October 31, 2023

Dear Commissioners Peirce and Uyeda:

The Chamber of Digital Commerce ("The Chamber") commends you for the thoughtful questions raised in your jointly published statement entitled "NFTs & the SEC: Statement on Impact Theory, LLC"[1] regarding the Securities and Exchange Commission's (the "SEC" or the "Commission") first enforcement action in the non-fungible token (NFT) sector.

As you are aware, The Chamber is the world's largest digital asset and blockchain trade association. The Chamber represents more than 200 diverse members of the blockchain industry globally, including digital asset exchanges, leading banks and investment firms, startups, and other digital asset economy participants. Guided by the principle of promoting industry compliance with applicable law, The Chamber seeks to foster a legal and regulatory environment in which digital asset users can enjoy regulatory certainty as they apply blockchain technologies to an array of commercial, technological, and social purposes.

The Chamber strongly concurs with your statement that "Regardless of what one thinks of the *Howey* analysis, this matter raises larger questions with which the Commission should grapple before bringing additional NFT cases." We also concur that this enforcement action raises many difficult questions, including, to our mind, understanding the statutory basis for the Commission's purported authority to regulate sales of NFTs. It is imperative that these issues be addressed and that thoughtful conclusions be reflected in SEC rules and regulations. Otherwise, we risk stifling U.S. innovation, and potentially undermining individual creators and artistic freedom.

Please find below our detailed responses to your enumerated questions, reflecting input from a range of our members involved in the NFT space:

1. **Non-fungible tokens are not an easy-to-characterize asset class, particularly because they can give the owner a wide array of rights to digital or physical assets. People are experimenting with a lot of different uses of NFTs. Consequently, any attempt to use this enforcement action as precedent is fraught with difficulty. <u>Are there useful ways for the Commission to categorize NFTs for purposes of thinking about whether and how the securities laws apply to offers and sales</u>?**

In our view, the easiest way to categorize NFTs for the purpose of securities law application is based on their intended use. Although there are many use cases for NFTs, we believe NFTs

[1] Peirce, H., & Uyeda, M. (2023, August 28). NFTs & the SEC: Statement on Impact Theory, LLC https://www.sec.gov/news/statement/peirce-uyeda-statement-nft-082823

can generally be categorized into two macro groups: 1) financial products, and 2) consumer products.

a. Financial Product NFTs:

- Financial product NFTs represent a financial interest in a venture, project, or asset. This type of NFT may provide the holder with rights to profits, shares in revenue, or other financial benefits. A financial product NFT may sometimes be considered a security based on the specific facts and circumstances associated with that digital asset.

b. Consumer Product NFTs:

- Consumer product NFTs represent ownership or proof of authenticity of a digital or physical item, such as art, collectibles, music, or virtual real estate. This type of NFT is generally designed to provide some functional use or access to a specific product, service, or experience.
- We propose adoption of the following definition to clearly distinguish consumer product NFTs from financial product NFTs:
    - Consumer Product NFT - A type of digital asset that (1) functions as a unique, non-interchangeable digital identifier or non-fungible token linked to a separate digital or physical asset, (2) utilizes blockchain technology to store and track ownership, and (3) is sold where at least one permitted use is a consumptive use as a collector's item, hobby or for display.

Generally, consumer product NFTs (e.g., digital art, collectibles, in game items, subscription items) are not and should not be considered securities and, therefore, clearly fall outside of the SEC's jurisdiction.

We encourage the SEC to consider the representations made by the creator of a unique NFT at the time of sale, as well as the actual use case for that NFT, when determining whether a particular NFT is a consumer product or financial product.

Additionally, we acknowledge that, in some cases, NFTs may evolve from consumer products to financial products. This most often occurs when a consumer product NFT is fractionalized, and those fractional interests are sold with the promise of profits derived primarily from the efforts of others. This example illustrates a change from the creator's initial representations, in addition to usage within a specific context.

While, as we state above, a consumer product NFT should not be deemed to be a security, the act of fractionalizing ownership of the digital asset introduces dynamics and characteristics typical of financial markets and products. As such, fractionalized NFTs tread a fine line between consumer and financial products, and their classification will depend on the specific use case, regulatory considerations, and the intent behind the NFTs issuance and sale.

