Blockchain Law

A 'Telegram' to SAFTs: 'Beware!'

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How and when can a cryptocurrency or token offering transform from a security into a commodity or something else that is not subject to the securities laws? In his Blockchain Law column, Robert Schwinger discusses one approach that some issuers have tried in order to avoid or minimize having to face securities law requirements: "simple agreements for future tokens" or SAFTs.

Cryptocurrency and token offerings present a regulatory paradox. The Securities and Exchange Commission contends that in various circumstances many cryptocurrency and token offerings constitute "securities" that must comply with securities laws. See generally R. Schwinger, "Blockchain Law: SEC Takes Aim at Digital Tokens and Smart Contracts," 1/18/19 N.Y.L.J.; see also *Framework for "Investment Contract" Analysis of Digital Assets* (S.E.C. April 3, 2019). Yet the SEC has also suggested that a digital asset that was "originally offered in a securities offering" possibly could "be later sold in a manner that does not constitute an offering of a security," and that "the analysis of whether something is a security is not static and does not strictly inhere to the instrument." See W. Hinman, Dir., SEC Div. of Corp. Fin., Speech, *Digital Asset Transactions: When Howey Met Gary (Plastic)* (June 14, 2018) (contending that in present circumstances Bitcoin and Ether are not "securities"); CFTC Rel. No. 8051-19 (Oct. 10, 2019) (CFTC chairman characterizing Bitcoin and Ether as "commodities"). But how and when can a cryptocurrency or token offering transform from a security into a commodity or something else that is not subject to the securities laws?

One approach that some issuers have tried in order to avoid or minimize having to face securities law requirements is to use so-called "simple agreements for future tokens" or SAFTs. SAFTs are instruments that at a later stage are intended to convert into digital tokens, usually upon completion and launch of a functional blockchain network in which the tokens will have a utilitarian purpose. SAFTs are typically issued to sophisticated investors before the network in which the tokens are to be used is operational.

The SAFT theory is that even if the SAFT itself initially is an investment contract that may be subject to regulation under securities laws, the tokens that through the SAFT ultimately come into being later on would not necessarily need to be classified as securities under applicable law.

Yet recently in *SEC v. Telegram Grp.*, 2020 WL 1430035 (S.D.N.Y. March 24, 2020), the first judicial examination of using a SAFT strategy, the court granted the SEC's motion for a preliminary injunction preventing blockchain developer Telegram Group and TON Issuer (collectively, Telegram) from selling its new cryptocurrency "Grams" to an initial group of purchasers who later would resell them to others, in the absence of a registration statement. The court concluded that the SAFT structure used there could not be viewed as two isolated phases but rather should be viewed holistically as a single integrated scheme to issue securities that will yield profit. While *Telegram* is just a preliminary injunction ruling in one particular factual setting that is already up on appeal, it sends a cautionary message about how effective SAFT strategies may ultimately prove to enable tokens to stay outside the purview of the securities laws.

Robert A. Schwinger is a partner in the commercial litigation group at Norton Rose Fulbright US.
Jacob Laksin, an associate in the commercial litigation group, assisted in the preparation of this article.

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Background

Telegram is the brainchild of brothers Pavel and Nikolai Durov, successful Russian software developers and entrepreneurs who had previously founded the Russian version of Facebook and developed a globally popular messaging app, Telegram Messenger. In 2017, Telegram began developing a new a cryptocurrency project for a cryptocurrency that could be used in conjunction with the Telegram messaging app.

In early 2018, Telegram conducted a series of private placements and raised $1.7 billion from 175 initial purchasers—comprising sophisticated entities and high net-worth individuals—in exchange for a promise to deliver 2.9 billion Grams (referred to here as the “Initial Purchases”). Telegram planned to deliver the Grams to the Initial Purchasers after Telegram had created, and successfully launched, a corresponding blockchain to support the Grams called TON Blockchain. Upon receiving Grams, the Initial Purchasers could resell their Grams into a secondary public market via transactions on the TON Blockchain (referred to here as Resales).

