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Not Your Grandpa's Trading Cards: Understanding NFTs in Professional Sports and Why Some May Be Considered Securities

I. INTRODUCTION

In the summer of 1939, live televised professional sports entered people's homes for the first time.¹ NBC broadcasted a matchup between baseball's Cincinnati Reds and Brooklyn Dodgers to 400 local television sets.² This breakthrough served as a catalyst for the growth of sports coverage and entertainment.³ Over the history of professional sports, leagues and clubs have not shied away from technological innovation.⁴ Fifty-five years after the first live televised broadcast of a professional sporting event, the National Football League ("NFL") launched "NFL Sunday Ticket," allowing fans to access the broadcast of any live game around the country.⁵ More recently, the NFL innovated by moving exclusively to e-tickets to address ticket fraud.⁶ The latest innovation facing professional sports is the rise of Non-Fungible Tokens ("NFTs").⁷ One of the biggest problems facing potential NFT adapters is the uncertainty of how the digital asset will be regulated.⁸ Due to their recent

1. *First Televised Major League Baseball Game*, THE HISTORY CHANNEL (Aug. 24, 2021), <https://www.history.com/this-day-in-history/first-televised-major-league-baseball-game> [<https://perma.cc/2FVK-WGRK>].

2. *Id.*

3. See AJ Agrawal, *3 Ways Technology Has Changed the Sports Industry*, INC. (Dec. 21, 2015), <https://www.inc.com/aj-agrawal/3-ways-technology-has-changed-the-sports-industry.html> [<https://perma.cc/X6X8-YSBE>] (stating sports coverage is more expansive than ever due to advances in media).

4. See *id.* (listing different technological innovations in media, ticketing, and equipment).

5. *NFL Sunday Ticket Turns 20 Today*, NBC SPORTS (June 1, 2014), <https://profootballtalk.nbcsports.com/2014/06/01/nfl-sunday-ticket-turns-20-today/> [<https://perma.cc/SD92-7TPJ>].

6. Ryan Mayer, *NFL Stadiums to Have Fully Digital Ticket Systems in 2018-19 Season*, CBS BOS. (June 18, 2018), <https://boston.cbslocal.com/2018/06/18/nfl-stadiums-ticketmaster-fully-digital-ticket-systems-2018-season/> [<https://perma.cc/EG5H-ET8Z>].

7. Ethan Sears, *A Clear Explanation of NFTs and Their Potential Impact on Sports*, L.A. TIMES (July 15, 2021), <https://www.latimes.com/sports/story/2021-07-15/nft-role-future-of-sports> [<https://perma.cc/9652-4T54>].

8. See generally Adrian Krion, *NFT Regulation Looms Large, so Let's Start with the Proper Framework*, NASDAQ (Nov. 9, 2021), <https://www.nasdaq.com/articles/nft-regulation-looms-large-so-lets-start-with-the-proper-framework> [<https://perma.cc/NP49->

development and adoption, NFTs lack in-depth regulation and relevant case law.⁹ Although NFTs are not uniformly regulated,¹⁰ there are ways that NFTs can be structured that leave them vulnerable to regulation as a security.¹¹ While it may be possible to sell NFTs and avoid oversight from the U.S. Securities and Exchange Commission (“SEC”), the ways in which professional sports are currently selling and maintaining NFTs seems indicative that the most valuable uses of NFTs may ultimately qualify them as a security.

This note addresses why the current use of NFTs in professional sports may require leagues and clubs to comply with SEC disclosure requirements. This analysis ultimately leads to the conclusion that although NFTs must be assessed on an individual basis, their most popular uses likely qualify them as an investment contract, and thus, they must be regulated as a security. This note proceeds in five parts. Part II lays out the background and foundational information for an NFT and how some leagues and clubs are already implementing them.¹² Part III discusses why certain NFTs may be classified as a security.¹³ Part IV addresses ways in which leagues and clubs can avoid SEC oversight.¹⁴ Part V concludes by recognizing that while NFTs cannot be uniformly regulated, professional sports leagues and clubs are leaving themselves vulnerable to SEC oversight by using NFTs in a way that could make them investment contracts.¹⁵

C2K7] (stating that there is a general lack of regulation for NFTs and certain regulation could hinder NFT investors).

9. *Id.*

10. See Kyle R. Fath, Alan L. Friel & Carlton Daniel, *Your NFT Playbook*, THE NAT'L L. REV. (July 1, 2021), <https://www.natlawreview.com/article/your-nft-playbook> [<https://perma.cc/EK2Y-UXA6>] (stating that although not directly regulated, NFTs must comply with laws implicated by their use, such as intellectual property law).

11. See Robert Anello *Digital Art May be Next in the SEC's Crosshairs*, FORBES (July 15, 2021), <https://www.forbes.com/sites/insider/2021/07/15/digital-art-may-be-next-in-the-secs-crosshairs/?sh=4221549732df> [<https://perma.cc/57T5-DFKH>] (stating F-NFTs are on the SEC's radar).

12. *Infra* part II.

13. *Infra* part III.

14. *Infra* part IV.

15. *Infra* part V.

II. WHAT ARE NFTS AND HOW ARE THEY BEING USED?

A. *Understanding NFTs and Blockchain*

An NFT is not itself a digital artwork or creation, but instead serves as a token that represents the ownership rights of an underlying creation.¹⁶ The token is associated with an underlying creation and is used to identify and transfer the creation's ownership rights in a secure and authenticated way.¹⁷

One of the most common uses of NFTs is to exchange digital artwork.¹⁸ Imagine an artist creates a new logo for a team. A club wants to buy the logo from the artist. The artist could sell the ownership rights of that logo using an NFT. First, the artist would "mint," or create, an NFT on the blockchain platform of their choosing,¹⁹ via a simple process that associates the logo with an NFT, typically using a thumbnail image of the underlying creation.²⁰ The NFT can then be listed on the marketplace of the artist's choosing, including the blockchain platform they used to mint it.²¹ The club interested can then purchase the logo from the artist by purchasing the logo's NFT.²² Once the transaction is complete, the club is provided access to the host site that has the logo.²³ More importantly, the blockchain records that the club is the now the current owner of the new logo.²⁴ This is significant for reasons discussed below.

