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FINANCIAL SERVICES

JUNE 16, 2021

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Not Your Standard Orange Grove: Non-Fungible Tokens & Securities Laws

With offerings across a growing number of online platforms and increased trading volume, NFT issuers, promoters, and buyers should consider the legal and regulatory implications relating to NFTs and federal securities laws.

Throughout the first half of 2021, non-fungible tokens ("NFTs") have continued to experience widespread adoption across a range of industries. Just last week, rights to a so-called CryptoPunk NFT, dubbed "Covid Alien," was sold at a Sotheby's auction for $11.7 million.[1] The variety of use cases for NFTs, combined with rapid and significant growth in the number of offerings and—in some cases—the promise of a large potential upside for investors, have made NFTs increasingly popular. This increased interest from the public at large, especially from would-be investors, could very likely be followed by increased scrutiny from regulators.

This article discusses whether, and in what circumstances, NFTs might be found to be a "security" under federal securities laws. We identify key factors that might inform that analysis, as well as possible next steps for the regulation of NFTs by the Securities and Exchange Commission and other securities regulators such as the Financial Industry Regulatory Authority (FINRA) and state Attorneys General.

This article is the second in a multi-part series exploring the legal and regulatory implications surrounding the issuance, purchasing, and trading of NFTs. The first article, which addressed the current state of play, potential risks, and likely regulatory developments relating to the treatment of NFTs by federal anti-money laundering laws, is available here.

WHAT ARE NFTs, AGAIN? (A QUICK REMINDER)

NFTs are digital assets encoded on a blockchain that represent control[2] of a unique asset or set of rights. NFTs are "minted" by issuers or creators and are purchased through online exchanges or marketplaces. At the time of this writing, the overwhelming majority of NFT transactions were purchased with cryptocurrency.[3]

NFTs are not, however, limited to the digital space. They "can also represent any type of physical asset, acting as a kind of 'digital twin' to anything existing in the real world and enabling the ownership and exchange of physical possessions within digital marketplaces."[4] One key characteristic of NFTs is provable control. Given the reliability of blockchain technology and decentralized ledgers, an NFT holder can be confident that his or her control of the underlying asset(s) is secure. NFTs can also be accompanied by "smart contracts," which allow the seller to place conditions on the token-holder's rights, such as royalty payments to the original NFT creator.[5] The conditions of an NFT's underlying smart contract are designed to be automatically enforced by the NFT's code on the blockchain.

NFTs & *HOWEY*: ARE NON-FUNGIBLE TOKENS SECURITIES?

The U.S. Securities Act of 1933 contains a list of instruments that constitute a "security" for purposes of that law. Beyond the usual suspects like stocks and bonds, the statutory definition of "security" includes any "investment contract," but does not define that term. The *Howey* test, originally developed by the Supreme Court in 1943 and refined in the intervening decades, is a four-part test to evaluate whether a particular instrument constitutes an "investment contract" for purposes of the Securities Act. Under *Howey*, an "investment contract" exists where all of the following four factors are satisfied: (1) an investment of money; (2) in a common enterprise; (3) with a reasonable expectation of profits; and (4) to be derived from the entrepreneurial or managerial efforts of others.[6] This definition embodies a "flexible rather than a static principle, one that is capable of adaptation to meet the countless and variable schemes devised by those who seek the use of the money of others on the promise of profits."[7] The *Howey* test "permits the fulfillment of the statutory purpose of compelling full and fair disclosure relative to the issuance of 'the many types of instruments that in our commercial world fall within the ordinary concept of a security.'"[8] Under *Howey*, "form should be disregarded for substance,"[9] and "the emphasis should be on economic realities underlying a transaction, and not on the name appended thereto."[10]

The SEC has explained that crypto tokens, coins, or other digital assets issued on a blockchain *may* be securities under the federal securities laws, typically based on an analysis under the *Howey* test. And if a particular asset qualifies as a security, then a broad range of securities laws become relevant to the asset. Most significantly, issuers and others who offer or sell that asset in the United States must either register the offering and sale with the SEC or else qualify for an exception or exemption from registration. The marketing and sale of an asset that constitutes a security would also be subject to antifraud rules under the securities laws, the violation of which can result in both civil liability and criminal penalties.

