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Can It Be a Commodity if It's Not Fungible? Evaluating NFTs Under the Commodity Exchange Act

Understanding NFTs as commodities calls for a more nuanced analysis than what their "non-fungible" label might suggest at first glance.

The appropriate regulatory characterization of cryptocurrencies and digital assets for US legal purposes has spawned many pages of analysis and occupied many hours of industry, law firm, and regulatory consideration. Significant amounts of commentary, and later government and judicial attention, have been devoted to determining whether fungible cryptocurrencies and digital assets constitute securities for purposes of US federal securities laws, and/or commodities for purposes of the US Commodity Exchange Act (CEA) and the regulations promulgated by the Commodity Futures Trading Commission (CFTC) thereunder (CFTC Rules). More recently, attention has turned to whether non-fungible tokens (NFTs), and particularly fractional NFTs, may constitute securities for purposes of the US federal securities laws (for more information, see this Latham post).

Less attention has been given to determining whether NFTs constitute commodities under the CEA and CFTC Rules and, if so, the consequences thereof. While the answer will always depend on the facts and circumstances of the particular NFT or NFT project in question, we identify in this Client Alert a range of important factors and considerations that will likely loom large in any such analysis. As will become clear from the discussion below, the "commodity" status of NFTs requires a more nuanced analysis than may initially be expected from their "non-fungible" moniker.

What Are NFTs?

NFTs are unique, non-interchangeable digital tokens minted on a blockchain or distributed ledger network. In general, each NFT serves a specifically identifiable digital asset that can only be held by a single digital wallet address at any one time. Unlike fungible tokens, each NFT is indivisible (although through the advent of "fractionalization" there are ways for multiple people to collectively own a single indivisible NFT and have their fractional ownership represented by other digital assets). Through the use of metadata attributes and smart contract functionality, NFTs can be linked to or used to represent entitlements with respect to any number of digital or physical items or things. Transfers of NFTs are recorded on the relevant blockchain or distributed ledger network, providing an immutable and traceable transaction history.

A number of blockchains and distributed ledger networks now support minting and transacting in NFTs, with the Ethereum and Solana networks as notable examples. On the Ethereum network, NFTs are minted using the ERC-721 or ERC-1155 token standards (as opposed to the ERC-20 token standard used for fungible tokens on the Ethereum network). Recent innovations have led to new standards that push the boundaries of what an NFT is and what it can do. For instance, the ERC-6551 token standard is designed to enable NFTs to be paired with their own token-bound wallets, thus enabling such NFTs to hold their own digital assets, such as other NFTs or even other fungible tokens. For additional background, please see our Beginner's Guide to NFTs and NFTs 101.

For purposes of this Alert, we distinguish between (and focus on) two broad categories or use cases of NFTs:

- ***Digital Native NFTs***, i.e., the most familiar use case of NFTs as representing ownership, rights, accreditation, or entitlements with respect to some form of digital asset or linked data, such as a digital collectible, unique piece of digital art, in-game item, avatar, or profile picture; and

- ***Physically-Linked Representational NFTs***, i.e., the use case of NFTs as representing or evidencing ownership, rights, or entitlements with respect to some physical or off-chain asset, item, or thing (i.e., ownership of art pieces or real property).

However, we use these terms for convenience of reference, rather than as definitions that are necessarily exhaustive of the NFT space or mutually exclusive.

Evaluating the "Commodity" Status of NFTs

The CFTC is primarily concerned with the regulation and oversight of commodity derivatives — as opposed to spot commodity markets. A threshold matter to the application of the CFTC's regulatory perimeter and the application of the CEA and CFTC Rules is the identification of a relevant "commodity." Section 1a(9) of the CEA defines a "commodity" as follows:[1]