An NFT is an advantageous asset because of its unique digital identification on its blockchain network.²⁵ Blockchain has been a cornerstone in the 21st century evolution of digital assets.²⁶ It is

16. Mitchell Clark, *NFTs Explained*, VERGE (Aug. 18, 2021), <https://www.theverge.com/22310188/nft-explainer-what-is-blockchain-crypto-art-faq> [<https://perma.cc/E43T-FR78>].

17. *Id.*

18. *See id.* (stating most of the conversation regarding NFTs relates to collecting digital art).

19. Fath et al., *supra* note 10 (explaining the lifecycle of an NFT).

20. *Id.*

21. *Id.*

22. *Id.*

23. *Id.*

24. *Id.*

25. David Rodeck, *What is Blockchain?* FORBES (June 9, 2021), <https://www.forbes.com/advisor/investing/what-is-blockchain/> [<https://perma.cc/C7WV-2QCL>] (stating that an advantage of blockchain technology is that each asset is "individually tracked and identified on the blockchain ledger").

26. *Id.*

frequently associated with cryptocurrencies, but the scope of blockchain has been extended to the use of other digital assets such as NFTs.²⁷ Blockchain has driven interest in NFTs for two primary reasons. First, blockchain authenticates ownership rights.²⁸ Second, blockchain provides a transactional ledger that is essentially inalterable.²⁹ The precise, detailed process in which blockchain authenticates and records transactions is highly technical, but a broad overview is certainly comprehensible.³⁰

A blockchain network is a digital collection of data compiled and verified by “nodes.”³¹ Nodes are individual computers spread across a network used to process and verify transactions, the data, which are typically secured by cryptography.³² These nodes allow for the network to be decentralized, requiring that a majority of nodes confirm the legitimacy of new data before being added to the ledger as whole.³³ Each verified NFT transaction is a new data block on the chain of its past verified transactions.³⁴

Several features of a blockchain network play a pivotal role in adding value to an NFT.³⁵ The first is the decentralized nature of the network.³⁶ The fact that the nodes are not all located on one computer significantly reduces the security risks associated with a traditional centralized network.³⁷ In short, an NFT likely will not be stolen or altered.³⁸ In a similar way, the requirement that a majority of nodes confirm the legitimacy of new data ensures participants in the market that the information seen regarding the NFT is accurate.³⁹

27. *Id.*

28. *Id.*

29. *Id.*

30. *Id.* (explaining the exact process of recording information on a blockchain network).

31. *Id.*

32. *Id.*

33. *Id.*

34. *Id.*

35. *See id.* (stating that blockchain provides extra security, more accurate transactions, and more efficient transfers).

36. *Id.*

37. *Id.* (stating that that using a decentralized network makes it nearly impossible for someone to make fraudulent transaction).

38. *Id.*

39. *Id.*

NFTs are attractive to investors due to their ability to authenticate the ownership rights of the attached creation.⁴⁰ A blockchain network serves as a virtual ledger that records the transactions and transfers of assets.⁴¹ The ability to quickly authenticate an NFT perpetuates a sense of scarcity surrounding the underlying asset, which allows its owners to drive its value.⁴²

Authentication of an NFT entails verifying that the seller is the proper owner and identifying who else may have ownership rights.⁴³ Authentication drives scarcity by determining how many other copies of the NFT exist.⁴⁴ Returning back to the logo example, if the artist decides they want to sell more than one copy of the logo, they can.⁴⁵ The NFT created for the logo will keep track of how many are created and who owns them.⁴⁶ However, the more copies that exist of the logo, the less scarce they will be and thus less valuable.⁴⁷ Even if there is only one copy, a club likely does not want to share intellectual property rights with other fractional owners of the NFT.

The ability to authenticate the ownership rights also enables owners to maintain royalty or ownership interest in the media even after the initial transfer.⁴⁸ Artists often will incorporate royalty interests in the initial transactions of their work so that they will continue to profit down the line.⁴⁹ Compare this with a logo created and sold on a canvas, where it is unlikely that an artist would successfully negotiate a deal allowing them royalties in the logo after the first transaction, let alone multiple transactions.⁵⁰ NFTs allow artists to flip the script, embedding their

40. See Fath et al., *supra* note 10 (stating an NFT's ability to verify ownership is a unique benefit).

41. Robyn Conti, *What You Need to Know About Non-Fungible Tokens (NFTs)*, FORBES (May 14, 2021), <https://www.forbes.com/advisor/investing/nft-non-fungible-token/> [<https://perma.cc/56ZS-D6W4>].

42. Fath et al., *supra* note 10.

43. *Id.*

44. *Id.*; see also Clark, *supra* note 16 (stating there can be more than one copy of an NFT).

45. Clark, *supra* note 16 (stating that NFTs are unique in that they represent one token on the blockchain, but the underlying asset may be one of many copies sold by artist).

