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The SEC Finally Kicks Kik to the Curb: Federal Court Grants Summary Judgment to the SEC, Holding that Kin Tokens are Securities

Last week the U.S. Securities and Exchange Commission ("SEC") won a major victory in its ongoing war against initial coin offerings ("ICOs") of digital assets (called coins or tokens). A large number of ICOs were conducted in 2017 and 2018, raising billions of dollars for the promoters, without complying with the registration requirements of the Securities Act of 1933 ("Securities Act") or ensuring that there was an exemption from registration. The SEC brought high-profile enforcement actions against Kik Interactive Inc. ("Kik") and Telegram Group Inc. ("Telegram") in 2019. The SEC alleged that the Kik and Telegram tokens were in fact securities within the meaning of the U.S. securities laws and that Kik and Telegram should have registered the tokens under the Securities Act. Telegram settled with the SEC in June 2020 (returning $1.2 billion to investors), as have a number of smaller token issuers, including Unikm Inc. and Salt Blockchain Inc., f/k/a Salt Lending Holdings, Inc., which entered into settlements with the SEC in September 2020.

On September 30, 2020, Judge Hellerstein of the U.S. District Court for the Southern District of New York granted summary judgment in favor of the SEC in the Kik case, ruling that Kik's tokens, called "Kins," were securities and that the sale of $49.2 million in tokens in a "Token Distribution Event" (the ICO) was integrated with an earlier, arguably exempt, $50 million sale of "SAFTs" (Simple Agreements for Future Tokens) to accredited investors.

To recap the federal securities law applied by the SEC to token offerings, a token or other digital asset may be a "security" within the meaning of the Securities Act because of the 1946 Supreme Court Case *SEC v. W.J. Howey Co.* ("*Howey*"). An "investment contract" is included in the Securities Act's definition of a security. In *Howey*, the Supreme Court defined an "investment contract" as an investment of money in a common enterprise with an expectation of profits, derived solely from the entrepreneurial and managerial efforts of others.

Judge Hellerstein did not have the benefit of direct precedent applying the *Howey* test to cryptocurrencies. However, he had little difficulty applying *Howey* to the Kin tokens, holding that (i) the parties agreed that there was an investment of money, (ii) there was a common enterprise by reason of Kik's depositing the ICO proceeds in a single bank account and using them for operations (construction of the Kin ecosystem), and (iii) there was an expectation of profit on the part of the investors deriving from the efforts of others. As to the expectation of profits "prong" of the *Howey* test, Judge Hellerstein noted that Howey's requirement that profits derive "solely" from the efforts of others has been modified by subsequent Second Circuit precedent to delete "solely" as a literal requirement. He further noted that Kik promoted the Kin token sale by telling prospective investors that the limited supply and planned cryptocurrency exchange listings for Kin meant, "you could make a lot of money." Judge Hellerstein brushed aside Kik's "consumptive use" argument because the digital ecosystem for Kin did not exist at the time of the ICO. He also explained that the "efforts of others" element clearly was present because the demand for Kin and the value of the investment would depend on "Kik's entrepreneurial and managerial efforts," principally the development of the Kin ecosystem and integration of Kin into the Kik Messenger app.

Accordingly, Judge Hellerstein ruled that Kik's offering of Kin tokens in its ICO was an unregistered offering of securities that violated the Securities Act.

Kik had argued that its $50 million pre-sale of SAFTs to a limited number of accredited investors was exempt from Securities Act registration by reason of Rule 506(c) of Regulation D, which permits a general solicitation of investors if sales are made only to "accredited investors" who meet income and net worth requirements. However, Judge Hellerstein held that the SAFT sale was integrated with the unregistered sale of Kin tokens, which commenced the day after the SAFT offering concluded. As a result, the SAFT offering was also held to be in violation of the registration requirements of the Securities Act.

In determining whether the two offerings should have been integrated, Judge Hellerstein considered the factors set forth in Rule 502(a) of Regulation D: (a) whether the sales are part of a single plan of financing; (b) whether the sales involve issuance of the same class of securities; (c) whether the sales have been made at or about the same time; (d) whether the same type of consideration is being received; and (e) whether the sales are made for the same general purpose. Giving (a) and (e) the most weight, Judge Hellerstein reasoned that the funds from both offerings were used to fund Kik's operations and Kin ecosystem development. As he noted: "[o]ne would not have happened without the other, and both were integral to the successful launch of Kin." As a result, neither the pre-sale of SAFTs nor the sale of Kin tokens in the ICO complied with the registration provisions of the Securities Act. The parties were ordered to submit an order for injunctive and monetary relief by October 20.

Judge Hellerstein's ruling provides rare case law guidance as to the question of when a digital asset constitutes a security. By contrast, the SEC has failed to conduct a rulemaking in this area that would give the digital asset industry a clearer road map for compliance. An SEC rulemaking on when a digital asset constitutes a security would represent a step in the direction of less "regulation by enforcement" and would update *Howey's* 1946 test for the crypto age. Offering a greater degree of regulatory certainty for the crypto industry would lead to more innovation and benefits to the U.S. economy.

Additional Information

If you have any questions regarding 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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