



April 12, 2021

Hon. Vanessa Countryman  
Secretary  
Securities and Exchange Commission  
100 F Street, NE  
Washington, DC 20549

**Re: Rulemaking Regarding Non-Fungible Tokens**

Dear Secretary Countryman,

Arkonis Capital, LLC ("Arkonis") is a broker-dealer registered with the U.S. Securities and Exchange Commission ("SEC") and the Financial Industry Regulatory Authority ("FINRA"). Arkonis is a subsidiary of Sustainable Holdings, PBC, a financial technology ("FinTech") company focused on sustainability. The author of this petition is very familiar with blockchain technology and digital assets and has petitioned the SEC in the past to adopt rules on the regulation of digital assets that are securities, the remediation of initial coin offerings that violated the securities laws, and the regulation of the miners of digital assets.<sup>1</sup> Arkonis believes the SEC needs to provide regulatory clarity with respect to the regulation of a new form of digital assets - non-fungible tokens ("NFTs").

Arkonis encourages the SEC to engage in a meaningful discussion of how to regulate FinTech companies and individuals that are creating NFTs that may be deemed digital asset securities and the platforms that facilitate the issuance and trading of NFTs. We believe in certain instances NFTs may be securities. We believe existing securities laws that were written in the 1930s provide a crude mechanism for the regulation of NFTs. We encourage the SEC to publish a concept release on the regulation of NFTs to provide suitable guidance to the industry followed by the adoption of a new regulation on the same.<sup>2</sup>

## **I. Background**

Arkonis believes the development of NFTs presents a unique challenge to SEC's ability to protect investors from products that may be illegally offered securities.

### *A. Digital Assets*

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<sup>1</sup> Rulemaking petition regarding the regulation of digital assets and blockchain technology (Mar. 15, 2017), *available at*: <https://www.sec.gov/rules/petitions/2017/petrn4-710.pdf>; see also Rulemaking petition on digital asset mining (Revised) (Apr. 4, 2019), *available at*: <https://www.sec.gov/rules/petitions/2019/petrn4-743.pdf>, Request for rulemaking to address how digital assets are regulated once a trade occurs (Dec. 12, 2018), *available at*: <https://www.sec.gov/rules/petitions/2018/petrn4-736.pdf> and Rulemaking petition related to issuance of initial coin offerings that took place prior to the promulgation of related guidance by the Commission (Jan. 26, 2018), *available at*: <https://www.sec.gov/rules/petitions/2018/petrn4-719.pdf>.

<sup>2</sup> The SEC and other agencies such as the Office of the Comptroller of the Currency (the "OCC") have taken important steps in acknowledging the growing importance of FinTech in the broader financial services industry.

The past several years has seen an increasing number of digital assets, including NFTs. Digital assets that rely on distributed ledger technology commonly known as blockchain, exist in a variety of forms and provide industry actors with a variety of benefits.<sup>3</sup> Digital assets use blockchain technology to create a secure, distributed network for transactions.<sup>4</sup>

The SEC has defined digital assets as “an asset that is issued and transferred using distributed ledger or blockchain technology.”<sup>5</sup> Digital assets include, but are not limited to virtual currencies, coins, and tokens.<sup>6</sup> A digital asset may in certain instances be deemed a security under the federal securities laws. While not defined in the securities laws, the SEC often refers to digital assets that are securities as a “digital asset securities.”<sup>7</sup>

### *B. Non-Fungible Tokens*

NFTs use blockchain technology to establish authenticity, ownership, and transferability of a unique asset. NFTs differ from other digital assets such as Bitcoins which are fungible. NFTs can be purchased and sold peer-to-peer or on dedicated platforms. NFTs are commonly associated with art, gaming and digital collectibles. The artist Mike Winkelmann, also known as Beeple, recently used an NFT to sell his digital art “Everydays - The First 5000 Days” for \$69 million. The sale was the third-highest price paid for a piece of art by a living artist. Collectors and speculators have spent more than \$200 million on NFT based artwork, memes and Graphics Interchange Format (“GIF”). An NFT of a video clip of LeBron James recently sold for more than \$200,000 on NBA Top Shot. Not to be out done by King James, seven-time Super Bowl champion Tom Brady is launching an NFT platform called Autograph to support NFTs.