46. See Fath et al., *supra* note 10 (stating an NFT verifies ownership rights and authenticity).

47. See *id.* (stating that NFTs drive value through their scarcity).

48. See *id.* (discussing built-in smart contracts).

49. Clark, *supra* note 16.

50. See Laurel Wickersham Salisbury, *It's Not That Easy: Artist Resale Royalties and The ART Act*, CTR. FOR ART L. (July 1, 2019), <https://itsartlaw.org/2019/07/01/its-not-that-easy-artist-resale-royalty-rights-and-the-art-act/> [<https://perma.cc/BES4-QL5U>] (stating that artist resale royalty rights have not historically been recognized in the United States).

royalty interest in the token itself, guaranteeing a profit for them on each sale.⁵¹

Some NFT creators and owners have gone a step further and created what are called fractionalized NFTs (“F-NFTs”). F-NFTs take a single NFT, divide up its ownership interests and sell those interests to multiple owners.⁵² Investors have become increasingly interested in F-NFTs because of how expensive many standard NFTs have become and the quick turnaround on the investment in F-NFTs.⁵³ Purchasers of standard NFTs have two primary investment strategies to make a profit: buy an NFT that is already valuable and hope that its value continues to increase, or buy a lower-value NFT and hope that the market naturally drives up the NFT’s value.⁵⁴ F-NFTs allow investors to buy into NFTs that already have a high price tag and remove the guessing game of when or if a NFT’s will become valuable.⁵⁵ Although F-NFTs are a lucrative opportunity for investors, F-NFTs appear to be the most vulnerable to SEC oversight.⁵⁶

B. *How NFTs Are Being Used in the World of Sports*

Sports leagues and individual clubs have been creative in implementing NFTs as revenue generators.⁵⁷ One of the earliest, and perhaps biggest entries into the NFT marketplace by a professional sports league was the National Basketball Association’s (“NBA”) launch of NBA Top Shot in 2019.⁵⁸ NBA Top Shot is a digital platform used to exchange digital NBA “moments.”⁵⁹ These moments function like

51. Clark, *supra* note 16.

52. Jinia Shawdagor, *What are Fractionalized NFTs?*, CRYPTOVANTAGE (Oct. 29, 2021), <https://www.cryptovantage.com/non-fungible-tokens/what-are-fractionalized-nfts/> [<https://perma.cc/3C9Q-TY5F>].

53. *See id.* (stating F-NFTs allow low volume investors to invest in NFTs whose overall value continues to grow).

54. *Id.*

55. *See id.* (stating F-NFTs allow market participants to purchase and sell pieces of NFTs that are already high in value).

56. Anello, *supra* note 11.

57. *See infra* Part II. (discussing the different ways leagues, clubs, and players have sold NFTs).

58. Shaker Samman, *What's All the Fuss About Virtual NBA Trading Cards?*, SPORTS ILLUSTRATED (Mar. 17, 2021), <https://www.sicom/nba/2021/03/17/nba-top-shot-crypto-daily-cover> [<https://perma.cc/M6W8-D7HR>].

59. *Id.*

trading cards and are sold as NFTs.⁶⁰ In 2021 alone, Top Shot netted over \$700 million in sales.⁶¹

The NBA partnered with Dapper Labs to create and maintain a platform for its Top Shot NFTs.⁶² The revenue the NBA has generated has caught the attention of other leagues as well.⁶³ Since the launch of NBA Top Shot, Dapper Labs has signed partnerships with the NFL, the Women's National Basketball Association, the Spanish professional soccer league La Liga, and the Ultimate Fighting Championship.⁶⁴

Individual clubs have also explored the NFT space through the online auction of unique goods.⁶⁵ Earlier this year, the Golden State Warriors sold digital championship rings to collectors as NFTs.⁶⁶ Although buyers received a physical replica of the championship ring, the NFT represented the digital creation of the ring.⁶⁷ Clubs are also researching the use of NFTs as tickets to games, focusing in part on the NFT's value as a collectible after a significant game.⁶⁸ Mark Cuban, owner of the Dallas Mavericks, has stated the Mavericks will offer NFT tickets as soon as the 2022 season.⁶⁹

Individual athletes have also made a jump into the NFT space. NBA stars LeBron James and Zion Williamson each have minted their own NFTs.⁷⁰ James' NFT was for a digital clip of him dunking in the

60. *Id.*

61. Christopher J. Brooks, *Sports NFTs are Popular, but Are They a Winning Investment?*, CBS NEWS (Nov. 12, 2021), <https://www.cbsnews.com/news/sports-nft-dapper-labs-nba-investment/> [<https://perma.cc/B4N9-B65D>].

62. *Id.*

63. *Id.*

64. Brian Quarmby, *Pro Sports Leagues are no Longer Resisting NFTs: Dapper Labs*, COINTELEGRAPH (Oct. 26, 2021), <https://cointelegraph.com/news/pro-sports-leagues-are-no-longer-resisting-nfts-dapper-labs> [<https://perma.cc/7TUN-F5EJ>].

65. Matthew De Saro & Leila Stein, *NFTs Disrupt Sports World - What this Means for Athletes*, BEINCRYPTO (May 7, 2021), <https://beincrypto.com/nfts-disrupt-sports-world-what-this-means-for-athletes/> [<https://perma.cc/GUX2-Y5M2>].

66. *Id.*

67. Matthew De Saro, *Golden State Warriors Become First US Sports Club to Release Own NFT*, BEINCRYPTO (Apr. 27, 2021), <https://beincrypto.com/golden-state-warriors-become-first-us-sports-team-to-release-own-nft/> [<https://perma.cc/7NDH-E2DW>].

68. Taylor Locke, *Mark Cuban: The Dallas Mavericks Are Thinking About 'Turning Our Tickets into NFTs'*, CNBC (Mar. 26, 2021), <https://www.cnbc.com/2021/03/26/mark-cuban-dallas-mavericks-may-use-nfts-for-ticketing.html> [<https://perma.cc/BWD7-QDPU>].

