

# Goodmans<sup>LLP</sup> Update

## SEC Sues Canadian Company for Conducting Illegal Token Offering

Earlier this week, the U.S. Securities and Exchange Commission (SEC) sued Kitchener-based Kik Interactive Inc. (“Kik”), alleging the company’s sale of approximately US\$100 million of its “Kin” tokens undertaken in 2017 (the “ICO”) amounted to an illegal offering of securities. The SEC is seeking a permanent injunction, disgorgement of Kik’s profits from the ICO plus interest, and a fine to be paid by Kik as a penalty. The lawsuit represents an important opportunity for a U.S. court to clarify when U.S. securities laws will apply to the sale of digital coins and tokens.

### Background

Founded in 2009 by a group of University of Waterloo students, Kik’s business initially centred on the development of a mobile messaging application. In 2017, as the messaging app failed to generate profits, Kik announced it was creating its own cryptocurrency labelled Kin. Kin was designed as a “utility token”, as the tokens did not represent an ownership stake in Kik. Instead, the tokens were purportedly to be used as a currency to access features on the company’s messaging app as well as a future ecosystem of digital services to be developed by Kik.

Based on these characteristics, Kik proceeded on the basis the Kin tokens were not “securities” under U.S. or Canadian securities laws and did not structure the offering so as to comply with such laws. However, when the Ontario Securities Commission informed Kik that it viewed the Kin tokens as securities and would require compliance with conditions regarding investor protection for the ICO to proceed, Kik announced that Canadian residents would be excluded from the ICO.

Kik pushed forward, selling nearly US\$100 million of the Kin tokens first in a private pre-sale round pursuant to a Simple Agreement for Future Token (SAFT) and then by way of a public offering completed on September 12, 2017. Although Canadians (and residents of certain other jurisdictions) were excluded from the offering, over 10,000 investors participated in the ICO from 117 countries. Over half of the proceeds from the ICO came from investors located in the U.S.

For further background on the Kik ICO, refer to our August 30, 2017 Update, [Initial Coin Offerings in Canada: The CSA Weighs In](#), our September 12, 2017 Update, [Cryptocurrencies: Further Legal Developments](#), and our December 6, 2017 Update, [Read this Before Your ICO: Exploring the SAFT Framework for Compliant Token Sales in Canada](#).

### The Suit

On June 4, 2019, the SEC launched a civil suit against Kik, claiming the ICO was an illegal offering of securities because the tokens were sold by way of a public offering in the U.S. without a registration statement as required by U.S. securities laws.

The SEC’s lawsuit is premised on its view that the Kin tokens qualify as securities under U.S. securities laws because they are “investment contracts” under the “Howey” test established by the U.S. Supreme Court in *SEC v. Howey*. According to the SEC, Kik represented to investors that rising demand for Kin would drive up the value for the tokens, and that Kik’s future business activities would spur this increased value, paving the way for token holders to turn a profit on secondary markets. Kik allegedly told investors the company would hold on to 3 trillion Kin tokens after the ICO, and would profit alongside investors as the tokens immediately began trading following the ICO.

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“Kik told investors they could expect profits from its effort to create a digital ecosystem,” said Robert A. Cohen, Chief of the SEC enforcement division’s cyber unit. “[F]uture profits based on the efforts of others is a hallmark of a securities offering that must comply with the federal securities laws.”

The SEC’s claim also highlights the fact that, at the time of the ICO, Kik had not incorporated Kin into its messaging app, and there was no service or system with which Kin could be used as a currency to purchase anything.

## Implications

The SEC’s lawsuit against Kik is consistent with its clearly enunciated view that most (if not all) ICOs amount to securities offerings and its well-established track record of pursuing enforcement actions against those who conduct unregistered ICOs in the U.S. Its complaint lays out a compelling case, backed up by significant evidence, that Kik conceived of and conducted the ICO as a fundraising exercise that was promoted as an attractive investment opportunity at a time when the Kin tokens had little or no actual functionality. The complaint also takes aim at the SAFT structure that many token issuers, including Kik, have employed to complete private pre-sale rounds of token financing as exempt securities offerings. In the SEC’s view, the SAFT sales were not exempt from registration because they were effectively part of a single ICO transaction in which securities were offered to the public.

Kik has been bracing itself for the SEC suit, including by launching a campaign coined “Defend Crypto”, in support of its looming battle with the SEC and to support other cryptocurrencies in their fight to be exempted from securities regulation. The campaign has raised over US\$5 million in support of the cause. In response to the SEC’s allegations, Kik remains adamant that Kin is not a security because it was always intended to be used on a digital network of services, pointing to the token’s wide use as a currency across a multitude of apps.

The action represents the first time the SEC’s position on the application of U.S. securities laws to digital tokens and coins will be directly tested in court. Many in the cryptocurrency community will hope the proceedings help to clarify the SEC’s stance on when a token will be considered a security, potentially through the development of a legal test that could be applied to future tokens.

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