Following some initial guidance on how to apply the *Howey* test to digital assets,[11] in April 2019, staff members from SEC's Strategic Hub for Innovation and Financial Technology ("FinHub") published a "Framework for 'Investment Contract' Analysis of Digital Assets."[12] In part a reaction to the wave of initial coin offerings during the preceding few years, this Framework provided updated, and more granular, considerations for analyzing the application of the federal securities laws to the growing number and types of digital assets.

When it comes to NFTs, however, neither the SEC, the Commodities Futures Trading Commission, nor any court has offered specific guidance on how (or even whether) the *Howey* test might be applied. The following sections of this article are intended to provide insight for NFT creators, issuers, and downstream market participants, based on prior

case law relating to digital and physical assets. We aim to identify some of the questions and considerations that courts or the SEC might take into account when applying the “investment contract” analysis to NFTs.

*Howey* Prong # 1: Investment of Money

This is perhaps the only clear answer when it comes to *Howey* and NFTs. The SEC and several courts have held that, to meet the definition of a security, an investment of “money” need not be in the form of cash.[13] As noted above, NFTs are almost entirely purchased with cryptocurrency, primarily Ether, which would be sufficient to satisfy the first prong of the *Howey* test.

*Howey* Prong #2: Common Enterprise

In its Framework for Digital Assets, the FinHub staff explained, without lengthy analysis, that “based on [FinHub’s] experience to date, investments in digital assets have constituted investments in a common enterprise because the fortunes of digital asset purchasers have been linked to each other or to the success of the promoter’s efforts.”[14] FinHub’s staff also acknowledged the inconsistency among federal courts—some applying the “horizontal commonality” test and others applying one of two variants of the “vertical commonality” test[15]—but noted that, unlike federal courts, the SEC “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.’”[16] Thus, based on this fairly broad definition, to the extent the value of an NFT is “linked” to either the fortunes of the NFT promoter or to those of other investors, issuers should beware that such NFTs could satisfy *Howey’s* common enterprise prong.

At first blush, the very nature of NFTs—that they are non-fungible and grant unique rights to a single purchaser—makes the “common enterprise” analysis different, as compared to assets that are widely distributed and interchangeable. For example, the connection between a single purchaser of a piece of digital artwork and the creator of that artwork is not the same as the connection between an individual shareholder and the company that issued the investor’s shares. The former merely purchased a piece of art and might not interact with the art’s creator beyond that single transaction; the latter is connected to the company as a going concern into the future until that shareholder decides to sell the shares. Of course, as with all prongs of the “investment contract” analysis, the inquiry would be highly fact-dependent. If, for example, an NFT’s value is affected by a broader scheme or strategy—*e.g.*, where the NFT is part of a series of similar NFTs, the value of which will likely rise and fall together—a court or the SEC could be more likely to find that the assets are part of a common enterprise. Similarly, it is theoretically possible that a smart contract itself might constitute an entire business (and thus a common enterprise), with the associated NFT representing an equity-like security issued by the business.

Perhaps the most likely target for regulators are fractional NFTs, also known as “F-NFTs” or “shards,” which constitute partial ownership of a larger underlying NFT. These fractionalized assets bear an obvious resemblance to securities: they represent partial ownership in a larger asset; their value is linked to the value of the asset overall; and they are held by a pool of similarly situated investors, each with his or her own connection to the original NFT creator or issuer (seemingly satisfying the horizontal and vertical commonality tests discussed above). Both the SEC and courts have frequently held that fractional interests in underlying assets that are not securities may nonetheless constitute securities when other aspects of the *Howey* test are present.[17] Thus, while the common-enterprise prong for NFTs will depend on the facts and circumstances of the token in question, it seems reasonably likely that regulators and courts would be inclined to treat fractionalized NFTs as securities.

