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Legal Update

For the First Time, the US SEC Sanctions an NFT Issuer for Selling Unregistered Securities in *SEC v. Impact Theory*

In a published settlement of the charges on August 28, 2023, the US Securities and Exchange Commission ("SEC") stated that non-fungible tokens ("NFTs") issued by Impact Theory, LLC ("Impact") were "securities" under US federal securities law and the sale of those NFTs without registration or reliance on an exemption from the registration requirements violated federal securities law.

This action highlights the SEC's continued digital enforcement policy and represents the first time the SEC has charged an NFT issuer with selling unregistered securities. The SEC's action was also accompanied by dissents to the settlement from two SEC Commissioners, who disagreed with the conclusions.

What does this mean for NFT issuers and the market? In this Legal Update, we provide a snapshot of the settlement and the dissent and distill some key takeaways for the NFT market.

Background

According to the settlement, between October and December 2021, Impact offered and sold NFTs named Founder's Keys ("KeyNFTs")[1] and, in doing so, raised nearly $30 million. Some key facts about the NFTs and their offer, sale and marketing based on the settlement:

- KeyNFTs were offered in three tiers ("Legendary," "Heroic" and "Relentless"), and each tier of NFT was offered at a different price range and had different attributes.[2]
- Impact marketed the KeyNFTs through speaking events, social media and other channels. The SEC highlighted numerous statements by Impact that focused on the potential increase in value and profit from the KeyNFTs (more on that below).
- KeyNFTs traded on various secondary markets, and Impact publicized that KeyNFTs could be purchased and sold on two secondary market platforms. Impact received a 10% royalty from each secondary market sale.

Key Facts, Charges and Settlement

The SEC determined that Impact's sale and accompanying actions "invited potential investors to view the purchase of a KeyNFT as an investment into the business," therefore constituting the offer and sale of investment contracts under the *Howey* test.[3] In particular, the settlement order focused on several events and public statements in which Impact forecast delivering "tremendous value" to KeyNFT purchasers. The SEC cited specific statements and direct quotes from Impact, including the following:

- "If you're paying 1.5 [ETH], you're going to get some massive amount more than that. So no one is going to walk away saying, 'Oh man, I don't think I got value here.'"[4]
- "We're going to be investing that money into development, into bringing on more team, creating more projects, making sure that we're delivering just an obscene amount of value."[5]
- "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 are also enriched."[6]

As part of the settlement, Impact accepted the SEC's findings that the offer and sale of KeyNFTs constituted unregistered investment contracts in violation of Sections 5(a) and 5(c) of the Securities Act of 1933.[7] The Settlement includes disgorgement of over $5 million, a civil money penalty of $500,000, and the requirement to destroy all NFTs in Impact's possession and to revise the NFT smart contract to eliminate any future royalties Impact may receive from "future secondary market transactions."[8] Additionally, the SEC noted that Impact repurchased approximately $7.7 million of KeyNFTs from investors as part of remedial efforts prior to the settlement.[9]

The Dissenting Commissioners' View

The settlement order was decided along party lines, with Commissioners Hester Peirce and Mark Uyeda declining to impose sanctions and issuing a statement noting that Impact Theory's offer and sale of NFTs did not constitute investment contracts (the "Dissent").[10] Commissioners Peirce and Uyeda shared the concerns expressed by the other Commissioners about "hype" in these markets but also questioned both the *Howey* analysis in this instance as well as the nature of the penalties imposed. The Dissent analogized the NFTs at issue to watches, paintings and other collectibles and reasoned that the SEC does not bring enforcement actions against sellers of those tangible items even when those sales are coupled with "vague promises to build the brand and thus increase [the products'] resale value."[11] The Dissent also rejected the Commission's findings with respect to Impact's public statements, stating that "[t]he handful of company and purchaser statements cited by the order," while concerning, "are not the kinds of promises that form an investment contract."[12] Commissioners Peirce and Uyeda concluded their statement by calling on the Commission to issue guidance on potential intersections between NFTs and the securities laws, particularly with respect to differentiating among the wide array of rights that different NFTs provide holders.[13] Commissioners Peirce and Uyeda noted nine specific questions and areas that the SEC should seek to address in guidance or rulemaking related to NFTs.[14]

Key Takeaways

- *Impact Theory* continues the long line of enforcement actions in which the SEC has considered statements made by digital asset teams and issuers in applying its investment contract analysis. It should be clear to NFT issuers, digital asset protocols and token issuers that their public statements will be scrutinized closely by regulators—in particular, any references to investment returns, economic value or profits accruing to token holders.

- The dissenting Commissioners raised a number of open questions facing the NFT industry that they believe the SEC should address. Notably, the settlement order fails to define which NFTs might fall within—or outside of—the SEC's purview. At this time, it appears unlikely that the SEC's current approach will be influenced by the points noted in the Dissent.

For more information about the topics raised in this Legal Update, please contact any of the following lawyers

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Endnotes

[1] *Id.* at 2.

[2] *Id.*

[3] *Id.*

[4] *Id.* at 3.

[5] *Id.*

[6] *Id.* at 3-4.

[7] *Impact Theory* at 7; 15 U.S.C. § 77b(a)(1).

[8] *Id.* at 6-7.

[9] *Id.* at 6.

[10] NFTs & the SEC: Statement on Impact Theory, LLC, SEC.gov | NFTs & the SEC: Statement on Impact Theory, LLC.

[11] *Id.*

[12] *Id.*

[13] *Id.*

[14] *Id.*