2. **If the Commission were to craft guidance for NFT creators seeking to understand potential intersections with the securities laws, what questions would be helpful for us to address?**

As we recently stated in an Amicus Brief filed in the case of the SEC v. BAM Trading Services Inc. (among others) (the "Amicus Brief"), while blockchain-based digital assets are a relatively new category of asset, courts have recognized the obvious distinction, in schemes involving both tokens and many other types of more conventional assets, between the *subject* of a regulated "investment contract," which is an ordinary asset that is not a security, and the "investment contract" itself, where a promoter packages the ordinary asset *together with* a bundle of rights, responsibilities, services and promises into a "contract, transaction, or scheme" that creates a security under the totality of the facts and circumstances.

To that end, we believe that it is critical for the SEC to propose and adopt clear rules or issue a no-action letter specifying which types of NFT creator marketing, social media and promotional practices would trigger the "expectation of profit" and "profits to come solely from the efforts of others" elements of the *Howey* test.

For example, the recent enforcement action brought by the SEC against Stoner Cats 2, LLC, has resulted in significant concerns for all U.S.-based NFT creators around the implications of their marketing and social media efforts. We fear that the SEC's willingness to bring enforcement actions against individual NFT creators without promulgation of a clear regulatory framework will have a significant chilling effect on free right of expression of the American artists, writers, and musicians who are sharing their ideas with the world through this new digital technology.

3. **How should recent legislative efforts to construct a framework for crypto inform our thinking about the application of securities laws to NFTs?**

Congress' recent legislative efforts have specifically indicated that the SEC does not have unfettered jurisdiction over all NFTs. The bipartisan FIT for the 21st Century Act, which passed unanimously out of the House Agriculture Committee, states that the SEC shall only have clear authority over digital assets that have the "traditional characteristics" and "functionality" of a security.

Moreover, the FIT for the 21st Century Act includes a provision requiring that a study on NFTs be conducted by the Comptroller General of the United States. The terms of the proposed study would impose on the Comptroller General an obligation to compare NFTs to digital commodities and payments stablecoins but, quite interestingly, does not require a comparison to securities. Additionally, the terms of the proposed study would direct the Secretary of Commerce to issue a report on the findings, likely due the Commerce Department's role in ensuring that business practices are fair and transparent. Although there have been nearly 100 legislative bills drafted and/or introduced over the last three years by various members of Commerce related to digital assets, it is important to note that not even one has proposed to delegate jurisdiction over NFTs to the SEC.

In addition, it is important to note that other jurisdictions around the world are taking actions consistent with U.S. Congressional efforts around NFTs. For example, the European Union's recently passed its Markets in Crypto-Assets (MiCA) regulation. This comprehensive crypto regulatory framework, which will take full effect in June 2024, does not apply to crypto assets that "are unique and not fungible with other crypto assets." In fact, MiCA will only apply to NFTs if they have the characteristics of a financial instrument.

4. **Is a securities law regime best suited to ensure that NFT purchasers obtain the information they need before buying an NFT? What type of information do these purchasers want? Might other regulatory frameworks be more appropriate?**

We do not think that a securities law regime would be best suited to sales of consumer product NFTs since such assets are not securities. It goes without question that imposing the existing securities disclosure regime to consumer product NFTs would hard to justify from a regulatory authority point of view. As discussed above, the functional nature of consumer product NFTs clearly differentiates such digital assets from securities. Subjecting these types of assets to the same regulatory framework that applies to securities would be akin to applying existing securities law registration obligations to a grocery store selling oranges, or a multiple listing service allowing real estate brokers to list plots of land for sale, or perhaps to an online ecommerce marketplace, like eBay or Amazon, where consumers routinely purchase collectibles and memorabilia with the hope of a future increase in value, a concept that decades of case law has determined not to be the case.

