

# Dapper Settlement Offers Rules Of The Road For NFT Issuers

By **Eden Rohrer, Andrew Hinkes and Joshua Durham** (July 9, 2024)

On June 3, Dapper Labs agreed[1] to settle a putative class action brought by private plaintiffs, subject to court approval in the U.S. District Court for the Southern District of New York, putting to rest allegations[2] that its NBA-endorsed non-fungible tokens 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 that 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 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 gameplay, such as a three-pointer by Stephen Curry.[3] These NFTs are tradeable like physical trading cards.

Nevertheless, the lawsuit alleged that these collectible NFTs were securities because, according to the plaintiffs, Moments satisfied the Howey test, derived from the U.S. Supreme Court's 1946 decision in U.S. Securities and Exchange Commission v. W. J. Howey Co., and were "an investment of money in a common enterprise with a reasonable expectation of profits to be derived from the efforts of others." [4]

Dapper argued that Moments are collectibles, and that 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 that 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,[5] 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 the Howey test.

In terms of Dapper's marketing, the court also focused on tweets leading to the reasonable



Eden Rohrer



Andrew Hinkes



Joshua Durham

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 \$4 million, outlines business changes already made and to be made by Dapper:

- Dapper no longer has control over the Flow blockchain, which is now completely permissionless and decentralized.
- Moments may now be displayed, bought and sold on other marketplaces.
- Dapper corrected withdrawal delays, including updating its customer wallet, enhancing anti-money laundering and know-your-customer policies, increasing withdrawal limits, and partnering with new payments and custody providers.
- Dapper and co-founder and CEO Roham Gharegozlou will relinquish control of reserve Flow tokens to the Flow Foundation.
- 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 Sept. 17.

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 SEC settlements[6] regarding NFT securities — In re: Impact Theory[7] and In re: Stoner Cats 2[8] from August and September 2023, respectively — industry participants can start to piece together a few rules of the road.

In those two other settlement orders with the SEC, the commission's approach shared some core similarities with the Dapper court, but also some areas of divergence.

Like in Dapper, the SEC focused on extensive media campaigns suggesting to buyers that they should view the NFTs as investments. Specifically, the NFT creators made public statements about expecting asset appreciation, including via the issuer's use of revenues from sales and their key entrepreneurial efforts to develop the respective NFT projects — which the Dapper court also emphasized.[9]

However, unlike Dapper, the NFTs in Impact Theory and Stoner Cats 2 were not traded on exclusive marketplaces controlled by their creators.

In Dapper, the court found that the exclusive marketplace was key to finding profits derived by the efforts of others since NFT trading relied on Dapper maintaining the marketplace, "because Moments can be purchased only from NBA Top Shot in packs, or traded on the Marketplace that Dapper Labs controls, Dapper Labs's continued management and efforts to develop the ecosystem, both technologically and as a matter of promotion, are crucial to Moments retaining and increasing in value."

In contrast, the SEC settlements suggest that marketplace royalties are key to the "common enterprise" analysis. Royalties derived from trades on independent secondary marketplaces, "assure[d] owners of the NFTs that [Stoner Cats 2] would remain committed ... [i]f the Stoner Cats show was successful, the price of the NFTs could rise and so could the amount of royalties," according to the SEC's Stoner Cats 2 settlement.

Thus, the structure of the marketplace on which NFTs trade is material to how they will be viewed under the Howey test. Exclusive marketplaces may evidence efforts of others, whereas royalties derived from secondary marketplaces may indicate a common enterprise.

Moreover, the Impact Theory and Stoner Cats NFTs also differed from Moments in that they had actual utility, whereas Moments had no utility beyond seeing the NFT's video clips or using the marketplace. The lack of substantive consumptive use led the Dapper court to reason that Moments "were purchased with 'investment intent,'" because profits were "the primary motivator of Moments purchasers."

