Facebook And Kik: Similar Products, Disparate SEC Treatment

By **Zvi Gabbay** (July 29, 2019, 1:47 PM EDT)

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In the course of June 2019 two seemingly unrelated events occurred. A closer look at these two events, however, reveals an interesting connection and a troubling conclusion.

The first event occurred in early June 2019, when the U.S. Securities and Exchange Commission commenced legal proceedings against Kik Interactive Inc. — an instant messaging app developer — in federal court in New York. In its complaint, the SEC alleged that Kik violated Section 5 of the Securities Act of 1933 by offering and selling unregistered securities in interstate commerce absent an exemption.

The second event occurred two weeks later, when Facebook Inc. released the Libra white paper, announcing to the world the launch of a new cryptocurrency: "[A] reliable digital currency and infrastructure that together can deliver on the promise of "the internet of money."[1]

So how are these two events connected?

According to the SEC, between May and September 2017, Kik offered and sold digital tokens called "Kin" that are allegedly unregistered securities. These tokens were designed to be used as a payment means for products and services distributed on the platform that Kik intended to launch based on blockchain technology.

Kik's vision was to make the use of fiat money and the need to convert fiat to cryptocurrency unnecessary. Payments can be as simple as sending a text message or a picture, no matter the nationality or location of the payer or the transferee.

Admittedly, this vision sounded in the summer of 2017 somewhat naïve and utopic, and the language of the SEC complaint makes it abundantly clear that the SEC viewed the Kin initiative as a disingenuous attempt to raise money quickly and avoid shutting down the company. But then, along came Facebook, with the exact same vision and exact same plan (but better developed than the one presented by Kik) — using an existing social network in order to create a cryptocurrency ecosystem — and suddenly the utopic vision doesn't sound so utopic anymore.

One may ask why is the vision and its realistic prospects relevant at all? If a company offers and sells unregistered securities absent an exemption it is in violation of Section 5 of the Securities Act, end of story. True, but why are the digital tokens offered by Kik considered securities?

At this point, and until the court instructs otherwise, Kin is allegedly a security only because the SEC says so. In order to support its theory, the SEC relies on the test set forth in SEC v. W.J. Howey,[2] a U.S. Supreme Court decision from 1946 — when home refrigerators were a novelty — in order to classify Kin as an "investment contract."

Under Howey, investment contracts are transactions in which investments are made in a common enterprise, and profits are expected to be derived from the efforts of others. This broad definition will catch anything the SEC wants it to catch, and I am quite sure Kik will

argue in court that the Howey test does not deem Kin a security.

What I would like to argue is that the Howey test should not be applied in this case, not that it cannot be applied. I believe that the SEC looked at Kik's initial coin offering as an attempt to sell a dream to the public and therefore the Kin project could not be anything more than a highly speculative investment.

What makes it highly speculative is the utopic vision and the seemingly incapable visionary. But these two factors cannot play a role in the analytical classification of a digital product, and the fact that they did merely illustrates the regulators' attempts to cling to existing definitions and classifications when encountering new technologies and innovative products. I know, I am an ex-regulator myself.

I also understand this natural tendency to fit innovation in boxes we already have. Sometimes it works and is appropriate. Many ICOs were in fact unregistered securities offerings, and the fact they were called "digital tokens" should not make a difference. But if this was so simple, why isn't the SEC approving these offerings when approached by companies seeking to issue security-tokens in full compliance with securities laws?

Libra was announced two weeks after the Kik lawsuit was filed. Libra is intended to function in a very similar way to Kin, but interestingly, the SEC did not issue a public warning to Facebook that if it continues to pursue the Libra initiative it will face similar consequences as Kik.

In fact, in mid-July 2019, a month after Facebook published the Libra white paper, SEC Chairman Jay Clayton publicly said that he did not discuss the Libra "ambitious project" with Facebook and that he was "keenly interested in their securities law analysis."[3]

So one of the most powerful securities regulators in the world is waiting patiently for Facebook to make the first move and feels the need to understand Facebook's "securities law analysis" before making up its mind.

Why should the "securities law analysis" of Libra be any different than the "securities law analysis" of Kin? Perhaps securities laws do not apply here at all, and, as President Donald Trump wrote on Twitter: "If Facebook and other companies want to become a bank, they must seek a new banking charter and become subject to all banking regulations, just like other banks, both national and international."[4]

The truth is that it is not at all clear that securities laws apply to Kin or to Libra, and it is not at all clear that they should apply. The world is moving forward fast, and blockchain technology is going to impact the financial industry in ways that we cannot grasp at this point. Kik understood this and ran ahead with the ICO of Kin. They wanted to be ahead of the game when Facebook made its move, because they knew that it was their only chance to survive once Facebook launches its own cryptocurrency.

Indeed, Kik operated in a difficult legal environment because of the regulatory uncertainty. Theoretically, they could have approached the SEC and asked that it approve the ICO as a securities offering. But in 2017, and the same can be said also for 2019, the SEC did not provide such approvals, and more importantly — Kik did not believe that Kin was a security.

For these reasons, among many others, regulatory uncertainty should not deter innovation, and regulators should not impose existing regulatory classifications on innovative technology that we still have a hard time understanding today, and the world did not even

dream of in 1946.

Kik did not wait for the SEC and enthusiastically promoted its own vision for creating an independent financial system based on its platform, through technology that will redefine the financial system as we currently know it. However, just like Galileo Galilei, it was confronted by the "church" — i.e., the SEC — which attempted to prevent progress with all its might.

But progress cannot be prevented. Now, Facebook — a corporate super power — joined by formidable business partners like Visa Inc., Mastercard Inc., Uber Technologies Inc., PayPal Holdings Inc. and others, stepped into the ring, with a similar — but purportedly better and bigger — digital token, and suddenly the SEC is waiting to hear Facebook's analysis of securities laws.

Apparently, Galileo was right when he said, "And yet it moves." The SEC cannot and should not attempt to stop it.

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[1] Libra White Paper, p. 3, https://libra.org/en-US/white-paper/.

[2] SEC v. W.J. Howey Co., 328 U.S. 293 (1946)

[3] https://www.reuters.com/article/us-facebook-crypto-sec/u-s-sec-chief-says-he-has-not-discussed-libra-with-facebook-idUSKCN1UB2DK.

[4] https://www.reuters.com/article/us-usa-trump-cryptocurrency/trump-blasts-bitcoin-facebooks-libra-demands-they-face-banking-regulations-idUSKCN1U701I.