> The term "commodity" means wheat, cotton, rice, corn, oats, barley, rye, flaxseed, grain sorghums, mill feeds, butter, eggs, Solanum tuberosum (Irish potatoes), wool, wool tops, fats and oils (including lard, tallow, cottonseed oil, peanut oil, soybean oil, and all other fats and oils), cottonseed meal, cottonseed, peanuts, soybeans, soybean meal, livestock, livestock products, and frozen concentrated orange juice, and all other goods and articles, except onions and motion picture box office receipts (or any index, measure, value, or data related to such receipts), and **all services, rights, and interests** (except motion picture box office receipts, or any index, measure, value or data related to such receipts) **in which contracts for future delivery are presently or in the future dealt in**." (emphasis added)

We explore below how this definition applies to NFTs and identify certain factors and considerations that will likely predominate the analysis of any particular NFT or NFT project.

CFTC Guidance on Virtual Currencies as "Commodities"

The CFTC has stated on multiple occasions, and relevant judicial decisions have confirmed, that virtual currencies (including Bitcoin and Ether) are "commodities" for purposes of the CEA and the CFTC Rules. The CFTC first asserted this view in an enforcement action in 2015,[2] and the position that virtual currencies are "commodities" has since been taken in a range of CFTC enforcement actions[3] and related judicial decisions.[4]

In 2020, the CFTC adopted an interpretation of "actual delivery" of a digital asset for purposes of the CFTC's authority with respect to retail commodity transactions offered on a leveraged, margined, or financed basis under Section 2(c)(2)(D) of the CEA (the Actual Delivery Interpretation).[5] In the Actual Delivery Interpretation and citing its own prior enforcement actions, the CFTC observed that it "considers virtual currency to be a commodity as defined under Section 1a(9) of the Act, like many other intangible commodities that the Commission has previously recognized."[6] For these purposes, the CFTC adopted the following definition of a "virtual currency":[7]

> "[A] digital asset that encompasses any digital representation of value or unit of account that is or can be used as a form of currency (i.e., transferred from one party to another as a medium of exchange); may be manifested through units, tokens, or coins, among other things; and may be distributed by way of digital "smart contracts," among other structures."

As should be immediately apparent, NFTs do not fall neatly within this definition of "virtual currency." In general, NFTs are not used as a form of currency, transferred from one party to another as a medium of exchange. Further, virtual currencies like Bitcoin or Ether are fungible. By their nature, however, NFTs are not supposed to be fungible. Accordingly, NFTs would not seem to constitute commodities squarely on the basis of the CFTC's current interpretative position that virtual currencies are commodities.

Application of Commodity Definition as a Matter of First Impression

Even if NFTs do not fall within the four corners of the CFTC's existing interpretation of virtual currencies as commodities outlined above, this does not preclude an analysis that an NFT or NFT project may constitute or involve a "commodity." Indeed, the CFTC cautioned in the Actual Delivery Interpretation that it did "not intend to create a bright line definition given the evolving nature of the commodity and, in some instances, its underlying public distributed ledger technology." Accordingly, it is important to consider whether NFTs may fall within the CEA definition of a "commodity" as a matter of first impression.

The Relevance of (Non-)Fungibility

In the aftermath of the Dodd-Frank Wall Street Reform and Consumer Protection Act, the CFTC adopted a final rule defining the term "agricultural commodity" (the Agricultural Commodity Rule).[8] Although at first blush NFTs seem far removed from the world of agriculture, the Agricultural Commodity Rule contains certain observations that are potentially instructive in evaluating the commodity status of NFTs.

By way of background, the Agricultural Commodity Rule adopted a multi-prong definition of an "agricultural commodity" for CFTC regulatory purposes.[9] Under this definition, the term "agricultural commodity" includes certain expressly enumerated agricultural products (such as wheat, cotton, rice, and corn) but also:

> "All other commodities that are, or once were, or are derived from, living organisms, including plant, animal and aquatic life, **<u>which are generally fungible</u>**, within their respective classes, and are used primarily for human food, shelter, animal feed or natural fiber" (emphasis added)