## **II. Are NFTs Securities?**

The SEC evaluates digital assets in the same manner as traditional assets to determine whether they are securities. Unlike initial coin offerings which are a type of digital asset that has drawn a considerable level of attention from the SEC staff, NFTs have not been the subject of interpretative guidance by the SEC. The SEC has not initiated an enforcement action against the creator of an NFT or the operator of a platform that facilitates the offer and sale of NFTs. The issue of when an NFT is a security is unclear.

The definition of “security” under the Securities Act of 1933 (the “Securities Act”) and Securities Exchange Act of 1934 (the “Exchange Act”) are nearly identical and broad enough to cover some NFTs. Section 2(a)(1) of the Securities Act defines a “security” as:

any note, stock, treasury stock, security future, security-based swap, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, **investment contract**, voting-trust certificate,

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<sup>3</sup> See RICHARD B. LEVIN ET AL., REAL REGULATION OF VIRTUAL CURRENCIES, HANDBOOK OF DIGITAL CURRENCY, 328-31 (2015).

<sup>4</sup> See *id.* at 331-32.

<sup>5</sup> Statement on Digital Asset Securities Issuance and Trading, Division of Corporation Finance, Division of Investment Management, and Division of Trading and Markets, SEC (Nov. 16, 2018), *available at*: <https://www.sec.gov/news/public-statement/digital-asset-securites-issuance-and-trading>.

<sup>6</sup> *Id.*

<sup>7</sup> *Id.*

certificate of deposit for a security, ... or, in general, any interest or instrument commonly known as a "security."<sup>8</sup>

The definition of security is sufficiently expansive to grant the SEC broad authority to regulate a variety of products as securities. While the definition of security is very broad, it does not explicitly include digital assets or NFTs. In enforcement actions, the SEC has argued offerings of digital assets are investment contracts.<sup>9</sup>

What constitutes an investment contract is determined based on the test articulated by the U.S. Supreme Court in *Securities and Exchange Commission v. W. J. Howey Co.* Under the *Howey* test, an investment contract is a contract, transaction, or scheme involving (i) an investment of money, (ii) in a common enterprise, (iii) with the expectation that profits will be derived from the efforts of the promoter or a third party. The *Howey* Test brings many non-traditional offerings within the scope of the term security.

While the SEC has not provided guidance on when an NFT is a security, the SEC staff have noted:

***the main issue in analyzing a digital asset under the Howey test is whether a purchaser has a reasonable expectation of profits (or other financial returns) derived from the efforts of others.*** A purchaser may expect to realize a return through participating in distributions or ***through other methods of realizing appreciation on the asset***, such as selling at a gain in a secondary market.<sup>10</sup>

If an NFT relates to an existing asset and is marketed as a collectible with a public assurance of authenticity on the blockchain, it should not be deemed a security. If an NFT promises a return on investment from the efforts of others, the NFT could be deemed a security. However, as noted by the SEC staff in its 2019 Framework, "***Price appreciation resulting solely from external market forces*** (such as general inflationary trends or the economy) impacting the

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<sup>8</sup> Securities of 1933 § 2(a)(1).