69. *Id.*

70. Brooks, *supra* note 61.

Staples Center, while Williamson's was a digital clip of him blocking another player's shot.⁷¹ Both NFTs sold for over \$100,000 each.⁷²

Now that the NCAA allows student athletes to make money from their name, image, and likeness,⁷³ college athletes are also making money by selling NFTs.⁷⁴ The 2021 Heisman Award winner, Bryce Young, minted an NFT of a digital painting of himself, and has sold copies for close to \$500 each.⁷⁵

Professional clubs and leagues have been creative in generating new avenues of revenue using NFTs.⁷⁶ Clubs have sold NFTs with built in royalty interests to generate long term payoffs on future sales,⁷⁷ and leagues have created entire platforms to grow the market for their new NFTs.⁷⁸ However, this creativity could lead to regulatory headaches for the leagues and clubs if they do not curtail their use of NFTs going forward.⁷⁹

III. ARE NFTS SECURITIES?

One of the challenges facing the regulation of NFTs is the wide variety of ways in which NFT creators mint and sell their creations.⁸⁰ NFTs must be analyzed on their specific qualities to determine whether it is a security, including their ownership structure and the environment in which they are sold.⁸¹

The SEC oversees any transaction involving what they deem to be a security.⁸² The term "security" captures many different financial

71. *Id.*

72. *Id.*

73. *NCAA v. Alston*, 141 S. Ct. 2141, 2144 (2021).

74. Brooks, *supra* note 61.

75. *Id.*

76. De Saro & Stein, *supra* note 65.

77. *Id.*

78. Quarmby, *supra* note 64.

79. *See infra* Part III (discussing certain features of NFTs being sold that could qualify them as security); *see generally* Anello, *supra* note 11 (explaining why F-NFTs may be targeted by the SEC).

80. *See infra* Part III . (discussing that NFTs face different regulation based on their individual features).

81. *See* SEC STRATEGIC HUB FOR INNOVATION AND FINANCIAL TECHNOLOGY, FRAMEWORK FOR 'INVESTMENT CONTRACT' ANALYSIS OF DIGITAL ASSETS 10, <https://www.sec.gov/files/dlt-framework.pdf> [<https://perma.cc/WPE9-N59W>] (last visited Feb. 5, 2022) (stating digital assets may be deemed a security based on market provided by the promotor).

82. 15 U.S.C. § 77b(a)(1) (defining a security).

assets, but there is one type that particularly resembles the traits of an NFT: investment contracts.⁸³

Investment contracts were originally labeled as securities by the Securities Act of 1933, but the act failed to provide a clear definition of what exactly constitutes an investment contract.⁸⁴ Thirteen years after being labeled a security, the Supreme Court provided a clear test in *SEC v. W.J. Howey Co.* to determine whether a financial instrument qualifies as an investment contract, known as the Howey Test.⁸⁵ The Howey Test provides four factors to consider in determining whether an instrument is an investment contract: (1) there is an investment of money; (2) the investment is in a common enterprise; (3) there is a reasonable expectation of profit; and (4) the expectation of profit is derived “from the efforts of the promoter or a third party.”⁸⁶

When analyzing an NFT under the Howey Test, different conclusions will be met based on the NFT’s ownership structure and the manner in which the NFT is sold. While prong one is likely satisfied regardless of how NFTs are created and sold, prongs two, three, and four likely require fact dependent analyses based on the ownership structure, the environment in which the NFT is sold, and the actions of the NFT’s seller.⁸⁷

A. *An Investment in an NFT May be an Investment in a Common Enterprise if the Seller’s Relationship with the NFT Continues After its Purchase*

The Securities Exchange Commission (“SEC”) has stated that it does not view a “common enterprise” as its own required element in the Howey Test, which suggests the prong may not need to be satisfied for NFTs to be considered securities by the SEC.⁸⁸ Regardless, the SEC has

83. See *infra* Part III (discussing why NFTs may be an investment contract under the Howey Test).

84. *Id.*

85. *SEC v. W.J. Howey Co.*, 328 U.S. 293, 299 (1946).

86. *Id.*

87. See *Uselton v. Comm. Lovelace Motor Freight, Inc.*, 940 F.2d 564, 574 (10th Cir. 1991) (“[I]t is well established that cash is not the only form of contribution or investment that will create an investment contract ... the ‘investment’ may take the form of ‘goods and services.’”).

88. See SEC STRATEGIC HUB FOR INNOVATION AND FIN. TECH *supra* note 81, at 13 n.10 (stating the commission does not require commonality per se).

noted that investments in digital assets have previously been recognized as investments in a common enterprise.⁸⁹

There are two tests that courts have used to determine the existence of a common enterprise: vertical and horizontal commonality.⁹⁰ Vertical commonality focuses on “the relationship between the promoter and the body of investors,” while horizontal commonality focuses on the relationship between each of the investor’s investment and its return.⁹¹ As illustrated below, standard NFTs likely struggle to satisfy either test. While the SEC does not require the satisfaction of either of these tests to establish an investment contract, they have nonetheless served as useful tools to establish common enterprise in the affirmative.⁹²

1. Strict and Broad Vertical Commonality

Courts have previously recognized two types of vertical commonality: strict vertical commonality and broad vertical commonality.⁹³ The strict vertical commonality test requires that the fortunes of the investor be tied to the fortunes of the promotor.⁹⁴ For example, strict vertical commonality would likely exist if an investor bought stocks in a promotor’s company because the value of the stocks (the fortune of the investor) is likely intertwined with the success of the company (the fortune of the promotor). Strict vertical commonality is difficult to satisfy for standard NFTs because when an NFT and its ownership rights are transferred in their entirety, the relationship between the seller (the promotor) and the buyer (the investor) ends there.⁹⁵ This termination in relationship prohibits strict vertical commonality after the sale, but what about broad vertical commonality?

89. *See* SEC v. Int’l Loan Network, Inc., 968 F.2d 1304, 1307 (D.C. Cir. 1992) (holding that investments in digital assets constituted an investment in a common enterprise).