In the Agricultural Commodity Rule, the CFTC observed that "generally fungible" means "substitutable or interchangeable within general classes."[10] As an example, the CFTC noted that "apples, coffee beans, and cheese are generally fungible within general classes, even though there are various grades and types, and so they would be agricultural commodities." On the other hand, the CFTC observed that:

> "[C]ommodities that have been processed and have taken on a **<u>unique identity</u>** would not be generally fungible. Thus, while flax or mohair are generally fungible natural fibers, lace and linen garments made from flax, or sweaters made from mohair, are not generally fungible and would not be agricultural commodities." (emphasis added)

On this line of reasoning, "unique identity," as opposed to mere variations in grade or type, may indicate that a particular item or thing does not constitute a commodity for CFTC regulatory purposes.

For NFTs, it is tempting to conclude that the ostensibly non-fungible nature of such tokens precludes commodity status. On closer consideration, however, this is an over-simplification.

In terms of Digital Native NFTs, there are instances and use cases in which such NFTs may appropriately be viewed as having a "unique identity." For example, consider an NFT relating to a custom and truly unique piece of digital art or a one-of-a-kind and truly unique in-game item. On the other hand, certain Digital Native NFTs and use cases thereof involve issuing a substantial number of distinct (and individually tokenized), but ultimately similar, digital items or pieces of digital art. For example, there are a range of NFT art "collections" composed of a large number (e.g., 10,000) of procedurally generated NFT art pieces based on a template of character art (e.g., a cartoon character) that differ only in certain traits or parameters such as color, appearance characteristics, or apparel and accessories. Or, consider NFT collections in which 500 uniquely numbered NFTs are all linked to the same piece of content, but what distinguishes each NFT from others that link to the same content are programmed in characteristics, such as rendering differently when opened within an NFT-linked game or social media app. In such contexts, depending on the nature and extent of the differences in variation and type, one may argue that the individual NFTs are not sufficiently unique to fall outside the definition of a "commodity" — notwithstanding that each NFT is represented by a cryptographically unique digital token or has different sub-qualities in integrated applications.

Considering this notion of "unique identity" in the context of Physically-Linked Representational NFTs further underscores the need for nuanced analysis. Consider, for example, the potential use of Physically-Linked Representational NFTs as a digital representation of ownership or entitlements with respect to real-world assets such as real property or physical art. In such contexts, both the underlying physical asset and the linked NFT would have a "unique identity," supporting the argument that the "commodity" definition should not apply. On the other hand, "unique identity" may be less apparent in other potential use cases of Physically-Linked Representational NFTs. For example, consider a potential use case in which NFTs are used to represent or track entitlements to individual barrels of oil or carbon offsets of a specific project. While each such entitlement or ownership interest may be distinct and represented by a cryptographically unique digital token, the underlying physical assets — barrels of the same type of oil or carbon offsets of a project — are arguably not. In this regard, the commoditized nature of the underlying physical asset may inform the commodity status of the linked NFT.

These cursory examples demonstrate that the nature and fungibility of the relevant linked digital or physical items or thing may be instrumental to the CFTC's interpretation of the commodity status of both Digital Native NFTs and Physically-Linked Representational NFTs.

Notably, however, the relevance of fungibility to analyzing whether a particular NFT is a commodity is still undetermined. We underscore that the definition of "commodity" under Section 1a(9) of the Act is incredibly broad, and includes a catch-all which captures "all other goods and articles, except onions and…motion picture box office receipts" under the definition of commodity. The CFTC thus does not necessarily have to satisfy or prove any particular indicia of fungibility in order to determine the existence of a commodity.

The Relevance of Futures Trading as a Determining Factor to Meeting the Commodity Definition

Further, in the enumerated list of what constitutes a "commodity" under Section 1a(9) of the CEA, the definition tacks on after the catch-all described above, "and all services, rights, and interests . . . *in which* *contracts for future delivery are presently or in the future dealt in*" (emphasis added) (referred to herein as the Futures Qualifier). That is, notwithstanding the enumerated list, the definition of commodity also arguably captures all asset underliers to futures contracts. By way of background, in the traditional US financial markets, futures are CFTC-regulated exchange-traded contracts to buy or sell a commodity for a specified price and at a specified future point in time. Unlike bilaterally negotiated over-the-counter forward contracts, futures contracts are highly standardized and trade based on precisely defined specifications and lot sizes.

