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The SEC Sows Confusion With NFT Enforcement Action

By Jeffrey Alberts

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On Aug. 28, 2023, the U.S. Securities and Exchange Commission (SEC) brought its first non-fungible token (NFT) enforcement action. In that action, the SEC charged Impact Theory, a media and entertainment company headquartered in Los Angeles, with conducting an unregistered offering of crypto asset securities in the form of NFTs, which Impact Theory called "KeyNFTs."

Two of the SEC's Commissioners, Hester Peirce and Mark Uyeda, dissented from the SEC's decision to initiate an enforcement action on a variety of grounds, including that the KeyNFTs were not investment contracts and therefore were not securities.

Indeed, by treating these NFTs as securities, the SEC appears to be taking a legal position that could sweep a variety of products that never have been viewed as securities, including collectibles, into the category of "investment contract" and thus within the SEC's jurisdiction.

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KeyNFTs as Investment Contracts

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In the SEC's order, it alleges that KeyNFTs were securities because they were offered and sold as investment contracts, and therefore securities, pursuant to the test laid out in *SEC v. W.J. Howey Co.*, 328 U.S. 293 (1946).

In *Howey*, the U.S. Supreme Court held that "an investment contract, for purposes of the Securities Act, means a contract, transaction or scheme whereby a person invests his money in a common enterprise and is led to expect profits solely from the efforts of the promoter or a third party." 328 U.S. at 298-299.

The SEC does not allege that Impact Theory entered into a contract with the KeyNFT purchasers in which it agreed to make efforts to enhance the profitability of KeyNFTs. Instead, the SEC quotes several public statements by Impact Theory expressing its intention to take actions

that would make KeyNFTs more valuable. Based largely on these statements, the SEC concluded that Impact Theory led purchasers of KeyNFTs to expect profits in the form of increases in the market value of purchased KeyNFTs.

Watches, Paintings And Collectibles

What is wrong with using a company's statements of intent to take actions to increase the resale value of a product to establish that the product sale is a securities offering? In short, it proves too much.

Congress has not acted to insert technological considerations into the definition of "investment contract."

As Commissioners Peirce and Uyeda note in their dissent, there are many examples of consumer products that people buy in the hopes that the products will go up in value due to actions taken by the product's manufacturer to build its brand. Companies selling these products frequently make public statements that they are going to engage in efforts to enhance their brand. Yet, historically this has not been sufficient to transform these products into securities.

As the dissenting Commissioners explained, "We 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." This point is particularly apt as applied to NFTs because many of the most valuable and well-known NFTs, such as Bored Apes and CryptoPunks, are digital collectibles.

Justifiable Technological Discrimination?

Some people who would not advocate treating tangible collectibles such as watches, paintings, or collectibles as securities argue that a different standard should be applied to NFTs either because the technology underlying NFTs make them easier to re-sell through anonymous transactions or because the value of NFTs is less clear than for other products, which increases the risk of consumer harm. These arguments, however, conflict with public statements made by SEC Chair Gensler, who has stated, "There's no reason to treat the crypto market differently just because different technology is used. We should be technology-neutral."

In addition, there currently is no clear legal basis for such technological discrimination. The Supreme Court certainly made no reference to technological factors in *Howey*. Congress has not acted to insert technological considerations into the definition of "investment contract." Neither has the SEC itself promulgated regulations that could serve as a legal basis for such discrimination on the basis of technology (and may lack the legal authority to do so).

Moreover, allowing the SEC to decide whether to initiate enforcement actions based on its independent assessment of a given product's technological characteristics or value undermines the predictability of U.S. securities law by forcing market participants to rely on their predictions concerning the prejudices and inclinations of the SEC staff, rather than on the letter of the law. This lack of predictability is unfair to NFT developers and provides a disincentive for NFT developers to invest in creating NFT products, because they cannot be confident about where regulatory lines will be drawn.

Finally, purchasers of NFTs have not been asking for the protections that the SEC now seeks to impose on them. Just as purchasers of watches, paintings, and sports cards and memorabilia generally do not want to pay more for these products to cover the expense of manufacturers and distributers of these products implementing securities law compliance programs, purchasers of NFTs have not been clamoring for the SEC to protect them by deeming NFTs to be securities.

This makes expanding the application of the concept of "investment contract" to NFTs sold "along with vague promises to build the brand and thus increase the resale value" of NFTs particularly difficult to justify.

Collateral Implications

In addition to NFT developers and their customers, the SEC's efforts to regulate the NFT market also may have collateral implications for a variety of other market participants and service providers.

The SEC staff has observed that if a digital asset is a security, then not only does the company that offers the digital asset have to register with the SEC (in the absence of an exemption), but also anyone who, with respect to the digital asset, is acting as a broker-dealer, investment adviser, alternative trading system, or exchange must register with the SEC, a state regulator, and/or a self-regulatory organization such as FINRA.

Thus, a business that purchases NFTs for the account of others may be obligated to register as a securities broker. A person engaged in the business of buying and selling NFTs for their own account may be obligated to register as a securities dealer. A person who provides a marketplace or facilities for bringing together purchasers and sellers of NFTs may be obligated to register as a securities exchange.

For these reasons, the difficulty in predicting whether a specific NFT is a security not only makes it difficult to predict whether the unregistered offering of the NFT is unlawful, it also makes it difficult to predict whether other NFT market participants and service providers are acting as unregistered broker-dealers, investment advisers, alternative trading systems, or exchanges. Expanding the concept of "investment contract" to NFTs without any clear legal basis thus threatens to destabilize the NFT ecosystem.

In their dissent from the SEC's action against Impact Theory, Commissioners Peirce and Uyeda note that the action raises difficult questions and suggest that, rather than announce its position on NFTs through enforcement actions, the "Commission should have grappled with these questions long ago and offered guidance when NFTs first started proliferating." Having failed to do so, the SEC has created a situation in which its actions in the NFT marketplace threaten to cause more harm than good.

Rather than launching an aggressive campaign of enforcement actions, the SEC should first answer the questions that NFT market participants, and now some of its own commissioners, have been asking it to address.