But on Oct. 11, 2019, just as Telegram was preparing to launch the TON Blockchain and deliver Grams to the Initial Purchasers, the SEC filed a complaint charging that Telegram had violated the registration provisions of §5 of the Securities Act of 1933 (Securities Act), 15 U.S.C. §77e, and obtained a temporary restraining order to prevent the Grams’ distribution to the Initial Purchasers. Following several months of expedited discovery, the parties in January 2020 filed cross-motions for summary judgment, and the SEC also sought a preliminary injunction to prohibit Telegram from delivering the Grams to the Initial Purchasers or from offering or selling Grams to the investing public.

Framing the issue: distinct sales or a single scheme

While Telegram sought to frame the Initial Purchases of the Grams and their prospective future Resales by the Initial Purchasers as separate and distinct sets of transactions, with the former but not the latter subject to U.S. securities laws, the SEC took a different view. It viewed both sets of transactions as a single overarching scheme to distribute Grams to the public and evade §5’s registration requirements. The SEC contended that the 175 Initial Purchasers would be acting as “underwriters” and engaging in an unregistered “distribution” of the Grams to the public via their subsequent Resales of Grams.

Telegram’s response was twofold. First, while Telegram conceded that the Initial Purchasers’ “interest in the Grams” were “securities” subject to the registration requirements in §5 of the Securities Act, Telegram argued that the Initial Purchases ultimately were exempt from these requirements under the Securities Act’s §4(a)(2) safe harbor provision (which applies to “transactions by an issuer not involving a public offering,” 15 U.S.C. §77d(a)(2)) and Rule 506(c) of the SEC’s Regulation D, 17 C.F.R. §230.506(c), which exempts transactions that satisfy its enumerated conditions.

Second, Telegram argued that the subsequent Resales were “wholly-unrelated transactions” not subject to §5 because they did not involve the offer or sale of “securities.” Rather, argued Telegram, following the launch of the TON Blockchain the Grams would have “functional consumptive uses” because they would be used to store or transfer value, and certain of the Initial Purchasers could use Grams as a form of currency to purchase goods and services. Thus, post-launch the Grams would be a “commodity” rather than a “security” and therefore not subject to securities laws.

The court’s decision

On the SEC’s preliminary injunction application, the court’s findings largely adopted the SEC’s view that the two stages of Telegram’s offering were inseparable. The court found that that the SEC had shown a substantial likelihood of success in proving that “the series of contracts and understandings” relating to the Grams, including both the Initial Purchases and the Resales, were “part of a larger scheme to distribute those Grams into a secondary public market, which would be supported by Telegram’s ongoing efforts.” Rejecting Telegram’s efforts to cast the Initial Purchases and the Resales as separate and distinct transactions, the court instead viewed them holistically and “in their totality” to find that the *entire scheme* constituted an “investment contract” under the Supreme Court’s test for identifying a security in *SEC v. W.J. Howey Co.*, 328 U.S. 293 (1946), and is progeny.

Applying the ‘Howey’ test

Under *Howey*, an “investment contract” is considered a “security” if it is (1) an investment of money; (2) in a common enterprise; (3) with the expectation of profit; (4) from the essential efforts of another. The court found each of these prongs satisfied.

The “investment of money” prong was satisfied by the Initial Purchasers’ investment of approximately $1.7 billion in the 2018 private placements in exchange for the future delivery of 2.9 billion Grams upon the launch of the TON Blockchain.

The “common enterprise” prong was satisfied through both “horizontal” and “vertical” commonality. “Horizontal” commonality—the pooling of assets from multiple investors so that all share in the profits and risks of the enterprise—was demonstrated by Telegram’s pooling the funds it received from the Initial Purchasers to use them to develop the TON Blockchain software. Had Telegram failed to successfully develop the TON Blockchain, noted the court, the value of the Grams held by Initial Purchasers would be diminished, thus

showing they shared in the risks of the TON Blockchain enterprise.

