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Texas, Alabama Regulators Order Halt to Virtual Casino NFT Sales, Alleging They Constituted an Offering of Securities and Misled Buyers

In the non-fungible tokens (NFT) space, many have focused their attention on how the Securities and Exchange Commission (SEC) may view these digital assets. However, state laws are important, as well, as evidenced by recent actions by Texas and Alabama securities regulators to shut down an NFT project that the regulators concluded violated their respective state's securities laws. These developments highlight how the manner in which NFTs are sold and promoted can render them securities.

Sand Vegas Casino Club Sells NFTs

In December 2021, the founders of the Sand Vegas Casino Club began offering 11,111 "Gambler" NFTs and 1,111 higher-end "Golden Gambler" NFTs for sale through the OpenSea NFT marketplace in order to fund and build virtual casinos accessible through both the Internet and various metaverses. Of the Gambler NFTs, 334 were reserved for members of the team developing the Sand Vegas Casino Club, and for marketing the casinos and awarding prizes to virtual gamblers.

The NFTs entitled holders to various benefits, including a pro rata share of future profits from the casinos, along with other perks such as free entry into weekly tournaments, access to exclusive events, and guaranteed entry into a monthly lottery that included rewards such as airdrops, cash, iPhones and MacBooks, and Tesla automobiles.

The founders reportedly advertised that the Gambler NFTs could generate profits of up to $24,480 per year, while the figure for Golden Gambler NFTs could reach up to $81,000 annually.

Meanwhile, in January 2022, hackers stole more than $150,000 worth of ethereum cryptocurrency from users of the Sand Vegas Casino Club Discord, but the founders did not disclose the hack to law enforcement or any regulatory agency.

Texas and Alabama Issue Emergency Cease-and-Desist Orders

In April 2022, securities regulators in Texas and Alabama issued parallel emergency cease-and-desist orders against the Sand Vegas Casino Club, ordering the developer and its founders to immediately stop selling Gambler and Golden Gambler NFTs. The states alleged that the company sold the NFTs through an unlawful securities offering and also defrauded the public.

Texas Order: In its emergency cease-and-desist order, the Texas State Securities Board called the Sand Vegas Casino Club "an illegal and fraudulent securities scheme" that would cause "immediate and irreparable harm to the public." The order stated that the Sand Vegas Casino Club founders misled potential customers by claiming the NFTs were not regulated by securities law and that they could avoid regulation by "adding illusory terms" and using different terminology when describing the payment of profits to owners of NFTs.

The order further alleged that the founders concealed their locations, hid the identities and qualifications of company managers, and obscured the significant risks associated with investing in their NFTs. The founders also allegedly deceived customers by claiming the NFTs would "at least triple or quadruple" in value.

Additionally, while the Sand Vegas Casino Club has no association with the Las Vegas Sands Corporation, the Texas regulator alleged that the founders used a similar logo and color scheme that would cause investors to materially confuse the two entities.

Alabama Order: Alabama regulators simultaneously issued an emergency cease-and-desist order against the Sand Vegas Casino Club, stating that the NFTs "constitute investment contracts and certificates in or under profit sharing agreements" and thus were subject to state securities law.

The Alabama order closely tracks the Texas order, including allegations that the founders failed to disclose material facts to investors. For example, both states alleged that the founders did not disclose the value of creator royalties it would receive from OpenSea based on sales of the Gambler and Golden Gambler NFTs.

While OpenSea was not a respondent to either order, the regulators said they would be sending the orders to OpenSea to notify it that it was offering securities available for sale in Texas and Alabama. As of April 20, 2022, it appeared that the Gambler and Golden Gambler NFTs were no longer available or visible on OpenSea.

Both the Texas and Alabama authorities concluded in their orders that:

- The Gambler and Golden Gambler NFTs constitute "securities" as defined in their respective state statutes;
- The founders were violating state securities law by offering securities for sale without registering them in those states;
- The founders were engaging in fraud in the offer and sale of the securities, including by making materially misleading and deceptive statements; and
- The founders' conduct, acts and practices threatened immediate and irreparable harm to the public.

As of April 20, 2022, the Sand Vegas Casino Club appeared still to be operational, though its website stated that all NFTs have been sold out and it no longer referred to the NFTs generating passive income.

Key Takeaways

- Industry participants should remain cognizant that, in addition to the federal securities laws, each state has its own securities laws that could apply to the offer, sale or promotion of NFTs.
- NFTs should not be seen as automatically exempt from securities laws. As with any asset, they can be structured or promoted in a manner that may violate federal or state securities laws. In the case of Sand Vegas Casino Club, the promoters were explicitly selling NFTs to fund the creation of casinos and offering purchasers a share of the profits generated.
- Merely stating that an NFT is not a security does not absolve an issuer of liability, and in some cases can form the basis of an allegation that the issuer misled purchasers.
- The Texas order lists a number of material risk factors that the Sand Vegas Casino Club promoters failed to disclose, providing guidance to what at least one state considers to be important to disclose to purchasers:
  - Bad actors may hack or exploit systems and steal NFTs;
  - Legislation or regulation could be adopted that negatively impact the use, transfer, exchange or price of NFTs;
  - NFTs compete with other digital assets, and this competition may negatively impact the price of an NFT;
  - The market for NFTs is new and volatile, and the price of an NFT relative to fiat currencies may greatly decrease over a short period of time, impacting the liquidity and the price of the NFT;
  - Bad actors may attempt to impersonate owners of NFTs, counterfeit NFTs, sell replicas of original NFTs or misuse art tied to NFTs; and
  - Businesses or organizations that issue NFTs may go out of business, declare bankruptcy or cease operations, thereby decreasing the use or value of its NFTs.
- Given the new and rapidly-evolving digital asset space, those contemplating issuing NFTs should consult experienced securities counsel.