*Howey* Prong #3: Reasonable Expectation of Profits

While the nature of *Howey*’s case-by-case and fact-intensive approach makes it difficult to predict how any particular case might be handled by a court or the SEC, certain key factors have frequently been considered when addressing

whether investors in a particular instrument had a reasonable expectation of profits. The following questions have been discussed in the context of both non-digital and digital assets alike and would similarly apply to NFTs:

- **How do Marketing and Promotional Materials Characterize the Asset?** Several cases have discussed the importance of an issuer's representations in advertising and promotional materials. The more these materials focus on the likelihood that an instrument will appreciate in value, describe the instrument as an investment opportunity (rather than a token for purely consumptive use), or the issuer's efforts that have been (or will be) undertaken to support the demand for the token in question, the more likely it will be treated as a security.[18]
- **Has the Issuer Made Efforts to Increase Demand or Value?** In addition to considering whether issuers merely promote the benefits of a particular investment, courts will consider whether the issuers do, in fact, take steps to increase the demand or value of the instrument in question. The more those efforts are aimed at increasing the value, the more likely an investor would have a reasonable expectation of profits.[19] In the crypto space, several cases have held that, where the issuer takes steps to foster an "ecosystem" for digital tokens that will allow such tokens to increase in value, investors in those tokens had a reasonable expectation of profit.[20]
- **Is There a Secondary Market for the Asset?** The SEC has noted that where secondary markets exist or where the promoters have endeavored to foster a secondary market to provide liquidity for purchasers, it is more likely that investors in the instrument had a reasonable expectation of profit.[21]
- **Who Is the Target Buyer?** If an issuer's outreach suggests that it is targeting investors rather than end-users who might simply purchase tokens for their practical utility, this makes it more likely that the instrument in question should be treated as a security. In the case of *Munchee*, the defendant company ceased its initial coin offering after the SEC found that its conduct constituted unregistered securities offers and sales, and the SEC specifically noted that the company "targeted . . . people with an interest in tokens or other digital assets that have in recent years created profits for early investors."[22] The SEC elaborated that Munchee's "marketing did not . . . target current users . . . [n]or did Munchee advertise the offering . . . in restaurant industry media to reach restaurant owners and promote how MUN tokens might let them advertise in the future. Instead, Munchee and its agents promoted the MUN token offering in forums aimed at people interested in investing in Bitcoin and other digital assets[.]"[23]

The fact that NFT issuers or promoters can grant royalty rights in the NFT's underlying smart contract could also affect a court's evaluation of whether a purchaser had a reasonable expectation of profits. Where an NFT issuer is entitled to a royalty in perpetuity, for example, that starts to look more like interest or a dividend, and it is more likely that a court or the SEC could find that this type of revenue-sharing agreement is sufficient to satisfy *Howey*'s third prong. This would be particularly true where, as in the case of F-NFTs, a royalty-bearing NFT was fractionalized and pooled with other revenue-generating assets.

As with all prongs under the *Howey* analysis, these questions will be considered along with other relevant details relating to the NFT in question, the content of its offering materials, and the facts and circumstances surrounding its issuance. That said, to the extent a particular NFT is marketed as an investment, targeted towards an investment-minded audience (rather than an audience of collectors or end-users), and is available for trading on a secondary market, even where the

NFT itself serves certain non-investment (*i.e.*, practical or utilitarian) purposes, the NFT in question comes closer to resembling a security.

***Howey* Prong #4: Managerial Efforts of Others**

With respect to *Howey's* fourth prong, the SEC has explained that "[t]he central issue is 'whether the efforts made by those other than the investor are the undeniably significant ones, those essential managerial efforts which affect the failure or success of the enterprise.'"[24] The SEC's first and most fulsome analysis applying *Howey* to the crypto space was its investigative report on The DAO, a now-defunct digital decentralized autonomous organization that operated effectively as an investor-directed venture capital. The DAO issued "DAO Tokens," which provided holders the right to share in anticipated earnings from projects funded by the sale of the tokens.[25] In finding that the tokens constituted securities, the SEC emphasized the *relative* control of the project's founders compared to that of investors who purchased tokens. The mere fact that token-holders had limited voting rights and maintained some control over the project's efforts did not change the fact that investors reasonably expected to rely on the founders to oversee and manage the business.[26]

How this rationale might apply to NFTs would likely depend on the circumstances surrounding the NFT in question. On one hand, for digital art or collectibles, after an NFT is purchased, absent any surviving intellectual property rights,[27] the NFT's seller does not control the rights embodied by that NFT any more than a physical art dealer exercises control over a painting after selling it to a customer. Further, courts have held that where the value of a particular investment fluctuates based on market conditions alone, rather than in response to external managerial efforts of others, that investment is not a security.[28] On the other hand, investors in fractional NFTs like the ones discussed above may be more dependent on the managerial efforts of others, in that the issuers or creators retain significant control over the underlying asset(s). In that case, a court or the SEC may find that an NFT's value was sufficiently dependent on third-party efforts such that it satisfied *Howey's* fourth prong.