Unlike Moments, the NFTs in the relevant SEC settlements to date provided discrete goods and/or services, such as access to watch an animated show or access to a virtual avatar builder. The SEC in Impact Theory and Stoner Cats 2 nevertheless looked past the NFTs' utility, an approach that SEC Commissioners Hester Peirce and Mark Uyeda criticized.[10]

Unlike traditional securities, which are investments in future promises of profits, Peirce and Uyeda noted that: "[t]he Stoner Cats NFT purchasers received what they paid for — a still image of a character from the series, access to all six episodes of the Stoner Cat series, and the excitement of being part of a popular phenomenon."

While the Dapper settlement suggests that having zero utility may make it easier to show that purchasers had investment intent, Peirce and Uyeda would disagree that all collectibles are securities.

### **Compliance Considerations for NFT Issuers**

After "reading the tea leaves" — as Peirce put it[11] — from the private settlement and SEC settlements, NFT issuers should be thoughtful about running over several trip wires when designing their NFTs. Specifically, there are six key practices to avoid:

1. Technical or managerial control over an NFT's native blockchain;
2. Creating an exclusive marketplace for NFTs;
3. Using revenues from sales to develop a project or service for a product;

4. Marketing suggesting investment value or investment returns;
5. Extracting royalties from secondary market sales; and
6. Providing zero utility or consumptive use of an NFT.

Based on these factors, NFT projects should evaluate their economic structure, technology decisions and marketing strategy to evaluate the level of risk created. While no one single practice implicates securities laws alone, the more an NFT project starts to have the above features, the more it looks like an investment contract security.

---

*Eden Rohrer is a partner at K&L Gates LLP.*

*Andrew Hinkes is a partner and co-chair of the digital assets industry group at the firm.*

*Joshua Durham is an associate at the firm.*

*Associate McNair Nichols contributed to this article.*

*The opinions expressed are those of the author(s) and do not necessarily reflect the views of their employer, its clients, or Portfolio Media Inc., or any of its or their respective affiliates. This article is for general information purposes and is not intended to be and should not be taken as legal advice.*

[1] [https://storage.courtlistener.com/recap/gov.uscourts.nysd.562991/gov.uscourts.nysd.562991.67.0\\_1.pdf](https://storage.courtlistener.com/recap/gov.uscourts.nysd.562991/gov.uscourts.nysd.562991.67.0_1.pdf).

[2] [https://storage.courtlistener.com/recap/gov.uscourts.nysd.562991/gov.uscourts.nysd.562991.27.0\\_2.pdf](https://storage.courtlistener.com/recap/gov.uscourts.nysd.562991/gov.uscourts.nysd.562991.27.0_2.pdf).

[3] <https://nbatopshot.com/listings/p2p/675759de-692f-486a-80c1-a727983877f0+05765a2c-7193-403f-88c7-152414edb409>.

[4] [https://storage.courtlistener.com/recap/gov.uscourts.nysd.562991/gov.uscourts.nysd.562991.27.0\\_2.pdf](https://storage.courtlistener.com/recap/gov.uscourts.nysd.562991/gov.uscourts.nysd.562991.27.0_2.pdf).

[5] [https://storage.courtlistener.com/recap/gov.uscourts.nysd.562991/gov.uscourts.nysd.562991.43.0\\_1.pdf](https://storage.courtlistener.com/recap/gov.uscourts.nysd.562991/gov.uscourts.nysd.562991.43.0_1.pdf).

[6] <https://www.fintechlawblog.com/2023/08/29/an-sec-first-nfts-are-sold-as-securities/>.

[7] <https://www.sec.gov/files/litigation/admin/2023/33-11226.pdf>.

[8] <https://www.sec.gov/files/litigation/admin/2023/33-11233.pdf>.

[9] 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.

[10] <https://www.sec.gov/news/statement/peirce-uyeda-statement-stonercats-091323>.

[11] <https://www.theblock.co/post/265508/sec-commissioner-peirce-says-agency-should-work-more-efficiently-to-regulate-crypto>.