90. *See* SEC STRATEGIC HUB FOR INNOVATION AND FIN. TECH., *supra* note 81, at 13 n.10 (stating federal courts have required either vertical or horizontal commonality).

91. *Revak v. SEC Realty Corp.*, 18 F.3d 81, 87-88 (2d Cir. 1994).

92. *In re Barkate*, 57 SEC 488, 496 n.13 (Apr. 8, 2004) (stating the SEC does not view common enterprise as a distinct element of an investment contract under the Howey Test); *SEC v. Continental Commodities Corp.*, 497 F.2d 516, 523 (5th Cir. 1974) (holding that horizontal commonality not required to prove common enterprise).

93. *See* SEC STRATEGIC HUB FOR INNOVATION AND FIN. TECH., *supra* note 81, at 13 n.10 (stating federal courts have required either vertical or horizontal commonality).

94. *See Brodt v. Bache & Co., Inc.*, 595 F.2d 459, 461 (9th Cir. 1978) (stating vertical commonality only occurs when success of promotor and investor are dependent on each other).

95. *See id.* (vertical commonality cannot occur if there is no relationship between the investor and promotor).

Broad vertical commonality, on the other hand, only requires that the investor's fortunes be linked to the promotor's efforts rather than its fortune.⁹⁶ While it is possible for an NFT's creator to continue promoting its creation to the benefit of its new owner, there is no immediate financial incentive to do so since the creator no longer retains any financial interest in the specific NFT sold. However, NFT creators who choose to keep royalty interest in the NFTs after they are sold may be enticed to continue promoting the NFT in order to drive up the value and cause a resale.⁹⁷

For example, the Golden State Warriors ("GSW") recently sold a series of NFTs celebrating their previous NBA championships.⁹⁸ The NFTs were digital replicas of the championship rings given to the players. At first glance, the sale of the rings seems like a simple transaction: buyer compensates seller for the digital ring and both parties part ways, appearing on the surface as a termination of vertical commonality.⁹⁹ However, the GSW retained a royalty interest in each of the NFTs they sold.¹⁰⁰ This royalty interest may encourage the GSW to continue to promote the ring and its platform so that it be continue to be sold and generate profit.¹⁰¹ This promotional effort by the GSW may satisfy the broad vertical commonality test because the NFT owner's fortune would be impacted by the GSW's effort.¹⁰²

2. Horizontal Commonality

96. See *Long v. Shultz Cattle Co., Inc.*, 881 F.2d 129, 140–41 (5th Cir. 1989) (quoting *SEC v. Cont'l Commodities Corp.*, 497 F.2d 516, 521 (5th Cir. 1974)) (stating "the critical inquiry is confined to whether the fortuity of the investments collectively is essentially dependent upon promoter expertise").

97. See SEC STRATEGIC HUB FOR INNOVATION AND FIN. TECH., *supra* note 81, at 5 (stating it is reasonable to assume promoters would continue to promote the digital asset after the sale).

98. De Saro, *supra* note 67.

99. *Id.*

100. *Terms & Conditions for NFTs Bought as Part of the Golden State Warriors NFT Collection Auction*, GOLDEN STATE WARRIORS LEGACY NFT COLLECTION, <https://gswnft.com/terms> [<https://perma.cc/T362-7XJ7>] (last visited Dec 12, 2021).

101. See SEC STRATEGIC HUB FOR INNOVATION AND FIN. TECH., *supra* note 81, at 5 (stating it's reasonable for purchasers to assume that the promoter would undertake efforts to maintain and enhance the value of the network where the promotor has retained interest in the underlying asset).

102. See *Long v. Shultz Cattle Co., Inc.*, 881 F.2d 129, 140–41 (5th Cir. 1989) ("[I]nterdependence may be demonstrated by the investors' collective reliance on the promoter's expertise.").

The horizontal commonality test determines whether individual investor's fortunes are tied to the fortunes of the other investors by the pooling of assets, usually combined with the pro-rata distribution of profits.¹⁰³ The individual nature of NFTs as a singular good likely prevent this test from being satisfied.

When standard NFTs are sold, their entire ownership interest is transferred from the seller to the buyer, meaning that there is no pooling of assets.¹⁰⁴ Even if there is more than one copy of the NFT that is sold, the buyers (the investors) are not pooling their money in the purchase of their individual NFTs, i.e., the NFTs are purchased completely separately.¹⁰⁵ And even if there are royalty fees attached to the NFT, each owner owns their NFT in its entirety and is not affected by what a separate owner may do with their copy.¹⁰⁶

Although standard NFTs cannot likely satisfy horizontal commonality or strict vertical commonality, there is one type of ownership structure that satisfies both, the fractional NFT ("F-NFT").¹⁰⁷

3. F-NFTs Likely Satisfy Both Horizontal and Strict Vertical Commonality

F-NFTs are attractive to impatient investors because they are typically sold for underlying NFTs that already have a high price valuation.¹⁰⁸ When an investor buys a shard of an F-NFT, they are in effect pooling their funds with the other owners of the F-NFT, thus satisfying the horizontal commonality test.¹⁰⁹ Unlike a standard NFT that has one owner, the fortunes of the F-NFT owners become intertwined and change with the value of the underlying NFT.¹¹⁰

F-NFTs also likely satisfy the strict vertical commonality test, even without retained royalty interests. Unlike the standard NFT, the F-

103. *Revak v. SEC Realty Corp.*, 18 F.3d 81, 87 (2d Cir. 1994).

104. *Anello*, *supra* note 11.

105. *Id.* (stating that F-NFTs allow investors to purchase "shards" of an NFT rather than the entire NFT).

106. *See Clark*, *supra* note 16 (stating that although artists may retain copyright and reproduction rights, there is still only one owner of the NFT).

