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## Toke of the Town: SEC Lights Up Stoner Cats NFTs



### Executive Summary

On September 13, 2023, the U.S. Securities and Exchange Commission (SEC) charged Stoner Cats 2 LLC (SC2) with conducting an unregistered offering of crypto asset securities in the form of non-fungible tokens (NFTs). The NFTs were issued to raise funds for an animated web series known as Stoner Cats. Following closely on the heels of the SEC's first-ever NFT-related enforcement action announced last month (discussed here), this case highlights the SEC's determination to assert jurisdiction over crypto asset securities and protect investors.

### Background

The Stoner Cats animated series is centered around the escapades of feline characters who gained the ability to speak after exposure to medical marijuana, and boasts a star-studded roster of actors lending their voices, including Ashton Kutcher, Mila Kunis, Chris Rock, Jane Fonda, and Seth MacFarlane.

On July 27, 2021, SC2 offered and sold more than 10,000 Stoner Cats NFTs to investors for 3,647 ETH (then valued at approximately \$8.2 million), selling out in 35 minutes.

The NFTs, each associated with a unique still images of a character from the Stoner Cats web series, provided purchasers with exclusive access to the show, access to the Stoner Cats community (including

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the opportunity to engage with the show’s creators), and an option to resell their NFTs on the secondary market.

SC2 promised buyers “that the proceeds of the offering would fund the production of the [show],” as well as support the company’s initiatives, including establishing a decentralized autonomous organization (DAO) comprised of holders of Stoner Cats NFTs, and developing “at least one new animation project a year for the next three years.”

SC2 also configured the NFTs so that it received a 2.5% royalty for each secondary market transaction. These royalties served as incentives for SC2 to actively promote the buying and selling of Stoner Cats NFTs in the secondary market, and provided reassurance to NFT owners that SC2 would remain committed to the animated show, even after receiving the proceeds from the Stoner Cats NFT offering.

### **Marketing and Investor Expectations**

As part of its marketing strategy, SC2 emphasized its expertise as Hollywood producers, its knowledge of crypto projects, and the involvement of well-known actors in the Stoner Cats series. SC2’s marketing led investors to believe that owning Stoner Cats NFTs could result in profits, as a successful web series would likely increase the NFTs’ resale value in the secondary market. Investors were told that owning an NFT was akin to holding a “ticket,” which could be sold for a profit if the show performed well, as “the more successful the show, the more successful your NFT” will be.

Given the buzz generated from SC2’s marketing campaigns, within less than a year, there were at least 10,475 secondary market transactions involving Stoner Cats NFTs, with purchasers spending ETH valued at more than \$20 million to acquire these digital assets.

### **The Legal Basis for SEC Action**

In light of these facts, the SEC held that the Stoner Cats NFTs constituted investment contracts, making them securities under the *Howey* test<sup>1</sup> and subsequent precedents. Investors had a reasonable expectation of obtaining a profit based on SC2’s managerial and entrepreneurial efforts, thus meeting the criteria for an investment contract. SC2, however, failed to register the offering with the SEC, and no exemption from registration was applicable, leading to violations of Sections 5(a) and 5(c) of the Securities Act of 1933.

“Regardless of whether your offering involves beavers, chinchillas or animal-based NFTs, 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.” — Gurbir S. Grewal, Director of the SEC’s Division of Enforcement.

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<sup>1</sup> *SEC v. W.J. Howey Co.*, 328 U.S. 293 (1946). Under the U.S. Supreme Court’s “Howey test,” 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) 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.

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## SC2's Settlement with the SEC

In response to the SEC's charges, SC2 agreed to a cease-and-desist order without admitting or denying the findings. As part of the settlement, SC2 was ordered to pay a civil penalty of \$1 million. Furthermore, SC2 was required to destroy all Stoner Cats NFTs in its possession or control and publish notice of the SEC's order on its website and social media channels. A Fair Fund was also required to be created pursuant to Section 308(a) of the Sarbanes-Oxley Act of 2002 to return monies to injured investors.

## Dissent

As was the case following the SEC's first NFT enforcement action, Commissioners Hester M. Peirce and Mark T. Uyeda issued a joint statement disagreeing with the SEC's application of the *Howey* test.

In their [dissent](#), Commissioners Peirce and Uyeda highlighted the following points:

- **Clear Guidance:** The application of the *Howey* investment contract analysis lacks any “meaningful limiting principle,” and could affect “creators of all kinds.” If the securities laws were to be applied to physical collectibles in the same way as they are applied to NFTs, “artists’ creativity would wither in the shadow of legal ambiguity.” Rather than “arbitrarily” initiating enforcement actions against NFT projects, the dissent urged the SEC to “lay out some clear guidelines” on whether and how securities laws apply to NFT offerings.

“While updated for the digital age, the Stoner Cats NFTs are not that different from Star Wars collectibles sold in the 1970s.... To the delight of millions of children [the 1977] holiday season, the toy company Kenner sold “Early Bird Certificate Packages,” redeemable for future Luke Skywalker, Princess Leia, and R2-D2 action figures and membership in the Star Wars fan club.... Would those I.O.U. certificates, which could be re-sold, constitute investment contracts? Using the analysis of today’s enforcement action, the SEC should have parachuted in to save those kids from Star Wars mania.” — SEC Commissioners Hester M. Peirce and Mark T. Uyeda

- **Business Creativity Should Be Encouraged:** The dissent emphasized the need to allow artists and creators who use NFTs as a means of supporting their creative work, engaging with fans, and involving the fan base in future creative endeavors. “That is what was happening in the 1970s with Star Wars, and that is what was happening here with Stoner Cats.... The Commission’s application of the securities laws here makes little sense and discourages content creators from exploring ways to harness social networks to create and distribute content. More generally, it contributes to the legal ambiguity facing artists, writers, musicians, filmmakers, and others seeking to build a loyal, engaged following.”

## Implications for the NFT Market

The SEC's action against Stoner Cats has broad implications for the NFT market and those involved in NFT offerings. It sends a clear message that the regulatory framework extends to digital assets, and issuers must adhere to securities laws. The case underscores the importance of proper registration or exemption compliance when conducting NFT offerings, especially when marketing tactics lead investors to expect profits based on the issuer's efforts.

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As this case demonstrates, the SEC is focused on the manner of marketing and sale of crypto assets in determining whether such offerings constitute a securities transaction. Factors such as whether investors have a reasonable expectation of obtaining a profit based on the issuer's managerial and entrepreneurial efforts and whether the fortunes of the issuer are linked to their own are key.

As the NFT market continues to evolve, and as the SEC further maps out the boundaries of its jurisdictional reach, market participants should closely monitor regulatory developments to avoid running afoul of the law.

To put it bluntly, if you are considering issuing NFTs, be sure to smoke out details of current securities laws and future legal developments, or risk having your fortunes take a hit.

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