Goodmans LLP Update

U.S. District Court Finds U.S. Securities Laws Apply to Kik ICO

On October 1, 2020, the U.S. District Court for the Southern District of New York (the "**Court**") ruled that in 2017, Canadian technology company, Kik Interactive Inc., violated U.S. federal securities laws when it conducted the US$100 million initial coin offering of its "Kin" tokens (the "**ICO**"). The ruling states the ICO was an illegal securities offering because the tokens were sold without a registration statement or an exemption from registration as required by U.S. securities laws. This decision confirms that, in most circumstances, digital coin and token sales will be considered securities offerings to which U.S. securities laws apply.

Background

The Securities and Exchange Commission (SEC) began its investigation of Kik in 2017 as a result of the company's ICO and filed a lawsuit in June 2019. The lawsuit alleged that Kik's ICO was an illegal securities offering because the tokens were sold by public offering in the U.S. without a registration statement as U.S. securities laws require.

Kik argued that Kin is not a security; it is a "utility token" purchased for consumption purposes and not speculative purposes. Kik maintained that Kin was intended to be used on a digital network of services that would be developed using the ICO proceeds. As Kin was not a security, it was not subject to securities laws and the requirement to register the Kin tokens did not apply.

In May 2019, Kik launched a "Defend Crypto" campaign and raised $5 million in crowdfunding to support its legal battle. By the end of 2019, however, Kik faced serious financial pressure from its fight against the SEC. This caused Kik to sell its app and the vast majority of its employees. Kik stated the company is now focused solely on its cryptocurrency, Kin.

For further background on the Kik ICO, refer to our June 5, 2019 Update, *SEC Sues Canadian Company for Conducting Illegal Token Offering*, 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 Court's Ruling

The Court held that the ICO violated the U.S. Securities Act of 1933 (the "**Securities Act**") when Kik failed to register the sale of Kin tokens in connection with the ICO because Kin is a security.

Under the Securities Act, the definition of security includes an "investment contract". To determine what constitutes an investment contract, the Court relied on the "Howey" test established by the U.S. Supreme Court in *SEC v. Howey*. The Howey test defines an investment contract as (i) an investment of money, (ii) in a common enterprise, (iii) with profits to be derived solely from the efforts of others.

The Court considered it uncontroversial that the ICO involved an investment of money, satisfying the first element of the Howey test. Next, the Court found that Kik established a common enterprise when it deposited

Authors

Allan Goodman
agoodman@goodmans.ca
416.597.4243

Michael Partridge
mpartridge@goodmans.ca
416.597.5498

Andrew Schipper
aschipper@goodmans.ca
416.849.6006

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the funds into a single bank account and used the funds to create the digital ecosystem it promoted. This was a critical point because "the success of the ecosystem drove demand for Kin and thus dictated investors' profits," satisfying the second element of the Howey test. Finally, and possibly most importantly, Kik made repeated public statements extolling Kin's profit-making potential through increasing demand for Kin, and explained how Kin would be tradeable on cryptocurrency exchanges. These statements contradicted the view that Kin is merely a "utility token". The third element of the Howey test was therefore satisfied.

In addition, the Court found that Kik's private pre-sale round of Kin tokens pursuant to a Simple Agreement for Future Token (SAFT) before the ICO also amounted to an unregistered offering of securities and did not qualify for any exemptions. The pre-sales took place immediately before the ICO and the proceeds from both sales went towards the same general purpose. The Court concluded that "the two consecutive sales were part of a single plan to introduce Kin and jumpstart the Kin economy" and should therefore be viewed as a single integrated offering of securities that violated the Securities Act.

Implications

The Court confirmed the SEC's long-held position that U.S. securities laws apply to the sale of digital tokens where such sales constitute an investment contract under the Howey test. The decision echoed the views of the SEC that many digital token sales create investment contracts that constitute securities under the Howey test and must be registered with the SEC before a public offering. Absent the issuance of a pure "utility token" with none of the indicia of an investment contract, an issuer risks that the token offering will be offside securities regulation.

The decision also indicates that private pre-sale rounds of token financing under the SAFT structure will not be exempt from registration where they are effectively part of a single ICO transaction in which securities are offered to the public, even if the SAFT pre-sale is conducted as an exempt securities offering in compliance with U.S. securities laws. By treating the pre-sale round and the ICO as a single integrated offering, the decision raises questions about whether SAFTs can effectively separate the sale of a right to acquire tokens from the subsequent distribution of the tokens themselves. If nothing else, the Court's conclusion makes it clear that token issuers who wish to engage in pre-sales using the SAFT structure, must be very careful to ensure the SAFT sale is a separate, stand-alone transaction that is clearly separate from any subsequent token distribution.

Kik commented it is considering appealing the decision, remaining adamant that the public sale of Kin was a sale of a functional currency and not a securities offering. The earliest time for it to file an appeal is after October 20.

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