INSIGHT | SEPTEMBER 14, 2023

The SEC's First-Ever Non-Fungible Cryptocurrency Token (NFT) Enforcement Action: Implications for Issuers of Token Offerings

Executive Summary

On August 28, 2023, in a landmark regulatory development, the U.S. Securities and Exchange Commission (SEC) issued a cease-and-desist order against Impact Theory, LLC, for conducting an unregistered sale of its non-fungible tokens (NFTs) called "Founder's Keys." (A copy of the Order can be found here.)

Without admitting or denying the SEC's findings, as part of its settlement, Impact Theory agreed to pay a combined total of more than $6.1 million in disgorgement, prejudgment interest, and penalties.

While SEC enforcement actions within the cryptocurrency industry are on the rise, this case marks the SEC's inaugural move against an issuer of NFTs for selling unregistered securities. This action could potentially signal the SEC's growing commitment to enforcing securities laws within the rapidly evolving digital asset space. It also serves as a reminder to companies engaged in token offerings to thoroughly assess whether their tokens constitute securities and to adhere to the appropriate registration or exemption requirements.

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What are NFTs?

Before diving further into the case, a brief word on NFTs.

NFTs are unique digital identifiers that are recorded using distributed ledger technology and may be used to certify authenticity and ownership of an associated right or asset. Ownership of an NFT may also provide its holder with a right to a digital file—think digital art, digital music, digital trading cards, or virtual real estate—that is separate from the NFT itself.

Alternatively, NFT ownership may provide the holder with a right to an asset that is not a digital file, such as the right to attend a concert or ownership of a physical items such as antiques, sports memorabilia, fine wine, rare books and manuscripts or luxury automobiles.

Unlike cryptocurrencies, NFTs serve a variety of functions, with many of them bearing no resemblance to securities at all. The protean nature of NTFs render them difficult to characterize—and thus regulate. As a result, this first-ever NFT-related enforcement action by the SEC is all the more remarkable.

Case Background

Impact Theory, LLC, a Los-Angeles based media and entertainment company, conducted an offering of unregistered crypto asset securities known as Founder's Keys (KeyNFTs) from October 13, 2021, to December 6, 2021. They raised approximately $29.9 million worth of crypto-token Ethereum (ETH) from hundreds of investors, including those in the United States.

Impact Theory marketed these KeyNFTs to the public as a unique investment opportunity, emphasizing the potential for significant returns and describing them as unlocking the future of the company's projects. Impact Theory likened its aspirations to "building the next Disney" and pledged to deliver "tremendous value" to KeyNFTs purchasers.

Impact Theory also publicly tied its investors' fortunes with those of the founders and the company, stating: "Our goal is to make sure that as Impact Theory is enriched, as [its founders] are enriched, as our team here at Impact Theory is enriched, that you guys also are enriched. And so that is why we are so aggressively behind NFTs."

Given these assertions, numerous prospective and actual purchasers of KeyNFTs stated that they viewed the crypto assets as investments into Impact Theory — publicly declaring that "[t]his is like being offered to invest in a booming company when they're Series A" or "Everyone here is an early adopter! Buying a founders key is Like investing in Disney, Call of Duty, and YouTube all at once."

Are KeyNFTs (Regulated) Securities or (Unregulated) Commodities?

Under the U.S. Supreme Court's seminal "Howey test,"[1] a transaction qualifies as an investment contract and, therefore, as a security under U.S. federal securities laws, if the transaction (i) involves an investment of money, (ii) in a common enterprise, (iii) with a reasonable expectation of profits, (iv)

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

derived solely from the efforts, expertise or managerial skills of others. Assets that fail to meet the criteria for securities under the *Howey* test are categorized as commodities.

According to the SEC, purchasers of KeyNFTs had a reasonable expectation of obtaining future profits based on Impact Theory's managerial and entrepreneurial efforts. As a result, the SEC found that the KeyNFTs were offered and sold as investment contracts, thereby qualifying as securities, and charged that Impact Theory violated Sections 5(a) and 5(c) of the Securities Act of 1933 by offering and selling these securities without registering with the SEC or qualifying for an exemption.

The Order

Based on the SEC's findings and Impact Theory's offer of settlement, the SEC's Order directs Impact Theory to:

- cease and desist from any further violations of Sections 5(a) and 5(c) of the Securities Act
- destroy all KeyNFTs in its possession
- publish notice of the SEC's order on its websites and social media channels
- revise the smart contracts underlying the KeyNFTs to eliminate any royalties that Impact Theory would have received for any future secondary market transactions
- pay disgorgement of $5,120,718.27, prejudgment interest of $483,195.90, and a civil money penalty of $500,000 to the SEC

The Order also establishes a Fair Fund pursuant to Section 308(a) of the Sarbanes-Oxley Act of 2002, ensuring that disgorgement, interest, and penalties are distributed to affected investors.

