

THE SEC PLUNGES INTO THE NFT SPACE: WHEN “SMART CONTRACTS” BECOME “INVESTMENT CONTRACTS”

In recent weeks, the U.S. Securities and Exchange Commission (SEC) has staked its claim to new territory in the digital asset arena: nonfungible tokens (NFTs). The SEC brought two enforcement actions against companies launching NFTs (the “NFT Actions”). Up until now, the SEC has focused its efforts on developers and promoters of the NFT’s cousin, cryptocurrencies, with multiple enforcement actions brought against those in the industry. NFTs have been considered a safe space from the SEC, providing a means for artists, authors, musicians and photographers to distribute and monetize their work without the need for traditional commercial middlemen. Likewise, NFTs have been used for event tickets, and owners of major brands and trademarks have used NFTs in the advancement of new frontiers in the collectibles space, including sports memorabilia, digital trading cards and superhero digital paraphernalia.

Headlines of the SEC’s latest entry into the digital asset space raise very concerning thoughts. Can NFTs truly be considered securities? Is this another example of government trying to thwart the digital revolution’s push to efficiency? In many situations, the answer to these questions would be ‘no.’

BACKGROUND

The legal theory underlying both NFT Actions is that the NFTs were “investment contracts” and, thus, securities. The question of whether any economic transaction is an investment contract is guided by the 1946 U.S. Supreme Court case of *SEC v. W.J. Howey Co.*^[i] Under the *Howey* test, an “investment contract” is any “contract, transaction, or scheme whereby a person [(i)] invests his money [(ii)] in a common enterprise and [(iii)] is led to expect profits solely from the efforts of the promoter or a third party.”^[iii]

If a transaction falls within the definition of a security, it opens the door to securities regulator jurisdiction and the application of the full array of state and federal securities laws. While the SEC has applied *Howey* to a number of cryptocurrencies, until recently, the agency has never applied it specifically to NFTs.

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THE RECENT SEC ENFORCEMENT ACTIONS

The First Action

The SEC charged a media company with violating Section 5 of the Securities Act of 1933 (1933 Act) alleging that its sale of NFTs were an illegal unregistered offering and sale of securities.^[iii] The media company sold three tiers of NFTs. Each NFT contained a digital graphic featuring a combination of four symbols, with 50 possible combinations. The media company represented that the proceeds from the NFTs would be used to “build the next Disney,” by enabling the media company to develop business and content, adding additional staff and creating additional media projects over the next 18 to 24 months.

In advance of the NFT offering, the media company engaged in a promotional campaign via a Discord channel, YouTube and the media company’s website and social media channels. During the promotional campaign, the media company pitched the NFTs to potential purchasers as it would typically pitch investors in a business. The media company promised that the NFTs would deliver “tremendous value” and the NFTs’ future value would significantly exceed the purchase price. The “upside to be largely captured by [the buyers]” represented up to 90% of the potential media company value. The media company also touted that the “NFTs are the mechanism by which communities will be able to capture the economic value from the growth of the company they support.” “Buying the [NFTs] is like investing in Disney, Call of Duty and YouTube all at once.” The media company also promoted that the NFTs could be resold on at least two crypto asset trading platforms.

The media company sold almost 14,000 NFTs, raising \$28.9 million. On the secondary market, the underlying NFT smart contract provided that the Media company would receive a 10% royalty on each secondary market sale. The media company netted nearly \$1 million in aftermarket sales.

The SEC obtained a cease-and-desist order in the case, \$5.6 million in disgorgement and prejudgment interest, and a \$500,000 civil penalty. The media company also had to destroy any unsold NFTs and rewrite the smart contract eliminating the 10% secondary market royalty payment.

The Second Action

Next, the SEC charged a production company with violating Section 5 of the 1933 Act for its sales of NFTs.^[iv] The production company stated that the purpose of the NFTs was to fund the production of an animated web series, future productions and the development of an online community. Each NFT would feature a unique image of one of the series’ animated characters. An owner of the NFT could view the series once released, have access to other content related to the series, and view any future project series. The proceeds would be used in the production of the animated series featuring a team of animators and writers with major Hollywood experience, and well-known

voiceover actors. The NFT sales process was described as an approach that could “revolutionize the financing and production of entertainment content.”

