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# Digital Assets

## Top Trends for 2022

SUMMER 2022



## **TABLE OF CONTENTS**

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- 04 | **DeFi World Has a New Star Called DAO**
- 08 | **The Law of Tokenomics, Revisited**
- 12 | **Tax Considerations for Transactions of Non-Fungible Tokens**
- 16 | **The Varying Federal, State and Local Attitudes on Crypto**
- 22 | **What GCs Exploring NFT, Web3 Opportunities Need to Know**
- 24 | **POTUS Issues Executive Order Directing Study of Digital Assets**
- 28 | **SEC Adds Twenty New Crypto Asset Enforcers**
- 30 | **A Checklist Of Legal Considerations for The NFT Marketplace**
- 32 | **DeFi and the DAO: How the Law Needs to Change to Accommodate Decentralized Autonomous Organizations**
- 34 | **NFT Art – Your Top 40 Legal Questions Answered**
- 40 | **Could the Crypto Downturn Lead to a Spike in M&A?**
- 41 | **Investors Take Sink-or-Swim Approach to Struggling Crypto Startups**

# DeFi World Has a New Star Called DAO

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As financial markets wrap up the year 2021 and launch into 2022 at warp speed, the “DeFi” world has a new star called the “DAO”.

Decentralized finance, short-handed as “DeFi”, refers to peer-to-peer finance enabled by Ethereum, Avalanche, Solana, Cardano and other Layer-1 blockchain protocols, as distinguished from centralized finance (“CeFi”) or traditional finance (“TradFi”), in which buyers and sellers, payment transmitters and receivers, rely upon trusted intermediaries such as banks, brokers, custodians and clearing firms. *DeFi app users “self-custody” their assets in their wallets, where they are protected by their private keys. By eliminating the need for trusted intermediaries, DeFi apps dramatically increase the speed and lower the cost of financial transactions. Because open-source blockchain blocks are visible to all, DeFi also enhances the transparency of transactions and resulting asset and liability positions.*

Although the proliferation of non-fungible tokens, or NFTs, may have gathered more headlines in 2021, crypto assets have become a legitimate, mainstream and extraordinarily profitable asset class since they were invented a mere 11 years ago. The Ethereum blockchain and its digitally native token, Ether, was the wellspring for DeFi because Ether could be used as “gas” to run Layer-2 apps built to run on top of Ethereum. Since then, Avalanche, Solana and Cardano, among other proof-of-stake protocols, have launched on mainnet, providing the gas and the foundation for breathtaking app development which is limited only by the creativity and industry of development teams.

Avalanche and its digitally native token AVAX exemplify this phenomenon. Launched on mainnet a little more than a year ago, Avalanche already hosts more than 50 fully-launched Layer-2 apps. The AVAX token is secured by more than 1,000 validators. Recently,



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the Avalanche Foundation raised \$230 million in a private sale of AVAX tokens for the purpose of supporting DeFi projects and other enhancements of the fully functional Avalanche ecosystem. Coinbase, which is a CeFi institution offering custodial services to its customers, facilitates purchases and sales of the Avalanche, Solana, Cardano and other Layer-1 blockchain tokens, as well as the native tokens of DeFi exchanges such as Uniswap, Sushiswap, Maker and Curve. So formidable is DeFi in its potential to dominate the industry that Coinbase, when it went public in 2021, cited competition from DeFi as one of the company’s primary risk factors.

If DeFi were “a company,” like Coinbase, the market capitalization of AVAX would be shareholder wealth. But DeFi is code, not a company. Uniswap is a DeFi exchange that processed \$52 billion in trading volume in September 2021 without the help of a single employee. Small wonder that CeFi and TradFi exchanges are concerned.

DeFi apps require “DAOs,” or Decentralized Autonomous Organizations, to operate. DAOs manage DeFi apps through the individual decisions made by decentralized validator nodes who own or possess tokens sufficient in amount to approve blocks. Unlike joint stock companies, corporations, limited partnerships and limited liability companies, however, DAOs have no code (although, ironically, they are creatures of code). In other words, there is no

“Model DAO Act” the way there is a “Model Business Corporation Act.” DAOs are “teal organizations” within the business organization scheme theorized by Frederic Lalou in his 2014 book, “Reinventing Organizations.” They are fundamentally unprecedented in law.

Just as NFTs have been a game changer for creators, artists and athletes, our legal system will need to evolve to account for the creation of the DAOs that govern NFTs and other crypto assets. (NFTs are a species of crypto asset.) Adapting our legal system to account for DAOs represents the next wave of possibility for more numerous and extensive community efforts.

A DAO is fundamentally communitarian in orientation. The group of individuals is typically bound by a charter or bylaws encoded on the blockchain, subject to amendments if, as and when approved by a majority (or some other portion) of the validator nodes. Some DAOs are governed less formally than that.

The vast majority of Blockchain networks and smart contract-based apps are organized as DAOs. Blockchain networks can use a variety of validation mechanisms. Smart contract apps have governance protocols built into the code. These governance protocols are hard-wired into the smart contracts like the rails for payments to occur, fully automated, and at scale.

In a DAO, there is no centralized authority — no CEO, no CFO, no Board of Directors, nor are there stockholders to obey or serve. Instead, community members submit proposals to the group, and each node can vote on each proposal. Those proposals supported by the majority (or other prescribed portion) of the nodes are adopted and enforced by the rules coded into the smart contract. Smart contracts are therefore the foundation of a DAO, laying out the rules and executing the agreed-upon decisions.

There are numerous benefits to a DAO, including the fact that they are autonomous, do not require leadership, provide objective clarity and predictability, as everything is governed by the smart contract. And again, any changes to this must be voted on by the group, which rarely occurs in practice. DAOs also are very transparent, with everything documented and allowing auditing of voting, proposals and even the code. DAO participants have an incentive to participate

in the community so as to exert some influence over decisions that will govern the success of the project. In doing so, however, no node participating as part of a decentralized community would be relying upon the managerial or entrepreneurial efforts of others in the SEC v. Howey sense of that expression. Neither would other nodes be relying upon the subject node. Rather, all would be relying upon each other, with no one and no organized group determining the outcome, assuming (as noted) that the network is decentralized. Voting participants in DAOs do need to own or possess voting nodes, if not tokens.

As with NFTs, there are limitless possibilities for DAOs. We are seeing a rise in DAOs designed to make significant purchases and to collect NFTs and other assets. For example, PleasrDAO, organized over Twitter, recently purchased the only copy of the Wu-Tang Clan’s album “Once Upon a Time in Shaolin” for \$4 million. This same group has also amassed a portfolio of rare collectibles and assets such as the original “Doge” meme NFT.

In addition to DAOs that are created as collective investment groups, there are DAOs designed to support social and community groups, as well as those that are established to manage open-source blockchain projects.

As is true with any emerging technology, there is currently not much regulation or oversight surrounding DAOs. This lack of regulation does make a DAO much simpler to start than a more traditional business model. But as they continue to gain in popularity, there will need to be more law written about them.

The State of Wyoming, which was first to codify the rules for limited liability companies, recently codified rules for DAOs domiciled in that state. So a DAO can be organized as such under the laws of the State of Wyoming. No other state enables this yet.

Compare the explosion in digital assets to the creation of securities markets a century ago. After the first world war concluded in 1917, the modern securities markets began to blossom. Investors pooled their money into sophisticated entities called partnerships, trusts and corporations, and Wall Street underwrote offerings of instruments called securities, some representing equity ownership, others representing a principal amount of debt plus interest. Through the “roaring ‘20s,” securities markets exploded in

popularity. Exuberance became irrational. When Joe Kennedy's shoeshine boy told him that he had bought stocks on margin, Kennedy took that as a "sell" signal and sold his vast portfolio of stocks, reinvesting in real estate: he bought the Chicago Merchandise Mart and was later appointed by FDR to chair the SEC. When the stock market crashed, fingers were pointed. Eventually, a comprehensive legislative and regulatory scheme was built, woven between federal and state legislation and regulatory bodies. Almost a hundred years later, securities markets have become the backbone of our financial system, and investors and market participants have built upon the certainty of well-designed architecture to create financial stability and enable growth.

But the legislative paradigm designed in the 1930s was not created with digital assets in mind. The world was all-analog then. The currently disconnected and opaque regulatory environment surrounding digital assets presents a challenge to sustained growth in DeFi markets. Without "crypto legislation," government agencies have filled the void, making their own determinations, and they are not well suited to do so. Just before Thanksgiving, the federal banking agencies released a report to the effect that they had been "sprinting" to catch up on blockchain developments, that they are concerned by what they see, and that next year they will start writing rules. Plainly, technological development has outpaced Washington again.

Whether crypto assets should be characterized as securities, commodities, money or simply as property is not clear in present day America. Will entrepreneurs continue to create digital assets and will investors buy them if their legal status is in doubt? The SEC mantra is "come talk to us," but the crypto asset projects actually approved by the SEC are precious few in number, and SEC approvals are not timely. We have clients that have run out of runway while waiting for SEC approvals. In decentralization as in desegregation, justice delayed is justice denied. The recent experience of Coinbase in attempting to clear its "Lend" service through the SEC, only to be threatened with an SEC enforcement action (but no explanation), has caused other industry participants to question the utility of approaching officials whose doors might be open for polite conversation but whose minds seem to be closed.

Similarly, DAOs are a path-breaking form of business "organization" that are not well understood. They are not corporations. Should they nevertheless file and pay taxes, open bank accounts or sign legal agreements? If so, then who would have the power or duty to do that for a decentralized autonomous organization whose very existence decries the need for officers, directors and shareholders? The globally significant Financial Action Task Force, in its recent guidance on "virtual assets and virtual asset service providers," called on governments to demand accountability from "creators, owners and operators," as it put it, "who maintain control or sufficient influence" in DeFi arrangements,



“even if those arrangements seem decentralized.” Some observers have characterized the FATFs guidance as an attempted “kill shot” targeting the heart of DeFi.

This, too, we know: SEC Chair Gensler has his eye on DeFi. We know that because he has said so, repeatedly. Trading and lending platforms, stablecoins and DeFi are the priorities that he mentions. SEC FinHUB released a “Framework” for crypto analysis that includes more than 30 factors, none of which is controlling. That framework is unworkable because it is too complex and uncertain of application. Chair Gensler, however, apparently applies what he calls the “duck” test: If it looks like a security, it is one. With respect to Mr. Gensler, that simple approach is no more useful than the late Justice Potter Stewart’s definition of obscenity: “I know it when I see it.” Less subjectivity and greater predictability in application are essential so development teams and exchange operators can plan to conduct business within legal boundaries. What we need are a few workable principles or standards (emphasis on “few” and “workable”) that define the decentralization that is at the core of legitimate DeFi and the consumer use of tokens that are not investment contracts. We also need the SEC to adhere to Howey analysis, which it has told us to follow slavishly, and not try to move the goalposts by misapplying the Reves “note” case when it senses that Howey won’t get it the result it craves.

Although futuristic DAOs are a decentralized break from the centralized past and present of business organization, the SEC has seen them before. Indeed it was the “DAO Report” issued in 2017 that began SEC intervention in the crypto asset industry. The DAO criticized in the DAO Report was unlike the DAOs seen today for a variety of reasons, including these: that DAO was a for-profit business that promised a return on investment, similar to a dividend stream, to token holders; and the token holders didn’t control the DAO. “Curators” controlled it, by vetting and whitelisting projects to be developed for profit. DAO participants necessarily relied on the original development team and the “Curators” to build functionality into the network. That sort of reliance on the managerial or entrepreneurial efforts of others is absent in a latter-day DAO whose participants can avail themselves of a fully functional network without reliance on the developers and without delay. It is earnestly to be hoped that the SEC will recognize these critical differences.