With that in mind, we also question the SEC's authority to impose a securities disclosure regime on consumer product NFTs. We note that existing state and federal regulations under UDAAP (Unfair, Deceptive, or Abusive Acts or Practices) already provide consumer protections aimed to prevent misleading practices around the sale of consumer goods and ensure transparency. Such concepts align well with the needs of NFT purchasers, ensuring they have all the necessary information to make informed decisions and are protected from potential malpractices in the market.

Based on our experience and the experience of our members, it is evident that purchasers of NFTs are primarily concerned with the intellectual property rights (IPR) associated with the NFT they are seeking to acquire. Prospective purchasers want specific clarity on the exact rights associated with an NFT, especially in terms of licensing, e.g., does the NFT give them the right to reproduce the artwork, use it commercially, or merely display it in a digital gallery? Additionally, transparency around costs and potential ongoing fees is also crucial to prospective investors. Prospective purchasers want details not only on the initial purchase price, but also on any potential ongoing fees, such as maintenance costs, platform fees, or royalties that might be due on future sales or uses of the NFT. It is our understanding that some of the platforms used by consumers looking to purchase consumer product NFTs already provide this type of information.

With respect to the platforms on which consumer product NFTs are sold, if the rare case where an NFT platform, marketplace, or issuer is found to be in violation of consumer protection laws at the Federal level, then the Federal Trade Commission (FTC) is already the appropriate regulator for such activity. The FTC's existing power enforcing the Federal Trade Commission Act's enforcement of Section 5: Unfair or Deceptive Acts or Practices (UDAP). Section 5 already applies directly to NFT platforms because they engage in commerce and interact directly with consumers. The FTC aims to ensure that these platforms operate fairly and transparently, preventing deceptive practices and protecting consumers.

The Commodity Futures Trading Commission (CFTC) also has expertise in overseeing markets and ensuring they are free from manipulation. Given that many concerns around consumer product NFTs relate to market dynamics (e.g., pump-and-dump schemes, insider trading, high-frequency trading, etc.), the CFTC's market oversight would also be more relevant and effective than a potential securities-focused approach. The CFTC could focus on ensuring fairness and transparency in NFT marketplaces, without burdening individual NFT issuers with irrelevant securities disclosures.

5. **If a securities law regime is best, how could SEC registration requirements be tailored to reflect the unique nature of NFTs? Would compliance with any requirements be prohibitively costly? If so, what alternative approaches would be more workable, but still achieve the Commission's objectives of protecting investors and the integrity of the marketplace?**

As stated above, we do not believe that a securities law regime is best suited for consumer product NFTs. The SEC's primary mandate is to protect investors, maintain fair, orderly, and efficient markets, and facilitate capital formation. While some NFTs should rightly be deemed to be financial product NFTs and, thus, securities, many other NFTs should be deemed to be consumer product NFTs and, thus, not securities. Attempting to regulate all NFTs as securities would exceed the SEC's statutory mandate and enumerated authority and might not effectively address the unique risks and challenges of the NFT market.

Traditional securities disclosure focus on aspects such as an issuer's financial condition, management, risks, and business operations. For financial product NFTs, the existing securities disclosure regime may be relevant depending on the facts and circumstances of the specific NFT issued. For consumer product NFTs, especially those representing art, music, or collectibles, such disclosures are irrelevant and don't provide meaningful information to potential buyers. And requiring consumer product NFT creators, many of whom are individual artists, to provide such disclosures would impose staggering costs and unnecessary burdens on such creators.

6. **Does this action indicate that the Commission generally views previous NFT offerings as securities offerings? If so, will the Commission provide specific guidance to those issuers describing what they need to do to come into compliance?**

This is a critically important question. To date, the SEC has generally provided "guidance" to various segments of the digital asset industry via enforcement actions. If it is, indeed, the SEC's position that offerings of NFTs that meet the proposed definition of consumer product NFTs were securities offerings, such a position will have an incredibly consequential impact on the NFT industry and creators. It is imperative that the SEC provide clear and concise guidance on this point immediately.

