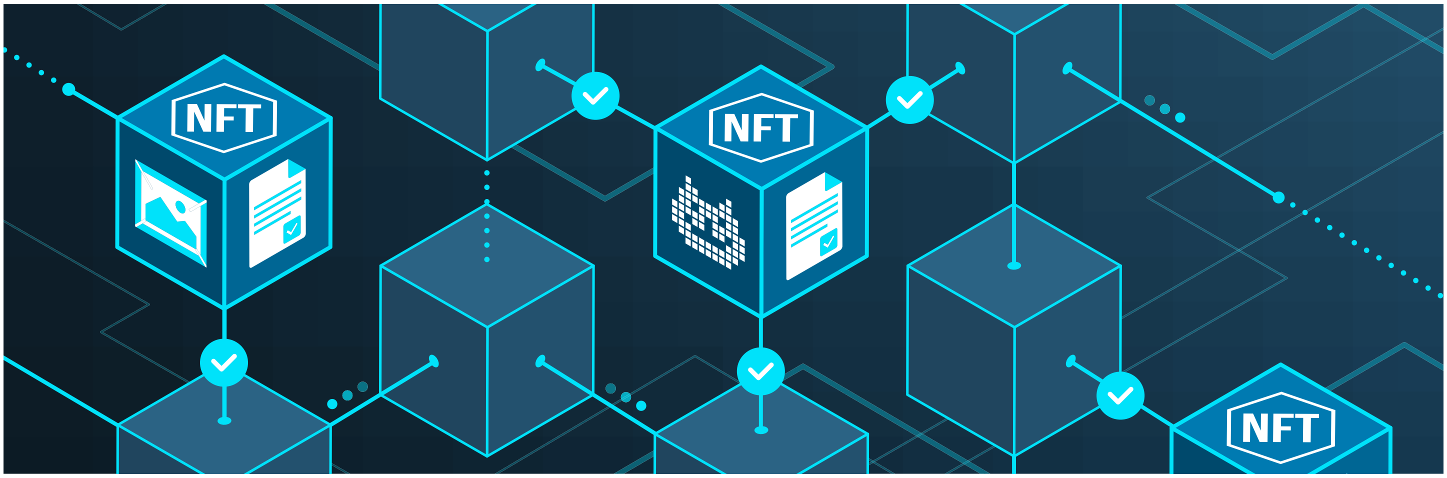


# NFT Regulatory Issues – a 2022 Review and 2023 Preview

By: James Gatto

Despite the minimal regulatory enforcement actions against blockchain game companies and NFT issuers, now is NOT the time to become complacent about regulatory issues. As indicated below, many U.S. agencies are increasing their focus on regulatory enforcements in the crypto space and NFTs are no exception. In 2022, we saw U.S. regulators ramp up staffing for more enforcements. All of this was happening before the FTX debacle. Things are only going to intensify in 2023 as a result of FTX. Some of the areas to remain focused on include the following.

- **Insider Trading** – legal action was brought against Nathaniel Chastain (formerly of Open Sea) for insider trading charges relating to NFTs, despite the fact that the NFTs were not even alleged to be securities. See here and here for more info on these actions. Similar charges were filed against another individual. We continue to recommend that companies adopt an NFT insider trading policy. One reason for this is that the SEC is investigating the lack of such policies for NFT/crypto exchanges.

- **Sanctions** - OFAC sanctioned an exchange and designated 57 cryptocurrency addresses (associated with digital wallets) as Specially Designated Nationals (SDNs). These designations appear to be the first time NFTs have been publicly impacted as "blocked property" – as one of the designated cryptocurrency addresses owns non-fungible tokens (NFTs). Because U.S. persons are essentially prohibited from transacting with the individuals and entities associated with the designated cryptocurrency addresses, dealing in those NFTs is prohibited for U.S. persons as well. See here for more. OFAC is likely to be more vigilant with crypto and NFT enforcement in 2023.

