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Another Significant Cryptocurrency Decision: *SEC v. Kik Interactive Inc.* and Token Offerings Under the Securities Laws

In March 2020, a Southern District of New York court issued a significant decision in *Securities and Exchange Commission v. Telegram Group Inc. et al.*, strengthening the U.S. government's efforts in cryptocurrency enforcement – an area that is largely unsettled. As we wrote in our article discussing that decision,[1] Judge P. Kevin Castel's opinion is potentially groundbreaking for the token industry – and the SEC's enforcement efforts in this space – because the court focused on "economic reality" in piercing through contractual representations and warranties to decide whether a token sale should be regulated under the securities laws.

Following on the heels of *Telegram Group*, on September 30, 2020, Judge Alvin K. Hellerstein of the Southern District of New York issued an equivalent decision in the matter of *Securities and Exchange Commission v. Kik Interactive Inc.*[2] In *Kik Interactive*, Judge Hellerstein granted the SEC's motion for summary judgment based on reasoning that principally aligned with *Telegram Group*, although Judge Hellerstein only referenced *Telegram Group* as "instructive" but distinguishable on its facts. As Judge Castel's opinion did, however, Judge Hellerstein's decision provides insight into a key regulatory

[1] David I. Miller, Charlie Berk, *SEC v. Telegram: A Groundbreaking Decision in Cryptocurrency Enforcement?*, GT Alert: Blockchain/Litigation, April 1, 2020.
[2] Unless otherwise indicated, all docket citations herein refer to the docket in *Securities and Exchange Commission v. Kik Interactive Inc.*, 19-cv-05244-AKH (S.D.N.Y. June 4, 2019).

question: when is the issuance of digital assets subject to the securities laws and SEC regulation? In granting the SEC's summary judgment motion, Judge Hellerstein found that Kik Interactive Inc. (Kik) offered and sold securities without a registration statement or exemption from registration, in violation of Section 5 of the Securities Act.[3] As was the case in *Telegram Group*, Judge Hellerstein emphasized the "economic realities" of the transactions at issue and concluded that under the Supreme Court's test in *SEC v. W.J. Howey Co.*, Kik's public sale of its token was a security offering, and its pre-public sale was part of an integrated offering with the public sale, all necessitating a registration statement. *Kik Interactive* and *Telegram Group* are two critical decisions for those contemplating issuing digital tokens.

Factual Background

Kik is a private company primarily known for its product "Kik Messenger," which allows users to communicate in real-time through their mobile devices, much like a text message application. In 2017, Kik created and sold a digital currency, which it called "Kin."[4] Kin was intended to be a cryptocurrency that would be stored, transferred, and recorded on a "blockchain." A blockchain is a distributed ledger that tracks the current and historical state of accounts, transactions, and/or events occurring on a network of computers, and is maintained by multiple parties, often referred to as validators or miners – who validate transactions occurring among users on the network. Transactions are grouped together over some time interval and posted to the ledger in "blocks," and each block is cryptographically linked to the previous block, creating an unbroken chain of valid transactions.[5]

Internally, Kik set a goal of raising $100 million through private and public sales of Kin.[6] Kik publicly promoted Kin, offering only a fixed supply of the digital currency in hopes that as the supply stayed fixed, demand, and thus price, would go up.[7]

Kin's launch took place in two phases: a private offering between June 2017 and September 11, 2017 (Pre-Sale), and a subsequent public offering known as a Token Distribution Event (TDE) beginning on September 12, 2017.[8] Through the Pre-Sale, Kik raised $50 million by entering into "Simple Agreements for Future Tokens" (SAFTs)[9] with 50 sophisticated investors, entitling those investors to pay U.S. dollars in exchange for Kin at a discounted price, to be received at and after the public offering.[10] Under the SAFTs, sophisticated investors acknowledged that their right to acquire Kin was a security and unregistered with the SEC, and that the right was being acquired for investment and not for resale.[11]

During the TDE (which began one day after the Pre-Sale ended), approximately 10,000 purchasers bought roughly one trillion Kin for 168,732 Ether, worth approximately $49.2 million.[12] Kik retained an additional three trillion Kin and – in combination with an associated not-for-profit entity that received six trillion additional tokens – controlled 90% of all issued and outstanding Kin tokens. At the time of Kin's

