

CLIENT ALERT

SEC Settles First-of-its-Kind Enforcement Action Involving Offers and Sales of Uniquely-Generated Tokens

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Introduction

On September 13, 2023, the U.S. Securities and Exchange Commission (“**SEC**”) announced a settlement with Stoner Cats 2 LLC (“**SC2**”) for failing to register its offers and sales of securities in violation of Sections 5(a) and 5(c) of the Securities Act of 1933 (“**Securities Act**”).¹ The action relates to SC2’s sale of uniquely-generated images of “Stoner Cats,” which are animated web series characters embedded in non-fungible tokens (“**NFTs**”). SC2 earned approximately \$8.2 million in revenue from the sales. As part of the settlement, SC2 agreed to pay a penalty in the amount of \$1 million, destroy all of the NFTs in its possession, and publish notice of the SEC settlement order (“**Order**”) on its social media channels.

The settlement represents the first SEC enforcement against an issuer of uniquely-generated “profile picture” NFTs (“**PPF NFTs**”), but the SEC’s allegations harken back to its early enforcement actions involving initial coin offerings (“**ICOs**”). SEC enforcement actions involving NFTs and ICOs have principally focused on issuers’ marketing tactics and manner of sale in asserting that issuers offered and sold the products as investment contracts. In addition, the Order and statements made in the accompanying press release imply that the SEC does not distinguish between offerings of fungible and non-fungible crypto assets in determining whether the assets constitute investment contracts. SEC Division of Enforcement Director Gurbir S. Grewal emphasized that “[r]egardless of whether [an] offering involves beavers, chinchillas or animal-based NFTs,

¹ In the Matter of Stoner Cats 2, LLC, Securities Act Release No. 11233, SEC File No. 3-21655 (Sept. 13, 2023) available [here](#).

SEC Settles First-of-its-Kind Enforcement Action Involving Offers and Sales of Uniquely-Generated Tokens

under the federal securities laws, it's the economic reality of the offering – not the labels you put on it or the underlying objects – that guides the determination of what's an investment contract and therefore a security.”²

Summary of the Facts

According to the Order, on July 27, 2021, SC2 offered and sold to the public, including U.S. investors, 10,320 PFP NFTs containing images of animated “Stoner Cats” characters (“**SC NFTs**”) for 0.35 ETH (approximately \$800) each. The sales generated gross proceeds in ETH equal to approximately \$8.2 million at the time, and the proceeds were used to fund the production of “Stoner Cats,” an adult animated television show about house cats. The SC NFTs provided holders with exclusive access to view the “Stoner Cats” series on the internet. SC2 produced and released six episodes of “Stoner Cats,” which were released between July 29, 2021 and December 23, 2022. The production of the series involved well-known writers, animators, and voice actors recognized for their work on major animated films and motion pictures. SC2 compensated the actors and artists (as well as the producers and managerial and technical professionals on the project) with proceeds from sales of SC NFTs.

The SC NFTs are ERC-721 tokens recorded on the Ethereum blockchain. Each ERC-721 token has an embedded pointer to a uniquely-generated image of a “Stoner Cats” character. While purchasers could “own,” collect and trade their particular SC NFT as a blockchain-based NFT, SC2 reserved all commercial rights to the underlying intellectual property, including the images of the characters. SC2 also received a 2.5% royalty for each transaction in SC NFTs on a certain secondary market platform, which, according to the SEC, created incentives for SC2 to encourage individuals to buy and sell the SC NFTs in the secondary market and helped to assure owners of such NFTs that SC2 would remain committed to the show after receiving the SC NFTs offering proceeds.

A smart contract generated (or “minted”) each unique SC NFT on demand for the purchaser after the purchaser transferred the purchase price to the smart contract during a public minting event. SC2 coded the smart contract underlying the SC NFTs on the Ethereum blockchain and effected the sales of the NFTs to the public from the website. The smart contract minted SC NFTs through an automated function that transferred purchaser funds to an SC2-controlled wallet and transferred the NFT to the purchaser.

The Order emphasizes that “SC2 engaged in an extensive media campaign to promote the SC NFTs both before *and* after they were sold to the public.”³ The SEC notes that the SC NFTs were promoted on its website and on social media, including on podcasts, YouTube, Twitter, Instagram, and Discord as well as during interviews on prominent network and cable television shows. The SEC further highlights that SC2 promoted certain benefits of owning the SC NFTs, including: (a) exclusive access to “Stoner Cats” content, along with additional access to any other content that the producers created “in

² Press Release, SEC Charges Creator of Stoner Cats Web Series for Unregistered Offering of NFTs (Sept. 13, 2023), available [here](#).

³ See Order at 4 (emphasis in original).

SEC Settles First-of-its-Kind Enforcement Action Involving Offers and Sales of Uniquely-Generated Tokens

perpetuity”; (b) exclusive access to the “Stoner Cats” community on Discord, which included events, contests, and opportunities to engage with the creators of the animated show; and (c) the option for holders to resell their NFTs on the secondary market.⁴

In addition, SC2 pledged on its website to facilitate the creation of a decentralized autonomous organization (“DAO”) comprising SC NFT holders if all NFTs were sold (which they were). Once formed, the DAO would develop one new animation project each year for the next three years, and SC NFT holders would have access to the additional content.