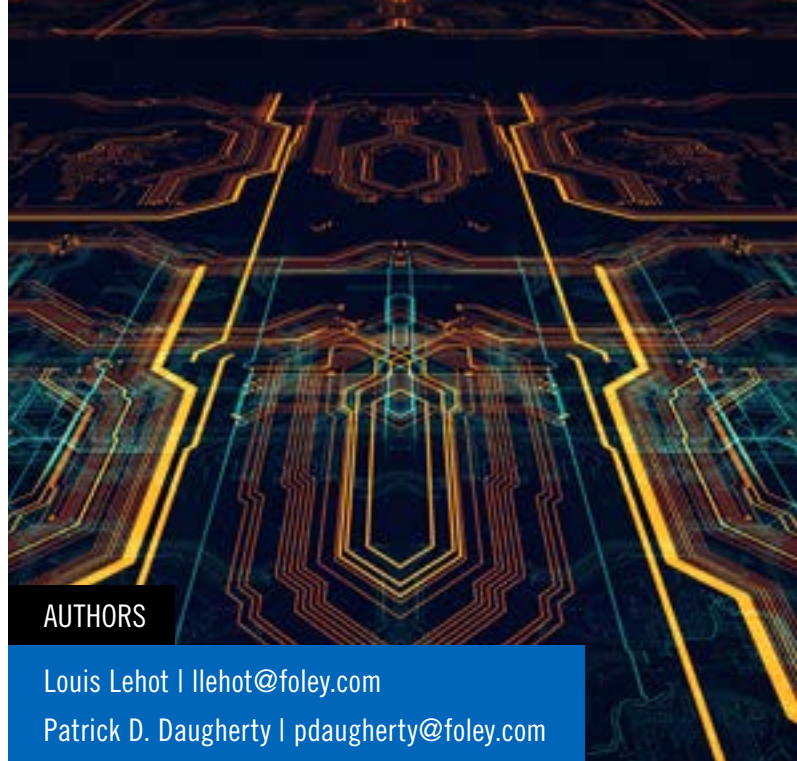
# The Law of Tokenomics, Revisited

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As the web further decentralizes based on blockchains, we are seeing new technology business models, particularly in the ecommerce sector, incorporate digital tokens into transaction flows by using digitally native tokens as a medium of payment for transacting on the platform. The boom in financial markets is also a cause-and-effect situation of decentralized financial applications as well as the tokenization of unique, or nonfungible tokens and assets, colloquially referred to as “NFTs,” whether tangible (like your house) or intangible (like a digital photo).

Increasingly, we are seeing these business models emerge as decentralized, autonomous organizations that will govern a business from the bottom up rather than top down in the classical capitalist style. Entrepreneurs build financial assets in the form of fungible cryptographic tokens for platform users to receive and pay as currency without bank or government involvement. The economical design of the token, the allocation of tokens among stakeholders in the business, on what terms the token commences trading, as well as how that trading evolves over time, are referred to as “tokenomics,” or the economics of a token.

What is driving tokenomics and tokenization? The wave of tokenization has gone from forms of payment, or currency tokens, to hard assets, to debt and equity securities, to utility tokens such as pay for a specified service or a reward for participation on the platform. Extended periods of pandemic-induced confinement accelerated the growth of virtually everything, not least of which have been crypto assets. According to one reliable source, more than 9,000 different crypto assets are trading in public markets today. Tokenization of assets allows the holder to trade the whole or a fraction of owned property. While currency tokens and tokens underlying commodities like gold and silver are “fungible,” monetization of a holder’s ownership of unique assets such as art, music, and even real estate has spawned a boom in non-fungible



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tokens, or NFTs. The governance of companies, virtual worlds, and games has also become tokenized.

Benefits of tokenization to entrepreneurs and token users can include broader distribution and increased customer engagement, improved liquidity, enhanced accessibility, transparency, and, ultimately, transaction efficiency. Challenges include data security and privacy, technological reliability, and, importantly, legal and regulatory uncertainty — particularly in the United States.

Whether you are a content creator looking to monetize the value of non-fungible assets, or a token buyer looking to transact in a fungible digital asset, tokenomics practices will factor into the success or disappointment of your experience.

The status of a token as currency, security, commodity, or property — or all of them — has considerable legal significance. The status of a token can facilitate its use as a form of payment, or impede its usage to the extent regulated, especially if regulated as a security:

- A token that is generated by and for use as a form of payment is by definition a currency under banking laws. The exchange of currencies can be regulated by national governments and central banks.
- Entities that facilitate the exchange of currencies are typically regulated as “money transmitters” under national, state and local regulations, which triggers a complex hodgepodge of registration and licensure requirements.



- A token in the flow of interstate commerce in the United States that fails the “Howey” test will be a security, most likely because it will have been sold to raise capital with which to build the platform. Thus, rendering it an investment contract as to which token buyers primarily expect to earn profits based on the efforts of the founders.
- Futures contracts, “swaps” and other derivatives can also be subject to extensive, prohibitive, regulation depending on the facts and circumstances. The Commodity Futures Trading Commission (CFTC) takes the view, with which the Securities and Exchange Commission (SEC) has acquiesced, that common cryptocurrencies such as Bitcoin and Ether are commodities, with the result that the CFTC, but not the SEC, has jurisdiction over them to some extent.

### The chicken or the egg?

Where crypto assets are tokenized as NFTs, the market for the NFT is typically denominated in one or more of the prominent Layer-1 coins, and they are purchased, sold and traded as some fraction of a “coin.”

In the creation of any new workflow, the question arises as to what comes first, the chicken or the egg? Or, in this case, the commercial utility or the investment value? Similarly, the creation of a new token and its commercial utility do not occur at the same moment. On the flip side, the creation of a new token can have immediate investment value as a security or commodity.

There is a paradox here: If the token is currently useful in commerce, then it’s not an investment contract security and can be sold and resold freely. But to become useful in commerce, it might need to be broadly distributed, and broad distribution of the token before it is useful might be an unlawful securities offering if conducted in the United States. At the core of a token’s value is its utility in contracting in the flow of the web3 ecommerce ecosystem. But the traction achieved in the underlying business and the velocity of use of the token in the flow impacts its intrinsic value as a digital asset, which attracts investors.

While initially, this was the province of highly specialized “DeFi” investors, investment platforms like Coinbase, Binance, FTX and even Robinhood democratized crypto asset investing for retail, and it is now ubiquitous in the retail world. The acceleration of digital transformation, combined with extended confinement at home and global government stimulus,

has made crypto assets a matter of common parlance in American households.

If the summer of 1968 was the summer of love, then 2017 was the summer of coin. Initially, the Securities and Exchange Commission and state “blue sky” regulators vacillated between creating safe regulatory sandboxes (e.g., Wyoming statutes and SEC Commissioner Peirce’s safe harbor) on the one hand, and enforcement actions on the other (the infamous DAO Section 21A report, Munchee, and other cases). The markets began to respond by moving offshore, as then-SEC Chairman Jay Clayton, encouraged them to do by citing private placements and offshore offerings as two lawful means of selling investment contract tokens.

If cholera and “Spanish flu” made the 1920s both the time of cholera and the “roaring 20s,” then COVID-19 has turned the 2020s into the pandemic age and a crypto-boom (with even party-going moving to the metaverse). While stocks went mainstream in the 1920s, digital assets (and not only Bitcoin) are becoming a ubiquitous portfolio allocation for main street retail investors in the 2020s. Investment advisers no longer talk about “whether” investors should hold crypto assets, but instead “how much.” One percent of a person’s portfolio is not an unusual suggestion.

So, how does one navigate the murky waters of tokenomics? It can be challenging to discern which crypto asset project to adopt or invest in and what gives it value (its commercial use or its potential for appreciation). Tokenomics can help to determine whether you should invest or not. Tokenomics is often discussed in a project’s whitepaper and helps clarify the token’s objective, functionality, allocation policy, and more.

Tokenomics, the combination of token and economics, refers to a crypto asset’s qualities that make it appealing to both users and investors. It refers to the supply and demand characteristics of the asset



What should you look for to understand the tokenomics of a digital asset? First, look to understand how the token will be used in the flow of commerce. Is it the medium of payment? Does the accomplishment of a task result in the delivery of a new token? Does an exchange of goods or services result in an exchange of the token? How many tokens exist now? How many tokens can exist in the future? Is there a hard cap or a soft cap? Can the token be forked and, if so, by what vote? To whom and in what amounts were the tokens initially issued in the stream of commerce?

## Evaluating a token's worth 101

Tokenomics is also helpful when assessing the likely future value of a token. This is important not only when judging a token in isolation, but also and especially when considering versus alternative tokens. When considering tokenomics, any factor that even remotely concerns the value of a token should be identified and weighed. Below are some key metrics to consider when deciding a token's worth.

**Allocation of Tokens:** Check to see how the token is being distributed. There are two main ways of generating crypto tokens at present – either by pre-sales leading to a public tokenization event or else by a so-called “fair launch.”

Pre-sales compares with the traditional private financing model according to which crypto tokens are generated and distributed to early investors such as the founders, friends and family, key employees, and venture capitalists before later being sold to the public in a public tokenization event, sometimes called an ICO. In this model, the pre-sales (which might occur in more than one round) are best viewed as additional rounds of financing preceding a public offering. Pre-sale proceeds are generally used to build out the functionality of the network on which the tokens will be used. The fair launch model, in contrast, does not automatically result in preferred terms being offered to these categories of stakeholders, but it does depend upon the creation and operation of a DAO.

**Supply:** A primary component of a crypto asset's tokenomics is supply. There are different types of supply to check when it comes to crypto assets. The number of tokens issued and currently in circulation is called the “circulating supply” of a token. The “total token supply” refers to the number of tokens in existence, excluding ones that might have been burned (i.e., destroyed). And the maximum supply is

exactly that — the maximum number of tokens that can ever be generated. Think of the circulating supply as being equivalent to the “outstanding” amount of a company's debt or equity securities, and the maximum supply as being the limitation on issuance built into the company's charter documents or debt indentures.

**Market Cap:** The market capitalization of a token shows the amount of fiat currency, usually expressed in US dollars, that's been invested in the crypto project so far. In the context of cryptocurrencies, the market capitalization or market cap is a metric used to determine how widely and deeply held the token is at a point in time. It is calculated by multiplying the current market price of a token, expressed in US dollars, with the circulating supply. It helps to strive to understand a project's fully diluted market cap. This provides some insight into how to value a token. The higher a token's market cap and the lower its circulating supply, the more valuable it could become in the future.

**Token Model:** Every crypto token has a model which factors into its value. Is the token inflationary or deflationary? Do you know? An inflationary token doesn't have a maximum supply and will continue to be produced over time. Fiat currencies are inflationary by design, which can be abused by governments, leading to devaluation and wealth destruction. The deflationary token model is the opposite. A deflationary token has either a maximum supply, like Bitcoin's 21 million, or even a decreasing supply. A deflationary token is perhaps more likely to increase in value over time, everything else being equal.

**Allocation:** Leaving aside the fair launch model, a key question is how the token in question will be allocated, among whom, and in what amounts. The many stakeholders or constituencies of a token and its related protocol can be classed into these groups: founders and other insiders; private investors; a foundation; and the community. Each token is allocated differently from all others. There is no one-size-fits-all model. In general, however, an investor will prefer a token in which the insiders retain less, rather than more, of the maximum supply of the token upon public launch. Twenty percent or so is typical. Private investors in the aggregate might be allocated a similar portion. These percentages should decline over time as the foundation distributes tokens, and will decline further if and to the extent that the token is inflationary. The public tokenization event

might account for as little as five or ten percent of the maximum supply. The remainder is typically owned by a foundation whose purpose is to assure the smooth functioning of the protocol and the token in line with directions received from the community. The community is or becomes a DAO, ultimately determining the future direction of the business.

**Lock-ups:** Tokens are not freely trading from date of issuance by an early-stage crypto business. Pre-sold tokens, like privately placed bonds or shares, will be locked up for a year or more if sold in the US or to US persons because U.S. federal securities laws impose that requirement. Tokens sold offshore, whether in a pre-sale or in the public tokenization event, will be subject to lock-up restrictions as well, at least for a while. If and when the protocol and the tokens are sufficiently decentralized, or if and when the protocol is fully functional and other conditions are satisfied, the tokens (whenever and however issued) will not be investment contract securities, and will at that point be freely tradable in the United States. That judgment is best made in close collaboration with experienced counsel. Many tokens are subject to lock-up restrictions that exceed legal requirements in duration and geographic scope. Lengthy lock-ups are viewed as a positive for token value because less supply to the market implies a higher price to the extent that a trading market exists or later develops. Under current law, founders are well-advised not to assist in the development of a U.S. trading market for their tokens, so long as they are securities.

To succeed in creating new technology business models in 2022 that leverage web3, much like successful investment in DeFi, you will need to articulate and understand the tokenomics of a project, and the transaction flows contemplated should be created, and in the quantum anticipated.



# Tax Considerations for Transactions of Non-Fungible Tokens

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Creators, investors, users, and dealers of non-fungible tokens (NFTs) are at the forefront of the intersection of art, music, sports, entertainment, and technology — and they are simultaneously charting a new path when it comes to U.S. federal income tax considerations.

According to published estimates, 2021 saw more than \$22 billion in global sales of NFTs, with an excess of 104 new NFT start-ups getting funded with more than \$2 billion.

