

SEC Claims Kik's Kin Is a Security and Its Offering Was Illegal

The Bottom Line

- *The SEC's lawsuit against Kik Interactive, Inc. over the Kin ICO serves as a warning to those who want to start a new cryptocurrency: People will not use a new currency if it is not widely accepted, but the promoters' efforts to encourage its acceptance — and particularly the promoters' promises regarding the cryptocurrency's future value resulting from such efforts — have the potential to get the promoters in hot water with the SEC.*
- *Until there is a definitive answer as to whether and when a cryptocurrency is a security, those who wish to promote cryptocurrencies will need to tread carefully.*

The U.S. Securities and Exchange Commission (SEC) has sued Kik Interactive, Inc. (Kik), the owner and operator of Kik Messenger, a mobile messaging app, in federal court claiming that Kik's 2017 \$97-million crowdfunded initial coin offering (ICO) was an illegal public offering.

Cryptocurrency and ICO's

Cryptocurrency is "virtual currency" that uses blockchain technology to control the creation of digital tokens and operates independently of banks. Bitcoin and Ether are well-known examples of cryptocurrency. An ICO is an offering of cryptocurrency. ICO's are usually conducted via crowdfunding, often by startups seeking to raise money for a new app or service.

The Kik Case

The predominant question in the Kik case is whether cryptocurrency is a security, the public offering of which would require registration under the Securities Act. The Securities Act's definition of the term "security" includes the term "investment contract." While the definition of "security" in the Securities Exchange Act of 1934 expressly excludes "currency," the Securities Act definition does not.

The SEC has claimed that the digital tokens sold by Kik, which Kik named Kin, were marketed as an investment opportunity, and that Kik told investors that, based on Kik's efforts, demand for Kin would increase and drive up its value. Therefore, according to the SEC, Kik's Kin met the test of an "investment contract" set forth by the U.S. Supreme Court in *SEC v. Howey Co.*, 328 U.S. 293 (1946), in what is known as the *Howey* test — a contract, transaction or scheme whereby a person invests money in a common enterprise with an expectation of profit derived from the efforts of the promoter or other third parties.

The SEC has taken a similar position in a series of orders pertaining to settled administrative proceedings in respect of similar cryptocurrency offerings, including *In the Matter of Gladius Network LLC* (2019), *In the matter of Carriereq, Inc.* (2018) and *In the matter of Paragon Coin, Inc.* (2018).

SEC Claims

The SEC has acknowledged that, under certain circumstances, cryptocurrency might not be a security — e.g., a token that could be used to represent a participation interest in a “Book of the Month Club” might simply be a utility token— but that merely calling a token a utility token or designing it to provide some utility does not mean it’s not a security.

In other words, a token that had a fixed value against a fiat currency (e.g., dollars) and that could be used only to purchase something, say a book, would not be an investment contract as there would be no expectation that it might become more valuable in the future. However, a token that purported to have some utility but was offered and sold as a means of making a profit based on the efforts of the issuer of the token — e.g., a token representing an ownership interest in a book publisher — might very well be a security.

In its complaint, the SEC claimed that Kik sold Kin in order to raise cash for company operations. Kik’s marketing efforts described its plans to create, develop and support what it called the “Kin Ecosystem” in which, at some future point, Kin could be used to buy things, including the development of new technology to speed transactions in Kin and a “rewards engine” that would incentivize developers to make new products and services for Kin. Kik also described an investment in Kin as an opportunity to “make a ton of money.”

The SEC noted that Kik was well aware that Kin might be a security and attempted to give the tokens hypothetical “utility” by developing digital cartoon stickers that would only be available to Kin buyers who also had a Kik Messenger account.

Kik’s Defense

Kik has responded publicly to the SEC’s complaint by arguing that the SEC’s application of the *Howey* test to Kin is off-target. Filed on August 6, Kik’s lengthy answer to the SEC’s complaint portrays the complaint as twisting and mischaracterizing the facts to make them fit the *Howey* test.

A focus of the SEC’s complaint is that, at the time of the offering, the Kin Ecosystem was not already up and running. Had it been, and had Kik sold Kin simply as a means of effecting transactions on the Kin Ecosystem, the SEC might not have concluded that Kin was a security. It remains to be seen whether this view — that whether or not an instrument is a security can change over time depending on how it is marketed and used — will hold up in court.

Related People

Ralph W. Norton

Partner

212 468 4944

rnorton@dglaw.com