- **Money laundering** - The Department of the Treasury published a study on the facilitation of money laundering and terrorist financing through the art trade. Among other considerations, the report discussed the risks of financial crimes in connection with high-value art, including NFTs (see our previous blogs about NFTs here and here). The study found that the high-value art market has certain inherent qualities that make it potentially vulnerable to a range of financial crimes. NFT purchasers, marketplaces, issuers, and other intermediaries in NFT transactions should be aware of the Treasury Department's interest in regulation and the potential for abuse through NFT transactions. As the study continues, expect enforcements to follow. For more see here.

- **Taxes –** The IRS continues to increase its efforts to compel taxpayers to report digital asset activity on their tax returns and apparently is continuing to compel information from exchanges to target users who do not. For more see here. To date, their efforts have had only minimal effect. Look forward to more rigorous enforcement in 2023.

- **Securities –** despite written requests, the SEC has not issued specific guidance on the applicability of securities laws to NFTs. In the interim, the general guidance in its Framework for "Investment Contract" Analysis of Digital Assets should be considered to assess whether an NFT offering implicates securities laws, especially where NFTs are used in place of traditional fundraising. Some of the scenarios where this may occur include fractionalization, presales of NFTs where a game is not yet built and attaching certain revenue rights to ownership of NFTs. However, the determination in each case will be highly fact specific. The SEC has reportedly sent subpoenas related to the investigation of NFTs and is particularly interested in information about fractional NFTs. For more on that see here. The SEC has announced a near doubling of its staff to focus on enforcements of crypto assets including NFTs, with an emphasis also on crypto asset lending, staking and defi platforms. For more see here. A pending securities class action lawsuit against Dapper Labs alleges NFTs sold on Dapper's platform constituted unregistered securities in violation of federal securities laws. Many in the industry are watching this case. *Friel v. Dapper Labs, Inc., et al.*, No. 1:21-cv-05837-VM. The SEC is reportedly investigating Yuga Labs for potential violations of federal securities laws in connection with its sales of Bored Ape NFTs and its subsequent issuance of ApeCoins as governance and utility tokens. As the Bored Ape Yacht Club is one of the most successful NFT projects, any enforcement action against it would have potentially significant ramifications for the industry. Keep an eye on this one in 2023.

- **Intellectual Property** – The IP issues with NFTs continue to be somewhat murky. The United States Patent and Trademark Office and the U.S. Copyright Office are conducting a joint study to consider intellectual property law and policy issues associated with NFTs. The results of this study could lead to new policy directives and potential regulatory changes to IP issues with NFTs. I am working with the American Bar Association (ABA) and the American Intellectual Property Law Association (AIPLA) to provide input for this study. If anyone is interested in commenting, comments are now due February 3, 2023. Feel free to reach out to me for more info or to discuss. As part of this study, the two offices will conduct a series of three virtual public roundtables focusing on IP considerations as they relate to NFTs. They will take place on the following dates:

  - **Roundtable 1: Trademarks and NFTs (January 24, 2023)**
  - **Roundtable 2: Patents and NFTs (January 26, 2023)**
  - **Roundtable 3: Copyright and NFTs (January 31, 2023)**

  Also, the number of lawsuits relating to the misuse of IP and other IP issues in connection with NFTs is increasing. While two high profile NFT-related IP lawsuits settled in 2022 (*Roc-A-Fella Records, Inc. v. Damon Dash* and *Miramax, LLC v. Quentin Tarantino et al*), a number of big cases are pending on these issues, including:

  - **Nike v. StockX –** whether StockX NFTs are merely a digital certificate of authenticity or a separate product
  - ***Hermès v. Rothschild*** – whether NFTs of Hermès' iconic Birkin handbags advertised and marketed as "MetaBirkins" are infringing works or expressive works of art that are protected under the First Amendment under *Rogers v. Grimaldi*
  - ***Yuga Labs v. Ryder Ripps*** – whether Ryder Ripps is infringing Yuga's IP and whether Yuga actually has any copyright protection due to the ape images allegedly "having been generated by an automated computer algorithm where no humans were involved in determining which of the 10,000 BAYC Images were selected." *Yuga Labs, Inc. v. Ryder Ripps, et al.*