After discussing what NFTs are and how they are created, sold, and used, we will discuss some of the federal income tax issues for the various participants in the marketplace. Given the lack of specific guidance from the IRS and other government authorities, taxpayers must apply general tax principles to determine the tax treatment of NFT transactions.

## What Is an NFT?

NFTs are powering the new iteration of the World Wide Web based on blockchain technology, which incorporates decentralization, privacy, and tokenization of digital assets and is commonly referred to as “Web3.” Tokens can be either fungible or non-fungible assets, depending on whether the content is interchangeable. If they are interchangeable, or fungible, they are not uniquely identifiable — when you pay for a gallon of gas with a 20-dollar bill, no one cares which 20-dollar bill it is; it’s fungible.

Typically, fungible tokens are referred to as “cryptocurrencies,” like bitcoin, ether, or solana. Sometimes these cryptocurrencies represent a fractional interest in an enterprise or business, or the right to future profits. If so — or if the capital raised from the sale of the cryptocurrency is used to build a business — then it may be a security. In a Web3 ecosystem, fungible tokens provide a decentralized, secure, and private way for users to make payments to each other without any intermediary.



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NFTs, on the other hand, are unique assets that are verifiable and distinct, and typically are representations of real-world objects like art, music, in-game items, and videos. NFTs provide a whole new way to monetize content by breaking it into parts and allowing for its digital realization and exchange.

NFTs are created or “minted” on marketplace platforms like OpenSea, Rarible, or Foundation and then listed for primary sale or secondary resale. Each has a digital signature that is unique and impossible to be exchanged for or equal to another.

A marketplace distributes payments and can therefore trip over “money transmitter” rules under federal, state, and local laws. Content creators can avoid money transmitter laws if they partner with a marketplace that is a licensed money transmitter. The market for NFTs has exploded with the proliferation of Web3 business models. NFTs had a market capitalization exceeding \$7 billion in a mid-2021 report. OpenSea reported more than \$6.5 billion in NFT trading volume in 2021 alone. There were more than 265,000 active wallets that traded NFTs on the ethereum blockchain in the third quarter of 2021 alone. Twitter co-founder and former CEO Jack Dorsey minted an NFT for his first tweet that sold for more than \$2.6 million.

As more investors buy, sell, and hold NFTs, it’s time to start thinking about how to report them on tax returns.

## U.S. Federal Income Taxation of NFTs

### A. IRS Guidance

IRS guidance on the taxation of digital assets is sparse. To date, the agency has issued one notice<sup>1</sup> on virtual currency transactions; FAQs<sup>2</sup> on virtual currency transactions for taxpayers who hold virtual currency as a capital asset; one revenue ruling<sup>3</sup> related to the taxation of hard forks and airdrops; and a few legal memoranda.<sup>4</sup> The notice defines virtual currency as “a digital representation of value that functions as a medium of exchange, a unit of account, and/or a store of value,” and provides that virtual currency is treated as property and not as currency that could generate foreign currency gain or loss for U.S. federal income tax purposes.

The taxation of NFT transactions has yet to be addressed in any formal or informal IRS guidance. Thus, taxpayers must use the existing statutory, regulatory, judicial, and subregulatory framework to determine the tax treatment of NFT transactions. The following discussion uses general tax principles to consider the likely tax treatment of NFT creators, investors, non-dealers, and dealers.

### B. Creation

The creation of an NFT generally shouldn't be a taxable event until the creator receives income from its sale.

#### 1. Sale.

Income from the sale of an NFT generally will be treated as ordinary income. Under section 1221, a “capital asset” is “property held by the taxpayer” other than “a patent, invention, model or design (whether or not patented), a secret formula or process, a copyright, a literary, musical, or artistic composition, a letter or memorandum, or similar property, held by a taxpayer whose personal efforts created such property.” Thus, an NFT likely wouldn't be treated as a capital asset in the hands of the creator, and the income from the sale would be taxed at ordinary income rates, which now are a maximum rate of 37 percent for individuals and 21 percent for corporations.

#### 2. Business vs. hobby.

If the creator is carrying on a trade or business of creating or minting and selling NFTs, she would be allowed to deduct some ordinary and necessary business expenses from the gross NFT sales proceeds to reduce her taxable business income. However, she would be subject to self-employment tax on the net earnings from the business. If instead the creator is considered a hobbyist — that is, she isn't engaging in the activity of the creation and sale of NFTs for profit — expenses related to the creation of the NFT generally aren't deductible, and any losses are disallowed. The proceeds from the activities would be “other income” not subject to self-employment taxes.





### 3. Royalties.

Another possibility is that the creator has ongoing royalty income through a “smart contract” that automatically provides a payment when the NFT is used or resold. A creator can use a smart contract to build into the marketplace the desired economics of secondary sales, royalties, transaction costs, and other terms of use following the primary sale. As with royalty payments on patents, copyrights, and other intellectual property assets, these payments may continue for years after the NFT is initially created and sold. Royalty income generally is taxable as ordinary income and may also be subject to the 3.8 percent net investment income tax.

### 4. Virtual currency.”

NFT sales generally are transacted in cryptocurrency and not fiat currency. If the purchase price is paid in cryptocurrency, gross proceeds from the sale equal the fair market value of the cryptocurrency on the date of the transaction. This amount would also be the tax basis of the cryptocurrency in the hands of the creator, which would be used to determine whether there is gain or loss on the ultimate disposition of the cryptocurrency. Any gain on the disposition of the cryptocurrency would be treated as capital gain and would be eligible for long-term capital gain treatment if the cryptocurrency is held for more than one year from the date of acquisition of the cryptocurrency.

### C. Secondary Purchase

Regardless of whether it is being purchased as an investment, for personal use, for use in a business, or to be sold by a dealer, the purchase of an NFT on a marketplace could be a taxable event if cryptocurrency is used to purchase it.

A buyer may be subject to tax on the disposition of cryptocurrency used to purchase an NFT because the cryptocurrency is treated as property under the notice. The amount of taxable gain would be the difference between the basis (generally, the cost) in the cryptocurrency used to make the purchase and the FMV of the cryptocurrency on the date of the NFT purchase.

For example, if a buyer purchased an NFT for 3 ethereum (ETH) at a time when the FMV of 3 ETH was \$9,000, and the buyer’s cost basis in the 3 ETH was \$6,000, the buyer would have taxable income of \$3,000, even though she received no U.S. dollars in the exchange. The rate of tax would be determined by the amount of time that the buyer held the ETH — if it was more than one year, the gain would be characterized as longterm capital gain and generally would be taxed at preferential rates for individuals and other noncorporate taxpayers, currently a maximum rate of 20 percent, plus an additional 3.8 percent NII tax. The buyer’s holding period in the NFT would begin on the date that she purchased the NFT, not on the date that she purchased the ETH that she exchanged for the NFT. Interestingly,

CCA 202124008 indicates that even if section 1031 was in pre-Tax Cuts and Jobs Act form, the exchange of ETH for an NFT likely would not be eligible for tax-free like-kind exchange treatment.

1. NFT held for investment.

If a buyer — which could be an individual or a business — holds an NFT for investment for more than one year, the profits on the sale likely would be characterized as long-term capital gain and could be subject to preferential rates. If the NFT is held for one year or less, the profits would be characterized as short-term capital gain and would be taxed at ordinary income tax rates.

An NFT could be classified as a collectible, so that the gain on disposition would be subject to a higher 28 percent rate of tax under section 1(h) (4). Section 408(m)(2) defines a “collectible” as: any work of art, any rug or antique, any metal or gem, any stamp or coin, any alcoholic beverage, or any other tangible personal property specified by the IRS for this purpose. Because each NFT is unique, some NFTs that are similar to works of art or other listed collectibles could be subject to this higher rate of tax.

The gain on disposition of an NFT held for investment may also be subject to the 3.8 percent NII tax.

2. Nonbusiness use.

Personal use property is generally defined as property that is neither held for investment nor used in a trade or business. The taxpayer’s intent determines whether an asset is considered held for investment or for personal use. An example is an NFT purchased on a marketplace by an individual for use in a video game. When the buyer later sells the NFT, she would be taxed on any capital gain, but losses generally wouldn’t be deductible.

3. Dealers.

For a buyer who holds NFTs primarily for sale to customers in the ordinary course of her business (that is, a dealer), an NFT wouldn’t be a capital asset. Dealers may deduct ordinary and necessary expenses associated with the business and will recognize ordinary income on the net proceeds from the sale of an NFT. If an NFT is considered a “security” for income tax purposes, a dealer may be required to account for gains and losses on a mark-to-market basis. This classification is unlikely for most types of NFTs.

4. Business use.

A business may purchase an NFT to use in its business rather than for resale to its customers. For example, a business might commission a creator to create a business logo for use in marketing materials. The business may be permitted to depreciate the purchase price of the NFT over the course of the years that the NFT is in use. If the NFT is later sold for a profit, some of the depreciation deductions could be subject to recapture and treatment as ordinary income. Any remaining gain could be treated as long-term capital gain.

**Conclusion**

Although the IRS hasn’t provided specific guidance on the classification of NFTs, existing rules, regulations, case law, and informal guidance provide an adequate framework for determining the proper tax treatment of the creation, purchase, use, and sale of NFTs.

In addition to the federal income tax issues discussed here, NFT transactions and uses implicate many other local and international tax issues such as state and local income tax; sales or use taxes; installment sales; valuation issues surrounding gifts, bequests, and charitable donations; and identification of counterparties for information reporting to the IRS. Recent statements by members of Congress and the Biden administration suggest that more guidance is coming. In the meantime, any informal guidance from the IRS would be welcomed by taxpayers engaged in this increasingly popular new asset class.



# The Varying Federal, State and Local Attitudes on Crypto

*This article originally appeared in [Law360](#) on May 25, 2022. It is republished here with permission.*

The U.S. Securities and Exchange Commission is adding 20 positions to its Crypto Assets and Cyber Unit. These positions are all enforcement-related.

None of the new staff will be charged with carrying out the SEC's statutory duties to propose rules and interpret the law for industry participants.

The SEC proposed two new regulations recently, each of which would augment its powers while potentially stifling the burgeoning digital asset industry. While the SEC is pumping the brakes on growth and development of that industry, other government actors, including the Biden administration, Congress and the Newsom administration in California are taking a more balanced approach.

The cities of Miami, New York and now Dallas and Fort Worth, Texas, are aggressively recruiting digital asset businesses, vying to add them to their local economies. The differences in philosophical outlook inherent in these divergent treatments of the very same businesses can be explained.

We begin with the SEC's Crypto Assets and Cyber Unit, which has existed for five years, during which time it has initiated enforcement actions against more than 100 crypto asset offerings and platforms, obtaining more than \$2 billion in settlements. The SEC trumpets this record as a success, and without question some of its cases served the public interest by shutting down frauds and scofflaws.

Aggressive SEC action was warranted during the 2017 initial coin offering craze, when token teams that had no business at all, nary a business plan in some cases, sought to raise quick bucks from an unsuspecting public. Fraud should always be prosecuted by some government agency and the SEC acted properly by moving quickly to shut down fraudulent offerings.



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But bad facts create bad law, as subtleties that matter in harder cases are swept away or ignored. Fraud is relatively easy to spot and is rarely controversial. Registration violations, in contrast, require detailed analysis and are often controverted.

While the SEC has addressed registration as well as fraud in its enforcement actions, virtually all SEC enforcement actions are settled without admitting or denying the government's allegations because of the cost and distraction of mounting a defense. SEC orders issued in connection with settlements are written by the SEC staff and do not have the same legal precedential value as court orders and opinions by federal judges.

The result has been a lack of clear guidance about how digital tokens can be sold lawfully. We can spot the plainly unlawful offerings easily enough. It's much harder to navigate through the thicket toward a lawful result without nuanced SEC guidance pointing the way. We fear that adding enforcement lawyers to the SEC staff while understaffing the SEC's advisory and interpretive function will only make things worse.

Most recently, on May 6, the SEC issued an order in connection with settlement of charges it brought against Nvidia Corp., one of the world's largest producers of graphics processing units, or GPUs, from which the unit extracted a \$5.5 million fine over alleged inadequate disclosures about the impact of crypto mining on its publicly filed financial results.



According to the order, during two consecutive quarters in 2018, the SEC alleged that the company failed to make clear that demand from crypto miners was responsible for a significant part of the increase in sales of its GPUs that were also used for gaming.

