The SEC Can’t Keep Kik-ing the Crypto Can Down the Road

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The Securities and Exchange Commission, the most important regulator for the largest capital market in the world, has been grappling with the question of how to regulate cryptocurrencies for more than two years. Yet as of mid-2019, more than 10 years since the birth of bitcoin, it cannot claim to have made much progress.

The latest example of the SEC’s ambiguous approach is the launch of an enforcement action against Kik Interactive, Inc. Kik is a social media platform that began issuing its own cryptocurrency (Kin) in mid-2017.

Before the enforcement action, Kin’s market capitalization was $40 million – tiny by comparison to the wider crypto market ($245 billion), which is itself a tiny fraction of the $65 trillion market value of U.S.-listed stocks and bonds.

The SEC has a mandate to bring actions against individuals and firms that issue securities without registering the offering or adhering to an exemption. But the Commission has so far failed to provide any reliable guidance as to which criteria it uses to determine whether a token qualifies as a security.

Important spokespeople for the SEC, such as its Chairman Jay Clayton and the Director of Corporation Finance Bill Hinman, have made divergent statements. More generally, the SEC has repeatedly stated that it will judge future cases by their individual “facts and circumstances,” which has not helped market participants understand its general approach.

What has been lacking is a clear statement of the circumstances in which a token offering is not a securities offering. The SEC has failed to provide an avenue for crypto issuers who – as seems to be the case with Kin’s promoters – do not wish to offer a security and want to make that clear from the outset to prospective buyers.

Mixed signals

As recently as last year, Chairman Clayton claimed that “all ICOs [initial coin offerings] [he’d] seen [were] securities.” Yet, in the more than 12 months since, the SEC has pursued three dozen enforcement actions against digital asset issuers. That’s less than 10 percent of the 434 ICOs that the SEC’s own complaint against Kin cites for 2017, using figures from CoinDesk. What’s more, many of those three dozen involve outright fraud, not just unregistered securities offerings.

Clayton has not yet, to my knowledge, amended his previous statement. Meanwhile, Hinman almost exactly a year ago said in a speech that if a cryptocurrency was decentralized enough, it would not meet the SEC's definition of a security, which involves a common enterprise and profits generated solely from the efforts of people other than the owner – the so-called Howey test.

A long-awaited guidance on digital asset offerings sought to outline, in plain English, the SEC's procedure for deciding whether a token offering is an investment contract regulated by the SEC. Unfortunately, the guidance turned the 70-year-old, four-pronged Howey test into a 40-point-plus list of potential reasons why the SEC might consider a token offering to be an offering of securities. The guidance also introduced new concepts, like that of an "active participant," which arguably broaden the reach of the Howey test beyond what the courts have previously interpreted.

Even SEC insiders have been critical of this guidance. Commissioner Hester Peirce, one of the loudest voices for innovation and clarity currently holding a top office at the SEC, has warned that the guidance risks unduly expanding the Commission's remit in cryptocurrency regulation and discouraging innovators from doing business in the United States.

Fleeing the US

Indeed, major industry players like Binance and Circle have already either fully or partially geo-blocked United States IP addresses from using their services. Companies and talent have relocated to friendlier jurisdictions, such as Singapore and Switzerland. U.S. consumers and investors have been forced to forgo participation in what could be beneficial innovation in which they have a right to partake. Given America's pre-eminent status as a financial and technology hub, and the large size of U.S. consumer and investment markets, this shift in geographic location appears to be mainly due to a failure of regulation. As the main regulator and the most aggressive when it comes to cryptocurrencies, the SEC has, however unwittingly, prolonged regulatory uncertainty.

Kik and its supporters see the SEC's enforcement action as a chance to provide clarity for the crypto industry, and they have established a legal defense fund to that end. They argue that Kin was not marketed as an investment of money, but rather as a medium of exchange on the Kik platform and as a reward for performing certain activities on that platform. Kik also disputes the SEC's claim of centralization and denies that users could have had an expectation of profits based on the efforts of the promoters.

Whether these arguments will persuade the court is an open question. Kin's offering certainly shares some features with other ICOs, such as Munchee, that have previously settled with the SEC and returned the funds raised to their investors. The language used by Kin representatives and in documents relating to the 2017 token offering also arguably hint at a common enterprise and the possibility of quick returns, two prongs of the Howey test. Those statements might strengthen the prosecution's case that Kin meets the Howey test.

Regardless of the outcome on the question of a securities law violation, a court might take a stab at defining decentralization, at last providing a reliable standard to establish which crypto projects fall under the SEC's remit. The court is not the sole path for greater certainty. Legislative efforts, notably the Token Taxonomy Act, look to provide a legal definition of a digital token that would, in specific and clearly defined circumstances, fall outside the purview of the securities laws. I have also offered a frameworkthat would treat functional cryptocurrencies as commodities and provide an off-ramp from securities registration for non-functional tokens that meet certain conditions, while retaining existing rules for tokens that meet the Howey test.

Over the last two years, the SEC has missed several opportunities to give clear and consistent guidance about the regulatory status of cryptocurrencies. This inaction has needlessly prolonged uncertainty and instilled distrust and fear among market participants. The effects of this failure on America's leadership in financial innovation are likely to be long-lasting.

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