



## ALERTS

### Stoner Cats Settlement Signals Intensifying SEC Interest In NFT Offerings

October 23, 2023

#### Highlights

The SEC found that Stoner Cats conducted an unregistered securities offering to early NFT buyers

In the settlement agreement, the SEC highlights secondary market sales and programmatic royalties paid to the NFT offeror

The dissenting SEC Commissioners drew ties to Star Wars collectibles sales in questioning the potentially limitless application of *Howey*

The Securities and Exchange Commission (SEC) [announced a settled enforcement](#) action last month against Stoner Cats 2 LLC (SC2). The SEC had alleged that SC2's sale of non-fungible tokens (NFTs) to fund production of an animated web series constituted an unregistered offering of crypto asset securities in violation of the Securities Act of 1933. SC2 neither admitted nor denied wrongdoing in the September [settlement order](#), which does not include any allegation of fraud.

The SC2 order follows closely on the heels of the SEC's late August [settlement](#) with another NFT issuer, Impact Theory LLC. Together, these

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proceedings showcase the SEC's emerging view that an issuance of NFTs in some cases may amount to a de facto securities offering subject to the registration requirements of the Securities Act.

## **The Stoner Cats NFTs**

The Stoner Cats NFTs operate on the Ethereum blockchain. Each NFT is linked to a uniquely generated image of a character in the Stoner Cats animated series, which revolves around "house cats that become sentient after being exposed to their owner's medical marijuana."

According to the SEC's order, on July 27, 2021, SC2 offered and sold to investors more than 10,000 Stoner Cats NFTs for the ETH equivalent of roughly \$800 each. The offering sold out in 35 minutes and yielded gross proceeds to SC2 of approximately \$8.2 million.

## **An Offering of Investment Contracts**

The SEC found that SC2's issuance of NFTs was a public offering of securities in violation of the registration provisions of the Securities Act. The SEC characterized the Stoner Cats NFT offering as an offering of "investment contracts" under the so-called *Howey* test. That test says that an investment contract – and thus a security – exists when there is an "investment of money in a common enterprise with a reasonable expectation of profits to be derived from the efforts of others."

The SC2 order doesn't spell out the SEC's *Howey* reasoning on an element-by-element basis. Nor does the order refer pointedly to the NFTs themselves as securities. What does seem evident is that the SEC viewed the capital-raising purpose of the Stoner Cats NFT offering and SC2's related "extensive media campaign" as bringing the offering of NFTs within the investment contract framework.

The order alleges that SC2 stated clearly that the NFT offering's purpose was to fund production of the Stoner Cats web series; emphasized the special skills and Hollywood experience the SC2 team would bring to the development process; touted the involvement in the web series of well-known actors; promised that a successful offering would facilitate the creation of a decentralized autonomous organization and the production of at least one animated series a year for three years; and made numerous public statements "highlighting the specific benefits of owning" the NFTs, including the ability of investors to monetize any increased value of their NFTs by reselling them on the secondary market.

In sum, it appears that the SEC thought the Stoner Cats NFT offering ticked the *Howey* boxes, as a capital-raising and platform-development project with respect to which the SC2 team "led investors to expect profits from [its] entrepreneurial and managerial efforts, because a successful web series could cause the resale value of the Stoner Cats NFTs to rise in the secondary market."

## **Issuer Royalties**

A particularly interesting aspect of the SC2 order is its emphasis on the means by which SC2 would benefit from secondary market trading. The SEC found that the Stoner Cats NFTs were configured to pay SC2, as the

NFT issuer, a 2.5 percent royalty for each secondary market transaction in the NFTs. Following its approach in Impact Theory, the SEC believed that the prospect of receiving trading-based royalties gave SC2 an incentive to encourage secondary market activity, and that SC2's public encouragement in fact prompted individuals to spend more than \$20 million acquiring NFTs in at least 10,000 secondary market transactions during and following the initial offering.

The order's focus on royalties appears to be an implicit nod to the *Howey* "expectation of profits" and "efforts of others" elements. In the SEC's view, by structuring a right to receive trading-related royalties, SC2 was signaling to NFT investors its ongoing commitment to the success of the Stoner Cats project, to the benefit of NFT holders and SC2 alike: "If the Stoner Cats show was successful, the price of the NFTs could rise and so could the amount of royalties."

## Remedies and Settlement

In addition to the standard cease and desist order, SC2 agreed to several conditions in settlement of the SEC's enforcement action. These included publication of the settlement order on SC2's website and social media channels; payment of a \$1 million civil fine; committing to help the SEC distribute the fine to NFT purchasers; and destruction of the Stoner Cats NFTs still in SC2's possession. These actions are similar in thrust to those mandated by the prior Impact Theory settlement order. Unlike Impact Theory, however, the remedies in the Stoner Cats order did not include a requirement for SC2 to disable its secondary trading royalties arrangement.

## Dissenting SEC Commissioners

In the SEC press release announcing the Stoner Cats settlement, Director of Enforcement Gurbir Grewal made some tongue-in-cheek animal references before stating that "it's the economic reality of the offering – not the labels you put on it or the underlying object – that guides the determination of what's an investment contract and therefore a security."

SEC Commissioners Hester Peirce and Mark Uyeda, however, were unamused, [stating in dissent](#) that "application of the *Howey* investment contract analysis in this matter lacks any meaningful limiting principle" and therefore threatens the withering of artists' creativity "in the shadow of legal ambiguity." Referencing 1970s Star Wars collectibles IOUs that were redeemable for future Luke Skywalker, Princess Leia, and R2-D2 action figures and membership in the Star Wars fan club, Commissioners Peirce and Uyeda questioned whether the resale of such Star Wars IOUs might be deemed securities under the Stoner Cats analysis. Echoing their [August 2023 dissent](#) to the Impact Theory settlement, Commissioners Peirce and Uyeda urged the SEC to provide "clear guidelines for artists and other creators who want to experiment with NFTs as a way to support their creative efforts and build their fan communities" rather than bring enforcement actions,

## Takeaways

The SEC's two recent enforcement actions demonstrate that the agency

is paying close attention to NFT offerings and statements made by NFT creators to prospective purchasers. NFT offerings conducted for fundraising purposes, especially in connection with a project or platform that is still under development, may be particularly likely to draw SEC scrutiny.

In addition, NFT offerors should be careful about making social media or other public statements concerning the prospect of NFT price appreciation and secondary market liquidity, which may be seen as leading to an “expectation of profit” under the *Howey* analysis. In this connection, programmatic royalty arrangements tied to secondary market activity are likely to remain relevant in the SEC’s eyes.

While applying the securities laws to an offering of NFTs may feel intuitively wrong to some, the risk of regulatory destruction of a project due to missteps is currently too large to ignore. As even the dissenting Commissioners noted, “NFT creators, along with other artists, do not get a free pass from the securities laws.”

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