On the same day, the SEC announced fraud charges against MCC International Corp., which does business as Mining Capital Coin Corp., as well as its founders and related entities, in connection with allegedly unregistered offerings and fraudulent sales of investment plans called mining packages. This was also led by the unit.

In February, lending protocol BlockFi Inc. agreed to pay \$50 million to settle with the SEC and \$50 million more to settle state law charges. In the BlockFi matter, the SEC asserted that BlockFi was selling notes to the public without registration.

This claim did not surprise us, but it was notable because the SEC has previously relied almost exclusively upon investment contract analysis as its basis for jurisdiction. BlockFi shows that the SEC is prepared to assert that particular crypto assets might be securities even if they are not investment contracts.

Meanwhile, SEC v. Ripple Labs Inc. is expected to go to trial in November of this year. Ripple is closely watched for clues about the SEC's changing positions in the new Biden administration and judicial rulings which, unlike SEC orders resulting from enforcement proceedings, have deep precedential value. The outcome of Ripple is certain to affect advice given to core development teams, traders, platforms and investors in this industry.

The SEC's move to beef up enforcement comes on the heels of President Joe Biden's executive order on ensuring responsible development of digital assets, which noted that 40 million Americans now invest in crypto assets. Crypto assets have been the fastest-growing asset class since they were first invented in 2010. Indeed, to demonstrate the point, virtually all major university endowments now own digital assets, as do most of the largest hedge funds.

Prominent skeptics like Ray Dalio of Bridgewater Associates LP and Ken Griffin of Citadel Securities LLC have publicly announced that they were wrong to doubt the bona fides of this new asset class. Fidelity Investments Inc., the largest retirement plan provider in the U.S., announced recently that later this year it will allow employers to offer 401(k) retirement funds allocated to bitcoin.

The federal executive order directed the Biden administration to study the industry carefully and to work with the industry in the course of developing a comprehensive federal approach to regulating crypto assets. The Financial Stability Oversight Council is given a central role in that process, as is the U.S. Department of Commerce, emphasizing a desire to help rather than hinder this new technology-driven industry. The SEC is mentioned of course, but is not directed to lead the federal initiative.

One might wonder, therefore, why the SEC is continuing along the same course as in the past. The SEC is an independent agency that need not take orders from the White House.

Still, the growing emphasis on regulation by enforcement rather than regulation by regulation is noted by many observers as being inconsistent with the executive order, as well as the SEC's own traditions of careful study and consultation with stakeholders in the course of adopting rules and regulations to govern financial markets.

Including the 20 new positions, the SEC's Crypto Assets and Cyber Unit will have a total of 50 staff employees and will seek to increase its focus on the growing crypto market, with particular focus on:

- Crypto asset offerings;
- Crypto asset exchanges;
- Crypto asset lending and staking products;
- Decentralized finance, or DeFi, platforms;
- Nonfungible tokens, or NFTs;
- Stablecoins.

The first four categories are well-known targets of SEC enforcement action. The SEC's jurisdiction over NFTs is debatable in light of the absence of legislation that governs these instruments, at least as interpreted by modern judicial precedent.

The NFT industry sees itself as being engaged in the collectibles business, not the securities business. An NFT that represents ownership of a Babe Ruth baseball card is a hard asset, not an investment contract.

Stablecoins that offer no profit opportunity are not investment contract securities. Still, the SEC has been aggressive in positing novel theories of law to justify expanding its reach and enlarging its turf. Watch for the SEC's creativity to be put on display as the recent selloff and subsequent crash of Terra and Luna are explored.

Other countries are taking a more deferential approach to crypto asset regulation. Switzerland and

the Bahamas, for example, are frequently cited as places to domicile crypto industry business because the regulations adopted there are clearer and more accommodating than the SEC's U.S. enforcement actions enforcement. Dubai is a third and increasingly prominent choice for digital asset development and experimentation.

Many crypto businesses founded in the U.S. have moved offshore because of the SEC's regulation by prosecution. It is possible that more will do so as the SEC ramps up with these new hires. Mike Fasanello of crypto trading company LVL was quoted expressing concern that more enforcement by the SEC "will stifle innovation in an emerging market."

Make no mistake, however, that when the SEC doubles the size of the Crypto Assets and Cyber Unit, more enforcement actions are on the way. At least one SEC commissioner is not on the same page.

On the heels of the SEC's announcement that it was doubling the size of the unit, SEC Commissioner Hester Peirce tweeted: "The SEC is a regulatory agency with an enforcement division, not an enforcement agency. Why are we leading with enforcement in crypto?"

Peirce will soon be joined by two new commissioners, one of whom had been seconded to Sen. Pat Toomey's, R-Pa., staff. Toomey, who is retiring at the end of this term, was a thoughtful moderate on digital asset regulation. So Peirce may soon have an ally at the SEC.

Potential responses from Congress include new legislation. On April 28, a bipartisan group of U.S. House of Representatives members introduced the Digital Commodity Exchange Act of 2022, which would extend the Commodity Futures Trading Commission oversight powers to cryptocurrency activities via digital commodity exchanges. The bill encourages digital asset platforms to register as exchanges that would be regulated by the CFTC.

Sen. Cynthia Lummis, R-Wyo., has revealed plans to introduce the Responsible Financial Innovation Act, which would attempt to "fully integrate digital assets into our financial system," detailing regulation on taxation and payments. Perhaps most importantly, Lummis' bill would include a definition of "digital asset" that would help the industry design compliant instruments while clarifying which regulatory agencies have jurisdiction.

While the SEC has increased its enforcement staff, as noted at the outset, it also has proposed two new regulations that would make it harder, if not impossible, to trade crypto assets that it deems to be securities.

One proposal would redefine the word “exchange” to include “communication protocol systems” that make available for trading any type of security, including crypto assets that are correctly or mistakenly treated as investment contract securities.

Many commentators have objected on multiple grounds, including:

- The SEC’s failure to assess the impact on the crypto industry;
- The unworkability of the proposed redefinition for digital asset markets; and
- The lack of authority to revise statutory terms such as “exchange” beyond their settled interpretations.

The other proposal would redefine the term “dealer” to include most proprietary trading firms and other day-traders on the theory that they are dealer-like and therefore should be regulated as if they were dealers.



Critics have pointed out that Congress, not the SEC, properly determines what sort of entities should be regulated as dealers — and what sort should not be so regulated — and that day traders of digital assets cannot comply with the SEC’s proposed redefinition because of the SEC’s own interpretations regarding capital requirements, custody and quotations of market prices for digital assets.

While the SEC continues on its unique path of discouraging digital asset industry growth every chance that it gets, California Gov. Gavin Newsom has chosen a different path. Noting that California has the fifth-largest economy in the world and is home to the leading technology companies across the country and around the globe, Newsom on May 4 signed an executive order to foster responsible innovation, bolster California’s innovation technology and protect consumers.

Referring to the president’s executive order, Newsom inaugurated a regulatory approach in California that will

Spur responsible innovation while protecting California consumers, assess how to deploy blockchain technology for state and public institutions, and build research and workforce development pathways to prepare Californians for success in this industry.

The California order signifies a desire to engage with stakeholders, and engage in and encourage regulatory clarity. We believe this is a wholesome approach.

At the local level, the competition to attract and retain digital asset teams is hot. Miami Mayor Francis Suarez has attracted more than a trillion dollars of assets under management to his city by enticing financiers and technology mavens to relocate from metro New York and California.

Vowing to take his pay in crypto assets, newly elected New York City Mayor Eric Adams is waging his own campaign to retain and attract business to the Big Apple. In doing so, he needs to contend with a state legislature that is inclined to shut down bitcoin mining in the Empire State and a Department of Financial Services that has been slow to license digital asset businesses in New York.

Texas, too, is getting into the act. Austin and lately Dallas have attracted crypto talent and built profitable digital asset businesses. Most recently, Fort Worth became the first city in the nation to mine Bitcoin for its own account.

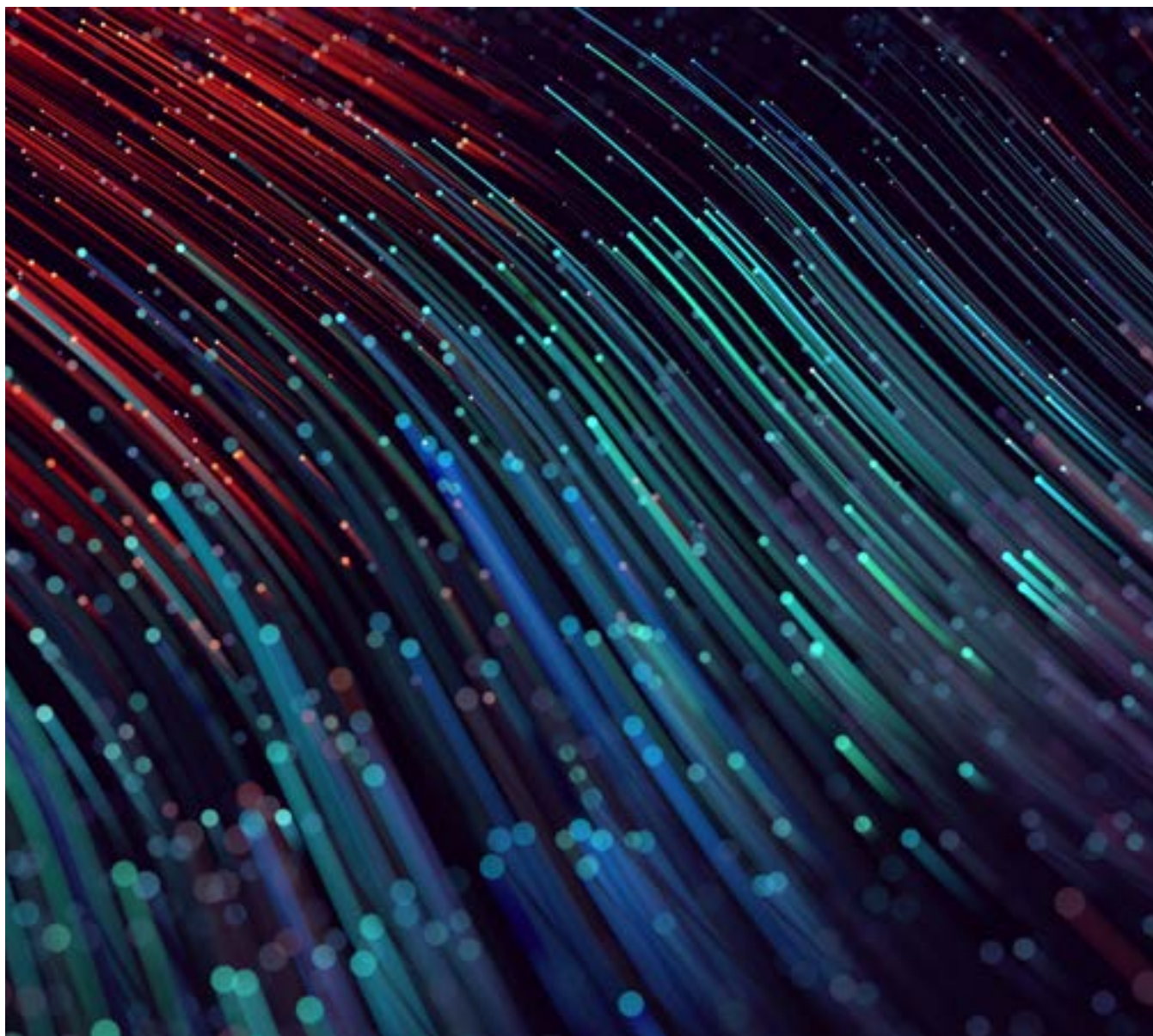
We view the varied initiatives of state and local governments as salutary experiments in economic development. The laboratory of the states is a feature, not a bug, of our federalism, from which optimal policy can emerge over time.

The federal government speaks best in one voice, not several. The president's executive order calls for a coordinated all federal government response, not just heightened enforcement action.

Potential responses from the industry to escalating SEC intervention may be founded in legal limits on federal agency powers. In this chess game, each side

has players to maneuver on the board. The SEC is using congressional money grants to beef up its team, but the industry is not without resources and talent to deploy as well.

As we look forward, the digital asset industry could thrive from the Digital Commodity Exchange Act being enacted by Congress, the FSOC and the Department of Commerce driving the federal regulatory response after taking input from all their constituents including the industry and the public, the digital asset industry growing from hospitable American cities— rather than offshore— and the SEC regulating first, and enforcing second.



