A Picture is Worth a Thousand Pixels: NFT Liquidity through Fractionalization

In March 2021, Mike Winkelmann, a digital artist also known as Beeple, sold an NFT of his work for $69 million.[1] Prior to this piece, Beeple's highest NFT sale was $100. This record NFT sale positioned Beeple among the top three wealthiest living artists. But, this particular sale differed from typical artist transactions because enjoyment and ownership of the artwork does not remain in exclusive control of the buyer.[2] There are innumerable copies that anyone on the internet can access and download. This brings the question puzzling everyone observing the recent NFT craze: If the buyer doesn't own the work, what is the incentive in buying it?

Given the high price tags and high profile buyers, many spectators simply see the NFT movement as a bubble for the rich to play in. However, embracement of NFTs by traditional establishments signals a more concrete future. Thus, investors must find greater liquidity to find longevity in their investments. Liquidity is a major challenge in the NFT sphere due to the restriction of exchange in the secondary market. Lack of liquidity further dampens the incentive to invest in high-value NFTs as investors cannot easily flip the asset for money. In addition, there are significant information barriers for investors who seek to participate in the exchange given the technological background and novelty of the area.[3] This leads to a smaller pool of potential participants for each sale.[4] Fractionalizing NFTs may be a viable solution to introducing liquidity to the NFT market. Fractionalized NFTs are NFTs split into smaller pieces by their original owner.[5]

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[1] Jacob Kastranakes, *Beeple sold an NFT for $69 million*, THE VERGE (Mar. 11, 2021), https://www.theverge.com/2021/3/11/22325054/beeple-christies-nft-sale-cost-everydays-69-million
[2] Elena Debre and Aaron Mak, *How in the World Did a "Digital Artwork" Sell for $69 Million at Christie's?*, SLATE (Mar. 11, 2021), https://slate.com/technology/2021/03/beeple-auction-christies-nft-69-million-explained-why-why-why.html
[3] *Why NFTs can be a riskier investment than cryptocurrencies*, COINTELEGRAPH (Oct. 1, 2021), https://cointelegraph.com/news/why-nfts-can-be-a-riskier-investment-than-cryptocurrencies-report
[4] *Id.*
[5] Edward Wilson, *What are fractionalized NFTs?*, ARGENT (Sep. 3, 2021), https://www.argent.xyz/learn/fractionalized-nfts/#:~:text=are%20fractionalized%20NFTs%3F-

For example, the *First 5000 Days* could be split into its component pieces and sold for 1/5000th of the total NFT price. This makes it possible for high-value buyers to earn liquidity on their assets by opening a market for wider participation and allowing investors to discover fair prices.[6]

Fractionalized NFTs may come across SEC oversight as an investment contract under the *Howey* test. In order to combat the Howey Test and aid the crypto sector, SEC commissioner, Hester Peirce, noted that she hopes for a collaboration with SEC chairman, Gary Gensler, to develop a safe harbor plan that would reduce the regulatory scrutiny over new digital assets on the blockchain.[7] This plan includes a window for token issuers to build decentralized networks to prove that securities laws do not apply to their projects.[8] With an optimistic outlook from the SEC, it is possible that companies could decentralize their fractional NFT platforms in a way that bypasses the "efforts by others" prong of the *Howey* test.

This model would involve an on-chain, open-source smart contract to allow anyone to submit an NFT to the smart contract and receive back fractionalized NFTs in return.[9] These fractional NFTs would not require promoter efforts to maintain a ledger or ensure transferability because they are created on an existing open-source standard like the Ethereum blockchain, which allows holders to directly transfer their fractional NFTs on chain without reliance of any third party.[10] This kind of decentralized technology takes issuers and promoters out of the underlying transaction, making it more akin to a Bitcoin or Ethereum system which has been given greater autonomy to operate by the SEC.

,Fractionalized%20NFTs%20are%20NFTs%20split%20into%20smaller%20pieces%20by%20their,locked%20into%20a%20smart%20contract.

[6] *Id.*

[7] Anthony Lehrman, *Selling Fractionalized NFTs Could Break the Law*, CRYPTOBROWSER (Mar. 26, 2021), https://cryptobrowser.io/news/selling-fractionalized-nfts-could-break-the-law-says-sec-commissioner/

[8] *Id.*

[9] *Id.*

[10] *Id.*

Uncertainty in the NFT market is met with greater uncertainty in the legal space. The SEC has not publicly filed any enforcement cases against NFT or fractional NFT companies. With no pending guidance or announcements from the SEC, it is likely that the commission will continue to observe the technology and burgeoning market before stepping in as regulators. This gives fractional NFT companies, creators, issuers, and platforms the time needed to adjust their processes to avoid potential SEC regulation. By implementing smart contract and distributed ledger mechanisms into their platforms, companies will have a stronger argument against *Howey's* "efforts of others" prong.

Fractional NFTs can add liquidity to the market by allowing high roller investors to profit from a wider pool of everyday investors looking to participate at a lower price. Fractional NFTs could meet SEC regulation under *Howey*, but given the SEC's slow response to cryptocurrency, platforms may be able to structure their exchanges in a way that bypasses the *Howey* test.

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