The digital asset market has witnessed indications of the emergence of NFT futures and options trading. For example, NFT futures smart contracts are minted based on fractional values of Digital Native NFTs or Digital Native NFT collections which allow market participants to gain exposure to a particular NFT or collection without actually owning it. Furthermore, the use of metrics such as NFT collection floor prices to value Digital Native NFTs and the emergence of option transactions thereon may indicate that standardized futures and options trading could have more ample liquidity than first expected.

The mere existence of an NFT futures and options market, however, is not conclusive evidence that NFTs are commodities. For example, single stock futures contracts are securities futures products regulated by both the Securities and Exchange Commission (SEC) and the CFTC. They constitute both a futures contract and a security. The fact that the single stock trades as the reference asset to a futures contract does not recharacterize the underlying asset into a commodity.

To further complicate the regulatory history, differing views exist on the appropriate interpretation of the Futures Qualifier to the definition of a commodity under Section 1a(9) of the CEA. On the strictest reading, the Futures Qualifier means that a particular item or thing cannot constitute a commodity unless futures are traded on that specific item or thing. However, this reading may be overly narrow. An alternative view is that the Futures Qualifier is satisfied so long as futures are traded on another item or thing that belongs to the same category as the item or thing in question, even if futures are not traded on that specific item or thing. This interpretation is implicit in the motion to dismiss decision of Judge Rya Zobel of the US District Court for the District of Massachusetts in *CFTC v. My Big Coin Pay, Inc.*[11] An even broader interpretation is that the Futures Qualifier requires only the potential for — but not the actuality of — trading in futures on the category of commodity. This view most closely aligns with that of the CFTC when it declared that Bitcoin and Ether constituted commodities prior to the development of Bitcoin and Ether futures in the US.

Accordingly, depending on the interpretation, the current NFT-based futures may or may not be dispositive. Moreover, any interpretive analysis cannot be viewed in a regulatory vacuum. There are political interests at stake and while the CFTC undoubtably has a keen interest in preserving market integrity and protecting customers within its jurisdictional ambit, the SEC has certainly planted its flag in the NFT market by asserting regulatory concerns and targeting NFT projects for enforcement (for more information, see these Latham posts here and here.)

While the market demands clarity and the regulators generally remain silent, attention to the regulatory history may further support or negate the case for an NFT to be a commodity. The ultimate arbiter will be the regulator (or the legislature through statutory clarity).[12]

Implications of NFTs Being Deemed Commodities

If a particular NFT or NFT project is deemed a commodity for CFTC regulatory purposes, a number of potential implications result.

The CFTC has plenary regulatory and supervisory authority with respect to most commodity derivatives — i.e., futures, options, or swap contracts referencing a commodity underlier. The CEA and CFTC Rules impose a range of regulatory requirements with respect to such transactions, including various exchange and intermediary registration requirements. Accordingly, if a particular NFT or NFT project were deemed to constitute or involve a commodity, derivative transactions with respect to such NFTs would trigger CFTC regulatory licenses and requirements. NFT options protocols would need to be registered as designated contract markets or swap execution facilities in order to service, accommodate, and facilitate US customer trading. In such circumstances, however, consideration would also need to be given to whether an NFT-based derivative instrument that results in actual delivery of the relevant NFT can (or should, as a policy matter) qualify for the forward contract exclusion from swap status or the trade option exemption.

Separately, we note that the CFTC regulates certain retail leveraged, margined, or financed purchases of commodities as if such transactions were futures contracts. Accordingly, if a particular NFT or NFT project were deemed to constitute or involve a commodity, leveraged, margined, or financed trading in such NFTs would trigger CFTC regulatory obligations. Finally, if a particular NFT or NFT project is deemed to constitute or involve a "commodity" for CFTC regulatory purposes, the CFTC would retain enforcement authority to police against fraud and manipulation in spot NFT markets — notwithstanding the lack of any relevant derivative instrument or leverage, margin, or financing.

