

## SEC's Move on NFTs Continues Pattern of Case-by-Case Regulation

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Last week, the SEC filed its first ever enforcement action on non-fungible tokens, charging a media and entertainment company with conducting an unregistered sale of NFTs called “Founder’s Keys.”

Although the issuer, Impact Theory, immediately settled the enforcement action, the SEC’s apparent determination to regulate digital assets beyond cryptocurrency may raise a thorny precedent.

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## **‘The Next Disney’**

In late 2021, Impact Theory offered to the public three tiers of its Founder’s Key NFTs—Relentless, Heroic, and Legendary—sold at escalating prices. Impact Theory, which advertised it was “trying to build the next Disney,” wasn’t modest about the potential “tremendous value” of these NFTs and equated them to “g[etting] in on Disney when they were doing Steamboat Willie.” By December 2021, Impact Theory had raised almost \$30 million worth of ether through its Founder’s Key offerings.

In a divided order issued on Aug. 28, the SEC instituted and simultaneously settled cease-and-desist proceedings against Impact Theory. For the first time in an enforcement action, the SEC took the position that NFTs constitute securities, such that Impact Theory’s failure to register its Founder’s Keys violated the Securities Act of 1933.

In addition to paying \$6.1 million in disgorgement, penalties, and interest, Impact Theory undertook to destroy all Founder’s Keys in its possession and to rewrite the smart contracts underlying the Founder’s Keys to eliminate any royalties it might receive from secondary market transactions. Impact Theory didn’t admit or deny the SEC’s findings.

## Collectible or Security?

In its unprecedented move against NFTs, the SEC continued its practice of quilting a patchwork crypto policy through individual enforcement actions rather than clear-cut regulations.

The SEC again applied the 1946 test laid out by the Supreme Court in SEC v. W.J. Howey to determine whether a specific type of digital asset—here, NFTs—constitute securities that fall within the SEC’s purview.

According to the *Howey* test, an asset is an “investment contract”—and therefore a security—if it requires an investment of money; in a common enterprise; with the expectation of profit; and to be derived from the efforts of others. Assets that don’t qualify as securities under the *Howey* test are classified as commodities.

In characterizing the Founder’s Keys as securities, the SEC primarily focused on Impact Theory’s public statements inviting potential purchasers to view themselves as investors.

To that end, Impact Theory repeatedly shared its view that the fortunes of NFT purchasers were tied up with the company’s success, calling the Founder’s Keys “the mechanism by which communities will be able to capture economic value from the growth of the company that they support.” Moreover, the proceeds were used to develop the company with a view toward delivering value to NFT purchasers.

But not all commissioners were swayed by this logic. In a dissenting statement, Hester Peirce and Mark Uyeda questioned the applicability of the *Howey* test to NFTs, which “were not shares of a company and did not generate any type of dividend for the purchasers.”

Instead, according to Peirce and Uyeda, the Founder’s Shares were more akin to “watches, paintings, or collectibles” where the seller makes vague promises to build the brand and increase the resale value of the tangible commodities.

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## Looking Forward

The SEC’s expansion of its jurisdiction to NFTs is unsurprising. When it relaunched its cyber unit as the Crypto Assets and Cyber Unit in May 2022, the SEC specifically identified NFTs as a focus of its new unit.

And in February 2023, NFT sales formed the basis of a federal insider trading prosecution against digital marketplace OpenSea and its founder, Nathaniel Chastain.

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That said, it's unclear whether the commission intends to set a new precedent for treating NFTs as securities, or whether Impact Theory is simply a case decided on its specific facts. Although the dissent characterizes the facts underlying the NFT offering as "unremarkable," Impact Theory's management specifically touted the investment aspects of the Founder's Keys early and often.

More importantly, the SEC's opinion won't be the final word on the issue. If the SEC continues its regulation-by-enforcement strategy, the question of whether NFTs are securities is one that ultimately will be decided by the courts.

So far, court rulings on digital assets have been all over the map. In July, US District Judge Analisa Torres held that Ripple's XRP token wasn't a security when sold on public exchanges (as opposed to institutional investors)—a decision seemingly headed for an interlocutory appeal to the Second Circuit.

A few months earlier, US District Judge Victor Marrero held that basketball-focused "Top Shot" NFTs did qualify as investment contracts under *Howey* in the context of a securities class action.

Until the courts have their final say on the issue, or the SEC puts pen to paper on formal regulations, the SEC likely will keep NFTs in its crosshairs and apply federal securities laws to NFT offerings in appropriate cases.

NFT creators who don't wish to register their tokens as securities should promote NFTs as collectibles and avoid making claims that explicitly link their future value to the issuer's success.

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