[3] *See* Dkt. 88 (MSJ Decision).
[4] *See id.* at 3.
[5] *See* Miller and Berk, *supra* note 1.
[6] *See* MSJ Decision at 3.
[7] *See id.*
[8] *See id.*
[9] SAFTs are agreements for the eventual transfer of tokens from cryptocurrency developers to investors. *See* Jake Frankenfield, *Simple Agreement for Future Tokens (SAFT)*, Investopedia, July 1, 2020.
[10] *See* MSJ Decision at 3-4.
[11] *See id.* at 4.
[12] *See id.* at 5.

distribution, no goods or services were available to holders of Kin.[13] Kik raised nearly $100 million from its cryptocurrency distribution, through which it funded its business operations.[14]

On June 4, 2019, the SEC filed an action alleging violations of Sections 5(a) and 5(c) of the Securities Act, contending that Kik offered and sold securities without a registration statement or exemption from registration.[15] On March 20, 2020, the parties filed competing motions for summary judgment. On July 9, 2020, Judge Hellerstein heard oral argument on the motions.

The Parties' Positions

As was the case in *SEC v. Telegram Group*, the legal questions before the Court in *SEC v. Kik Interactive Inc.* were: (i) whether the tokens distributed in the public sale – i.e., the TDE in *Kik Interactive* – were "securities" under the securities laws; and (ii) if so, whether the sale of an investment contract – the SAFTs – to purportedly accredited investors should be integrated with the public sale of Kin, requiring registration under the securities laws. A key issue in resolving these questions was thus whether the tokens were, in fact, securities under the Supreme Court's test in *S.E.C. v. W.J. Howey Co.* Under *Howey*, a transaction is an investment contract or security if it involves "a contract, transaction or scheme" whereby someone (1) "invests his money," (2) "in a common enterprise," and (3) "is led to expect profits" (4) "solely from the efforts of the promoter or a third party."[16] Both the SEC and Kik agreed that, in this case, the first element of the *Howey* test had been satisfied.[17]

The SEC argued that both the SAFT participants and the public purchasers alike had invested in a "common enterprise," as "the fortunes of all Kin investors were tied together by Kik's pooling of the funds that the investors paid Kik," and because "Kin investors understood that their fortunes would rise and fall with those of Kik because of Kik's large stake in Kin."[18] The SEC further argued that "as a matter of economic reality, if the price of Kin rose or fell, it would rise and fall for all Kin holders – purchasers and Kik alike."[19] As for the remaining *Howey* prongs, the SEC noted that Kik's marketing techniques "pervasively touted Kik's plans to increase Kin's value," by, for example, highlighting that Kin would be easily tradeable on secondary trading platforms, thus priming expectations that investors would be able to easily resell Kin at a profit.[20] According to the SEC, these tactics combined with Kik's promise to develop the Kin ecosystem and drive up the token's demand sufficed to show that Kin purchasers reasonably expected Kik's efforts to increase Kin's popularity and lead to investor profits.[21] Key to the SEC's case was its argument that the Pre-Sale and TDE were not two separate offerings but, in fact, a single integrated sale. Citing Kik's public statements and roadshow presentations, the SEC pointed out that Kik "used the same marketing and logistics for the two stages of the offering," and further highlighted that "the delivery of Kin to SAFT participants and the price at which the participants bought the Kin were both conditioned on the public phase of the offering."[22]

In contrast, while Kik acknowledged that the rights afforded under the SAFTs were securities – but exempt under Rule 506(c) of Regulation D because they were sold to accredited investors who were not underwriters – Kik claimed that no "common enterprise" existed between Kik and Kin's public purchasers

[13] *See id.*
[14] *See id.* at 6.
[15] *See id.* at 7.
[16] *SEC v. W.J. Howey*, 328 U.S. 293, 298-299 (1946); *see also United States v. Leonard*, 529 F.3d 83, 88 (2d Cir. 2008).
[17] *See* MSJ Decision at 9.
[18] Dkt. 58 at 23 (SEC MSJ); *Id.* at 24.
[19] *Id.* at 24.
[20] *Id.* at 26-27.
[21] *Id.* at 26.
[22] *Id.* at 40, 41.