# What GCs Exploring NFT, Web3 Opportunities Need to Know

*This article originally appeared in [Law.com](#) on May 20, 2022. It is republished here with permission.*

Companies across every industry are jumping into non-fungible tokens (NFTs), seeking to seize what they perceive as huge business opportunities.

Attorneys working in the space see myriad reasons to be bullish, despite a recent plunge in NFT sales and a host of tricky legal and regulatory issues companies entering the field must navigate.

NFTs are digital certificates registered on a blockchain, a ledger spread across decentralized computer networks. NFTs can be everything from digital art and collectibles to a plot of land in the virtual world known as the metaverse. The digital certificates are a key cog in Web3, a new iteration of the internet built on blockchains.

Missing opportunities in this emerging field could be catastrophic, said Louis Lehot, a partner with Foley & Lardner in California.

“Businesses that fail to evolve will cease to be competitive,” he said.

Some companies already are unleashing bold moves. Earlier this month, video game publisher Square Enix sold off many of its major video game properties, such as Tomb Raider, to fund its entry into the NFT space.

Those making such moves are undeterred by a nearly 92% drop in NFT sales in the first week of May, compared with the all-time high last September, according to data from market tracker NonFungible.

Meanwhile, NFT startups raised \$2.4 billion in the first quarter, representing 25% of all blockchain funding. Lehot said that shows the market is going strong, and has barely slowed despite the transaction drop.

“The flow of capital into new transactions is still at a breakneck pace,” Lehot said. “We’ve got deals as if nothing happened in the public markets.”



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## Early Movers

Rob Potter, a partner with Kilpatrick Townsend & Stockton in New York City, said established brands will have varying degrees of success selling NFTs to mainstream, less technically savvy fans.

Potter is well-versed on how companies can interact with NFTs and Web3. He [authored a piece for the Association of Corporate Counsel late last year](#) offering advice to GCs on the subject.

He said tying NFTs into more traditional marketing opportunities and promotional benefits, like customer loyalty programs or exclusive products, is a safer bet.

For example, Clinique leveraged its loyalty program earlier this year by offering members an opportunity to win exclusive NFTs tied to products to be released each year for the next decade.

In March, rock band Kings of Leon cut out music publishers by releasing its latest album as an NFT. It deleted all unsold NFTs after two weeks of sales, with no more being made.

These examples are simply the tip of the iceberg, Lehot said. For example, mobile developers can use Web3 to distribute apps directly to customers without going through app stores. He added that going through Big Tech costs developers 25-30% of gross revenue and can be unreliable at times.

Those developers could even choose to cut out payment systems, by transacting with self-issued tokens or NFTs.

General counsel should consider which parts of their businesses are digital and require transactions through Big Tech entities, attorneys say. If blockchains and Web3 can cut out those middlemen, that business might be well-suited to experiment with NFTs.

### **Navigating Risks**

Max Dilendorf, a New York City attorney specializing in cryptocurrencies and Web3, said venturing into NFTs and other blockchain technologies brings big opportunities but also big risks.

He said general counsel must make sure their businesses are in compliance with money laundering regulations, such as the Currency and Foreign Transactions Reporting Act of 1970— commonly called the Bank Secrecy Act.

While that might sound surprising to the uninitiated, Dilendorf said NFTs carry a money-laundering risk, since decentralized technology makes their transactions untraceable.

Once legal teams have covered that territory, Dilendorf said they should brush up on the regulatory landscape, which is in flux.

Securities and Exchange Commission Chairman Gary Gensler last month announced plans to step up regulation of blockchain technologies and to nearly double the size of the agency's Crypto Assets and Cyber Unit.

Potter said that working with experienced partners, including outside counsel, can help GCs navigate the regulations.

"That's who you want to start with to get the benefit of that perspective, because it's moving rapidly," Potter said.

Companies also should get comfortable with the idea of selling an extremely risky asset, Dilendorf said, referencing the recent drop in NFT prices.

The average price of an NFT was about \$1,400 in April, according to NonFungible, down from \$4,000 in February.

He said buyers should be given disclosures and made to understand their investment can drop to zero at any time.

"This way, you protect yourself against future claims," Dilendorf said, emphasizing. "[This way,] your buyer cannot come to you and say 'I've lost \$5,000, and I want my money back.'"



# POTUS Issues Executive Order Directing Study of Digital Assets

On March 9, 2022, President Joe Biden signed the “[Executive Order on Ensuring Responsible Development of Digital Assets](#)” (the order), outlining his administration’s intention to begin a strategic review of potential legislative and regulatory approaches to digital assets. Having grown into a \$2 trillion dollar industry practically overnight, proponents and opponents of digital assets can agree on one thing: this is merely a directive to federal agencies to cooperate with one another while studying the industry and making recommendations that could inform future lawmaking.

While it does not drop an anchor on any specific issue or stake out positions, the order marks an official and long-anticipated acknowledgment of the digital asset era by the Biden administration. Citing the growth and scale of the industry, the White House acknowledges that digital assets are here to stay as financial and technological realities.

The order further paints the industry with the widest possible brush, defining “digital assets” as digital currencies, financial assets, and instruments, as well as “claims” relating to payments, investments, and transmission or exchange of funds, going as far as “other representations of value.” We can expect federal regulation of all digital tokens, whether fungible or non-fungible (i.e., NFTs), and whether evidencing currency or physical assets or enabling consumption of goods and services or the exercise of governance rights.

The order focuses on four policy concerns: (1) consumer and investor protection, (2) global market stabilization, (3) mitigation of illicit and dangerous activities, and (4) maintaining U.S. primacy in global finance and technology, while directing federal agencies to submit reports and make recommendations over the next year.

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## 1. Consumer and Investor Protection

The order identifies the administration’s top priority as protecting against consumer risks across the digital asset ecosystem. In light of perceived risks of crime, fraud, and theft in digital assets and trading platforms, the order calls for risk mitigation efforts combined with an expansion of access to safe and affordable financial services.

Section 5 of the order also calls for significant administrative guidance. The director of the Office of Science and Technology Policy and the chief technology officer of the United States, in consultation with the Department of the Treasury (Treasury) and the Federal Reserve (the Fed), are to submit to the president a technical evaluation of the infrastructure, capacity, and expertise needed at the relevant agencies to support a potential U.S. Central Bank Digital Currency (CBDC). A CBDC is fiat currency in digital form.

Also, the attorney general, in consultation with the Treasury and Department of Homeland Security (DHS), is directed to report on the role of law enforcement agencies in addressing criminal activity related to digital assets. The director of the Office of Science and Technology Policy, in consultation with the Treasury, Department of Energy, Environmental Protection Agency, and Council of Economic Advisers, among others, is directed to report to the president on the



connections between distributed ledger technology and economic and energy transitions, specifically the potential of these technologies to impede efforts to battle climate change and other impacts on the environment.

## **2. Global Market Stabilization**

In the order, the Biden administration identifies the size, complexity, and rapid growth of trading platforms and service providers as contributing to “systemic risk” to the stability of global financial system. In the interest of addressing the risk to “financial stability and financial market integrity,” Section 6 of the order calls on the Treasury to convene the Financial Stability Oversight Council to report on such risks and make recommendations.

## **3. Mitigation of Illicit and Dangerous Activity**

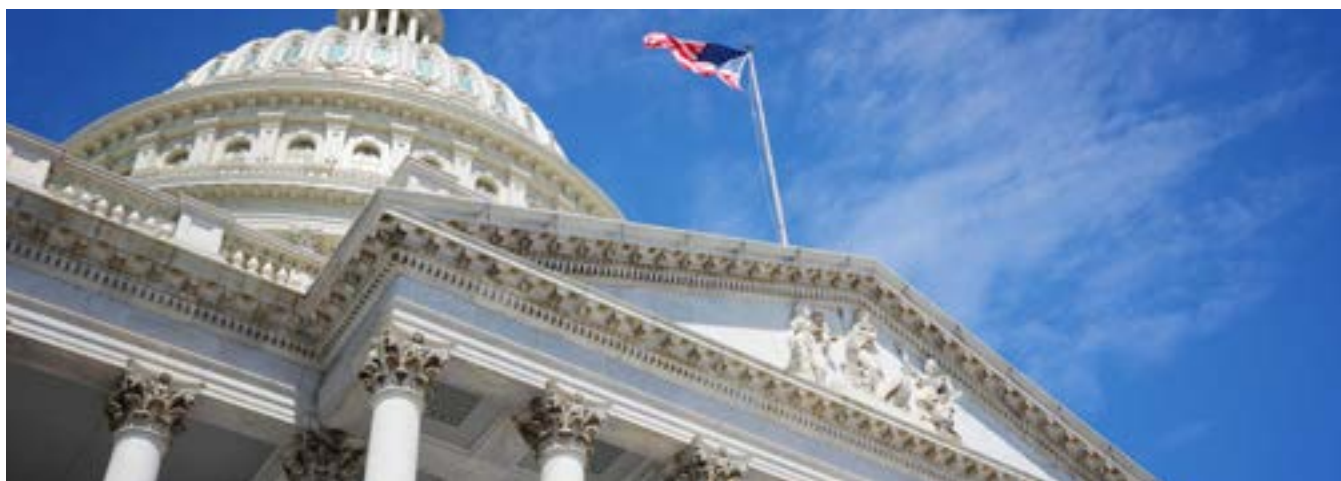
The order asserts that digital assets “may pose significant illicit finance risks” that must be mitigated. Section 7 of the Order discusses national security risks associated with the “growing use” of digital assets in money laundering, fraud, theft, and even terrorism. This Section also allows the Treasury, State Department, attorney general, Department of Commerce (Commerce), DHS, the director of national intelligence (DNI), and others to supplement the “National Strategy for Combating Terrorist and Other Illicit Financing” (an executive branch anti-terrorism report, due January 31, 2022). These agencies are also directed to develop a coordinated action plan recommending measures to mitigate these risks and identifying the role of law enforcement pertaining to money laundering and terrorism in the digital asset industry.

From our view, it seems unlikely that this process will unearth any new national security risks related to the use of digital assets. In developing its action plan, we expect the government to draw from its experience combating money laundering in the art market. In light of the current focus on cutting Russian oligarchs off from the world financial system, we also expect the government to pay special attention to the use of digital assets by high net worth individuals to evade sanctions, perhaps drawing on Treasury’s efforts to combat money laundering in the high-end art market.

## **4. Maintaining U.S. Primacy and Supporting Technological Development**

The order purports to be motivated to maintain the United States as the world’s financial and technological superpower. It asserts that implementing (or at least studying) a CBDC might be the cornerstone of continued American leadership.

Section 4 of the order states President Biden’s policies and plans related to a CBDC, an innovation meant to sustain U.S.-centric financial power. The order stresses urgency in research and development efforts for the design and deployment of a U.S. CBDC and also emphasizes the need for U.S. leadership pertaining to non-U.S. CBDCs, including international cooperation and pilot projects. A handful of countries in the Caribbean have already adopted CBDCs of their own, while scores of governments around the globe are either studying the concept or have begun pilot programs. Further, the order states that any future dollar payment system involving CBDCs should be consistent with both the priorities outlined in the order





and “democratic values,” including privacy protections, in a manner “that ensures the global financial system has appropriate transparency, connectivity, and platform and architecture interoperability or transferability, as appropriate.”

The order goes on to list potential benefits of a U.S. CBDC, including efficient and low-cost transactions and cross-border payments, boosting economic growth, supporting the continued centrality of the United States within the international financial system, and fostering greater access to financial systems with “fewer of the risks posed by private sector-administered digital assets.”

The order does not address the likely impact on the commercial banking industry of the adoption of a U.S. CBDC, nor does it explain why the federal government is better able than the private sector to manage retail deposits and payments for hundreds of millions of Americans. But the Treasury, in consultation with the State Department, attorney general, Commerce, DHS, the Office of Management and Budget, DNI, and heads of other agencies, are directed to report to the president on the future of money and payment systems, including analysis of the potential implications of a U.S. CBDC on all aspects and stakeholders of the financial markets and the overall interests of the United States. The order also calls for the involvement of the Fed in assessing the optimal form of a U.S. CBDC and development of strategic steps for potential implementation.

The attorney general, in consultation with the Treasury and the Fed, is to assess whether legislative changes are necessary to issue a U.S. CBDC. They also are expected to provide a corresponding legislative proposal.

Section 8 of the order promotes international comity. Treasury, State, Commerce, and others are directed to establish a framework for “international engagement with foreign counterparts” as to how to “appropriate, adapt, update, and enhance adoption of global principles and standards” for the use of digital assets and to “promote development of CBDC technologies.” The framework is supposed to include capacity-building efforts, coordination of global compliance, and general coordination in the international community. This section of the order also calls for ways to enhance

American “economic competitiveness in, and leveraging of digital asset technologies,” and it directs the Secretary of Commerce to establish that framework in consultation with other agencies.

