**Insights**

# SEC PUTS SAFT ISSUERS ON NOTICE (AGAIN)

Oct 06, 2020

On September 30, 2020, Judge Alvin Hellerstein, of the Southern District of New York ("SDNY") granted summary judgment to the Securities and Exchange Commission ("SEC") in its enforcement action against Kik Interactive Inc. ("Kik"), in which the SEC contended that Kik's 2017 $100 million Initial Coin Offering ("ICO") was an unregistered securities offering.[1] The **Kik** decision marks the second time this year that a federal judge in the SDNY has determined that an ICO involving the "Simple Agreement for Future Tokens" ("SAFT") framework constituted an unlawful unregistered securities offering, establishing a daunting precedent for both potential and past SAFT issuers.

## Background

As previously reported here, SAFTs were formulated in 2017 as a creative solution to conduct ICOs without triggering the registration requirements of the U.S. securities laws, thereby enabling startups to secure initial infusions of cash. Traditional SAFTs contemplate a two-step transaction: (i) an initial exempt securities offering to accredited investors, with those "securities" consisting of rights to receive future digital assets (often designated as "tokens" or "coins") that would be developed using funds raised in the exempt offering; and (ii) after the digital assets have been technologically developed and function as promised (achieving "utility"), an issuance and distribution of the assets to the initial rights purchasers. It was thought that if investors' interest in the digital assets – at the time they would receive them in the future – could be characterized as an interest in their consumptive use, rather than for investment purposes, then the instruments would not be considered securities under the test articulated by the Supreme Court in **SEC v. W.J. Howey Co.**[2]

The SEC initially sued Kik in June 2019, claiming that its 2017 offering, partially conducted via SAFTs, was an illegal issuance of unregistered securities. In Kik's SAFT, accredited investors who participated in the exempt offering purchased the right to receive future tokens (called "Kin") at a 30 percent discount to the price at which the public could purchase the Kin in a subsequent public offering.  The subsequent public sale of Kin began the day after completion of the purportedly-exempt securities offering of the right to receive the Kin in the future via the SAFT. Kik required each accredited investor to sign a legal disclaimer stating that it was entering into the agreement for its own account, and not for the purpose of resale. In total, Kik sold 1 trillion Kin, generating a total of approximately $100 million in both the private and public sales. Though Kik filed a Form D with the

SEC that claimed its initial private sales of SAFTs to accredited investors were exempt from the Securities Act's registration requirements, Kik did not register the Kin public offering with the SEC.

In cross-motions for summary judgment, Kik argued that at time of issuance Kin would have functional utility and act as a currency on a not-yet-developed decentralized ledger, so that investors' motivation to purchase them should be viewed as for consumption of their utility rather than investment purposes. It also claimed the two-transactions (the presale and public sale) were distinct and should be assessed separately. The SEC conversely argued that the initial sale of rights agreements to accredited investors was integrated with the subsequent public sale of Kin tokens, and the two transactions together constituted an illegal unregistered sale of securities.

## Court Decision

In granting the SEC's motion for summary judgment, Judge Hellerstein held the "undisputed facts" showed that Kik offered and sold securities without an effective registration statement or exemption from registration, in violation of Section 5 of the Securities Act. Kik had conceded that its public sale of Kin involved an investment of money (whether in the form of virtual or fiat currency), but argued that the SEC could not show that the second and third elements of the **Howey** test were met – i.e., that the money was invested in a common enterprise, and with expectation of profits based on the efforts of other.  The court found a common enterprise existed because Kik deposited the funds into a single bank account in order to fund its construction of the Kin ecosystem. And because the success of the ecosystem drove demand for Kin tokens, the court held that the economic reality consisted of proceeds from the sale of Kin tokens being pooled to fund buildout of the ecosystem in which they could be used, thus boosting demand for the instruments themselves – which the court deemed to be the "nature of a common enterprise." The court also found that Kik's public statements promoting Kin's potential led investors to reasonably expect profits derived from Kik's entrepreneurial and managerial efforts.  Moreover, the court rejected Kik's "consumptive use" argument, maintaining that no "consumptive use" was available at the time of distribution, and that such use would materialize only if Kik was successful in its efforts to attract investment. The court then concluded that the first or "presale" step of the SAFT was "intertwined" with the public sale as part of a single integrated offering under the traditional factors for assessing such transactions.  Because the two steps were a single effort to raise capital and build the Kin ecosystem, the court held that they constituted an unregistered offering of securities. The court ordered the parties to jointly submit a proposed judgment for injunctive and monetary relief, though Kik is expected to appeal the court's decision.

## Takeaways

While Judge Hellerstein acknowledged that "every cryptocurrency" and issuance is different and requires a fact-specific analysis, past SAFT issuers should nonetheless be aware of the SEC's heightened skepticism regarding the SAFT structure. This decision, along with the SDNY's earlier issuance of an injunction against Telegram, underscores that issuers and investors should examine any past SAFT issuance or investment to determine their most advisable course and legal options. Companies with questions regarding compliant fundraising methods utilizing digital assets and cryptocurrencies, or strategies for mitigating any past issuances that have proven problematic, should contact Ashley Ebersole (ashley.ebersole@bclplaw.com), Jason Semmes (jason.semmes@bclplaw.com), or a member of the BCLP Securities and Corporate Governance team.

[1] **SEC v. Kik Interactive Inc.**, Docket No. 1:19-cv-05244 (S.D.N.Y. Sep. 30, 2020) (opinion and order granting motion for summary judgment).

[2] **SEC v. W.J. Howey Co.***,* 328 U.S. 293, 301 (1946). Section 2(a)(1) of the Securities Act defines “security” to include an “investment contract.” Under the *Howey* test, a transaction represents an investment contract if “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.”

### RELATED PRACTICE AREAS

- Financial Regulation Compliance & Investigations
- Fintech
- Regulation, Compliance & Advisory
- Securities & Corporate Governance
- White Collar

## MEET THE TEAM

**Robert J. Endicott**

St. Louis

rob.endicott@bclplaw.com
+1 314 259 2447

This material is not comprehensive, is for informational purposes only, and is not legal advice. Your use or receipt of this material does not create an attorney-client relationship between us. If you require legal advice, you should consult an attorney regarding your particular circumstances. The choice of a lawyer is an important decision and should not be based solely upon advertisements. This material may be “Attorney Advertising” under the ethics and professional rules of certain jurisdictions. For advertising purposes, St. Louis, Missouri, is designated BCLP’s principal office and Kathrine Dixon (kathrine.dixon@bclplaw.com) as the responsible attorney.

© 2024 Bryan Cave Leighton Paisner LLP.