<sup>9</sup> See e.g., *SEC v. FLIK, et al.* (Sep. 10, 2020), available at: <https://www.sec.gov/litigation/complaints/2020/comp-pr2020-207.pdf>; *In the Matter of Boon.Tech, et al.* (Aug. 13, 2020), available at: <https://www.sec.gov/litigation/admin/2020/33-10817.pdf>; *SEC v. ICOBox, et al.* (Sep. 18, 2019), available at: <https://www.sec.gov/litigation/complaints/2019/comp-pr2019-181.pdf>; *SEC v. Kik Interactive Inc.* (June 4, 2019), available at: <https://www.sec.gov/litigation/complaints/2019/comp-pr2019-87.pdf>; *In the Matter of Gladius Network LLC* (Feb. 20, 2019), available at: <https://www.sec.gov/litigation/admin/2019/33-10608.pdf>; *In the Matter of Floyd Mayweather, Jr.* (Nov. 29, 2018), available at: <https://www.sec.gov/litigation/admin/2018/33-10578.pdf>; *In the Matter of Khaled ("DJ Khaled")* (Nov. 29, 2018), available at: <https://www.sec.gov/litigation/admin/2018/33-10579.pdf>; *In the Matter of Paragon Coin, Inc.* (Nov. 16, 2018), available at: <https://www.sec.gov/litigation/admin/2018/33-10574.pdf>; *In the Matter of CarrierEQ, Inc., d/b/a Airfox* (Nov. 16, 2019), available at: <https://www.sec.gov/litigation/admin/2018/33-10575.pdf>; *In the Matter of Zachary Coburn* (Nov. 8, 2018), available at: <https://www.sec.gov/litigation/admin/2018/34-84553.pdf>; *SEC v. Blockvest LLC, et al.* (Oct. 11, 2018), available at: <https://www.sec.gov/litigation/complaints/2018/comp-pr2018-232.pdf>; *TokenLot LLC, Lenny Kugel, and Eli Lewitt* (Sep. 11, 2018), available at: <https://www.sec.gov/litigation/admin/2018/33-10543.pdf>; *In the Matter of Tomahawk Exploration LLC and David T. Laurance* (Aug. 14, 2018), available at: <https://www.sec.gov/litigation/admin/2018/33-10530.pdf>; *SEC v. Titanium Blockchain Infrastructure Services Inc., et al.* (May 22, 2018), available at: <https://www.sec.gov/litigation/complaints/2018/comp-pr2018-94.pdf>; *SEC v. Sharma, et al.* (Apr. 2, 2018), available at: <https://www.sec.gov/litigation/complaints/2018/comp-pr2018-53.pdf>; *In the Matter of Munchee, Inc.* (Dec. 11, 2017), available at: <https://www.sec.gov/litigation/admin/2017/33-10445.pdf>; *SEC v. REcoin Group Foundation, LLC, et al.* (Sep. 29, 2017), available at: <https://www.sec.gov/litigation/complaints/2017/comp-pr2017-185.pdf>.

<sup>10</sup> Framework for "Investment Contract" Analysis of Digital Assets (2019), available at: [https://www.sec.gov/corpfin/framework-investment-contract-analysis-digital-assets#\\_edn1](https://www.sec.gov/corpfin/framework-investment-contract-analysis-digital-assets#_edn1).

supply and demand for an underlying asset generally is not considered ‘profit’ under the Howey test.”<sup>11</sup>

As NFTs proliferate, new regulatory questions will arise. Arkonis believes fractionalized NFTs could be considered a security. While NFTs are meant to be non-fungible, fractional NFTs that allow numerous purchasers to acquire a partial ownership interest in the NFT, increases the likelihood the NFT could be deemed a security. We encourage the SEC to provide guidance on the fractional ownership in an NFT.

### III. Regulation of NFT Platforms

If an NFT is a security, the platform facilitating the sale and secondary trading of the NFT may have to register with the SEC as an exchange. Section 3(a)(1) of the Exchange Act defines an “exchange” as “any organization, association, or group of persons, whether incorporated or unincorporated, which constitutes, maintains, or provides a market place or facilities for bringing together purchasers and sellers of securities or for otherwise performing with respect to securities the functions commonly performed by a stock exchange as that term is generally understood ... .”<sup>12</sup> Exchange Act Rule 3b-16(a) provides a functional test to assess whether a trading system meets the definition of exchange. Under Rule 3b-16(a), an organization, association, or group of persons will be deemed to provide “a marketplace or facilities for bringing together purchasers and sellers of securities or for otherwise performing with respect to securities the functions commonly performed by a stock exchange,” if such organization, association, or group of persons: (1) brings together the orders for securities of multiple buyers and sellers; and (2) uses established, non-discretionary methods (whether by providing a trading facility or by setting rules) under which such orders interact with each other, and the buyers and sellers entering such orders agree to the terms of the trade.