because, *inter alia*, Kik did not owe TDE purchasers any ongoing contractual obligations. Kik also argued that Kin purchasers did not invest in a "common enterprise" because token holders retained full, independent control over their Kin, and could do "whatever they legally pleased" with the tokens.[23] By way of analogy, Kik argued that a finding that ownership of the same type of coins constitutes commonality "would lead to the absurd result of every commodity, such as Chuck-E-Cheese tokens and Starbucks gift cards. . . constituting 'securities.'"[24] Kik further argued that its managerial efforts and the SEC's marketing campaign arguments were not "undeniably significant" enough to constitute the "*Howey*-level 'commitments and promises'" that would subject Kik's offerings to securities laws.[25] In contending that the SEC could not show that there was any expectation of profit through Kik's managerial efforts, Kik highlighted that the relevant contracts between Kik and Kin purchasers are "devoid of any contractual duty to perform ongoing managerial services."[26] Citing the fact that Kik did not operate exchanges or guarantee liquidity for Kin, Kik argued that it marketed Kin as a medium of exchange within a new digital economy, not as an investment opportunity.[27]

Further, in Kik's view, its Kin Pre-Sale and TDE offerings constituted two distinct transactions. Kik pointed to "glaring differences" between the Pre-Sale and TDE, such as the fact that the "transactions were directed toward entirely different groups of purchasers," "the parties underwent entirely different registration processes," and that the sales "involved different operative contracts."[28] Finally, Kik asserted as an affirmative defense that the term "investment contract" is vague as applied to the Kin transactions.[29]

The Court's Decision

On September 30, 2020, Judge Hellerstein granted the SEC's motion for summary judgment in its entirety. As Judge Castel did in *SEC v. Telegram Group*, Judge Hellerstein highlighted "the *Howey* test's 'emphasis ... on economic reality'" in analyzing whether Kik's token offering complied with the securities laws.[30]

In his decision, Judge Hellerstein assessed each prong of the *Howey* test to determine whether the public transactions (TDE) between Kik and the Kin purchasers constituted a securities offering. First, the Court noted that there was no dispute amongst the parties about the fact that an investment of money had occurred.[31] Judge Hellerstein next opined that "Kik established a common enterprise"[32] because it deposited the funds it earned from the offerings into a single bank account and used that capital to fund its operations and build "the digital ecosystem it promoted," the success of which "dictated investor's profits."[33] The Court rejected Kik's argument that its lack of ongoing contractual obligations indicated a lack of "common enterprise," finding instead that contractual obligations are "important to, but not dispositive of, the common enterprise inquiry, and courts regularly consider representations and behavior

[23] Dkt. 62 at 21 (Kik MSJ).
[24] *Id.* at 27.
[25] *Id.* at 29.
[26] Dkt. 77 at 20 (Kik Opposition to SEC MSJ).
[27] *See* Kik Opposition to SEC MSJ at 32-33, 37.
[28] *Id.* at 60.
[29] *See* Dkt. 22 at 118-128 (Kik Answer to SEC Complaint).
[30] MSJ Decision at 11 (internal citations omitted).
[31] *See id.* at 9.
[32] The "common enterprise" prong of the *Howey* test can be satisfied by a showing of either "horizontal commonality" or "vertical commonality." Horizontal commonality exists where "each individual investor's fortunes [are tied] to the fortunes of the other investors by the pooling of assets, usually combined with the pro-rata distribution of profits." *Id.* at 9. Judge Hellerstein noted that the Second Circuit has rejected "broad vertical commonality, which only requires the fortunes of the investors to be linked to the *efforts* of the promoter," but has not decided "whether strict vertical commonality, which requires that the *fortunes* of the investor be tied to the fortunes of the promoter, can satisfy the 'common enterprise' element of the *Howey* test." *Id.* at n.5 (emphasis in original). Here, Judge Hellerstein found that horizontal commonality existed and did not opine on the issue of vertical commonality. *Id.*
[33] *Id.* at 10.

outside the contract."[34] Judge Hellerstein summarized his view as follows: "The economic reality is that Kik, as it said it would, pooled proceeds from its sales of Kin in an effort to create an infrastructure for Kin, and thus boost the value of the investment." As the Court further noted: "This is the nature of a common enterprise, to pool invested proceeds to increase the range of goods and services from which income and profits could be earned or, in the case of Kin, to increase the range of goods and services that holders of Kin would find beneficial to buy and sell with Kin. . . The stronger the ecosystem that Kik built, the greater the demand for Kin, and thus the greater the value of each purchaser's investment."[35]

