

Fintech Alert | March 10, 2023
**NBA Top Shots Ruling: Certain NFT
 Transactions Constitute “Investment
 Contracts” and Therefore Are “Securities”**



NBA Top Shots, one of the most popular applications on the Flow Blockchain, a private blockchain created by Dapper Labs, allows consumers to purchase non-fungible tokens (NFTs) known as “Moments.” Moments are digital video clips of basketball highlights from NBA games. Consumers can acquire Moments on the NBA Top Shots application in two ways: they may purchase one or more “packs” of Moments, each of which is similar to a pack of basketball cards, or they may purchase one or more individual Moments on a secondary marketplace created and maintained by Dapper Labs. On the secondary marketplace, Moments owners may resell Moments they purchased in packs or from other Moment owners on the marketplace. Transactions involving Moments can occur only on Dapper Labs’ Flow Blockchain.

On Feb. 22, 2023, in the case of *Friel v. Dapper Labs, Inc.*, Judge Victor Marrero of the United States District Court for the Southern District of New York denied a motion to dismiss a class-action lawsuit that alleges that Dapper Labs violated federal securities laws by offering Moments for public sale without filing a registration statement with the Securities and Exchange Commission (SEC). The *Dapper Labs* court recognized that NFTs themselves are not necessarily securities but concluded that the plaintiffs had plausibly alleged that transactions in Moments are securities because they constitute “investment contracts” pursuant to *SEC v. W.J. Howey Co.*, 328 US 293, 298-299 (1946) (Howey), and in view of precedent such as *Gary Plastic Packaging v. Merrill Lynch, Pierce, Fenner, & Smith Inc.*, 756 F.2d 230 (2d Cir. 1985) (*Gary Plastic*).

Under *Howey*, a financial interest is an “investment contract” if it involves (1) an investment of money (2) in a common enterprise (3) with the expectation of profits (4) based upon the entrepreneurial or managerial efforts of others. The *Howey* test was applied in *Gary Plastic* to Merrill Lynch’s marketing and sale of insured certificates of deposit (CDs) that it obtained from various banks. Among other representations, Merrill Lynch promised purchasers that it would maintain a secondary market to guarantee purchasers liquidity for their deposits. Due in part to Merrill Lynch’s creation and maintenance of a secondary market, which was a critical part of Merrill Lynch’s marketing efforts, the *Gary Plastic* court concluded that the expectation of profits by purchasers rested heavily on the efforts of Merrill Lynch and, therefore CDs sold by Merrill Lynch were investment contracts.

As in *Gary Plastic*, the *Dapper Labs* court’s decision hinged on the “efforts of others” prong of *Howey* – whether the value of Moments depends on Dapper Labs’s expertise and managerial efforts. The Court concluded that it

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does because Moments can be purchased and traded only in the secondary marketplace in the NBA Top Shots application that runs atop Dapper Labs' Flow Blockchain. Looking to *Gary Plastic* and other *Howey* precedent, the *Dapper Labs* court concluded that the value of Moments depends on Dapper Labs' maintenance of the Flow Blockchain, maintenance of the secondary marketplace, and its ongoing promotion of Moments.

Although the *Dapper Labs* court emphasized that its ruling was "narrow," the decision is a reminder that even when an asset is not itself a security – for example, orange trees, whiskey, chinchillas, CDs, etc. – the manner in which the asset is marketed, sold, and maintained can cause the sale of the asset to constitute an investment contract.



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