



UNIVERSITY *of* NICOSIA

Session 10

Financing Models for NFTs and the Metaverse

META-511: Non-Fungible Tokens (NFTs) and the Metaverse

We are here

1. What is an NFT?
2. Copyright and Provenance in NFTs
3. PFPs
4. Art NFTs
5. Generative Art
6. Key Considerations in the NFT Space
7. Gaming NFTs
8. What is a Metaverse?
9. Trends in Visualization Technology
- 10. Financing Models for NFTs and the Metaverse**
11. Off-chain objects and the broader environment
12. A vision for the future

Week 10 →

Understanding Financing Models

- Understand the key frameworks of US securities law that shape financing models
- Understand the key financing models in use today

Note: The focus of this session will be US law. Today's session is very much NOT meant to be legal advice. Securities law is very complicated and specific. If you believe you have securities laws issues, please engage a qualified lawyer

This is an educational course only

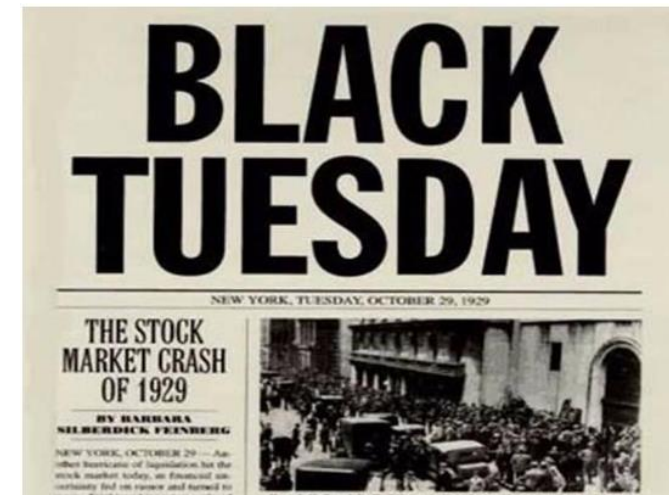
- We will discuss various projects, individuals or NFTs in this course
- These projects, tokens or the individuals associated with them, are only referenced for educational purposes
- Nothing in this course should be taken as a recommendation to buy or sell an NFT or token or any other financial instrument or security
- More generally, cryptoassets are extraordinarily volatile investments. Please take care if you are buying cryptoassets
- The information provided during this session does not, and is not intended to, constitute legal advice.
- Instead, all information, content, and materials made available is intended for general educational purposes only.

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1. Some Relevant Snippets of USA Securities Law

How is the securities regulation set up?

- The development of federal securities law was spurred by the stock market crash of 1929, and the resulting Great Depression.
- Congress enacted the Securities Act of 1933 (the "Securities Act") and the Securities Exchange Act of 1934 (the "Exchange Act"). Securities and Exchange Commission(SEC)
- Other securities laws:
 - Trust Indenture Act of 1939
 - Investment Company Act of 1940
 - Investment Advisers Act of 1940
 - Sarbanes-Oxley Act of 2002
 - Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010
 - Jumpstart Our Business Startups Act of 2012



What qualifies as an investment contract?

The Howey Test is a 4-part test

1. An investment of money
2. In a common enterprise
3. With the expectation of profit
4. To be derived from the efforts of others



If your proposed investment meets all four tests, congratulations you have created a security under US law!

Who may trade and purchase unregistered securities?

Accredited investors

- Annual income > \$200K (\$300K w/spouse/partner) for last 2 years and upcoming years
- or*
- Net worth > \$1M, excluding primary residence (individually or jointly with spouse/partner)
- or meets certain professional criteria*
- Holder of a Series 7, Series 65 or Series 82 license
- Directors/offices/general partners of the company selling the securities
- Any "family client" of a "family office" that qualifies as an accredited investor
- For investments in a private fund, "knowledgeable employees" of a fund
- or*
- Various similar rules for legal entities

Qualified Purchasers

- Individual or family business > \$5M of investments, not including a family residence
- A trust sponsored and managed for qualified purchasers
- An individual or entity that invests a minimum of \$25M for others and themselves
- Any entity where all owners are qualified purchasers
- Generally the above entities must not have been set up with the sole purpose of investing in a fund

Source: SEC.gov

What does registration mean?