107. *See infra* Part III(A)(iii)(discussing why F-NFTs satisfy horizontal and strict vertical commonality).

108. *See generally Anello*, *supra* note 11 (stating F-NFTs allow investors with less spending power to enter the NFT market).

109. *Id.*

110. *Id.*

NFTs’ “promotor” is likely whoever issues and controls the fractions of the underlying NFT.¹¹¹ In this scenario, the promotor’s fortune is directly tied to the F-NFT owner (the investor) because the change in the underlying NFT’s value affects both parties’ fortunes.¹¹²

B. Is There a Reasonable Expectation of Profit When Buying an NFT?

Courts have recognized a series of factors when determining whether an investment offered a reasonable expectation of profit.¹¹³ One factor is whether the issuer of the investment has made efforts to increase the demand or value of the investment.¹¹⁴

While the transactional nature of NFTs may indicate that sellers typically do not make efforts to increase the value of the NFTs after their original sale, a deeper look at how professional sports clubs are handling NFTs provides an alternative perspective. For instance, trading cards are an example of one of the basic uses of NFTs that appears to have no relation to a security.¹¹⁵ Even if the league retains a royalty interest in a way similar to how the Golden State Warriors have with their championship rings, does that mean the league is making any sort of effort to increase the demand or value of the investment? For the NBA, the answer appears to be yes when considering the NFT network created and maintained by the league.¹¹⁶

Outside of the NBA’s promotional efforts for its NFT trading card platform, “Top Shot,” the courts will also look at the “network” the digital marketplace has created for its participants.¹¹⁷ The SEC has stated that if the platform allows tokens to increase in value, then it likely

111. 17 C.F.R. § 230.405 (defining a promoter as any person who takes initiative in founding and organizing the enterprise of the issuer).

112. *See Brodt v. Bache & Co., Inc.*, 595 F.2d 459, 461 (9th Cir. 1978) (holding strict vertical commonality exists when the fortunes of the promotor and the investor are intertwined).

113. *See SEC v. W.J. Howey Co.*, 328 U.S. 293, 301 (1946) (holding that an investment contract can cause a reasonable expectation of profit without being promotional in nature).

114. *See id.* at 299 (“[A]n investment contract for purposes of the Securities Act means a contract, transaction or scheme whereby a person invests his money ... [and] expect[s] profits solely from the efforts of the promotor or a third party.”).

115. De Saro, *supra* note 65.

116. *See SEC STRATEGIC HUB FOR INNOVATION AND FIN. TECH.*, *supra* note 81, at 3 (stating that the more a promotor participates in developing and operating a network, the more likely they are causing the investor to have a reliance on others).

117. *Id.*

provides investors with a reasonable expectation of profit.¹¹⁸ Top Shot allows buyers to sell their NFT trading cards to other parties after the original purchase, providing a network for the NFT trading card to grow in value.¹¹⁹ The SEC has stated that investors are more likely to be provided with a reasonable expectation of profit when they are provided with a secondary market to liquidate their investment, which Top Shot provides.¹²⁰ In the case of Top Shot, the secondary market is the platform Top Shot provides buyers to sell their acquired moments. The NBA's creation, promotion and maintenance of Top Shot likely gives buyers a reasonable expectation of profit, which is something other leagues should consider when creating their NFT marketplace.¹²¹

C. *Who is Driving the Value of the Investment?*

The SEC has stated that in determining the fourth prong “[t]he central issue is ‘whether the efforts made by those other than the investor are the undeniably significant ones, those essential managerial efforts which affect the failure or success of the enterprise’” or in other words, whether third parties significantly impact the value and success of an investment.¹²² Further, courts have held that investments whose value fluctuates with market conditions alone do not count as securities.¹²³ Like

118. *Id.* at 4.

119. De Saro, *supra* note 65.

120. SEC STRATEGIC HUB FOR INNOVATION AND FIN. TECH., *supra* note 81, at 4.

121. *See id.* (stating that there is a stronger reliance on others and corresponding higher chance reasonable expectation of profit when the promotor is responsible for the operation and enhancement of the network).

122. *Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934: The DAO* (Exchange Act Re. No. 81207) (July 25, 2017), *9 (quoting *SEC v. Glenn W. Turner Enters., Inc.*, 474 F.2d 476, 482 (9th Cir. 1973)); *see also* Matthew B. Hanson, Daniel R. Kahan, Luke Roniger & Read William Mills, *Not Your Standard Orange Grove: Non-Fungible Tokens & Securities Laws*, KING AND SPALDING: NEWS & INSIGHTS (June 16, 2021), <https://www.kslaw.com/news-and-insights/not-your-standard-orange-grove-non-fungible-tokens-securities-laws> [<https://perma.cc/U6BU-EMC9>].

123. *SEC v. Belmont Reid & Co.*, 794 F.2d 1388, 1391 (9th Cir. 1986) (“To the extent the purchasers relied on the managerial skill of CMC they did so as an ordinary buyer, having advanced the purchase price, relies on an ordinary seller. We therefore agree with the district court that “[p]rofits to the coin buyer depended upon the fluctuations of the gold market, not the managerial efforts of CMC.”); *Noa v. Key Futures, Inc.*, 638 F.2d 77, 79-80 (9th Cir. 1980) (*per curiam*) (holding that the sale of silver bars was not an investment contract because the expected profits came from market fluctuations); *Sinva, Inc. v. Merrill, Lynch, Pierce, Fenner & Smith, Inc.*, 253 F. Supp. 359, 367 (S.D.N.Y. 1966) (holding that contracts to purchase sugar for future delivery were not “investment contracts” because the expected profits came from market fluctuations).

the previous three prongs, the answer of whether this applies to NFTs is not as clear as it may seem.

