Bull Blockchain Law LLP

A BOUTIQUE FIRM WITH A GLOBAL PERSPECTIVE

CLIENT ALERT

SEC Alleges NFTs Are Securities in Two Recent Enforcement Actions

By: Tyler Harttraft, Esq.

September 20, 2023

It's September 2023, and the SEC has come for NFTs.

Last month, the SEC announced a $6 million settlement with Impact Theory LLC in connection with its unregistered offering and sale of NFTs in which it raised approximately $30 million for the development of its media business.

On September 13th, the SEC fined SC2, the entity behind the popular and celebrity-backed web series Stoner Cats, $1 million for tis sale of NFTs to fund the production of a new TV show.

Both cases are unfortunate because the SEC has not provided any guidance regarding which characteristics of NFTs are problematic. These enforcement actions add to the legal ambiguity faced by creators who aim to use blockchain technology and Web3 to build and engage with audiences. It is clear, however, from these two cases that express statements that a token or NFT will appreciate in value, or that the purchasers may realize a benefit from the success of the project, may summon scrutiny by the SEC.

In the Matter of Impact Theory, LLC

According to the SEC's order, from October to December 2021, Impact Theory offered and sold three tiers of NFTs, known as Founder's Keys. The order finds that Impact Theory violated federal securities laws by offering and selling the NFTs that were investment contracts to the public in an unregistered offering that was not otherwise exempt from registration.

The order cites public statements from the company's founders on platforms like YouTube and Discord in which they encouraged potential purchasers to view the purchase of a Founder's Key as an investment in the business, stating that investors would profit from their purchases if Impact Theory was successful in its efforts. Impact Theory emphasized that it was "trying to build the next Disney," and, if successful, it would deliver "tremendous value" to Founder's Key purchasers. The company allegedly said it planned to invest proceeds from the NFT sales into the development of the platform and the hiring of staff. The SEC also alleged the business used a portion of the $29.8 million it raised from the sales to pay certain vendors.

The order requires ImpactTheory to pay pay disgorgement of $5,120,718.27, prejudgment interest of $483,195.90, and a civil money penalty of $500,000 to the Securities and Exchange Commission. It also requires that the company destroy the NFTs in its possession and revise the smart contract code to prevent the payment of royalties.

Two of the five SEC commissioners disagreed with the application of the *Howey* analysis. Hester Peirce and Mark Uyeda published a dissent stating that "the NFTs were not shares of a company and did not generate any type of dividend for the purchasers." They went on to state "[w]e do not routinely bring enforcement actions against people that sell watches, paintings, or collectibles along with vague promises to build the brand and thus increase the resale value of those tangible items."

The dissenting commissioners also took issue with the appropriateness of an enforcement action for this matter even assuming the SEC's analysis is correct. The typical cure for a registration violation is a rescission offer, which the company made by establishing a repurchase program for primary and secondary-market purchasers. In total, the company repurchased $7.7 million worth of NFTs in Ether. This means a significant portion of investors did not resell their NFTs.

The dissenters raise important questions, such as whether securities laws are the best mechanism for regulating sales of NFTs and how this precedent of restricting royalty payments to creators will impact future cases.

In the Matter of Stoner Cats 2, LLC

On September 13, 2023, the Securities and Exchange Commission charged Stoner Cats 2 LLC (SC2) with conducting an unregistered offering of crypto asset securities in the form of non-fungible tokens (NFTs) that raised approximately $8 million from investors to finance an animated web series called Stoner Cats.

According to the SEC order, SC2 offered and sold to investors more than 10,000 NFTs for approximately $800 each and conducted a marketing campaign touting various benefits of owning them. These benefits included the option for owners to resell their NFTs on the secondary market. The SEC also alleged that the SC2 team emphasized its expertise as Hollywood producers, its knowledge of crypto projects, and the well-known actors involved in the web series, leading investors to expect profits from the resale value of the NFTs in secondary markets if the web series was successful. According to the SEC, SC2 used the offering proceeds to compensate coders, writers, animators, and others working on the project.

The SEC also alleged that the StonerCats NFTs provided SC2 with a royalty of 2.5 percent for each secondary market transaction in the NFTs, although it is unclear how this fact impacts the SEC's *Howey* analysis. Importantly, SC2, not the holders of the NFTS, was entitled to the royalty.

Takeaways

1. **Public Statements Touting Appreciation Will Draw Scrutiny**

ImpactTheory published numerous statements likening its FounderKeys NFTs to getting in on the ground floor of high-value companies. This clearly can set an expectation of profits for the purchasers, which is a key prong of the *Howey* test. In contrast, SC2 did not make express promises that the NFTs would increase in value or that purchasers would be entitled to proceeds of the business. Instead, it promised exclusive access to content, and the SEC likely would have faced difficulty in proving that the purchasers expected to realize profit from the efforts of SC2 as opposed to secondary market forces.

2. Royalty Programs Under Fire

ImpactTheory and SC2 both received royalties from sales of their respective NFTs. Impact Theory received a 10% royalty on secondary market sales of its NFTs, and SC2 received a 2.5% royalty for all transactions. Notably, neither order alleges the royalties would be distributed to holders of the NFTs. Nevertheless, these cases signal the SEC may view such royalty structures as creating an expectation of profits based on the efforts of others if purchasers stand to benefit from appreciation of their NFTs as a result of efforts paid for using proceeds of such royalty programs.

3. The SEC Is Doubling Down On A Dubious Theory

In both cases, the SEC alleges the NFTs themselves are securities. The decision by Judge Torres in the Ripple case rejects the concept that tokens themselves, rather than the agreement between the purchaser and the issuer, constitute an investment contract. These cases indicate the SEC will not abandon this position until Congress or a higher court decides the issue.

Conclusion

These cases leave many unanswered questions for game developers, artists, and other creators and sellers of NFTs. We will be watching for additional enforcement actions and tracking legislative developments closely to determine the best course of action for our NFT clients.

Author

Tyler J. Harttraft, Esq.
tyler@bullblockchainlaw.com

Tyler Harttraft is a Partner at Bull Blockchain Law LLP, focusing his practice on corporate law, capital markets law, and financial regulations. Tyler provides strategic advice on the regulation of blockchain technology and digital assets. As counsel to various blockchain and cryptocurrency clients, Tyler provides critical legal advice on cryptocurrency, exchanges, non-fungible tokens (NFTs), decentralized autonomous organizations (DAOs), decentralized finance (DeFi), securities and commodities laws compliance, gaming platforms, governance token structures, and venture financing. Tyler also advises a wide range of clients interacting with or investing in blockchain technology, including start-ups and emerging companies, publicly traded companies, regulated financial services entities, fund managers, and money services businesses.