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Kardashian Settlement With SEC Is Latest in Agency's Ramp-up of Crypto Asset Enforcement Efforts

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On October 3, the Securities and Exchange Commission (SEC) issued a press release in which it announced that it had reached a settlement in an investigation involving celebrity influencer Kim Kardashian for touting a crypto asset without disclosing the payment she received for the endorsement. Per the SEC release, Kardashian agreed that she had used her Instagram account to endorse a cryptocurrency called EMAX, for which she was paid $250,000. The SEC found that Kardashian did not disclose the fact that she was paid for the endorsement, in violation of securities laws. Without admitting or denying the SEC's findings, Kardashian agreed to resolve the SEC investigation in return for the payment of $1.26 million, which included $250,000 in disgorgement, $10,000 in interest, and a $1 million penalty.

While this matter was discreet and is concluded, it is nonetheless a noteworthy development for those who offer, sell, or promote crypto-related assets because it is illustrative of the recent pattern of SEC enforcement actions involving crypto assets using existing securities laws. The enforcement action against Kardashian tracks with the SEC's history of crypto asset classification and recent aggressive enforcement action. The SEC alleged that Kardashian violated Section 17(b) of the Securities Act, otherwise known as the "anti-touting" provision, which prohibits the promotion of a "security" without fully disclosing the receipt of any consideration received for the promotion and the amount thereof. Because Kardashian had failed to publicly disclose her $250,000 payment, the SEC viewed her endorsement of EMAX to be in violation of Section 17(b). Necessary to making these allegations, of course, was the SEC having first made the determination that EMAX, the digital asset Kardashian promoted, was a "security" within the meaning of the Securities Act of 1933. The SEC's willingness to make that decision and proceed with its enforcement action against Kardashian, especially when considered in light of past SEC enforcement actions involving cryptocurrency assets, is further weighty evidence that the agency will likely continue to take an aggressive approach to the question of whether a particular crypto asset is a "security" subject to SEC regulation.

The Kardashian enforcement action is consistent not only with past enforcement actions by the SEC,[1] but also with other recent actions by the agency. Most notably, in May, the SEC signaled in a press release that it would be giving heightened attention to investigations involving the crypto market when it nearly doubled the size of its Crypto Assets and Cyber Unit team. Given the SEC's clear signaling of its intent to increase focus on cryptocurrency; the lack of extensive case law on this issue; the complex regulatory framework and public disclosure requirements that apply in the "securities" context; and the potential monetary and criminal penalties at stake; it is of crucial importance to understand the risks and implications of the SEC's treatment of cryptocurrency before embarking on potentially risky actions or business ventures in the cryptocurrency space.

The SEC's Treatment of "Crypto" As "Security"

While the Securities Act of 1933 undoubtedly regulates "securities," the advent of decentralized cryptocurrencies has presented new and complex legal challenges for participants in this newly minted market. Most importantly: (a) how are individuals and businesses to know whether the SEC will consider a particular cryptocurrency to be a "security" subject to their regulation; and, (b) what are some of the potential defenses to adverse SEC interpretation should an individual or business find itself facing a hostile SEC civil case and possible criminal prosecution?

Since 1946, the question of whether an asset constitutes a "security" under the Securities Act has been governed by the test the U.S. Supreme Court set forth in *SEC v. W.J. Howey Co.* There, the Court identified factors that guide the inquiry, including: (1) the investment of money; (2) a common enterprise; and (3) a reasonable expectation of profit derived from the efforts of others.

On April 3, 2019, the SEC provided guidance on the application of the *Howey* factors to digital assets in its Framework for "Investment Contract" Analysis of Digital Assets. In a statement accompanying the framework, the SEC stated, "[d]epending on the nature of the digital asset … it may fall within the definition of a security under the U.S. federal securities laws." While the framework provided some practical guidance for participants in the digital assets markets, it also left open significant questions as to the coverage of the ever-changing landscape of digital assets. Moreover, since the release of this guidance, SEC Chair Gary Gensler has made public statements that suggest that the SEC will treat many crypto assets as "securities," particularly if they are offered for sale in an initial coin offering (ICO, similar to an initial public offering of stock) or if they are traded on a cryptocurrency platform. Thus, the SEC framework, coupled with Gensler's public comments and recent SEC enforcement actions, including against Kardashian, certainly suggest that the SEC will continue to take a broad view of crypto assets as securities.

The EMAX Token at Issue in the Kardashian Enforcement Action

EMAX is a crypto token built on the Ethereum network and offered by EthereumMax. According to the whitepaper drafted for the project, EMAX is a "culture token," through which holders are promised access to an array of crypto benefits. One benefit is access to another token, based on the same platform, called XMAX.

As the whitepaper indicates, holders of XMAX can profit from the token in two primary ways: staking and bonding. Staking is the act of "locking" away your XMAX for a period of time — or preventing your free use of the token for the benefit of the pool — for which you receive a reward of additional XMAX. Bonding, similar to staking, is the commitment of upfront capital in forms other than XMAX for a minimum period of time; the bonder is promised a fixed return of discounted XMAX at the end of the commitment period.

Unlike profit generation through traditional securities, which typically involves more passive forms of financial growth, newer models of digital currency sometimes utilize more "active" forms of wealth generation, including staking and bonding. With these new forms of digital asset profit creation come new questions surrounding the asset's qualification as a "security" under the 1946 standard set forth in *Howey*. Implicit in the SEC's decision to investigate Kardashian is its conclusion that EMAX qualifies as a "security," despite the bonding and staking methods of profit generation associated with the XMAX token that was available to EMAX holders. Thus, the SEC

clearly viewed EMAX to be a "security" that met all three prongs of the *Howey* test, including "[a] reasonable expectation of profit derived from the efforts of others," even despite the arguably active methods of profit generation by staking and bonding the XMAX token.