7. **What, if any, restrictions should apply to secondary market sales of NFTs that the issuer sold as the object of an investment contract?**

As we further stated in our Amicus Brief, despite the SEC's efforts to conflate an investment contract with its subject and turn *Howey* on its head, tokens generally available for trading on secondary exchanges are not the "contract, transaction or scheme" that is the embodiment of a security. A bundle of rights, responsibilities, services and promises leading to an expectation of profits arising from *the issuer's entrepreneurial or managerial efforts* may be an investment contract, such as an orange grove packaged with a management contract that promises efforts by the promoter to generate profit for the holder, but the individual component parts generally are not. When courts have addressed the issue (including recently with respect to tokens), they have generally held that the *subject* of investment contracts – including tokens – are *not themselves* an investment contract or other type of security.

As we described above, a significant segment of NFTs are consumer product NFTs and not securities, and the markets on which consumers can buy and sell these types of NFTs are not and should not be required to be securities exchanges. A consumer product NFT alone, when sold on a secondary market between anonymous market participants in blind bid/ask transactions, is not a security. If it were, the SEC could conceivably extend its reach outside of the securities markets themselves to attempt to regulate a wide variety of ordinary assets and commercial or consumer products which may have once served as the *subject* of an investment contract at some point, such as oranges, plots of land, chinchillas, or whiskey. Taken to its extreme, the SEC could also attempt to regulate the storefronts or marketplaces through which those ordinary assets and commercial or consumer products are sold or resold, such as grocery stores, pet stores, liquor stores, online e-commerce platforms, real estate brokers, multiple listing services and other commercial businesses. That cannot be the correct outcome.

To that end, we do not believe any restrictions should apply to secondary market sales of consumer product NFTs because: (1) such NFTs are consumer goods and any sale should be subject to consumer protection laws and not securities law, and (2) the law is unsettled as to secondary transactions of digital assets overall.

As stated above, The Chamber believes that, if a given NFT does not include financial interests, such as legal rights to debt or equity, such NFT should be presumed to not be a security.

This viewpoint is shared by the drafters of the bipartisan Lummis-Gillibrand Responsible Financial Innovation Act ("RFIA"). The RFIA seeks to offer clarity to investors by creating a statutory distinction between the initial offering or distribution transaction and the underlying digital assets that are the subject of such a transaction, referred to as "ancillary assets." The proposed bill mandates disclosure requirements for such ancillary assets that are not fully decentralized, and whose value is determined by the entrepreneurial and managerial efforts of others. Under the RFIA, when an asset is fully decentralized and there are no longer entrepreneurial or managerial efforts, the disclosure requirements are terminated, and such asset is treated as a commodity.

It is our view that the RFIA is the natural application of *Howey* to digital assets because it codifies the "economic reality" element that distinguishes between the assets purchased pursuant to an investment contract from the investment contract itself. See *Howey, 328 U.S. at 298*. Additionally, it provides a sound framework for allowing secondary transactions and resales of digital assets to occur while requiring disclosures that appropriately protect digital asset consumers and increase market protections.

8. **This settlement includes an undertaking by the issuer to destroy NFTs in its possession. What precedent does this set for future cases in which the NFTs at issue represent unique pieces of digital art or music?**

The fact that the SEC settlement in this matter includes an undertaking by the issuer to destroy any NFTs in its possession creates a significant and highly problematic precedent with First Amendment and market manipulation implications for all NFTs, particularly where an NFT represents unique creations of digital art or music. We specifically note and support your statement that:

> "The typical cure for a registration violation is a rescission offer, which the company already made in the form of repurchase programs. The company offered to repurchase the NFTs from primary and secondary-market purchasers in December 2021 and August 2022. Order at ¶ 16. It paid out a total of $7.7 million worth of Ether. Presumably other purchasers likewise could have sold their NFTs back to the company."

How then does the SEC justify the imposition of such a unique and draconian settlement requirement? We question whether an NFT creator or owner with the wherewithal to fund an extended court battle based on the same facts have been subject to the same outcome. Recent judicial precedent indicates otherwise, as courts find against the SEC in a growing number of pivotal decisions around digital asset industry participants.

