

TYPES NOT MAPPED YET May 12, 2022 | TTR not mapped yet | Barry L. Fischer

Think an NFT is not a security? Don't bet on it. Three lessons from the Texas and Alabama cease and desist order of Sand Vegas Casino Club

Recently, the Texas State Securities Board and the Alabama Securities Commission each issued emergency cease and desist orders to stop Sand Vegas Casino Club and its principals from selling Non-Fungible Tokens ("NFTs") in those states. According to Sand Vegas, the proceeds of the sale of NFTs were stated to be used for the creation of virtual-casinos on the Internet and in virtual worlds known as "metaverses". The NFTs, which were sold on Sand Vegas's website and through promotions on social media through YouTube, Twitter and Instagram, provided the buyer with a virtual gambling character (a so-called "Gambler Ape"), with certain other benefits, including a share of any profits generated by the casinos Sand Vegas created (which they claimed would be amounts well in excess of the offering price of the NFTs). The Sand Vegas matter illustrates three important lessons for those who wish to issue NFTs.

- 1. Any digital asset, including an NFT, can be classed by security regulators as a security.** As noted in the cease and desist orders, as part of their marketing of the NFTs, Sand Vegas claimed that they complied with laws regulating securities, because, as they stated, securities laws do not currently regulate NFTs as an asset class. Sand Vegas also claimed that they could avoid the securities laws regarding the sale of the NFTs in the future by adding illusory terms to the NFTs and using different terminology. These two states flatly rejected those contentions. Under both federal and state securities laws, an 'investment contract' is a security, and in determining whether or not an asset is an investment contract, regulators and courts typically focus on the substance of an investment, not its form or title. Basically, if an investment involves an investor's expectation of profit from a common enterprise resulting from efforts of a promoter or third party, that investment is considered to be an investment contract and, as a result, a security. Here, where investors in the NFTs were promised a portion of the profits of casinos run by the promoters, the state officials determined that the contracts were securities, and that no terminology would change that analysis.
- 2. A sale of securities, requires full and complete disclosure, and practices that are seen in NFT and other digital asset sales, including the confidentiality of principals, can be seen by regulators as evidence of deceptive practices.** A party selling securities must disclose the material terms regarding the investments, information about investment enterprise, and the risks of that investment. Alabama and Texas in their stop orders detailed a number of material failures in the marketing of the Sand Vegas NFTs including:
 - Failing to disclose the actual address of Sand Vegas;
 - Using a name and logo that was confusingly similar to an established gaming company unrelated to Sand Vegas (the Las Vegas Sands Corporation);
 - Failing to provide the qualifications, experience or business reputation (and in some cases the actual identity) of the principals of Sand Vegas;
 - Not noting that the principals would be entitled to a 10% royalty on the sales of all NFTs listed on OpenSea (which is a popular online marketplace where the Sand Vegas NFTs were originally listed);

- Failing to identify the claimed Sand Vegas's business partners (such as software developers and NFT art designers);
- Omitting risks associated with operating casinos; and
- Omitting risks associated with purchasing NFTs in general, and the Sand Vegas NFTs in particular.

3. ***The States are also in the securities (and thus digital asset) regulation business, and their actions can have wide-ranging effects.*** It is worth noting here that, while the focus on the regulation of digital assets is typically at the federal level in the US, the 50 states have their own regulations. Each state has its own securities law, which typically overlap with federal laws, but in some states may have requirements that are different than, those in federal law (including how an investment contract is defined).

As also can be seen in the Sand Vegas cease and desist order, while the states remedies would appear to be limited to their own states, their actions can extend well beyond their borders. For example, while not naming OpenSea as a party to the cease and desist order, the cease and desist orders indicated that both Alabama's and Texas's securities enforcement arms would be sending the order to OpenSea to notify them that the NFTs of Sand Vegas it was listing were considered by the securities officials to be unregistered securities in those states. Likely as a result of that action (and as OpenSea is not registered to trade in securities), OpenSea removed the NFTs from its marketplace promptly following the issuance of the cease and desist order.

Until state and federal regulators provide express guidance on NFTs, companies seeking to offer NFTs should carefully consider, including consulting with counsel, whether the NFTs constitute securities. As the sale of Sand Vegas NFTs indicates, regulators are prepared to treat NFTs that have the features of securities as securities, no matter what they are called.

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