SEC Registration and Anti-Touting Enforcement Against EMAX and Other Crypto Assets

Although the SEC has been careful to make clear that its framework for classifying digital assets is merely guidance and that it does not represent law, an SEC enforcement action can have significant repercussions to the targets of that action. And the SEC's recent actions suggest that the SEC will continue to aggressively pursue enforcement actions in the cryptocurrency space. Because the issue of whether the SEC will deem a particular cryptocurrency asset to be a "security" can have significant implications, it is helpful to look at the SEC's recent treatment of other cryptocurrency assets to understand the factors upon which the SEC may rely in making such a determination.

In late September, not long before it announced the Kardashian enforcement action, the SEC announced two separate enforcement actions, both of which are further evidence of the SEC's intention to regulate the crypto industry through selective enforcement. On September 19, the SEC announced that it had issued a cease-and-desist order against Sparkster Ltd, its CEO, and a crypto influencer. The order asserted that Sparkster held an unregistered offering and sale of a crypto asset called "SPRK tokens." As the SEC release indicated, the cease-and-desist order found "[t]hat the SPRK tokens, as offered and sold, were securities, were not registered with the SEC, and were not applicable for a registration exemption." Without admitting or denying the SEC's findings, in order to resolve the matter, Sparkster and its CEO agreed, among other things, to collectively pay over $35 million into a fund for distribution to harmed investors. In addition, like its enforcement action against Kardashian, the SEC also filed a civil complaint against a well-known crypto influencer, Ian Balina, alleging, among other things, that Balina failed to disclose compensation received from Sparkster for publicly touting the SPRK coin.

Similarly, on September 28, the SEC announced in a release that it had filed a complaint in the Southern District of New York against The Hydrogen Technology Corporation and related officers regarding a scheme to effectuate the unregistered offer and sale of crypto assets called Hydro tokens. The complaint alleged that Hydrogen Technologies unlawfully offered, distributed, and eventually manipulated the price of the Hydro token. In its complaint, the SEC alleges that the Hydro tokens "[w]ere offered and sold as securities." As Joseph Sansone, chief of the Market Abuse unit put it in the press release that accompanied the complaint, "[t]he SEC is committed to ensuring fair markets for *all* types of securities… ."

SEC Enforcement of Additional Securities Laws Against Crypto Assets

The breadth of the SEC's enforcement actions involving cryptocurrencies as "securities" does not end there. In addition to actions sounding in violations of the anti-touting and registration provisions of the Securities Act, the SEC has brought crypto-related enforcement actions under several other securities laws, including insider trading and Ponzi schemes. For example, on July 21, the SEC announced it had filed a complaint against three individuals, alleging the trio used insider knowledge confidential to the Coinbase platform to trade ahead of the listing of certain crypto coins on the platform. On February 14, the SEC announced an investigation into BlockFi, a crypto lending project, for violations of the Securities Act as well as the Investment Company Act of 1940. According to the SEC release, BlockFi failed to register the offers and sales of its retail crypto lending product.

BlockFi agreed to pay $100 million — $50 million to the SEC and a combined $50 million to 32 states — to settle the action. In commenting on the case, Gensler, said "[t]oday's settlement makes clear that crypto markets must comply with time-tested securities laws."

Implications of the SEC's Overwhelming View of Crypto As Security

The pattern of the preceding enforcement actions suggests a broad ongoing effort by the SEC to ramp up enforcement of securities laws against what it terms "crypto asset securities." The SEC enforcement actions and comments suggest that it will continue its aggressive push to treat crypto and other digital assets as "securities" subject to all applicable securities law. This has already resulted in numerous and sizeable enforcement actions against corporations and individuals alike who offer, sell, or promote these assets. These enforcement actions have spanned several areas of securities law, including registration, anti-touting, insider training, Ponzi schemes, and even the Investment Company Act.

The SEC has given no indication that it intends to backtrack or alter its increasingly consistent view on cryptocurrencies as "securities." Quite the contrary, all signals suggest that the SEC's overwhelming view of crypto assets as "securities" is here to stay. With the SEC ramping up its enforcement of crypto assets, it is very likely that the next shoe to drop will be U.S. attorneys' offices following suit. Put simply, the previously underregulated crypto investment space is about to see a lot more enforcement activity and far more civil and criminal litigation that it ever has in the past. This will very likely include crypto-related investigations and charges alleging major securities violations — *e.g.*, insider trading, Ponzi and fraud schemes, etc.— as well as those alleging more indirect violations, such as those brought against Kardashian and Balina for violating the anti-touting rule.

Individuals and companies who operate, invest, and/or participate in the crypto currency space, and especially those who promote cryptocurrencies, should carefully consider the implications of these recent SEC actions. Individuals and companies should consult with counsel about risk mitigation steps that can be taken before engaging in any crypto-related activities that could potentially run afoul of securities laws, given the SEC's and the Department of Justice's current views and enforcement priorities.

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[1] For example, in 2018, the SEC settled similar anti-touting charges against pugilist Floyd Mayweather and music producer DJ Khaled for promoting investments in crypto initial coin offerings without disclosing that they were paid for their promotional activities.

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