NFTs & *HOWEY*: WHAT TO EXPECT FROM THE SEC?

While the SEC's guidance to date on digital assets, including FinHub's Framework on Digital Assets, have not spoken directly to NFTs, it is clear that the SEC and the market are watching the digital space.

Before his confirmation as SEC Chair, then-MIT professor Gary Gensler[29] noted the similarities between traditional securities and ordinary (fungible) tokens, explaining that "[t]he fungible nature of tokens and an expectation of profit" are "longstanding criterion in the US legal definition of a security."[30] Notably, however, then-professor Gensler pointed to the ICO of so-called "CryptoKitties," which at the time were among the first NFTs to gain widespread popularity, as his one example of a token offering that would ***not*** constitute a security.[31] Thus, Chair Gensler seemed to acknowledge not only the key differences between ordinary tokens and NFTs, but also the legal implications of those differences. That said, not all NFTs are created equal, and Chair Gensler may feel differently if a particular NFT offering were more akin to a traditional investment contract, or another type of security.

Similarly, in March 2021, Commissioner Hester Peirce, speaking at a digital asset event, expressed her view that the fundamental nature of NFTs—that are unique and non-fungible—makes it less likely that they would be treated as securities.[32] Commissioner Peirce cautioned, however, that the "creative" approach from creators and promoters of NFTs, including the issuance fractionalized shares, could pose a risk: "[Y]ou better be careful that you're not creating something that's an investment product, that's a security."[33] Commissioner Peirce stated that she hoped to work with Chair Gensler on this topic to provide a regulatory framework for NFTs.[34]

Given the wide and varied nature of the NFT market, SEC guidance may recognize certain differences within and across different types of NFTs. For example, the SEC could draw a distinction between the financing of NFT creators

or "minters," on the one hand, and the financing of downstream buyers or holders on the other. It is also possible that the SEC or courts delineate certain differences between NFTs tethered to natively digital assets, versus those tethered to physical or non-digital assets.

CONCLUSION

As of now, while the general principles from *Howey* and recent SEC staff pronouncements provide helpful guidance to those dealing with NFTs, the contours of the regulatory landscape are unclear. There is no shortage of commentary on the legal ramifications of the growing NFT space, and some industry participants have pushed for more clarity. Indeed, at least one FinTech firm wrote to the SEC in April 2021 requesting that it provide guidance with respect to whether, and in what circumstances, NFTs and F-NFTs should be treated as securities.[35]

Until more definitive rules or guidance is available, however, issuers, creators, and market participants dealing in NFTs should pay particular attention to the facts and circumstances of the token in question, its purpose, and the terms and underlying details of its issuance, using *Howey*, relevant case law, and recent SEC staff guidance as a guide.