Dissenting Statement

This action generated both support and dissent within the SEC, highlighting the complexities and uncertainties surrounding the regulation of NFTs and their place in the securities landscape.

In particular, immediately following the Order's publication, SEC Commissioners Hester M. Peirce and Mark T. Uyeda issued a joint statement disagreeing with the SEC's application of the *Howey* test. Their dissenting statement (available here) notes the following:

- **Hype vs. Investment Contract**: While there was hype surrounding the KeyNFTs, the statements made by the company and purchasers "are not the kinds of promises that form an investment contract." The dissent emphasized that these NFTs were not shares of a company and did not generate dividends, and observed that the SEC does 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."

- **Rescission Offer**: As "the typical cure for a registration violation is a rescission offer," which the company already did in the form of repurchase programs, the dissent also questioned whether this case really warranted an enforcement action even if the *Howey* test was met. Impact Theory had

already made efforts to offer a rescission by repurchasing NFTs from primary and secondary market purchasers, returning approximately $7.7 million worth of ETH to investors.

The dissenting statement also observed that the "matter raises larger questions with which the Commission should grapple before bringing additional NFT cases," including questions surrounding the following items:

- **Lack of Guidance on NFTs**: The dissent raised concerns about the lack of clear guidance from the SEC on how NFTs should be treated under securities laws. Noting that "[p]eople are experimenting with a lot of different uses of NFTs," and that NFTs "are not an easy-to-characterize asset class," they encouraged the Commission to find "useful ways" "to categorize NFTs for purposes of thinking about whether and how the securities laws apply to offers and sales."

- **Securities Law Regime** The dissent called for a broader discussion on NFTs, asking questions such as how to categorize NFTs, what type of information purchasers need, and whether other regulatory frameworks might be more appropriate. Given the "unique nature of NFTs," they also asked whether there are alternative approaches for the SEC to categorize NFTs that would "still achieve the Commission's objectives of protecting investors and the integrity of the marketplace."

- **Secondary Market Sales**: They also questioned whether restrictions should apply to secondary market sales of NFTs that were originally sold as investment contracts, and whether such secondary offerings also, by definition, constitute investments.

- **NFT Destruction and Royalty Elimination**: The dissent expressed concerns about the precedent set by ordering the destruction of NFTs and eliminating royalties, and the adverse impact these actions could have on the broader NFT market.

What's Next?

The SEC's first-of-its kind enforcement action against Impact Theory highlights the regulatory scrutiny surrounding the crypto asset market and reinforces the importance of compliance with securities laws. This case serves as a reminder to entities involved in crypto asset offerings to carefully evaluate whether their tokens constitute securities, and if so, to comply with registration or exemption requirements.

The SEC's Order also exemplifies the ongoing debate and challenges in regulating NFTs. While the SEC determined that KeyNFTs constituted securities, the dissenting commissioners called for a more comprehensive discussion on NFTs' regulatory treatment, suggesting critical questions for consideration as the regulatory landscape for NFTs continues to evolve.

As the SEC and Impact Theory ultimately reached a voluntary settlement, the SEC's findings have no precedential value. The question as to whether a court of law would agree that NFTs constitute securities under similar circumstances remains unresolved. That said, for those of us tracking such matters, the

Dapper Labs[2] case currently pending in the U.S. District Court for the District of New York— which earlier this year allowed a securities class action lawsuit to proceed against the issuer of NFTs on the grounds that the NFTs are securities under federal securities laws—may offer some much-needed clarity as to which types of NFTs constitute securities, and which do not. Issuers of NFTs should continue to monitor further developments in this evolving landscape.

In the meantime, companies contemplating offering or selling NFTs should consider the costs associated with operating in a manner consistent with the Impact Theory Order, and the potential consequences for failing to do so. At a minimum, companies who prefer not to register their tokens as securities should market their NFTs as collectibles and refrain from making statements that directly connect their future worth to the issuer's performance. Finally, market participants who have previously sold NFTs to investors should seek guidance from legal counsel to assess the most prudent course of action in light of the SEC's Order, which may include implementing voluntary corrective measures similar to those undertaken by Impact Theory.

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[2] *Friel v. Dapper Labs, Inc.*, No. 21 CIV. 5837 (VM), 2023 WL 2162747 (S.D.N.Y. Feb. 22, 2023).