Key Takeaways

The action against SC2 is the first involving PFP NFTs. However, the arguments contained in the Order are not new. The Order applies a familiar “*Howey test*”⁵ analysis reflecting the SEC’s continued focus on the manner of marketing and sale of crypto asset projects in assessing whether issuers are exhibiting managerial and entrepreneurial efforts to fund future developments of projects and to align issuer incentives with potential purchasers that would make such enterprises successful for purchasers and issuers alike, such as by charging royalties or reserving commercial rights for an issuer’s benefit.

Same Analysis, New Product. The reasoning in the Order resembles that of early SEC enforcement actions against crypto asset token issuers that offered and sold such tokens in ICOs.⁶ In those actions, the SEC applied a *Howey* analysis and focused on the marketing efforts of the issuers, including whether the issuers represented to purchasers that the proceeds from the ICOs would be used to fund future developments using the tokens and increase their value through the issuers’ managerial and entrepreneurial efforts. In this action, as in prior actions involving ICOs, the SEC alleges that SC2 sold crypto assets with limited functionality at the time of sale and provided a “roadmap” advertising future benefits and utility for the tokens in connection with SC2’s efforts to develop the “Stoner Cats” animated series.

Utility. Although SC2 communicated the consumptive value of the SC NFTs (such as by analogizing the SC NFTs to tickets), the SEC focused on the nature of SC2’s marketing campaign and manner of sale of the SC NFTs to determine that SC2 offered and sold the NFTs as investment contracts, and therefore securities, within the meaning of *Howey* and its progeny.⁷ The Order confirms the SEC’s view that a product with “utility” or consumptive use can nonetheless be sold as an investment contract if it is marketed and offered as such.

⁴ *Id.* The Order notes that between July 27, 2021 and June 2, 2022, there were at least 10,475 secondary market transactions in SC NFTs in which purchasers spent ETH worth more than \$20 million to acquire the NFTs. *Id.* at 6.

⁵ See *SEC v. W.J. Howey Co.*, 328 U.S. 293, 298-99 (1946).

⁶ See, e.g., In the Matter of CarrierEQ, Inc. d/b/a Airfox, Securities Act Release No. 10575, SEC File No. 3-18898 (Nov. 16, 2018), available [here](#).

⁷ 328 U.S. 293, 298-99 (1946).

SEC Settles First-of-its-Kind Enforcement Action Involving Offers and Sales of Uniquely-Generated Tokens

Marketing and Manner of Sale. The Order's focus on SC2's marketing campaign and manner of sale of the SC NFTs serves as a reminder of the importance that the SEC places on messaging. The Order alleges that SC2 emphasized that its team had the necessary credentials to execute the project plan and that SC2 sought to persuade purchasers that both the show and the SC NFTs would be successful as a result of SC2's entrepreneurial and managerial efforts. The Order notes that the media campaign highlighted the special skills and experience the "Stoner Cats" team brought to the project and emphasized the team's expertise as Hollywood producers. The Order states that SC2's media campaign advertised the reputations of the animators, writers, and editors, whose credits included highly regarded animated films while publicizing their knowledge of crypto projects. In doing so, the SEC believes that SC2 led purchasers to expect profits from SC2's entrepreneurial and managerial efforts, reasoning that a successful web series could cause the resale value of the SC NFTs to rise in the secondary market. The Order alleges, for example, that purchasers were told that "the more successful the show, the more successful your NFT [will be]" and that purchasers were told that the SC NFTs were analogous to a "ticket" which could be resold.⁸

Royalties. The SEC has characterized ongoing royalties from secondary market sales as evidencing that the common enterprise and expectation of profits elements of the *Howey* test are satisfied. The theory underlying the SEC's position is that the royalties provide the issuer with a share of the NFT seller's proceeds on sale such that incentives are aligned among the parties. The SEC appears to take the view that purchasers reasonably expect the issuer to engage in efforts to make the enterprise successful because the issuer will receive a cut of the revenue from future NFT sales. However, the Order does not require SC2 to disable secondary sale royalties.

Intellectual Property Rights. The fact that SC2 reserved all commercial rights to the underlying intellectual property, including the images of the characters, rather than offering the SC NFTs under a no copyright reserved (or CC0) license or conveying exclusive commercial rights to the NFT holder, appears to have bolstered the SEC's position that the NFTs were investment contracts or sold as part of investment contracts. This is because purchasers were arguably reliant on SC2 to commercialize the intellectual property rather than commercializing the intellectual property themselves.

Contract vs Object. The Order and corresponding SEC press release do not clearly articulate whether the SEC believes the securities offered or sold were the SC NFTs or the contract pursuant to which they were offered and sold. The SEC's press release announcing the issuance of the Order is titled "SEC Charges Creator of Stoner Cats Web Series for Unregistered Offering of NFTs" while the Order itself states that SC2 "conducted an unregistered offering of crypto asset securities in the form of [NFTs]." Yet the Order later explains that "SC2 offered and sold the [SC NFTs] as investment contracts." This language thus appears to muddle the distinction between the investment contract itself and the *object* or *subject* of the investment contract being offered or sold. In the recent *SEC v. Ripple Labs, Inc.* decision, Judge Analisa Torres held that crypto assets themselves are not investment contracts, but that crypto assets may be offered and sold as

⁸ *Id.* at 5.

SEC Settles First-of-its-Kind Enforcement Action Involving Offers and Sales of Uniquely-Generated Tokens

part of an investment contract.⁹ However, the SEC seems to conflate the investment contract and object of the investment contract in this Order.

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⁹ *SEC v. Ripple Labs, Inc.*, No. 20-cv-10832-AT-SN (S.D.N.Y. July 13, 2023), ECF No. 874.