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[1] *See* Taylor Lock, *'Covid Alien' CryptoPunk NFT Sells for Over $11.7 Million to Billionaire Buyer in Sotheby's Auction*, CNBC (June 10, 2021), *available at* https://www.cnbc.com/2021/06/10/covid-alien-cryptopunk-nft-sells-for-11point7-million-in-sothebys-auction.html.
[2] Control need not imply or justify a finding of ownership under applicable law. The results may vary and may change over time.
[3] *See* Ryan McNamara, *How to Buy NFTs*, BENZINGA (May 14, 2021) (noting that most NFTs are Ethereum-based tokens and popular marketplaces therefore transact with Ethereum tokens), *available at* https://www.benzinga.com/money/how-to-buy-nfts/.
[4] Non-Fungible Tokens Yearly Report 2020 (Free Version), NonFungible.com & L'atelier/BNP Paribas, PDF at 3.
[5] *See* Interview of Professors Burt Rosenberg and Tarek Sayed, University of Miami ((Mar. 26, 2021), *available at* https://news.miami.edu/stories/2021/03/nfts-are-a-new-financial-frontier-in-cyberspace.html ("NFT Yearly Report 2020").
[6] *See SEC v. Edwards*, 540 U.S. 389, 393 (2004); *SEC v. W.J. Howey Co.*, 328 U.S. 293, 301 (1946).
[7] *Howey*, 328 U.S. at 299.
[8] *Id*.
[9] *Tcherepnin v. Knight*, 389 U.S. 332, 336 (1967)
[10] *Forman*, 421 U.S. at 849. 29
[11] Remarks by W. Hinman at Yahoo Finance All Markets Summit: Crypto (June 14, 2018), *available at* https://www.sec.gov/news/speech/speech-hinman-061418.
[12] *See* SEC Strategic Hub for Innovation and Financial Technology, "Framework for 'Investment Contract' Analysis of Digital Assets," (Apr. 3, 2019), *available at* https://www.sec.gov/corpfin/framework-investment-contract-analysis-digital-assets#_ednref1 ("Framework for Digital Assets").
[13] *See, e.g.*, *SEC v. Shavers*, No. 4:13-CV-416, 2014 WL 4652121, at *1 (E.D. Tex. Sept. 18, 2014) (holding that an investment of Bitcoin, a virtual currency, meets the first prong of Howey); *Uselton v. Comm. Lovelace Motor Freight, Inc*., 940 F.2d 564, 574 (10th Cir. 1991) ("[T]he 'investment' may take the form of 'goods and services,' or some other 'exchange of value.'") (citations omitted); DAO (explaining that "money need not take the form of cash" and that investors who had purchased digital tokens with ether had made the "type of contribution of value that can create an investment contract under *Howey*").
[14] Framework for Digital Assets, n.11.
[15] Framework for Digital Assets, n.10. The horizontal commonality test ties "each individual investor's fortunes to the fortunes of the other investors by the pooling of assets"; conversely, both variations of vertical commonality focus "on the relationship between the promotor and the body of investors." *Id.* (quoting *Revak v. SEC Realty Corp*., 18 F.3d. 81, 87-88 (2d Cir. 1994)).
[16] *Id.* (citations omitted).
[17] *See, e.g.*, *SEC v. Bowser et al.*, Case No. 20-cv-00918, Compl. ¶¶ 55-59, (D. Utah Dec. 30, 2020) (alleging securities violations based on the sale of fractional tenancy in common interests); *SEC v. Zipprich et al.*, Case No. 20-cv-02308, Compl. (D. Nev. Dec. 21, 2020) (alleging Section 5 violations for unregistered fractional interests in promissory notes); *In re R. Baker et al.*, SEC Proceeding No. 3-17716, Consent Order (Mar. 22, 2018) (holding that individuals who sold fractional oil and gas interests violated Section 5 of the Securities Act by failing to file registration statements for the fractional shares); *SEC v. Green Tree Investment Grp., Inc.*, Case No. 17-cv-1091, Compl. ¶¶ 15-16 (W.D. Tex. Nov. 17, 2017) (fractional ownership interests in oil wells constituted securities where "investors paid money to purchase their ownership interests, and the controlling well owners pooled the investors' funds together to build, manage and operate the wells").
[18] *See, e.g.*, *In re Enigma*, Rel. No. 33-10755 (Feb. 19, 2020) ("Enigma promoted its ENG Token ICO on websites it maintained and through blog posts, social media posts, online videos, and online discussion boards. In its promotional materials, Enigma highlighted that the company was founded by an MIT-bred team of experts, backed by top-tier investors. Enigma paid promoters and others to tout Enigma as a good investment opportunity.")
[19] *See, e.g.*, *Airfox*, Rel. No. 33-10575, *1 ("A purchaser in the offering of AirTokens would have had a reasonable expectation of obtaining a future profit based upon AirFox's efforts, including AirFox revising its app, creating an 'ecosystem,' and adding new functionality using the proceeds from the sale of AirTokens. AirFox."); *Munchee*, Rel. No. 33-10445, *6–7 ("Munchee highlighted the credentials, abilities and management skills of its agents and employees. . . . the value of MUN tokens would depend on the company's ability to change the Munchee App and create a valuable 'ecosystem' that would inspire users to create new reviews, inspire restaurants to obtain MUN tokens to reward diners and pay Munchee for advertising, and inspire users to obtain MUN tokens to buy meals and to attain higher status within the Munchee App.")
[20] *Id.*
[21] *In re Kelvin Boon, LLC & R. Pavithran*, Rel. no. 33-10817, *1 (Aug. 13, 2020) (Issuers "touted the value of Boon Coins to investors, highlighted their efforts to make Boon Coins available for trading on digital asset trading platforms, and claimed that Boon Coins would increase in price as a result of their efforts."); In *re Airfox*, Rel. No. 33-10575, *1 (Nov. 16, 2018) ("AirFox stated that . . . [it] would undertake efforts to provide investors with liquidity by making AirTokens tradeable on secondary markets.")
[22] *In re Munchee*, Rel. No. 33-10445, *6 (Dec. 11, 2017).
[23] *Id; see also Airfox*, Rel. No. 33-10575, *5 ("AirFox's principals also participated in interviews with individuals focused on digital token investing. AirFox did not market the initial coin offering to the anticipated users of AirFox tokens— *i.e.*, individuals with prepaid phones in developing countries. Rather, AirFox marketed the ICO to investors who reasonably viewed AirTokens as a speculative, tradeable investment vehicle that might appreciate based on AirFox's managerial and entrepreneurial efforts.").
[24] *Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934: The DAO* (Exchange Act Re. No. 81207) (July 25, 2017), *9 (quoting *SEC v. Glenn W. Turner Enters., Inc*., 474 F.2d 476, 482 (9th Cir. 1973)).
[25] *Id.* at *1–2.
[26] *Id.* at *10 ("DAO Token holders' votes were limited to proposals whitelisted by the Curators, and, although any DAO Token holder could put forth a proposal, each proposal would follow the same protocol, which included vetting and control by the current Curators. While DAO Token holders could put forth proposals to replace a Curator, such proposals were subject to control by the current Curators, including whitelisting and approval of the new address to which the tokens would be directed for such a proposal. In essence, Curators had the power to determine whether a proposal to remove a Curator was put to a vote.").