NFTs are minted assets that are traded using a blockchain network.¹²⁴ Even if there is a royalty interest retained by the seller, one might think that the value of the NFT is likely to be driven solely by market conditions. While this conclusion may be correct for some NFTs, it is likely incorrect for the Dallas Mavericks NFTs, whose value is likely influenced by more than market forces.¹²⁵

Mark Cuban's announcement of tickets to Mavericks' games being sold as NFTs is yet another example of an NFT that appears too simple to qualify as a security, a simple transaction of a digital ticket between a buyer and seller.¹²⁶ However, Cuban has stated that the Maverick's NFTs are also meant to be memorabilia for the game the ticket represents rather than just a means of entry to the arena.¹²⁷ Meaning that the value of the NFT ticket may be influenced by the significance of the game, rather than just the NFT market.¹²⁸ The Dallas Mavericks' performance on the court, or other factors that make the game memorable or significant, will likely have a direct effect on the value of the NFT.¹²⁹ In a sense, an investment in an NFT ticket is an investment in the Dallas Maverick's success.¹³⁰ The value of the NFT is partially by how good the Mavericks are.¹³¹ If the club gets blown out, NFT holders might have a harder time selling their ticket. If Dallas wins on a double overtime buzzer beater, the NFT's value as memorabilia may increase significantly.

The same could be said for trading cards, the value of the NFT will likely rise with the quality of basketball provided by the league, quality that the NBA is constantly trying to increase, rather than mere market forces.¹³²

124. Clark, *supra* note 16.

125. Kendall Baker, *Sports Tickets Meets NFTs*, AXIOS (Nov. 21, 2021), <https://www.axios.com/sports-tickets-nfts-digital-bobbleheads-3a4d2c13-09a2-4629-9eb5-c44a736a603f.html> [<https://perma.cc/QS93-AQ2V>]

126. *Id.*

127. *Id.*

128. *Id.*

129. *See id.* (stating that NFT tickets can commemorate significant games).

130. *See id.* (stating NFT tickets allow sellers to make money with each sale of the NFT. If the game is significant, sellers will gain profit each time the NFT is sold afterward as a commemorative collectible).

131. *See id.* (quoting Mark Cuban emphasizing that NFT tickets will bring additional value as verification of attendance to significant games).

132. *See id.* (stating a player or clubs performance may impact the value of the NFT).

Sports leagues and clubs have sold NFTs in ways that could make them investment contracts because of the royalty interests they have retained, the marketplaces they created, and the reasonable expectation of profits that have been provided to buyers.

IV. CAN PROFESSIONAL SPORTS AVOID SEC OVERSIGHT?

Dealing in securities requires that dealers provide a high level of transparency through their filings and disclosures with the SEC.¹³³ This could be a problem for sports organizations that, historically, have prioritized keeping their inner workings private to avoid public scrutiny and sacrificing bargaining leverage with player's unions.¹³⁴ Further motivation to avoid SEC oversight includes the "complex and costly regulatory procedures for the creation and sale of NFTs" required if they were deemed to be securities.¹³⁵

While the current ways in which professional sports leagues and clubs are implementing NFTs leaves a significant chance of future SEC oversight,¹³⁶ there are safeguards that leagues and clubs can implement to avoid their NFTs being labeled as investment contracts, and thus securities.¹³⁷ One of the simplest ways to avoid SEC regulation is to restrict the way in which their NFTs are sold.

A. *Avoid Being Involved in a Common Enterprise*

The common enterprise analysis of NFTs provided varied likelihoods of whether specific NFTs would satisfy the prong.¹³⁸ The

133. *SEC Disclosures Laws and Regulations*, INC. (Jan. 5, 2021), <https://www.inc.com/encyclopedia/sec-disclosure-laws-and-regulations.html> [<https://perma.cc/6KXK-XUFT>].

134. *See, e.g., Players Pledge Unity, Call for Financial Data at Annual Meetings*, NFL (Mar. 17, 2011), <https://www.nfl.com/news/players-pledge-unity-call-for-financial-data-at-annual-meetings-09000d5d81ece0d8> [<https://perma.cc/NMC3-FN6Y>] (stating the NFL refused to share details of TV deals with players during TV revenue dispute due to concern of commercial sensitivity).

135. Marvellous Iheukwumere, *Legal Implications of NFTs in Sports*, HARV. J. OF SPORTS AND ENT. L. (Apr. 19, 2021), <https://harvardjsel.com/2021/04/legal-implications-of-nfts-in-sports/> [<https://perma.cc/6AY6-NN2N>].

136. *See supra* Part III (discussing that the ways NFTs are being sold may qualify them as an investment contract).

137. *See infra* Part IV (discussing the different ways clubs and clubs can avoid their NFTs being labeled as an investment contract).

138. *See supra* Part III.A (discussing when a NFT would satisfy vertical and horizontal commonality).

spectrum included standard NFTs on one end and fractioned NFTs on the other, the latter being more likely to be labeled as a common enterprise under either commonality test.¹³⁹ Although the SEC has stated it does not require common enterprise per se to establish an investment contract,¹⁴⁰ a much safer avenue would be for leagues and clubs to use NFTs in a way that would deny the SEC an argument in the affirmative for the common enterprise.

Leagues and clubs should exclusively sell NFTs in their standard form, transferring all ownership interest to a single buyer with each sale. Refusing to retain interests would undoubtedly make it harder to connect leagues or clubs with the NFTs buyers, especially after the NFT is sold again. Although it is true that a fractional NFT could be created after the NFT is sold, the original seller is unlikely to be considered the “promoter” of the fractional NFT if they have no ownership interest in the underlying NFT.¹⁴¹

Another way leagues and clubs can reduce the likelihood there being a common enterprise is to refrain from attaching royalty interests to their NFTs. Although the royalty interests likely do not satisfy the horizontal common enterprise test, there is an argument to be made that it satisfies the vertical common enterprise test.¹⁴² However, on the spectrum of risk, royalty interests appear to be much less risky than their F-NFT counterparts.¹⁴³

B. *Limit Involvement with the Secondary Market*

Professional leagues may also further deter SEC regulation by avoiding being involved with the creation or maintenance of a secondary market.¹⁴⁴ One of the characteristics the SEC uses in determining

139. *Id.*

140. See SEC STRATEGIC HUB FOR INNOVATION AND FIN. TECH., *supra* note 81 at 13 n. 10 (stating the commission does not require commonality per se).

