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Two Recent SEC Cases Involving Cryptocurrency Offerings

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Ever since the creation of Bitcoin in the late 2000s, the SEC has warned that, depending on the circumstances, "initial coin offerings" (ICOs) involving digital tokens or coins may be subject to regulation under the federal securities laws.[1] The SEC has provided "facts and circumstances" guidance regarding whether a particular cryptocurrency offering involves a security. *See*, *e.g.*, the SEC's Framework for "Investment Contract Analysis of Digital Assets." But officials have opined that cryptocurrencies sold only to be used to purchase a good or service, such as Bitcoin or Ethereum, may not be securities.[2]

The recent disposition of two SEC enforcement actions—*In the Matter of Unikrn, Inc.*, SEC Administrative Proceeding No. 3-20003, and *SEC v. Kik Interactive*, No. 19-cv-5244 (S.D.N.Y., filed June 4, 2019)—represent additional milestones in the debate over whether, and when, cryptocurrency offerings implicate the securities laws. In both actions, the SEC alleged the defendant violated Sections 5(a) and (c) of the Securities Act of 1933 by offering and selling securities—*i.e.* their respective cryptocurrencies—without a registration statement in effect, and without a valid exemption from registration. And, in *Kik*, the U.S. District Court ultimately agreed with the SEC.

These actions serve as a reminder that the *SEC v. Howey* investment contract factors should be considered when determining whether an ICO constitutes an offering or sale of securities. However, the unusual expression of dissent by one of the SEC's Commissioners regarding the *Unikrn* matter indicates this issue remains controversial and unsettled, particularly since there are relatively few cases that have resulted in published opinions.

SEC v. Kik Interactive

Background

In its Complaint in *SEC v. Kik Interactive*, the SEC alleged Kik conducted a $100 million illegally unregistered ICO of digital tokens. Kik disputed the allegations. Founded in 2009 as a messaging application company, in 2017 Kik "pivoted" to digital capital to raise funds. To this end, Kik created and sold a digital currency called "Kin," which was to be stored, transferred, and recorded on blockchain digital ledger. Kik contemplated that it would create demand for Kin by building a Kin "ecosystem" and incorporating it into its already existing messenger products.

Kik sold Kin in two phases: first via a private offering between June-September 11, 2017 (the "Pre-Sale"), and second via a public offering that took place beginning on September 12, 2017 (the "Token Distribution Event," or "TDE"). In the pre-sale, Kik entered into agreements with accredited investors, who acknowledged that Kin was an unregistered security. Kik received $50 million through the Pre-Sale and approximately $49.5 million though the TDE. On September 26, 2017, Kik distributed one trillion Kin to purchasers in the private and public sales, who had the right to make further sales in the secondary markets. On the same day, Kik distributed six trillion Kin to a not-for-profit entity it created, and it retained an additional three trillion Kin. As of September 26, 2017, when those distributions were made, no goods or services were available for sale to holders of Kin.

COURT'S HOLDING

On September 30, 2020, the United States District Court for the Southern District of New York granted summary judgment for the SEC, holding that Kik's entire offering constituted an illegally unregistered sale of securities in violation of Section 5 of the Securities Act of 1933.[3] The Court first reasoned that Kik's sale of Kin was an investment contract, and thus a security, under *SEC v. WJ Howey Co.*, 328 U.S. 293 (1946).[4] As established by the U.S. Supreme Court in *Howey*: "[A]n investment contract for purposes of the Securities Act means a contract, transaction or scheme whereby a person invests his money in a common enterprise and is led to expect profits solely from the efforts of the promoter or a third party." 328 U.S. at 298-99. The *Kik* Court found "horizontal commonality"—*i.e.* a circumstance in which each investor's fortunes are tied to the fortunes of other investors, by the pooling of assets—sufficient to establish a common enterprise, existed. It reasoned that Kik deposited all funds received from its offering into a single bank account and used those funds for its operations, including the development of the Kin ecosystem, which drove demand for and boosted the value of Kin. Thus, the stronger the ecosystem Kik built, the greater the demand for Kin, and the greater the value of each purchaser's investment. This supported the court's conclusion that there was a common enterprise.

Further, the Court found that "a reasonable expectation of profits to be derived from the entrepreneurial or managerial efforts of others," necessary for an investment to constitute an investment contract, also existed.[5] It reasoned that the demand for Kin, and the value of the investment, was "heavily dependent on Kik's entrepreneurial and managerial efforts." Kik was to integrate Kin into Kik messengers and create and foster the Kin ecosystem by creating a series of new products, services, and systems. Moreover, Kik had an incentive to increase demand for Kin, because it retained 30% of the tokens created. Kik's efforts were crucial because, without the promised digital ecosystem for Kin, Kin would be worthless. And, Kik had to be the primary driver of that ecosystem.

The Court further found that the Pre-Sale and TDE were an integrated offering. Therefore, the Pre-Sale did not qualify for an exemption under Regulation D and constituted an unregistered sale of securities.[6] It reasoned that the Pre-Sale and TDE were part of a single plan of financing made for the same general purpose, purchasers in both sales received identical assets, the sales took place at approximately the same time, and both sales were integral to a successful launch of Kin. As such, it held that the entirety of Kik's $100 million offering constituted an unregistered offer and sale of securities, in violation of Section 5. The Court concluded by ordering the parties to jointly submit a proposed judgment for injunctive and monetary relief. On October 20, 2020, the parties submitted Kik's consent to the entry of a final judgment that would require it to pay a $5 million civil penalty pursuant to Section 20(d) of the Securities Act.

In the Matter of Unikrn, Inc.