- **Consumer Protection** – The FTC has taken greater interest in the way NFTs are described and marketed to avoid deceiving consumers. This can arise, for example, when an NFT is advertised in a way that includes false advertising or misinformation. This often leads to NFT purchasers not understanding what they are purchasing. As one common example, NFTs are often advertised as granting "ownership" of a "unique" digital asset, but in reality the purchaser may only receive a limited license and/or the asset is not unique (e.g., NFTs are offered for many copies of the digital asset).

  The Uniform Law Commission adopted amendments (including a new Chapter 12) to the Uniform Commercial Code (UCC) to govern the transfer of digital assets, including cryptocurrency, digital tokens and non-fungible tokens (NFTs). The amendments span almost every article of the UCC and add a new Article 12 addressing certain types of digital assets defined as "Controllable Electronic Records" (CERs). The amendments provide new default rules to govern transactions involving these new technologies Several states have adopted or are in the process of adopting the changes and others plan to do so.

- **Celebrity Endorsements** - Many high profile NFT projects have used celebrities to endorse their projects. These endorsements may fall under the jurisdiction of the FTC and the SEC. The FTC Endorsement Guidelines apply to celebrity endorsements of NFTs. However, the SEC has even more stringent disclosure requirements for celebrity endorsement of crypto assets that are securities. The FTC's Endorsement Guidelines require disclosure of a "material connection" between the endorser and the company or product. By contrast, the SEC mandates disclosure of the "nature, scope, and amount of compensation" relating to the endorsement.

- o The SEC reached a $1.26 million settlement with Kim Kardashian for her role in endorsing, via social media accounts, a crypto asset that was being offered and sold and was a security. Kardashian did not fully disclose her compensation for her role. The SEC found that Kardashian's failure to disclose this compensation violated Section 17(b) of the Securities Act, which makes it unlawful for any person to promote a security without fully disclosing the receipt and amount of such consideration from an issuer.

- o A recent class-action lawsuit against 37 defendants alleges that stakeholders in Yuga Labs, the company that issued Bored Ape Yacht Club NFTs and its other digital products, engaged in a conspiracy with celebrities to defraud potential investors. The complaint alleges that the BAYC digital collectibles were "misleadingly promoted" using celebrities to bait investors without disclosing the nature, source, and amount of any compensation paid, directly or indirectly to the celebs. *Adonis Real, et al. v. Yuga Labs Inc.* This will also be closely watched in 2023.

- **Fraud –** fraudulent practices will continue to be prosecuted. This was happening before FTX and will likely accelerate as a result of FTX. For example, in March 2022, two fraudsters who engineered an NFT "rug-pull" were criminally charged with conspiracy to commit wire fraud and conspiracy to commit money laundering. The million-dollar scheme to defraud purchasers of NFTs was based on how they advertised "Frosties." Rather than providing the advertised benefits to Frosties NFT purchasers, the defendants funneled the proceeds of the sale to various crypto wallets under their control and shut down their NFT website.

One of the great things about NFTs and blockchain games is that they are just getting started. As more companies adopt NFTs and more game studios enter the space, more competition will result. This will undoubtedly drive continued experimentation and new developments. As these offerings evolve, new legal issues will continue to arise. The regulators are falling behind on enforcement based on the current state of technology. As the pace of NFT and blockchain game innovation increases, it will be harder and harder for regulators to develop clear guidance. This lack of clarity will continue to result in challenges for companies seeking to be regulatorily compliant. This will increase the need for such companies to seek counsel from lawyers who truly understand the NFT and blockchain game space and can help advise on issues where there is lack of regulatory clarity.

## For further details on blockchain and digital currency, please contact:

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