- Registration means you need to file the documentation needed for a public offering (IPO) and ongoing compliance with various regulations relating to public companies
- The main offering document is an S-1
- Registration will generally cost at least 7 figures in compliance costs

Reg A is a crowdfunding exemption

- Regulation A is an exemption from registration requirements—instituted by the Securities Act of 1933—that applies to public offerings of securities
- Reg A was updated in 2015 to allow companies to generate income under two separate crowdfunding tiers representing two different types of investments.
 - Under Tier 1 (maximum of \$20 million), companies don't have ongoing reporting requirements but must issue a report on the offering's final status.
 - Under Tier 2 (up to \$75 million), companies are required to produce audited financial statements and file continual reports, including its final status.

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2. Financing Models

Venture Capital

- Venture Capital funds are private investment funds that allowed to take investments from qualified purchasers and accredited investors
- These investors are typically known as "institutional investors". They include:
 - Pension funds
 - Sovereign wealth funds
 - Family offices
 - Ultra high net worth or high net worth individuals
- VC funds are allowed to invest in unregistered securities.
- They have been the primary source of startup financing in the United States and continue to be the primary source of startup financing for the equity of firms in the NFT space

DAOs

- DAO is an acronym for Decentralized Autonomous Organization. It was originally meant to be used for something like an autonomous smart contract.
- Today the word DAO is used casually in many different ways
- DAOs, in practice, fall into two categories
 - Legally organized DAOs (that are formally accredited investors or qualified purchasers)
 - Not legally organized groups of people making common investments, intermediated by a token (there is some risk that some of these DAOs will be considered unincorporated partnerships)

Token Offerings

- Initial Token Offerings (ICOs) were heavily used in the 2017-2018 era
- Theoretically it is possible to issue a token that is not a security, primarily by virtue of it being sufficiently decentralized
- In practice, the reasons most teams needed the funding from a token offering are sufficiently centralized so that most token offerings in practice are considered by the SEC to be securities

NFT Sales

- Sales of NFTs is a relatively newer funding method
- The NFTs can be PFPs, art NFTs, game NFTs, land NFTs or other 'utility like' NFTs
- If the NFT is not organized in a way that makes it a security, this is fine. It is income to the issuer (taxable) but does not create any securities law issues. For example, an artist minting an Art NFT with no further financial "utility" would generally not be a security.
- It is perfectly possible to issue an NFT however in a way that makes it a security. Certain NFTs that promise profit-sharing or that have casual DAO-like aspects may be securities
- Fractionalization of NFTs also presents some securities law risk

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4. Conclusions

What did we learn?

Takeaways from week 10

- US securities laws tend to have an outsized effect on the financial models used in the cryptoasset and NFT field
- The Howey Test is a principles based test to identify "securities" which can only be sold via registration or to accredited investors
- In practice, for most business opportunities, these securities laws incent most companies to raise money only from accredited investors
- Reg A is a potentially interesting financing model that has only been lightly used to-date in the cryptoasset field
- The most common financing models in the NFT space are venture capital and NFT sales, with DAOs and token offerings playing a smaller role

Further Reading

- [The US Securities Law](#): The Laws That Govern the Securities Industry by investor.gov
- [Framework for “Investment Contract” Analysis of Digital Assets](#): The SEC’s framework for regulating digital assets in order to protect investors and ensure that the market operates fairly and transparently.
- [What’s the Howey Test?](#): An article by Bloomberg explaining the Howey test and why does it matter in crypto space
- [The Howey test](#): A set of rules that determine if an investment is a security
- [Accredited Investors vs. Qualified Purchasers](#): An article determines the two categories and shows what you need to know about them
- [DAOs](#): An article explaining the concept of DAOs and how they work



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Questions?

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