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# Digital Assets as Securities under Federal Law: The SEC's New Framework as Applied to Kik's 2017 ICO

On June 4, 2019, the SEC filed a lawsuit in federal court in the Southern District of New York against the Canadian company, Kik Interactive Inc., alleging that Kik violated the U.S. Securities Act of 1933 (the "Securities Act") in its 2017 $100 million initial coin offering ("ICO"). The SEC's complaint against Kik illustrates how the SEC may apply its recent Framework for "Investment Contract" Analysis of Digital Assets (the "Framework") for analyzing digital assets as "investment contracts" that qualify as securities subject to federal regulation.

Kik was burning through cash in 2017. Its mobile messaging app revenues were far outpaced by its costs, and Kik was unsuccessful in its efforts to find a buyer. Expecting to run out of cash by the end of 2017, Kik management decided to "pivot" to a digital asset business model and sell one trillion digital tokens in return for cash to fund company operations. The new token, called "Kin," would be developed for use in a "Kin Ecosystem," where Kin could at some future date be used to buy goods and services.

After publication in May 2017 of a "white paper" describing the planned ICO and Kin Ecosystem development, Kik implemented a sophisticated international marketing effort, including appearances on CNBC, press releases, social media activity and investor meetings akin to an initial public offering "road show."

Although warned by various parties that its activities could run afoul of the U.S. securities laws, Kik paid little heed, although it did terminate the offering in Canada after the Ontario Securities Commission raised concerns that the sale of Kin would violate securities laws because the Kin tokens were investment contracts and, thus, securities. The Canadian authorities even specifically referenced *Howey*, the 1946 U.S. Supreme Court case that defines an investment contract as the investment of money in a common enterprise with a reasonable expectation of profits to be derived from the efforts of others.

Using the *Howey* test and analytical tools from the Framework, the SEC had little difficulty concluding that the Kin tokens were securities. Further, the SEC concluded that Kik was engaged in a public offering that should have been registered under Section 5 of the Securities Act, so that investors would have the protection of the prospectus disclosures required by the Securities Act.

Several factors appear to have been critical to the SEC's analysis. First, the Kik ICO was expressly marketed based on the prospect of investor profits, not the supposed utility of the Kin token in an as yet to be developed messaging app ecosystem. Kik described Kin as an opportunity for investors to "make a lot of money." Kik was to profit as well, having retained three trillion Kin tokens for its own account. Kik also assured buyers that the tokens would be tradeable on online trading platforms, and Kik imposed no restrictions on the transfer of the tokens. As a result, the "reasonable expectation of profits" element of the *Howey* test was met.

The second key factor was the abject failure of Kik to develop the Kin Ecosystem prior to the offer and sale of the tokens. Although Kik pitched the ecosystem as driving the future appreciation in the value of Kin, the promised "rewards engine," "transaction services" and redesign of the Kik messaging app were not completed. Kik only managed to develop a "minimum viable product" comprising the reward of Kin investors with cartoon stickers on the Kik messaging app. This was a cynical attempt to create a "use" for the token that would, Kik believed, turn Kin into a "utility token" that would not be characterized as a security.

Accordingly, the purchasers of Kin tokens were dependent on Kik for continued development of the Kin Ecosystem in order for it to attain its intended functionality and to enhance its value, thereby meeting the "third prong" of the *Howey* test, the "efforts of others."

Another takeaway from the Kik complaint is that so-called simple agreements for future tokens ("SAFTs") are not only securities in themselves, but also are likely to be integrated into a simultaneous public offering of tokens, thereby blowing the possible exemption from registration for the SAFT. Kik tried to use Rule 506(c) under Regulation D as an exemption from registration for SAFTs that it offered to a limited number of high net worth investors. However, the SEC found that the SAFT offering did not qualify for the exemption since it was made as part of the larger non-exempt offering of securities (the Kin tokens) to the public.

The post-Framework path for compliance with the Securities Act by ICO issuers will become less murky over time, as additional guidance and enforcement actions by the SEC are forthcoming. However, the Kik complaint makes it clear that tokens structured with minimal functionality and maximum fund-raising potential are likely to be viewed as securities by the SEC and therefore subject to the registration and disclosure requirements of the Securities Act of 1933.

**Additional Information**

If you have questions about this Client Alert, please contact your Kutak Rock attorney or one of the authors listed below. For more information regarding our practices, please visit us at www.KutakRock.com.


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