The First Amendment protects against government actions that suppress speech. Art and music are traditionally protected forms of expression under the First Amendment. If a government agency mandates the destruction of art or music NFTs, how is that not an overreach and a direct violation of a creator or owner's First Amendment rights to free speech? Additionally, such forced destruction could lead to significant cultural losses, especially if the art or music has significant value or meaning to a community.

This settlement will undoubtedly have a significant chilling effect on the U.S. NFT industry. Knowing that their work could be forcibly destroyed will, without doubt, deter artists and musicians from creating and minting NFTs in the United States. This chilling effect could also negatively impact the diversity and richness of content developed in the U.S. NFT space, as well as artificially reduce the supply of certain artworks or musical works, potentially inflating the value of remaining pieces.

This settlement could also result in unintended market dynamics since the forced destruction of existing NFTs may alter the natural supply-demand dynamics. If creators or platforms offering NFTs for sale are required to destroy NFTs, it might raise concerns about their ability to influence market prices intentionally. This could undermine trust in the consumer product NFT marketplace.

9. **The settlement includes an undertaking to "[r]evise the smart contract(s) or any other programming code(s) or computer protocol(s) underlying the KeyNFTs to**

eliminate any royalty." Given that one of the promising features of NFTs is the ability to reward creators with royalties every time an NFT they created is sold, what precedent does this set for future cases?

This element of the settlement would set an unfortunate precedent that directly contradicts the ethos of NFTs and Web3. Web3 represents a decentralized version of the internet, where power and control are distributed among users rather than centralized entities. One of the core promises of Web3, as well as NFTs, is to empower individuals, including creators, to have more control over their work and its monetization. NFTs do just that.

The payment of royalties is inherently associated with works of art of music, allowing creators to benefit from the ongoing value of their work. Removing this fundamental feature in the context of consumer product NFTs seems beyond justification. Independent creators often lack the resources and platforms of established entities. Consumer product NFTs, with automated royalty mechanisms, provide a way for these creators to generate sustainable income.

The action of forcibly removing royalties as a result of this SEC settlement agreement will disproportionately impact independent creators, specifically historically disadvantaged populations, making it harder for them to compete and thrive in the digital art space. Historically disadvantaged communities are increasingly selling NFTs on open blockchains[2], which has expanded economic opportunity. Just 1% of art auction spending over the last ten years related to works by Black artists, half of which is attributable to a single individual.[3] However, between January 2020 and March 2021 alone, 58 Black artists sold a combined 513 NFTs for a combined value of over $700,000.[4] In addition, several organizations have formed to promote the work of Black artists in the digital space.[5] Similar efforts are being made to expand inclusivity in art through NFTs for women,[6] transgender youth,[7] and other traditionally marginalized groups. Regulatory clarity is critical – the SEC has not provided guidance as to whether, and why, all NFTs could be considered securities. Should this settlement agreement become ongoing precedent, it has the potential to stifle innovation and prevent NFTs from continuing to empower economic equity.

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[2] There are several different types of blockchains. A public, open, or permission-less, blockchain network is one where anyone can participate without restrictions. Most types of cryptocurrencies run on a public blockchain that is governed by rules or consensus algorithms.
[3] Charlotte Burns and Julia Halperin, For African American Artists, the Market Remains Woefully Unbalanced, Sotheby's.com, February 2019.
[4] Cuy Sheffield, "Why I'm Collecting Black Crypto Art," Medium, Dec. 21, 2020 (citing One/Off data).
[5] One/Off, About, accessed November 3, 2021. Black NFT Art, About, accessed November 3, 2021.
[6] Marris Adikwu, "How Women Are Carving Out a Space in the NFT Market," Vogue, March 2021.
[7] Dan Avery, "Transgender teen's crypto art series fetches $2.16 million at Christie's," NBC News, July 2021.

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We would welcome the opportunity to discuss our feedback on this matter with you in greater detail. Please let us know if you would be interested in meeting with our team and the members involved in providing this feedback either via teleconference or in person at a date and time that would be most convenient for you. We hope to continue to serve as a resource for the Commission concerning NFTs and other digital asset issues.

We look forward to any questions you may have.

Sincerely,

Cody Carbone

Cody Carbone
Vice President, Policy
The Chamber of Digital Commerce