Judge Hellerstein also found that Kik's offering led purchasers to reasonably expect profits based on Kik's managerial efforts. The Court noted that in "public statements and at public events promoting Kin, Kik extolled Kin's profit-making potential," and that "the demand for Kin, and thus the value of the investment. . . rel[ied] heavily on Kik's entrepreneurial and managerial efforts," such as Kik's promise to "provide startup resources, technology, and a covenant to integrate with the Kin cryptocurrency and brand."[36] Here, Judge Hellerstein took another opportunity to place emphasis on the economic realities behind the Kin offering, as he soundly rejected Kik's position that it characterized Kin as a medium for consumptive use rather than as an investment. He noted that "none of this 'consumptive use' was available at the time of the distribution. It would materialize only if the enterprise advertised by Kik turned out to be successful."[37] Kik, as Judge Hellerstein wrote, "foster[ed] an ecosystem rooted in Kin by 'creat[ing] a series of new products, services, and systems. . . [Kik] ignores the essential role [it played] in establishing the market."[38]

After finding that Kik's TDE sale was of a security, the Court then agreed with the SEC that the Pre-Sale and the TDE constituted a single integrated offering: "the Pre-Sale and TDE sale were part of a single plan of financing and made for the same general purpose. Proceeds from both sales went toward funding Kik's operations and building the ecosystem for Kin."[39] Judge Hellerstein also found that purchasers in the two sales "received the same class of securities," and that "[the] sales [] took place at about the same time."[40] As a consequence of combining the Pre-Sale and the TDE into a single offering, the Court found that the Pre-Sale was not eligible for an exemption under Rule 506(c) of Regulation D.[41] Thus, Kik's entire offering – in Judge Hellerstein's view – constituted an unregistered offering of securities in violation of Section 5 of the Securities Act. Notably, the Court's decision recognized the existence of, but did not rely on, Judge Castel's *SEC v. Telegram Group* decision as presenting purportedly distinguishable facts, even though – as can be seen from our article on that decision – the two cases emanate from similar factual circumstances with similar *Howey* and integration analyses and results.[42]

Finally, Judge Hellerstein rejected Kik's attempted affirmative defense that the term "investment contract" as used in the Securities Act is unconstitutionally vague as applied to Kik.[43] The Court held that *Howey* and its progeny "provide[] a clearly expressed test for determining what constitutes an investment contract."[44] Also, the Court found that the "the law provides sufficiently clear standards to eliminate the risk of arbitrary enforcement."[45] To this end, the Court rejected Kik's focus on the SEC's failure to issue adequate guidance regarding cryptocurrency regulation and purported inconsistent public statements on

[34] *Id.* at 10-11 (internal citations omitted).
[35] *Id.* at 11.
[36] *Id.* at 13.
[37] *Id.*
[38] *Id.* (internal citations omitted).
[39] *Id.* at 15.
[40] *Id.* at 16.
[41] *Id.* at 15-16.
[42] Miller and Berk, *supra* note 1.
[43] *See* MSJ Decision at 17.
[44] *Id.* at 18.
[45] *Id.* at 18.

the issue, as "the law does not require the Government to reach out and warn all potential violators on an individual or industry level."[46]

The Court directed the parties to submit a proposed judgment for injunctive and monetary relief by October 20, 2020. At the time of this writing, Kik has stated that it is evaluating its appellate options.

Implications

While there remain many unanswered questions in the realm of cryptocurrency enforcement and regulation, *SEC v. Kik Interactive Inc.* and *SEC v. Telegram Group* represent a renewed warning to digital asset providers that formalism and carefully constructed contractual language will not preclude a finding of securities violations where the Court views such warranties as in conflict with the "economic realities" of an integrated private/public transaction. Clearly, the *Kik Interactive* and *Telegram Group* decisions, and the SEC's intensifying enforcement efforts in the cryptocurrency space, could have a significant impact on the ability of companies to create, promote, and support digital assets in a flexible manner. Accordingly, prior to considering a token offering, including one with private and public components (like SAFTs), one should consider the analytical framework in these recent decisions.

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[46] *Id.* at 18.