The production company promoted the NFTs on its website and social media channels, on YouTube, Twitter, Instagram and Discord, and during interviews on network and cable television shows. As part of the marketing efforts, the production company analogized the NFTs to “tickets” and “if people don’t appreciate it, you can take that ticket and sell it” on the secondary market. While only one NFT was needed for these perks, there were no limits on the amount of NFTs each buyer could purchase. The production company had previously arranged for the NFT resale on one crypto asset trading platform. The production company sold the entire allotment of over 10,000 NFTs in 35 minutes, receiving approximately \$8.2 million. The production company also minted 100 additional NFTs that were held back for future use. Under the NFT smart contract, the production company received a 2.5% royalty on all secondary market sales. After the release, the production company encouraged the public to buy the NFTs on the secondary market.

The production company agreed to the entry of a cease-and-desist order, the destruction of any unissued NFTs, and payment of \$1 million civil money penalty.

TAKEAWAYS

Based on their current actions, the SEC does not appear to be seeking to regulate NFTs in a wholesale manner. The NFT Actions – while no substitute for clearly thought-out promulgated rules and regulations – do provide a bit of a road map. The SEC appears to be focusing on the use of NFTs in ways typically found in the world of business finance. Businesses typically sell equity securities (stocks) or issue debt (bonds) to raise funds for the development of their businesses or provide operating capital. As such, these businesses typically sell the securities to investors who hope the profit will follow. Where the use of NFTs approaches these areas, caution must be taken. The SEC claims to focus on the economic realities of transactions, not the titles used in the public market. Investment in NFTs unrelated to business financing may continue to be unregulated for now. However, there are no bright lines.

The question of whether an NFT is a security depends on the facts and circumstance of each case. There are, however, features of the NFT Actions that can help guide the analysis of whether NFTs may be deemed an “investment contract.”

- **The intended use of the NFT sales proceeds:** Both NFT Actions focused on the proposed use of the NFT proceeds. Both were very similar to conventional business financing efforts. Both companies sought to use the resulting proceeds to fund the development of their business venture. In essence, they were looking for seed capital from which a

successful long-term venture would benefit.

- **NFT promotion matters:** The NFT Actions focused on the aspects of marketing that highlighted the opportunity for financial gain that could result from the acquisition of NFTs. The marketing efforts tied the degree of value accretion to the success of the company going forward as a means of capturing financial gain. The focus was not on the NFT's potential gain in value due to the unique inherent value of the digital commodity. Instead, the potential value gain, at least in part, focused on reliance on the "efforts of others." This factor implicated a key requirement under the *Howey* test.
- **Creating and supporting the secondary market demand:** Both companies actively took steps to ensure that prospective NFT purchasers had an available secondary market before the NFT release. They promoted this fact to their prospective purchasers. Moreover, their social media efforts post-launch propped up the demand. Of course, it did not help, given the promotional efforts, that both sets of smart contracts ensured that each company received a royalty on each secondary market sale.

Not surprisingly, the issue of whether NFTs are securities raises considerable legal and policy questions, even amongst the five SEC commissioners. In response to the NFT Actions, Commissioners Hester M. Pierce and Mark T. Uyeda released public dissents and argued that the SEC had gone too far.^[v] They were critical of the SEC's application of the *Howey* test to NFTs. They pointed out that the SEC arbitrarily applied different standards to NFTs than it would to comparable physical objects, like limited edition prints of artwork or other collectibles. This step, without clear guidelines, endangered an avenue whereby the artistic community can monetize their efforts. Moreover, the enforcement actions also endanger fan crowdfunding, another "common phenomenon in the world of artists, creators and entertainers."

^[i] *SEC v. W.J. Howey Co.*, 328 U.S. 293 (1946).

^[ii] *Id.* at 298-99.

^[iii] *In re Impact Theory, LLC*, Securities Act Release No. 1126 (Aug. 28, 2023).

^[iv] *In re Stoner Cats 2, LLC*, Securities Act Release No. 11233 (Sept. 13, 2023).

^[v] <https://www.sec.gov/news/statement/peirce-uyeda-statement-nft-082823>;
<https://www.sec.gov/news/statement/peirce-uyeda-statement-stonercats-091323>



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