Commerce is an interesting choice as the lead agency on this framework. Its selection will provide the digital asset industry the opportunity to state its concerns to an agency that has little past experience with digital assets. If industry participants can convince Commerce that digital assets are good for American business, we predict that they will find Commerce to be a strong federal advocate. Companies and trade groups that have not introduced themselves to agency policymakers should do so promptly in order to capitalize on this opportunity.

## Conclusion

The order is the Biden administration’s command for the federal establishment to engage with the digital asset world. Setting out basic policy objectives, the order answers the question of *why* digital assets must be incorporated into government policy much more than *how*. The order does not indicate whether or how any specific digital assets are to be regulated other than at present. While fungible digital assets such as Bitcoin and Ether have gained acceptance in the marketplace partly because they are largely beyond government control, the order proposes a U.S. CBDC, which would be a fiat currency issued by the Fed in digital form.



# SEC Adds Twenty New Crypto Asset Enforcers

The Securities and Exchange Commission (SEC) recently announced that it will be adding 20 positions to its newly renamed Crypto Assets and Cyber Unit, including fraud analysts, investigative staff attorneys, trial counsels, and supervisors. With the SEC's current Chair Gary Gensler on record stating that he believes the law is clear enough and only needs enforcement, it is important to highlight that all of these positions are enforcement-related and none of the new staff will be charged with carrying out the SEC's statutory duties to propose rules and interpret the law for industry participants. As reported by [Axios](#), this comes on the heels of news that current Crypto Assets and Cyber Unit Chief Kristina Littman is stepping down with plans to leave the SEC in early June.

## Background

Over the past five years of its existence, the Crypto Assets and Cyber Unit has initiated enforcement actions against more than 80 crypto asset offerings and platforms and obtained more than \$2 billion in settlements. Virtually all financial technology-related SEC enforcement actions are settled without admitting or denying the government's allegations due to the cost of mounting a defense, notably including lending protocol BlockFi's [agreement](#) to pay \$50 million to settle with the SEC, and \$50 million more to settle with 32 states, for violating the Investment Company Act of 1940.



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Another high-profile lawsuit, *SEC v. Ripple*, is expected to go to trial in November 2022. Legal observers will be watching that case closely for clues about the SEC's positions in the Biden administration and how judicial rulings will shape the law. The court's opinion will be binding precedent, unlike the SEC orders issued in connection with settlements, which are written by the SEC staff and do not carry the weight of law.

These SEC moves follow President Biden's Executive Order on Digital Assets (examined at length [here](#)), which noted that 40 million Americans now invest in crypto assets and overall have a market value of approximately \$2 trillion. Crypto assets have been the fastest-growing – and the most profitable – asset class over the past several years, expanding rapidly since they were first invented in 2010. In a sign of growing mainstream acceptance, Fidelity, the largest retirement plan provider in the U.S., [recently announced](#) that by mid-2022 it will allow employers to offer up to 20% of their investors' 401(k) retirement funds in bitcoin.

Biden's Executive Order directed the administration to study the marketplace carefully and work with industry participants to develop a comprehensive federal approach to regulating crypto assets. However, as an independent agency the SEC is not bound to follow the White House's direction. Still, the growing emphasis on "regulation by enforcement" rather than "regulation by regulation" is noted by many observers as being inconsistent with the Executive Order, as well as the SEC's own traditions.

## Impact

Including these 20 new positions, the Crypto Assets and Cyber Unit will have a total of 50 staff employees and seeks to increase its focus on the growing crypto market, specifically:

- Crypto asset offerings
- Crypto asset exchanges
- Crypto asset lending and staking products
- Decentralized finance (DeFi) platforms
- Non-fungible tokens (NFTs)
- Stablecoins

The first four categories are established targets of recent SEC enforcement action, with NFTs and stablecoins having generated some attention to date and appear to be in line to receive additional scrutiny.

The SEC's jurisdiction over this entire field is unclear in light of the absence of modern judicial precedent, especially so concerning NFTs and stablecoins. Many participants in the NFT industry sees their business as one of collectibles, not securities. Further, stablecoins offer no profit opportunity and are not likely to be ultimately defined as investment contract securities.

Still, the SEC under Chair Gensler has been aggressive and expansive in its enforcement reach, seeming to compete with the arguably more technologically adept Commodities and Futures Trading Commission (CTFC). In its announcement Chair Gensler cites investor protection as the justification for the additional positions at the Crypto Assets and Cyber Unit, stating, "By nearly doubling the size of this key unit, the SEC will be better equipped to police wrongdoing in the crypto markets while continuing to identify disclosure and controls issues with respect to cybersecurity."

The United States lags behind other major financial centers with respect to its crypto regulatory framework. The laws in Switzerland and the Bahamas, for example, offer investors more clarity and accommodation than the United States currently offers. As a result, crypto businesses founded in the United States may move offshore and the expansion of the Crypto Assets and Cyber Unit (and likely ramp up of enforcement) may drive more to so. In any event, the additions to the Crypto Assets and Cyber Unit will be another moving piece in the fluid and dynamic crypto asset markets.



# A Checklist Of Legal Considerations for The NFT Marketplace

*Originally published in Crunchbase on November 9, 2021. Reprinted with permission.*

With the growing interest from consumers and asset managers, investors as well as entrepreneurs interested in digital assets, we have created this checklist for monetizing items with unique artistic content characteristics through nonfungible tokens (NFTs).

We have seen businesses that aggregate content to be monetized on an NFT, while others mint the tokens or build NFT marketplaces, and many more that intermediate payment transactions between the creators, the licensors, the marketplaces, and the buyers, the sellers and the exchanges upon which they trade.

Each of these types of businesses, and the transactions in which they participate, will need to consider the legal ramifications of still-developing law, policy and regulation applicable to each link in the chain of NFT commerce.

But first, a quick primer: An NFT marketplace is a platform that connects content creators with NFT buyers with NFT sellers. Sellers mint NFT tokens with the created digital asset in this platform, and buyers can browse listed assets and buy or participate in an NFT auction. There are primary and secondary sales of NFTs in the marketplace with differing transaction costs depending on how the marketplace operates and who facilitates the sale.

With NFTs expanding into the mainstream consciousness, what are some key legal, policy and regulatory considerations you need to be aware of?



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## Key legal considerations when building an NFT marketplace

- **Formation:** You'll need to form a corporate entity before launching a marketplace. This will offer your business the most substantial liability protection, greater ability and credibility when seeking financing from external sources.
- **Conduct Code:** Most NFTs, given the predominance of user-generated content and transactions in NFT marketplaces, include an extra layer of legal restrictions in the form of codes of conduct to govern interactions on the platform.
- **Smart Contracts:** The unique digital creation must be independently identifiable, with ownership transferable within the smart contract. Creators should design-in the economics of trading: How much for a primary sale, how much for secondary sales, royalties, transaction costs and other features of the aftermarket to enable trading, with funds flowing to the appropriate parties by design.
- **Platform Terms of Service:** NFT marketplaces must have essential documents such as Terms of Service, which govern the relationship between the NFT marketplace operator and customers, and between the buyers and sellers of the NFTs featured on the platform. A well-thought-out terms of service agreement can help protect your organization from various legal issues and generally have provisions limiting the company's overall liability.

- **Terms of Sale:** Sellers or creators listing their NFTs on an NFT marketplace may wish to impose additional terms of sale on purchasers of their NFT, especially if the platform's terms of service do not sufficiently address risks to the seller or creator.
- **Intellectual Property Protection:** It is vital to verify each participant's intellectual property rights through each step of every NFT transaction. Be sure to allocate intellectual property rights between the creators/artists, purchasers/collectors, and other parties involved. The ownership of the original work is copyright ownership, which vests in the creator of the original work. If an NFT is minted and sold, the purchaser will receive a set of intellectual property rights from the creator as part of owning the NFT. The seller of the NFT determines the rights that accompany an NFT. When examining the ownership of the content that you are seeking to tokenize, consider the rights of ancillary parties: Is there a record label, a studio, a sports franchise that has the right to participate in the monetization of the content?
- **Securities law compliance:** To ensure your newly minted token does not have the characteristics of a security, it's crucial to design features that demonstrate the distinction between your NFT and what governments seek to regulate. For example, the proceeds of the primary and secondary sales should not be used to build other NFTs, the platform or the marketplace. Since currency is fungible, this requires careful planning.
- **Payments:** If payments are processed on behalf of counterparties, the party touching the money may be a "money transmitter" with its activities governed by applicable Treasury, state and local registration regulations. To avoid the complex process of registration in innumerable jurisdictions, many marketplaces partner with already-registered entities, acting as content creators rather than payment processors. But watch for commissions, gas fees and other transaction costs associated with validating transactions and processing payments. How is each payment characterized? Is it a fee for content creation or money transmission? This is a key question for compliance
- **Consumer Protection:** Most major jurisdictions have laws to protect consumers. Suppose an NFT marketplace adequately fails to inform its customers about what they are purchasing and the risks involved. The FTC may then argue deceptive or unfair advertising, which may lead to hefty fines. NFTs likely will be targeted by cybercriminals for financial gain. Your platforms will need robust controls to guard against such risks. You may also need to implement KYC, anti-money laundering, and other regulatory requirements.
- **Data Privacy:** Being transparent about your data collection and use is critical. Many jurisdictions require platforms to disclose their data practices in a privacy policy. The fines for privacy violations can be significant.
- **What else is in the kitchen sink?** The existing regulatory and legal environment was not designed in anticipation of the rapidly evolving metaverse, where digital assets predominate. Nonetheless, some key issues have emerged while investors, financial and fintech companies explore this space. Is there a gateway to your platform to protect from money launderers and bad actors subject to government sanctions?
- **Show me the money:** With each piece of content, and each media in which it is reproduced or tokenized, a different license fee may be payable to a different entity in the stream of commerce. Consider whether an album cover or a musical recording is subject to royalty streams to recording labels, agents, libraries or artists, and whether a payment is due only upon the initial sale or upon each subsequent resale in the after-market. Analyzing each contract involved in the monetization of content is a key task, and care should be taken to follow the trail through each transaction in the metaverse.

### Bringing it all together

If the last two years have taught us anything, it is that technology paradigms shift faster than the speed of law, policy and regulation. While contracts between two parties can be made and amended in a split second, the legal regime that governs does not always keep pace. Like all things, however, eventually the law, policy and regulation catch up. Sometimes, they land in unexpected places not envisaged at the time of contract. This checklist should help those involved in creating NFT marketplaces navigate the legal metaverse.

# DeFi and the DAO: How the Law Needs to Change to Accommodate Decentralized Autonomous Organizations

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As financial markets wrap up the year 2021 and launch into 2022 at warp speed, the “DeFi” world has a new star called the “DAO.”

Decentralized finance, short-handed as “DeFi”, refers to peer-to-peer finance enabled by Ethereum, Avalanche, Solana, Cardano and other Layer-1 blockchain protocols, as distinguished from centralized finance (CeFi) or traditional finance (TradFi), in which buyers and sellers, payment transmitters and receivers, rely upon trusted intermediaries such as banks, brokers, custodians and clearing firms.

DeFi app users “self-custody” their assets in their wallets, where they are protected by their private keys. By eliminating the need for trusted intermediaries, DeFi apps dramatically increase the speed and lower the cost of financial transactions. Because open-source blockchain blocks are visible to all, DeFi also enhances the transparency of transactions and resulting asset and liability positions.

Although the proliferation of non-fungible tokens, or NFTs, may have gathered more headlines in 2021, crypto assets have become a legitimate, mainstream and extraordinarily profitable asset class since they were invented a mere 11 years ago. The Ethereum blockchain and its digitally native token, Ether, was the wellspring for DeFi because Ether could be used as “gas” to run Layer-2 apps built to run on top of Ethereum. Since then, Avalanche, Solana and Cardano, among other proof-of-stake protocols, have launched on mainnet, providing the gas and the foundation for breathtaking app development which is limited only by the creativity and industry of development teams.



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DeFi apps require “DAOs,” or Decentralized Autonomous Organizations, to operate. DAOs manage DeFi apps through the individual decisions made by decentralized validator nodes who own or possess tokens sufficient in amount to approve blocks. Unlike joint stock companies, corporations, limited partnerships and limited liability companies, however, DAOs have no code (although, ironically, they are creatures of code). In other words, there is no “Model DAO Act” the way there is a “Model Business Corporation Act.” DAOs are “teal organizations” within the business organization scheme theorized by Frederic Lalou in his 2014 book, “Reinventing Organizations.” They are fundamentally unprecedented in law.

