NFT's transfer, sale, and custody.

**Jennifer Stivrins:** Right, and just last year, February 2022, the Department of Treasury, which is the entity that oversees FinCEN, released a report regarding money laundering through the trade in works of art.

Admittedly, this was largely focused on traditional physical art market but also did address the emerging digital art market as well. And specifically with regard to the digital market, the report notes that "NFT platforms . . . already allow owners of digital art to sell the assets on virtual exchanges."

So, "depending on the nature and characteristics of the NFTs [00:16:00] offered, these platforms may be considered virtual asset service providers (VASP) by [the Financial Action Task Force] "FATF and may come under FinCEN's regulations." That's a lot of technical jargon and as Merri pointed out to me, alphabet soup.

Here again, it's apparent that not all NFTs are created equal. Note, the language that the Treasury Department used, which is this quote, "depending on the nature and characteristics of the NFTs offered," really indicates that they're looking at each NFT individually.

**Meredith Challender:** Yeah. Exactly, Jenni. In that same report, the Treasury states that "NFTs or other digital assets . . . that are used for payment or investment purposes . . . may fall under the virtual asset definition, and service providers of these NFTs could meet the FATF definition of the VASP," which, again, is total alphabet soup.

But really what they're saying is that if a particular NFT is used as an investment or form of payment, it may be considered a virtual [00:17:00] asset that is subject to FinCEN regulation.

**Alice Budge:** So, for underwriting purposes, then, it's important to know whether an entity touches NFT in any way, but it is even more important to know *how* they interact with those NFTs and whether they may be subject to banking or any other money laundering laws.

**Vito Marzano:** Yes, and the same goes for sanctions. OFAC, or the US Office of Foreign Assets Control, has been very clear that the current sanctions regime applies to digital transactions. OFAC also enforces sanctions relating to blockchain-hosted transactions, and NFTs have been included as "blocked property" by OFAC and publicly impacted since at least late 2021.

This means, of course, that because US citizens, and permanent resident aliens, are essentially prohibited from entering into transactions with the people and entities associated with the designated cryptocurrency addresses, dealing in the NFTs that *live* on those addresses is also prohibited for US citizens and permanent resident aliens.

**Jennifer Stivrins:** Right. So, where OFAC designates a [00:18:00] person or entity as a Specially Designated National, or an SDN, OFAC essentially blocks that property. So, if OFAC designates a crypto wallet as an SDN, and there are NFTs in that wallet, those NFTs become blocked property too. This is why the KYC, or Know Your Customer, compliance protocols are so important for those who are dealing in NFTs.

**Alice Budge:** And I suppose from the underwriting perspective, why Underwriters really need to understand what their policyholder and KYC protocols are.

**Jennifer Stivrins:** Yeah, that's exactly correct.

**Alice Budge:** Now, we promised a chat about virtual currency and valuation at the top, but that was a bit of a teaser now, wasn't it Jenni?

**Jennifer Stivrins:** It was. So, as we've discussed throughout, NFTs and cryptocurrency go hand in hand, particularly when it comes to classification and the fact that not all NFTs are created equal for consideration as commodity or security. However, when you're talking about valuation, [00:19:00] it can swing pretty wildly with NFTs.

So, value today, gone tomorrow. And Merri mentioned this earlier, but again, the *Tarantino* case, which we talked about in Episode Two, in that case, the first NFT sold for $1.1 million, but then the next six of seven of those NFTs didn't even get put on the market because of "market volatility."

Similarly, in the *Hermès* case, Hermès and Rothschild discussed widely varying values for those MetaBirkins. So why do we care? To tease the upcoming underwriting episode a bit more, valuation of NFTs when it's used to support valuation of a company or to somehow show a company's “worth” in the underwriting and application process is really tricky.

Underwriters have to have that keen eye as to what type of value a policyholder is putting on both their NFT holdings and their NFT exposure. So, we will have more about that in a future episode.

**Alice Budge:** Another teaser for us, again. We'll have to look [00:20:00] forward to that next week. And I do understand you've got another golden nugget for us in regards to the final US tax update for us today.

**Jennifer Stivrins:** Yeah, so this is just an update to what we shared in Episode 1. So, in Episode 1, we spoke briefly about the fact that the Internal Revenue Service (“IRS”), which is our tax department here in the US federally, they had expanded their instructions for those filing tax forms to ensure that those tax forms included NFTs as well as cryptocurrencies.

So as an update, on March 21, 2023, the Treasury Department and the IRS published proposed guidance to clarify the tax treatment of digital assets, and, specifically, whether NFTs should get the same tax treatment as collectibles—so things like artwork, antiques, stamps—under the tax law. So, the Treasury and the IRS are requesting comments on this issue through June 19th.

Our listeners should be sure to write in if they want their voices heard on that issue.

**Alice Budge:** Thanks for that [00:21:00] update. Thank you very much to everyone again for coming on today, and thanks for Merri Challender for joining us, our special guest. And next week we are going to be talking about cybersecurity and the concerns around that, so look forward to that.

We have also got our email address for any questions you want to send in at the bottom of our post.

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