Published on *The National Law Review* https://www.natlawreview.com

The SEC's Sudden Impact on NFTs!

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On August 28, 2023, the Securities and Exchange Commission ("SEC") instituted cease-and-desist proceedings under Section 8A of the Securities Act against Impact Theory, a Los Angeles media and entertainment company, alleging that the company's sale of non-fungible tokens ("NFTs") violated the registration requirements under the Securities Act of 1933 (the "Act").

The SEC's enforcement action is significant because it is the first time that it has charged a company for violating the Act's registration requirements based on the sale of NFTs—as opposed to cryptocurrencies. Over the past year, the SEC has investigated NFTs with a close eye, focused on the manner in which NFTs were marketed, advertised, and sold. The proceeding against Impact Theory, however, is the first time that the SEC has brought an enforcement action alleging that the sale of NFTs was a violation of the Act's registration requirements *per se*. NFTs are different from other tokens that the SEC has attempted to regulate in that each NFT corresponds to a unique smart contract address on the blockchain it calls home. For a more in depth discussion on the details of tokenization, check out our article here.

Impact Theory sold $30 million worth of NFTs and accompanying those sales were numerous promises that the NFTs would increase in value. The SEC charged that the NFTs therefore constituted investment contracts under the 1946 United States Supreme Court case *Securities Exchange Commission v. W.J. Howey.* The SEC in finding the *Howey* test was met reasoned that the NFT's constituted securities because Impact Theory included with the NFT sales promises of increased value. It found that purchasers of the NFT's had a reasonable expectation they would receive a future profit resulting from Impact Theory's managerial and entrepreneurial efforts to "build the next Disney".

However, two Commissioner's disagreed with the SEC's decision to institute Section 8A proceedings. Commissioners Hester M. Peirce and Mark T. Uyeda stated that "Regardless of what one thinks of the Howey analysis, this matter raised larger questions with which the Commission should grapple before bringing additional NFT cases." The dissenting SEC Commissioners further noted, "the NFTs were not shares of a company and did not generate any type of dividend for the purchases." Accordingly, this particular enforcement action raises many "difficult questions" and

the dissent added that the SEC "should have …offered guidance when NFT's first started proliferating." The failure to provide guidance and Impact Theory's willingness to rescind its NFT contracts also moved the dissenting Commissioners to question why an enforcement action was warranted.

There are specific issues that arise in the context of NFTs that do not arise with other types of blockchain tokens, or even traditional securities. One key issue the dissent noted was that: "People are experimenting with a lot of different uses of NFTs. Consequently, any attempt to use this enforcement action as precedent is fraught with difficulty." In essence, the SEC's failure to provide real guidance and attempt to regulate by enforcement is likely to face significant challenges with respect to the application of this precedent to the myriad different circumstances surrounding NFT transactions.

The SEC's approach to cryptocurrency enforcement has frequently felt out of touch with contemporary investor desires to participate in the digital marketplace that is here to stay. The dissent notes this tension: "Is a securities law regime best suited to ensure that NFT purchasers obtain the information they need before buying an NFT? What type of information do these purchasers want? Might other regulatory frameworks be more appropriate?" While the dissent raises these questions, the SEC itself has not shown any willingness to answer them—leaving the industry to wrestle with uncertainty while experimenting with new technology. This is an unenviable position for crypto businesses in light of the recent finding by the D.C. Circuit that the current SEC administration has treated similar crypto products differently when applying its own rules. *See Grayscale Investments, LLC v. Securities and Exchange Commission*, No. 22-1142 (D.C. Cir. Aug. 29, 2023) (holding that denial of bitcoin spot ETF "was arbitrary and capricious because the Commission failed to explain its different treatment of similar products")

It is also worth noting that the SEC's remedies have little to no precedent. The defendant must not only pay disgorgement penalties to fund recovery by the NFT purchasers, but also is required to destroy all of the NFTs that are in its possession, and "[r]evise the smart contract(s) or any other programming code(s) or computer protocol(s) underlying the [NFTs] to eliminate any royalty . . ." The dissent highlights that "one of the promising features of NFTs is the ability to reward creators with royalties every time an NFT they created is sold[.]" The SEC's continued pursuit of this remedy will be important to track, but the dissent's emphasis on this point may be misplaced because there are royalty structures that function more like a license than a security.

The SEC's first Section 8A enforcement action against a non-fungible token was not without internal dissent. It highlights the agency's continued approach to regulation through litigation and not legislation. A "make my day" approach that Commissioners Peirce and Uyeda dissent in effect calls out as one that needs to change. The *Sudden Impact* on the industry due to this enforcement action may be just the thing to make change happen.

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National Law Review, Volumess XIII, Number 251

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