As the SEC noted in the DAO Report, a system that meets the definition of an exchange and is not excluded under Rule 3b-16(b), must register as a national securities exchange or operate pursuant to an appropriate exemption.<sup>13</sup> One frequently used exemption is for alternative trading systems (“ATS”). Rule 3a1-1(a)(2) exempts from the definition of “exchange” under Section 3(a)(1) an ATS that complies with Regulation ATS. An ATS that operates pursuant to the Rule 3a1-1(a)(2) exemption and complies with Regulation ATS would not be subject to the registration requirement of Section 5 of the Exchange Act.

If an NFT is a security, any platform that brings together multiple buyers and sellers of the NFT using non-discretionary methods, will likely be deemed an exchange.

### IV. Recommendations

#### *A. The SEC should publish a concept release on the regulation of NFTs.*

Arkonis believes SEC rulemaking paired with an opportunity for public comment, will provide guidance to parties looking to create NFTs and to facilitate the sales of NFTs. By allowing industry participants to raise questions and concerns through rulemaking, the SEC will

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<sup>11</sup> *Id.*

<sup>12</sup> 15 U.S.C. § 78c(a)(1).

<sup>13</sup> Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934: The DAO, Securities and Exchange Commission Release No. 81207 (July 25, 2017), *available at*: <https://www.sec.gov/litigation/investreport/34-81207.pdf>.

be able to make a general assessment of NFTs and to develop a regulatory framework that is better suited to address them.

As was the case with the proliferation of ICOs in the last several years, the number of FinTech firms facilitating the issuance and trading of NFTs is growing rapidly. Like ICOs, NFTs are attracting the attention of prominent athletes, entertainers, the media, and the public. Unlike the ICO frenzy of several years ago which was met with guidance and enforcement actions, the SEC has not published guidance on the regulation of NFTs as digital asset securities.

The regulation of NFTs presents the SEC with an opportunity to satisfy its statutory duties — protecting investors, maintaining fair, orderly, and efficient markets, and facilitating capital formation - by engaging in a constructive dialogue with the FinTech industry on how to regulate NFTs.

*B. The SEC should propose rules to address when NFTs are securities.*

While SEC enforcement actions have provided some guidance on when digital assets are securities, the actions have not addressed the needs of FinTech firms dealing with NFTs. Arkonis believes the publication of a concept release on how to regulate NFTs is a meaningful first step in providing guidance to the industry, which will only prove beneficial if it is followed by the SEC adopting a new rule on the regulation of NFTs. The current guidance on the regulation of digital assets as securities requires a facts and circumstances-based analysis by qualified counsel to determine if an NFT is a security and if a firm's activities require registration as a broker-dealer, an exchange, or an ATS. Such analysis is often cost prohibitive to the early stage companies that drive much of the innovation in FinTech.

Arkonis believes rulemaking by the SEC will provide much needed guidance to the industry that will promote market integrity, capital formation, and protection of investors.

## **V. Conclusion**

NFTs have tremendous potential to revolutionize industries including, sports, music, and entertainment. However, NFTs do not function as traditional securities and do not fit clearly under the existing regulatory framework. We believe the pace of change must be tempered by the statutory duties of the SEC to protect investors, maintain fair, orderly, and efficient markets, and facilitate capital formation. To help promote stability and innovation in the industry, Arkonis believes the SEC should publish a concept release on the regulation of NFTs that clearly defines when an NFT is a security, and what type of registration is required by firms facilitating the trading of NFTs.

We hope that you, the Commissioners, and the staff find these comments informative. Arkonis welcomes the opportunity to discuss with you how the SEC may develop a regulatory framework that harnesses the potential of the industry by creating more transparency and efficiency.

If Arkonis or I can be of any further assistance to you in this matter, please do not hesitate to contact me at the above address or at vince@sustainableholdings.io or our counsel Richard B. Levin of Nelson Mullins Riley & Scarborough LLP at 202-689-2860.

Very truly yours,

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