BACKGROUND

On September 15, 2020, the SEC issued a settled cease-and-desist order against Unikrn, Inc., operator of an online eSports gaming and gambling platform, again based on violations of Section 5, under very similar circumstances.[7] According to the SEC, Unikrn raised $31 million through the sale of Unikoin Gold ("UKG"), a digital token, through a pre-sale and an ICO. In the pre-sale, which began June 11, 2017, Unikrn offered UKG to Unikrn shareholders, wealthy individuals, and digital asset investment funds, who could purchase UKG through a "simple agreement for future tokens," or SAFT. In the ICO, beginning June 19, 2017, Unikrn offered its UKG to members of the public. UKGs were intended to facilitate users' access to products and services on the Unikrn platform, and the majority of the proceeds would be used for platform development. Unikrn retained 20% of the UKG tokens issued, while distributing another 10% to its employees.

CEASE-AND-DESIST ORDER

Based on *Howey*, the SEC determined that the UKGs were offered and sold as investment contracts, and were therefore securities, because a purchaser would have had a reasonable expectation of obtaining a future profit based on Unikrn's efforts. As such, the agency found that Unikrn violated Sections 5(a) and 5(c) of the Securities Act by offering and selling those securities without having a registration statement filed or in effect or qualifying for an exemption from registration. The SEC's order directed Unikrn to disable UKG and pay a $6.1 million civil penalty, representing substantially all of its assets. Although *Unikrn* was not litigated and not decided by a court, it provides additional context to the body of securities law governing cryptocurrency offerings.

DISSENT BY COMMISSIONER PEIRCE

The significant settlement in *Unikrn* gave rise to a rare dissent by Commissioner Hester M. Peirce, a Republican who has often expressed support for cryptocurrency and digital assets and concerns about regulator overreach. Commissioner Pierce opined that such enforcement actions quell innovation and stifle economic growth.[8] She noted that, by requiring Unikrn to permanently disable the UKG, which it had integrated into its product offerings, and pay a penalty representing substantially all of its assets, the SEC "effectively forc[ed] the company to cease operations because of an allegedly improper offering of supposed securities." The Commissioner noted that *Unikrn* involved no allegations of fraud, and disagreed that Unikrn engaged in an offering of securities. She further noted that, because determining whether an offering is an investment contract requires a weighing of facts and circumstances and is particularly challenging in the context of new businesses and technologies, there are no "clear guideposts for entrepreneurs and others to follow." Consequently, entrepreneurs may be forced to expend limited capital on legal consultation and compliance, or face enforcement actions.

To solve this dilemma, Commissioner Peirce thus proposed that companies such as Unikrn should be allowed a 3-year regulatory window to develop and refine its platform, while still being subjected to the antifraud provisions of the federal securities laws. The Commissioner noted that, if such a safe harbor had been available to Unikrn, instead of permanently disabling its tokens as a result of the SEC's settled enforcement action, Unikrn, in concert with its tokenholders, might be devoting its time and resources to identifying new uses and expanding its user base. And, though acknowledging not all might see the loss of benefits of innovation as large in the case of Unikrn, Commissioner Peirce opined that "posterity will feel the cumulative loss to society of innovation foregone" because of

action such as *Unikrn*. The Commissioner further opined that society "will never know the full magnitude of such losses, because some would-be entrepreneurs might, in light of enforcement actions like *Unikrn*, opt to shelve their most transformative ideas. Thus, Commissioner Peirce noted, by failing to experiment with new approaches to regulation, the SEC risks "surrendering the fruits of innovation."

Take-Aways

The dispositions of *Kik* and *Unikrn* demonstrate that ICOs may be viewed by the SEC and courts as offerings of securities; however, Commissioner Peirce's dissent indicates the legal issues remain controversial and somewhat unsettled. Accordingly, anyone offering cryptocurrencies should consult with qualified securities law counsel.

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[1] *See*, *e.g.*, SEC's *Report of Investigation* pursuant to Section 21 of the Exchange Act (the "DAO Report"), Release No. 81207, issued July 25, 2017. An "Initial Coin Offering" or "ICO" is a fundraising event in which an entity offers participants a unique digital asset – often described as a "coin" or "token" – in exchange for consideration.

[2] See *Digital Asset Transactions: When Howey Met Gary (Plastic)*, Speech of William Hinman, Director, Division of Corporation Finance (June 14, 2018).

[3] *See* Opinion and Order on Motions for Summary Judgment, Doc. No. 88, No. 19-cv-5244 (S.D.N.Y.), filed Sept. 30, 2020 (the "Summary Judgement Order").

[4] Under Section 2(a)(1) of the Securities Act, a "security" includes an "investment contract." 15 U.S.C. § 77b(a)(1).

[5] *See* Summary Judgement Order, *supra*, at note 3 (quoting *United Hous. Found., Inc. v. Forman*, 421 U.S. 837, 852 (1975)).

[6] The Court further rejected Kik's assertion that "investment contract" was unconstitutionally vague as applied to Kik.

[7] *See In the Matter of Unikrn, Inc.*, SEC Administrative Proceeding No. 3-20003, Release No. 10841, Order Instituting Cease-and-Desist Proceedings Pursuant to Section 8A of the Securities Act of 1933, Making Findings and Imposing Penalties and a Cease-and-Desist Order, available at https://www.sec.gov/litigation/admin/2020/33-10841.pdf.

[8] *See* Commissioner Hester M. Peirce, Statement on SEC Settlement Charging Token Issuer with Violation of Registration Provisions of the Securities Act of 1933, issued Sept. 15, 2020.

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