Just as NFTs have been a game changer for creators, artists and athletes, our legal system will need to evolve to account for the creation of the DAOs that govern NFTs and other crypto assets. (NFTs are a species of crypto asset.) Adapting our legal system to account for DAOs represents the next wave of possibility for more numerous and extensive community efforts.

A DAO is fundamentally communitarian in orientation. The group of individuals is typically bound by a charter or bylaws encoded on the blockchain, subject to amendments if, as and when approved by a majority (or some other portion) of the validator nodes. Some DAOs are governed less formally than that.



The vast majority of Blockchain networks and smart contract-based apps are organized as DAOs. Blockchain networks can use a variety of validation mechanisms. Smart contract apps have governance protocols built into the code. These governance protocols are hard-wired into the smart contracts like the rails for payments to occur, fully automated, and at scale.

In a DAO, there is no centralized authority—no CEO, no CFO, no board of directors, nor are there stockholders to obey or serve. Instead, community members submit proposals to the group, and each node can vote on each proposal. Those proposals supported by the majority (or other prescribed portion) of the nodes are adopted and enforced by the rules coded into the smart contract. Smart contracts are therefore the foundation of a DAO, laying out the rules and executing the agreed-upon decisions.

There are numerous benefits to a DAO, including the fact that they are autonomous, do not require leadership, provide objective clarity and predictability, as everything is governed by the smart contract. And again, any changes to this must be voted on by the group, which rarely occurs in practice. DAOs also are very transparent, with everything documented and allowing auditing of voting, proposals and even the code. DAO participants have an incentive to participate in the community so as to exert some influence over decisions that will govern the success of the project. In doing so, however, no node participating as part of a decentralized community would be relying upon the managerial or entrepreneurial efforts of others in the SEC v. Howey sense of that expression. Neither would other nodes be relying upon the subject node. Rather, all would be relying upon each other, with no one and no organized group determining the outcome, assuming (as noted) that the network is decentralized. Voting participants in DAOs do need to own or possess voting nodes, if not tokens.

As with NFTs, there are limitless possibilities for DAOs. We are seeing a rise in DAOs designed to make significant purchases and to collect NFTs and other assets. For example, PleasrDAO, organized over Twitter, recently purchased the only copy of the Wu-Tang Clan's album "Once Upon a Time in Shaolin" for \$4 million. This same group has also amassed a portfolio of rare collectibles and assets such as the original "Doge" meme NFT.

In addition to DAOs that are created as collective investment groups, there are DAOs designed to support social and community groups, as well as those that are established to manage open-source blockchain projects.

As is true with any emerging technology, there is currently not much regulation or oversight surrounding DAOs. This lack of regulation does make a DAO much simpler to start than a more traditional business model. But as they continue to gain in popularity, there will need to be more law written about them. The state of Wyoming, which was first to codify the rules for limited liability companies, recently codified rules for DAOs domiciled in that state. So a DAO can be organized as such under the laws of the State of Wyoming. No other state enables this yet.

DAOs are a path-breaking form of business "organization" that are not well understood. They are not corporations. Should they nevertheless file and pay taxes, open bank accounts or sign legal agreements? If so, then who would have the power or duty to do that for a decentralized autonomous organization whose very existence decries the need for officers, directors and shareholders?

What we need are a few workable principles or standards (emphasis on "few" and "workable") that define the decentralization that is at the core of legitimate DeFi and the consumer use of tokens that are not investment contracts.

Futuristic DAOs are a decentralized break from the centralized past and present of business organization. It's time for legislation and regulation to follow where the technology is taking us.



# NFT Art – Your Top 40 Legal Questions Answered

Non-fungible tokens were minted and sold under the radar until a relatively obscure artist sold an NFT for an immense sum. That seminal event invigorated interest in NFTs by artists, sales platforms and collectors. In this column, we undertake to identify and answer, in Q&A format, the top forty legal issues associated with this new medium of artistic expression.

## Copyright

1. How does copyright law apply to NFT art? NFTs do not change the operation of copyright. The underlying work is protected by copyright, which can be retained by the author or transferred to the holder of the NFT. This is similar to how a copyright in a conventional piece of art may be transferred to a third party. That said, copyright transfers must be in writing, and whether a smart contract is a writing for purposes of the Copyright Act is not a settled legal issue.
2. If the sales platform mints an NFT of digital art, does the smart contract need to specify who owns the copyright? Yes.
3. If a platform wanted to display an NFT image for public viewing, would the platform need the permission of the copyright holder, the owner of the NFT, or both? The answer will depend upon the terms associated with the NFT. A typical allocation of rights would be that the platform would need the permission of the copyright holder in the underlying work and not the permission of the owner of the NFT, but that allocation could change with the terms of the NFT. An artist could license the artist's rights to a work exclusively to the NFT owner, which would require the platform to obtain the owner's approval in order to display the work.

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## NFT Minting

4. What are the risks of NFT minting? The answer might depend on who is minting the NFT. The creator could mint the wrong NFT, or could input the wrong content or omit information, and not be able to change any of this afterward. If a platform is transferring an NFT that has already been minted, then there could be risks associated with the transfer (hacking, theft, counterfeiting, etc.). If the platform creates its own blockchain and mints NFTs to that blockchain, then there could be technical or structural risks.
5. If the platform mints the NFT art, will the art appear as having been generated by the artist, the platform, or both? The answer to this requires scrutiny of the smart contract deployed to mint the NFT. Typically, most marketplaces will require that participants mint only original content or content in which the participant has rights. If minting another's work, the participant could add information about the artist.
6. Will the NFT be held in the platform's wallet? The answer will likely depend on how the transaction is structured, as well as the smart contract deployed for the transaction. There might be tax consequences associated with temporarily holding an NFT.

## Smart Contracts

7. What is a smart contract? A smart contract is a computer protocol that digitally facilitates, verifies and/or executes the performance of a “contract” protocol.
8. Can a sales platform add terms to the NFT that govern how the sale will be conducted on the platform? Yes, it is common and recommended to impose terms applicable to the NFT purchase to affirm the legal enforceability of the protocol in the smart contract.
9. How does one embed a smart contract into the blockchain? Typically, a smart contract is deployed as a program on the blockchain, which is usually the Ethereum blockchain).
10. Could one settle a payment in fiat currency (rather than crypto currency) via smart contract? Answering with reference to currently available technology, the answer is probably not, because fiat currently payment settlements are recorded on private ledgers rather than on the blockchain. One could have the smart contract record on a distributed blockchain ledger, and then record that information in a traditional private ledger.
11. How would a smart contract handle a not-yet-determined sales price? Smart contracts define rules and automatically enforce the rules through their deployment. As long as the rules are programmed into the protocol, and the smart contract ingests accurate data, the smart contract deployment will produce a certified output. Smart contracts also can be crafted to communicate with other smart contracts, which may increase the output possibilities. The platform’s product development team should work with commercial lawyers versed in blockchain technology to assure that their smart contracts align with the parties’ legal commitments.
12. If the platform is paid cash by a buyer, then how can the platform reconcile that payment with the automatic royalty embedded in a smart contract? Most likely the platform would need to include the confirmation cash payment as an input in the data feed to the smart contract in order to trigger payment of the royalty via the smart contract.
13. What is a sales agent’s role in a smart contract where the platform does not mint the NFT and the smart contract already exists? This would depend on the protocol for the smart contract. One could program a smart contract to give the platform the temporary holding of an asset as an intermediate step.



### Transfer of the NFT

14. If the sales platform does not mint the NFT or if, after minting, the NFT is not transferred to the platform, how can the platform be sure that title will transfer to the buyer? An NFT will not transfer payment to the seller until title to the NFT is transferred to the buyer on the blockchain.
15. Does the platform need to take title in order to transfer possession? No. As in the case of physical goods, the platform can conduct the sale process, notify the seller and the winner of the result of that process, and the seller can transfer the NFT to the buyer. The platform does need to have, however, the contractual ability to force the seller to fulfil its obligation to transfer possession.
16. Can a platform possess an NFT without owning it? While it is possible that an NFT could provide this capability in its terms, that would be highly unusual.
17. One reason why a sales platform takes possession of physical art is to make sure that the seller doesn't sell it to someone else. Is there a way to do this without taking title to the NFT? An NFT can have only one owner at a time, so the only way to be sure of avoiding the classic "double spending" risk is to own the NFT. That said, there may be other, better, ways to achieve this goal; e.g., by contract with the seller or the use of escrow accounts to guarantee transfer by the seller.
18. Can the platform add to the blockchain that the platform was involved in the sale as agent without taking title to the NFT? Yes. The platform can become part of the NFT's provenance in this way.

### Transfer of Funds

19. Is there any need for a platform to consider compliance with securities laws, commodity laws or banking laws with respect to its role in the transfer of funds in the sale process? Yes, but, depending on how the transaction is structured, it should be possible for the platform to avoid these issues by involving third parties that possess the correct regulatory qualifications. Because of unmanageable regulatory burdens, the platform will rightly wish to lawfully avoid characterization of its activities as securities brokerage or exchange operation or a money service business.
20. Are you sure about that? We heard that NFT art is a 'utility token' and that the SEC has no jurisdiction over utility tokens. SEC jurisdiction is unclear and the consequences of being second-guessed by the SEC are severe. Calling a token a "utility token" does not make it one. The function rather than the label is what matters. Consult with expert legal counsel.

### AML

21. What are the anti-money-laundering laws and related issues that pertain to NFT sales? The Global Financial Action Task Force published guidance in March 2021 that has an impact on decentralized finance markets and NFTs that should be considered. Some of the key AML considerations for a platform relate to enhanced regulations in the US, EU and UK that expand AML requirements to dealers in art and antiquities. In addition, the platform should be

considering the application of such regulations to crypto assets, exchange providers and wallet providers. Under these enhanced regulations, activity involving exchange, security, and utility tokens are brought within the AML rules. From a regulatory standpoint, this may include obtaining appropriate registrations and making required disclosures and interfacing with the applicable Financial Intelligence Units. From a compliance standpoint, this may include the development of policies and procedures (including Know-Your-Transaction and Know-Your-Customer Procedures), risk assessments, training, suspicious activity investigation and reporting. As noted above, it is possible in some circumstances to avoid these sorts of obligations by partnering with an entity that has all the correct licenses and does all the necessary checking.

### **Warranties**

22. What warranties on NFTs should a sales platform provide? Platforms will want to minimize the warranties that they will make. If there is a warranty, it should be procured from the consignor, the creator or other providing party, as applicable.
23. What warranties related specifically to the NFT should a platform obtain from a seller? Warranties of title, authenticity, and continuing existence of the digital image, as well as non-infringement, and other standard warranties in the sale of goods, especially for art pieces and collectibles, should be procured from the seller.

### **Confidentiality**

24. Can the identity of a buyer of an NFT on the blockchain be kept confidential? There is no reason why a seller or a buyer cannot maintain the confidentiality of her, his or its identity, but so far most NFT marketplaces maintain the right to require an entity to prove its ultimate identity even while permitting the entity to transact business confidentially on the platform.

### **Future Resale Royalties**

25. How should the platform address artist-imposed future resale royalties (to the artist) in its sales agreements and conditions of sale? NFTs that provide for future resale royalties will automatically pay out future resale royalties to their creators when they're sold. Royalty systems differ for each marketplace, though, such that this issue needs to be reviewed on a marketplace-by-marketplace basis.
26. Is this part of the NFT software code, such that any future buyer contracts to pay the artist the royalty? A transfer within the same blockchain will trigger a payment from the buyer to the artist.
27. Does the platform need to get involved in collection of these royalties or enforcement of the terms? No. It's automatically handled by the blockchain.
28. How does an artist know when a transfer has occurred and thus a payment is due to the artist? Because the artist is identified in the NFT, notification to the artist (and payment) is automatically handled by the blockchain.
29. How would the platform handle the royalty if the winning bidder paid in fiat currency rather than crypto currency? Initial sales will not incur a future resale royalty. If the platform brokers a "secondary market" sale within the same blockchain, then payment of the resale royalty should happen automatically, without the need for the platform to get involved. A buyer desiring to use fiat currency to make a purchase would need to deposit that money into a suitable crypto wallet to make the purchase.
30. If the NFT is transferred to the platform before sale, will that trigger the resale royalty or any other conditions in the NFT? What happens if there is no sale? The answers will depend on the conditions coded into the NFT, but it would be unusual for a transfer not to trigger conditions. Unless a separate agreement with the original NFT holder was negotiated, the platform would incur the condition obligations, even on no sale, if the NFT were transferred to the platform's wallet.