[27] Copyright and other intellectual property issues will be explored in more detail in our next installment on NFTs. For our abbreviated purposes here, however, it is worth noting that an NFT seller's surviving intellectual property rights could potentially affect the analysis under *Howey's* fourth prong.
[28] *S.E.C. v. Belmont Reid & Co*., 794 F.2d 1388, 1391 (9th Cir. 1986) ("To the extent the purchasers relied on the managerial skill of CMC they did so as an ordinary buyer, having advanced the purchase price, relies on an ordinary seller. We therefore agree with the district court that '[p]rofits to the coin buyer depended upon the fluctuations of the gold market, not the managerial efforts of CMC.'"); *Noa v. Key Futures, Inc*., 638 F.2d 77 (9th Cir.1980) (per curiam) (holding that the sale of silver bars was not an investment contract because the expected profits came from market fluctuations); *Sinva, Inc. v. Merrill, Lynch, Pierce, Fenner & Smith, Inc*., 253 F.Supp. 359, 367 (S.D.N.Y.1966) (holding that contracts to purchase sugar for future delivery were not "investment contracts" because the expected profits came from market fluctuations)
[29] While at MIT, Char Gensler's teaching and research focused on blockchain technology, digital currencies, financial technology, and public policy.
[30] Remarks by G. Gensler at Massachusetts Institute of Technology Business of Blockchain Conference, (Apr. 23, 2018) available at https://www.media.mit.edu/posts/remarks-at-blockchain-event/.
[31] *Id*. ("Sounding like poet Riley, SEC Chairman Clayton stated in February that 'I believe every ICO I've seen is a security… You can call it a coin but if it functions as a security, it is a security.' I agree with the Chairman, ***except if one were to consider CryptoKitties an ICO***.") (emphasis added).
[32] S. Kiderlin, "The SEC's 'Crypto Mom' Hester Peirce Says Selling Fractionalized NFTs Could be Illegal," BusinessInsider, (Mar. 26, 2021), *available at* https://markets.businessinsider.com/currencies/news/sec-crypto-mom-hester-peirce-selling-nft-fragments-illegal-2021-3-1030250153.
[33] *Id.*
[34] *Id.*
[35] Letter from V. Molinari (CEO, Arkonis Capital) to V. Countryman, "Rulemaking Regarding Non-Fungible Tokens," (Apr. 12, 2021), *available at* https://www.sec.gov/rules/petitions/2021/petn4-771.pdf.