141. See *generally* Anello, *supra* note 11 (stating that the promoter is likely the entity who has control of the NFT).

142. See *Brodt v. Bache & Co., Inc.*, 595 F.2d 459, 461 (9th Cir. 1978) (holding strict vertical commonality exists when the fortunes of the promotor and the investor are intertwined).

143. See discussion *supra* Part III.A.iii. (discussing why F-NFTS are more likely to be an investment contract).

144. See SEC STRATEGIC HUB FOR INNOVATION AND FIN. TECH., *supra* note 81, at 3 (stating that investors likely rely on the efforts of others if the promotor is “responsible for the development, improvement (or enhancement), operation,

whether or not investors are relying on the efforts of others is if the party issuing the NFT is “responsible for the development, improvement (or enhancement), operation, or promotion of the network.”¹⁴⁵ The SEC applies the word “network” broadly to comprise the various elements of a digital asset’s network.¹⁴⁶

Some professional sports entities, such as the NBA, have teamed up with developers to maintain and provide buyers with a secondary market in which they can sell their NFT.¹⁴⁷ Providing this secondary market appears to have parallels to the network described by the SEC.¹⁴⁸ Sports leagues and clubs would be better served selling their NFTs in a way like the GSW did for their NFT rings. GSW partnered with a preexisting NFT host site and preexisting blockchain network.¹⁴⁹ Distancing the club or the league from the secondary market will likely decrease the chance of the SEC successfully arguing the NFT buyers’ reliance on the effort of others.¹⁵⁰

Clubs and leagues would also be wise to avoid manipulating the supply of NFTs to drive their value. The SEC has stated that manipulating the market price of their creation by limiting supply is a key characteristic in the evaluation of whether NFT sellers are stoking reliance.¹⁵¹ The NBA’s Top Shot has implemented a tier system that ensures purchasers with higher tiers have a very limited number of copies of each NFT being sold, ensuring their value.¹⁵² Leagues and clubs would be wise to avoid this kind of manipulation, which, according to the SEC, is a determining factor of whether the NFT is an investment contract.¹⁵³

or promotion of the network” on which the digital asset it hosted).

145. *Id.*

146. *Id.*

147. Brooks, *supra* note 61.

148. See SEC STRATEGIC HUB FOR INNOVATION AND FIN. TECH., *supra* note 81 at 3 (stating that a network that relies on the managerial efforts of the promotor may lead to the reasonable expectation of profits derived by the efforts of other).

149. *Terms & Conditions for NFTs Bought as Part of the Golden State Warriors NFT Collection Auction*, GOLDEN STATE WARRIORS LEGACY NFT COLLECTION, <https://gswnft.com/terms> [<https://perma.cc/T362-7XJ7>] (last visited Dec 12, 2021).

150. See SEC STRATEGIC HUB FOR INNOVATION AND FIN. TECH., *supra* note 81 at 3 (stating that there is a higher likelihood of the buyer relying on the efforts of other when the promotor provides and maintains a secondary market).

151. *Id.*

152. Iheukwumere, *supra* note 135.

153. See SEC STRATEGIC HUB FOR INNOVATION AND FIN. TECH., *supra* note 81, at 4 (stating investors are reliant on the efforts of others where “a [promotor] has a lead or central role in the direction of the ongoing development of the network or the digital asset”).

C. *Avoid Certain Promotional Strategies*

Professional sports leagues and clubs should also be very careful in the way in which they market their NFTs. The SEC has previously stated that promotional content that emphasizes the NFTs potential to increase in value will likely be viewed as driving a reasonable expectation of profits.¹⁵⁴ The SEC further states that promotional content with an emphasis on the digital assets readily transferable nature can also cause a reasonable expectation of profit.¹⁵⁵ In sum, the SEC advises that promoting the market on which the digital asset can be sold may lead to the asset being viewed as an investment contract.¹⁵⁶

Clubs and Leagues could further avoid being viewed as providing a reasonable expectation of profit by limiting the quantity of NFTs a particular buyer can purchase. The SEC has stated that allowing buyers to purchase digital assets in a quantity that likely exceeds reasonable personal use could lead to a determination of a reasonable expectation of profit.¹⁵⁷

V. CONCLUSION

154. See Enigma MPC, Exchange Act Release No. 33-10755 (Feb. 19, 2020), <https://www.sec.gov/litigation/admin/2020/33-10755.pdf> [<https://perma.cc/79PC-UA7F>] (stating that tokens sold were investment contracts due in part to their promotional content).

155. See SEC STRATEGIC HUB FOR INNOVATION AND FIN. TECH., *supra* note 81 at 8 (stating there is a reasonable expectation of profit when “[t]he digital asset is transferable or traded on or through a secondary market or platform, or is expected to be in the future”).

156. *Id.* at 6.

157. *Id.* at 7.

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NFT adopters currently face very little regulation. Although the absence of regulation is appealing, sports clubs and leagues should proceed understanding that in many of their current uses, NFTs will be considered securities. It is possible for these organizations to alter their current uses of NFTs, to avoid characterization as an investment contract. In order to do so, they would likely need to, at least partially, sacrifice their goal of producing long-term revenue streams. Although NFTs must be examined on an individual basis, their most profitable and attractive uses likely qualify them as a security.

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