In all cases, each of the commodity status and CFTC regulatory implications of a particular NFT or NFT project warrants careful consideration and analysis.

If you have questions about this Client Alert, please contact one of the authors listed below or the Latham lawyer with whom you normally consult:

Yvette D. Valdez
yvette.valdez@lw.com
+1.212.906.1797
New York

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Endnotes

[1] 7 U.S.C. § 1a(9).

[2] *In re Coinflip, Inc.*, CFTC No. 15-29, at 3, 2015 WL 5535736 (Sept. 17, 2015).

[3] See, e.g., *In re BFXNA Inc.*, CFTC No. 16-19, at 5-6, 2016 WL 3137612, at *5 (June 2, 2016) ("[V]irtual currencies are encompassed in the definition [of the CEA] and properly defined as commodities"); *Commodity Futures Trading Comm'n v. McDonnell v. HDR Global Trading Ltd. et al.*, No. 20-cv-8132 (S.D.N.Y. Oct. 1, 2020); *In re Coinbase, Inc.,* CFTC No. 21-03, at 4, 2020 WL 1101461 (Mar. 19, 2021) ("Bitcoin is encompassed within the broad definition of "commodity" under Section 1a(19) of the Act . . . and is therefore subject to applicable provisions of the Act and Regulations, which includes Section 6(c)(1) of the Act and Regulation 180.1(a)"); *In re Tether Holdings Limited, et al.,* CFTC No. 22-4, at 8, (Oct. 15, 2021) ("Digital assets such as bitcoin, ether, litecoin, and tether tokens are commodities").

[4] See, e.g., *Commodity Futures Trading Comm'n v. McDonnell*, 287 F.Supp.3d 213, 228 (E.D.N.Y. 2018) ("Virtual currencies can be regulated by CFTC as a commodity."); *Commodity Futures Trading Comm'n v. My Big Coin Pay, Inc.*, 334 F. Supp. 3d 492, 495 (D. Mass. 2018).

[5] Retail Commodity Transactions Involving Certain Digital Assets, 85 Fed. Reg. 37734 (Jun. 24, 2020), *available at* https://www.govinfo.gov/content/pkg/FR-2020-06-24/pdf/2020-11827.pdf (Actual Delivery Interpretation).

[6] Actual Delivery Interpretation, 85 Fed. Reg. at 37741.

[7] Actual Delivery Interpretation, 85 Fed. Reg. at 37741.

[8] Agricultural Commodity Definition, 76 Fed. Reg. 41048 (Jul. 13, 2011), *available at* https://www.govinfo.gov/content/pkg/FR-2011-07-13/pdf/2011-17626.pdf (Agricultural Commodity Rule).

[9] 17 C.F.R. § 1.3.

[10] Agricultural Commodity Rule, 76 Fed. Reg. at 41053.

[11] *My Big Coin Pay, Inc.*, 334 F. Supp. 3d at 498 ("Here, the amended complaint alleges that My Big Coin is a virtual currency and it is undisputed that there is futures trading in virtual currencies (specifically involving Bitcoin). That is sufficient, especially at the pleading stage, for plaintiff to allege that My Big Coin is a "commodity" under the Act").

[12] Of note, no bills introduced to date at the time of this publication address the characterization of an NFT. Only one bill, the Digital Asset Market Structure Bill, would require that the Secretary of Commerce, the White House Office of Science and Technology, the SEC, and the CFTC conduct a study on NFTs, addressing market size, scope, role, nature, mechanics, and use; comparison and interaction with other digital assets; benefits of verifiable digital ownership; general risks including intellectual property, cybersecurity, and market risks, and the risks of NFT integration into traditional markets; and the levels and types of illicit activities in the NFT market.