## Sale Cancellation

31. What commercial laws apply to the sale of an NFT? There are significant uncertainties about what substantive law will govern the sale. UCC Article 2 governs only sales of tangible property. Digital art is not tangible. Courts sometimes apply Article 2 by analogy, but even then most provisions of Article 2 can be overridden by express contract terms. The alternative to Article 2, in the United States, is state common law, which again can largely be overridden by express contract terms. Furthermore, courts applying the UCC and the common law have increasingly applied principles of good faith, fair dealing, conscionability and commercial reasonableness to avoid results that seem (to the particular court) unfair or harsh. This suggests that sale contracts in the NFT art area should be drafted with extraordinary specificity and reasonableness.
32. Technologically speaking, what could happen that might require an NFT art sale to be unwound? Because the Ethereum blockchain is decentralized, it's highly unlikely that there will be a total shutdown of the platform. Possible counterfeiting or hacking of smart contracts or wallets are genuine concerns. As with any work of art, we would expect that the principal concerns of a buyer would be that what it purchased was not the authentic, original work, or that multiple originals were or could be created. The usual supposition is that blockchain technology precludes these problems, but we would advise not indulging in that supposition in view of the rapidity of technological developments. We counsel protection against these risks.
33. For example, can the NFT be corrupted? This is a computer engineering question, not a legal one. The uniqueness of each NFT is said to be incorruptible, but again we counsel caution.
34. What happens if the platform that possesses the NFT files into bankruptcy? There are multiple risks associated with a platform going bankrupt. For example, a bankruptcy court could find that the NFT is or is not "property of the estate," depending upon the applicable contract language between artists and the platform, with consequences either way. A court could also face challenges with valuing the NFT to the extent the platform requires debtor-in-possession financing throughout the case, which could put the platform at a disadvantage when negotiating with the DIP lender. The murkiness surrounding valuation can also pose challenges to claims valuation and administration. Finally, given the opacity of the NFT market and the court's likely unfamiliarity with it in general, it is possible that a bankruptcy filing would subject the platform's directors, officers and other key principals to greater scrutiny than they would experience in a typical bankruptcy proceeding. Several platforms have gone into bankruptcy. Cred, Inc. is one that is currently in bankruptcy proceedings. Some of these risks can be managed by careful drafting of the sale contract. One bankruptcy risk of grave concern in this situation is that the bankrupt site's obligations to the buyer could be deemed "executory contracts" that could be rejected in the site's bankruptcy. Of note, licensees of copyrights are not given the protection against such treatment that the Bankruptcy Code gives to licensees of other types of intellectual property.
35. What are the mechanics of NFT sale cancellation? To delete an NFT, one would "burn" it to remove it from the blockchain. But this would remove the NFT entirely. If a sale were to be cancelled while preserving the existence of the NFT, then, if the new owner has already been recorded, one would need to execute a "cancellation" on the blockchain (potentially via smart contract) in order to change the record of ownership. This is primarily an issue to be dealt with in the terms of the contract.
36. If a buyer pays a USD purchase price in ETH, and if the sale is cancelled three years later and if ETH has become worthless, how will participants account for the change in value? We would draft the contracts such that the seller would be obligated to return the sale proceeds in the fiat currency of the relevant sales jurisdiction in an amount determined by using the exchange rate prevailing at the time of sale.

## Remedies

37. In the event of a dispute over the NFT, does the blockchain nature of NFT art mean that the current owner can pursue the artist rather than the sales platform? If the buyer is given cancellation rights, or warranties, then the contract should state precisely what the remedy will be. But under common law principles there could be questions about whether the remedy provided for is “reasonable,” particularly in these circumstances.
38. Can a sales platform’s terms and conditions of sale protect the platform from possible involvement in a dispute over the NFT? There are two scenarios to consider here: Either (1) the platform facilitates a transaction over an existing, public blockchain (e.g., Ethereum) or else (2) the platform uses a proprietary blockchain that it has created. In the former case, the platform is only tangentially involved and carefully drafted terms and conditions can limit its liability, likely making it immune from disputes about an NFT. In the second case, it is unlikely that the platform would be able to fully avoid being drawn into a dispute over an NFT minted on the blockchain, since it created the blockchain. Even in the latter case, though, it is likely that the platform’s liability would be limited to structural issues pertaining to the blockchain.

## Insurance

39. What role does insurance play with respect to the sale of NFTs? Insurance coverage opportunities for NFTs will develop over time, but it will be bespoke coverage or no coverage for the near future.
40. Should a platform expand its liability insurance for risk of loss to the NFT as it usually would do with conventional art? No. We expect that the platform could eliminate or significantly reduce its liability for loss because there’s no tangible object and because the risk of loss due to custody issues should be minimized or eliminated through the use of blockchain -- or at least we would credibly argue that it is eliminated.

We hope that our answers to these forty legal questions will be useful to artists and to platform developers and operators, but this FAQ is not legal advice to anyone. As is evident from the variety of legal questions arising in the fledgling NFT industry, not one but several fields of law are implicated: copyright law, commercial law, technology transfer, securities, commodities, banking, insurance, tax and other specialties. Artists and platform teams should engage teams of legal counsel who are experts in these fields -- and who also are experienced with crypto assets -- to advise them regarding their particular circumstances and plans.

# Could the Crypto Downturn Lead to a Spike in M&A?

In 2021, we saw a cryptocurrency boom with record highs and a flurry of activity. However, this year, the cryptocurrency downturn has been significant. We have seen drops in various cryptocurrencies ranging from 20 to 70 percent, with an estimated \$2 trillion in losses in the past few months.

Industry watchers had already predicted a spike in crypto M&A from the beginning of 2022, and in a recent interview with *Barron's*, John Todaro, a senior crypto and blockchain researcher at Needham & Company, said he believes this downturn could lead to a wave of mergers and acquisitions in the crypto space for the second half of this year and even into 2023.

Valuations have dropped across the board this year as the market has faced incredible volatility, and Todaro told *Barron's*, "The valuations for public crypto companies have fallen by about 70% this year." These lower valuations could make these companies increasingly attractive targets for acquisition, and this activity has already started to pick up.

According to recent coverage from *CNBC*, some larger crypto companies are already looking for acquisition targets in order to drive industry growth and to help them acquire more users. Todaro feels most of the



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M&A activity we will see will be this kind of crypto to crypto acquisition as opposed to traditional buyers, although there is still opportunity for non-crypto companies to capitalize on these lower valuations and some are already doing so.

With more government regulation coming for the crypto sector this year, it could also impact the activity level as well. Achieving some legal and regulatory clarity could have implications for this uptick in M&A for crypto companies. Our analysis of the SEC's recent proposed regulations, other government activity in this area, and their potential implications can be found [here](#).

We could of course see a growing number of acquisitions across industries as valuations remain lower than a year ago, but as the crypto sector continues to see this kind of a downturn, the level of activity in this area could be much greater than it has previously seen. With that said, both the target company and the acquirer should be looking at any transactions with the same level of due diligence instead of rushing into any deal fueled by panic or haste.

The downfall of Celsius Network LLC last week may be a harbinger of things to come for other troubled cryptocurrency startups, whose backers appear reluctant to prop them up with emergency funds, investors and analysts say.



# Investors Take Sink-or-Swim Approach to Struggling Crypto Startups

Celsius, a London-based crypto lender, filed for bankruptcy protection roughly a month after halting withdrawals to stem losses from sharp declines in digital currency prices. Last month, Celsius investors told The Wall Street Journal they had no plans to put up more capital to save the company.

Across the market, other investors appear to be taking a similar sink-or-swim approach to their crypto startups, as the virtual currencies continue their downward vortex.

Sarah Guo, a board partner at Greylock Partners, said investors generally aren't racing to bail out every troubled startup in their portfolio, "and that's even more true in crypto."

Easy money in recent years kept many unviable crypto startups afloat, Ms. Guo said. With cryptocurrencies crashing, investors now seem more willing to let these startups sink. "The market has gotten much quieter," she said.

Greylock was an early investor in Coinbase Global Inc., a cryptocurrency exchange that went public last year. In May, Coinbase reported a first-quarter loss of \$429.7 million. Greylock also has active investments in blockchain and Web3 startups.



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In venture capital, early-stage investors tend to contribute to a startup's subsequent fundraising efforts, as a way to underpin continued growth and increase the value of their equity stakes.

Between April and the end of June, there were 263 follow-on investing rounds for crypto-related startups worldwide, down from 307 over the previous three months, and 282 over the same period a year earlier, according to PitchBook Data Inc. The declines in crypto fundraising are part of a general slowdown in startup investing spanning sectors.

The total global dollar value of second-quarter follow-on deals for crypto and blockchain startups dropped to \$5.6 billion, from \$7 billion in the first quarter, though it remained above the \$4.4 billion fetched over the same three months in 2021, PitchBook said.





To be sure, some crypto startups have continued to land outside funding deals. Prime Trust, a startup that offers crypto custody and infrastructure services, said in late June it had closed a \$107 million Series B round. Also in June, FalconX, a brokerage startup offering crypto derivatives trades to institutional investors, announced a \$150 million Series D round. And Magic Eden, an NFT marketplace startup, closed a \$130 million Series B round, co-led by Electric Capital and Greyclock.

“Crypto has always been the purest form of capitalism,” said Satraj Bimbra, managing partner at Round13 Digital Asset Fund, a Toronto-based investment firm that closed a \$70 million fund in May to invest in cryptocurrency companies. “Whatever doesn’t work is going to get washed out, and money is going to go into new investments,” he said.

Several large investors have been hit hard by declining cryptocurrency values. Three Arrows Capital Ltd., a cryptocurrency hedge fund, last month was ordered by a court in the British Virgin Islands to liquidate its assets for failure to repay debts.

Vauld Group, a cryptocurrency lender backed by Peter Thiel’s Valar Ventures and Coinbase, this month filed for protection from creditors in Singapore, after recently pausing withdrawals and laying off 30% of its staff, The Wall Street Journal reported.

This is a time to witness which investors truly have a conviction in cryptocurrency—who is a true believer in the vision versus what I would call the tourist.

— Mathias Schilling, *Headline*



“This is a time to witness which investors truly have a conviction in cryptocurrency—who is a true believer in the vision versus what I would call the tourist,” said Mathias Schilling, a founding partner of San Francisco-based venture-capital firm Headline.

Some later-stage crypto funds are keeping an eye out for discounted shares in ailing crypto startup assets should investors start unloading stakes, Mr. Schilling said. That could include secondary sales of future equity or digital tokens, which crypto startups sell to investors in exchange for immediate cash, he said.

Headline itself has no investments in crypto startups as part of its core early-stage venture and venture growth funds, the firm says. Last year, it created a dedicated \$80 million crypto seed fund with roughly 130 investments to date, Mr. Schilling said. The fund recently led a \$3 million round for Alloy, a decentralized finance platform that lets users to send money anonymously over its blockchain.

Enzo Villani, founder and chief executive of Alpha Sigma Capital LLC, said he thinks Celsius won't be the only firm to slide into insolvency. Though not an equity investor in Celsius, Alpha Sigma until last year held CEL tokens—Celsius's unique digital currency used in transactions on its platform, which were issued to some investors in lieu of equity.

Recent turmoil “will cleanse the market,” Mr. Villani said, leaving those crypto companies that survive in a stronger position to move the industry forward.

Other investors have said occasional bailouts are the cost of doing business in an inherently risky market. But venture investors have come to the aid of [crypto startups that lost millions to hackers](#).

Crypto platform Wormhole received an infusion of capital from owner Jump Trading LLC in February after hackers broke into the platform and stole \$320 million. Game developer Sky Mavis Ltd. raised \$150 million from investors to help reimburse victims of a March cyberattack targeting the online game “Axie Infinity.”

Louis Lehot, a partner at law firm Foley & Lardner LLP, said investors are demanding friendlier terms on crypto-startup funding deals to gird themselves against added risk. These can be in the form of side letters with added investor rights and protections, such as co-sale rights, which entitle holders of minority stakes to cash out if a majority shareholder abandons the startup.

Armed with these and other safeguards, Mr. Lehot said, many high-profile investors with dedicated crypto funds are circling for possible Series A investments in the coming weeks, “presumably to take advantage of investor-favorable valuations in the current environment.”

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