DOES THE DAPPER SETTLEMENT OFFER RULES OF THE ROAD FOR NFT ISSUERS?

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Dapper Labs (Dapper) has agreed to settle a putative class action suit brought by private plaintiffs, subject to court approval, putting to rest allegations that its NBA-endorsed nonfungible tokens (NFTs) were offered and sold as unregistered investment contract securities. The terms of the settlement, including acts undertaken by Dapper to decentralize its network, may be a model for third parties who wish to avoid securities liability in connection with offering digital asset NFT collectibles.

Dapper, also the creator of CryptoKitties, sells NFTs called NBA Top Shot Moments (Moments) that are issued and transacted on the Flow blockchain, which was owned and originally operated by Dapper as a private blockchain. Moments are NFTs that depict notable snippets of NBA game play such as a three pointer by Steph Curry. These NFTs are tradeable like physical trading cards. Nevertheless, the lawsuit alleged that these collectible NFTs were securities because, according to plaintiffs, Moments satisfied the Howey test and were “an investment of money in a common enterprise with a reasonable expectation of profits to be derived from the efforts of [Dapper].”

Dapper argued that Moments are collectibles, and their purchase and sale does not constitute the sale of unregistered securities. Dapper maintained that collectors obtain Moments for consumptive use similar to traditional sports trading cards, based on their personal preferences, as opposed to for potential investment purposes, and a Moment's value is not directly correlated with Dapper's profitability, the value of Flow tokens, or the value of other Moments. Instead, factors such as player popularity, player performance, type of play, and player injuries drive value.

In denying Dapper's initial motion to dismiss, the court focused on: Dapper's (1) control over the then-private Flow blockchain; (2) control over the marketplace for sales of Moments; and (3) marketing efforts. The court, admitting it was a “close call,” reasoned that since Moments were traded on the Flow blockchain and marketplace, which Dapper privately controlled, purchasers relied on “Dapper Labs's expertise and managerial efforts, as well as its continued success and existence,” thus fulfilling the “common enterprise” and “efforts of others” prongs of Howey. In terms of Dapper's marketing, the court also focused on tweets leading to reasonable expectations of profits: “the 'rocket ship' emoji, 'stock chart' emoji, and 'money bags' emoji objectively mean one thing: a financial return on investment.” These facts were enough to defeat Dapper's motion to dismiss.

Although not reaching the merits of whether Moments were sold as securities, the parties' stipulation of settlement, which includes payment of US$4,000,000, outlines business changes already made and to be made by Dapper:

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1. Dapper no longer has control over the Flow blockchain, which is now completely permissionless and decentralized;
2. Moments may now be displayed, bought, and sold on other marketplaces;
3. Dapper corrected withdrawal delays, including updating its customer wallet, enhancing AML/KYC protocols, increasing withdrawal limits, and partnering with new payments and custody providers;
4. Dapper and co-founder and CEO Gharegozlou will relinquish control of reserve Flow tokens to the Flow Foundation; and
5. Dapper will train key personnel on marketing in compliance with securities laws.

The court initially approved the settlement, which is now subject to a final hearing on 17 September 2024.

The private settlement of a civil litigation does not have precedential value. Likewise, settlements of enforcement actions, while potentially revealing the inclinations of the regulator, do not establish precedent. However, after this class action settlement and two other Securities and Exchange Commission (SEC) settlements regarding NFT securities, industry participants can start to piece together a few "rules of the road." In the other settlement orders with the SEC (In re Impact Theory, and In re Stoner Cats 2), the SEC focused on public statements suggesting to buyers that they should expect asset appreciation and issuer use of revenues from sales and key entrepreneurial efforts to develop the respective NFT projects (which the Dapper court also emphasized).[1]

After "reading the tea leaves" (as SEC Commissioner Hester Peirce puts it), NFT issuers should be cautious about:

6. Technical or managerial control over an NFT's native blockchain,
7. Creating an exclusive marketplace for NFTs;
8. Using revenues from sales to develop a project or service for a product; and
9. Marketing suggesting investment value or investment returns.

Based on these factors, NFT projects should be evaluated with respect to their structure, technology decisions, and marketing to evaluate the level of risk created.

Please reach out to a member of our team for further information as we continue to closely monitor NFT regulatory and enforcement considerations.

FOOTNOTES

[1] The SEC's Division of Enforcement was reportedly engaged in an enforcement investigation of Dapper but closed its investigation without recommending an enforcement action to the Commission in late September 2023, following the settlements with Impact Theory and Stoner Cats 2. It is unclear whether, or to what extent, Dapper's implemented changes and planned changes as to operation and control of the Flow blockchain may have factored into the Division of Enforcement's decision.

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