Additionally, the court found there was "vertical" commonality—under which investors' fortunes are tied to the fortunes of the promoter—because the Initial Purchasers' fortunes were tied to Telegram's success in developing and launching the TON Blockchain. Telegram planned to retain a reserve of approximately 28% of all Grams, which the court noted would be Telegram's largest asset if the launch of the TON Blockchain proved successful, thus linking Telegram's financial fortunes to the market price of Grams and the overall success of the TON Blockchain. Similarly, the court found that Telegram's (and its founders') reputation was directly linked to the successful launch of the TON Blockchain. The court held that such interdependence was sufficient to establish vertical commonality.

The court held that *Howey's* "expectation of profit" prong was satisfied because it found that the Initial Purchasers had an expectation of profit through the Resales of Grams to the public via the TON Blockchain. Although Telegram argued that the Initial Purchasers bought the Grams with the expectation to use them as currency and not with any investment intent, the court rejected this contention, concluding that without the ability to resell the Grams into the secondary market, the 175 Initial Purchasers never would have paid $1.7 billion for the Grams. Moreover, "[w]hile the offering materials covered some potential consumptive uses [for Grams], they also highlighted the opportunity for profit by capital appreciation and resale based on the discounted purchase price." The court also found that Telegram's claim that the Initial Purchasers bought Grams solely for use as a currency was undermined by provisions in the agreements that created structural incentives for certain Initial Purchasers to quickly resell their Grams.

Telegram had defended its position by pointing to disclaimers and public statements it had made urging investors to reject any expectation of profit, including statements that Grams were "NOT investment products and there should be NO expectation of future profit or gain from the purchase, sale or holding of Grams," as well as a statement made on its website in January 2020 (after the SEC's action was filed) cautioning that "Grams won't help you get rich." However, the court found that such statements were insufficient to negate evidence that a reasonable Initial Purchaser expected to profit from Grams upon their launch, particularly given the planned integration of Grams with the Telegram messaging app and its nearly 300 million monthly users.

The court had little difficulty in concluding that the expectation of profit based on Resales stemmed "from the essential efforts of another," thereby satisfying the final *Howey* prong. The court found that Initial Purchasers "were entirely reliant on Telegram's efforts to develop, launch, and provide ongoing support for the TON Blockchain and Grams" in order to realize a return on their investment through the Resales, particularly since the Grams did not even exist (at least in any saleable form) at the time of the Initial Purchases. Most notable among these efforts once again was Telegram's intention to integrate its Messenger app with the TON Blockchain and Grams, which the court found the Initial Purchasers expected would drive investor demand for Grams.

The overall 'scheme' as the security

Telegram argued that Grams, as distinct from the underlying purchase agreements, must be evaluated under *Howey* when the Grams come into existence with the launch of the TON Blockchain. At that time, Telegram contended, the Grams would be commodities, not securities, because they would be used consumptively, would not be supported by Telegram's essential efforts, and would lack the requisite common enterprise. The court rejected Telegram's argument, and most fundamentally its attempt to characterize what the purported security at issue in the case was, explaining:

> While helpful as a shorthand reference, the security in this case is not simply the Gram, which is little more than alphanumeric cryptographic sequence. *Howey* refers to an investment contract, i.e. a security, as "a contract, transaction or scheme," using the term "scheme" in a descriptive, not pejorative, sense. This case presents a "scheme" to be evaluated under *Howey* that consists of the full set of contracts, expectations, and understandings centered on the sales and distribution of the Gram. (Citations omitted.)

Thus, because *Howey* requires "an examination of the entirety of the parties' understandings and expectations," the court found that "the appropriate point at which to evaluate this scheme to sell and distribute Grams is at the point at which the scheme's participants had a meeting of the minds, i.e., at the time of the 2018 Sales, rather than the date of delivery."

Exemptions inapplicable

Telegram argued that even if there was a "security" here, the Initial Purchases were not a public offering because they were made in private placements to sophisticated investors, and thus were exempt from registration under Securities Act §4(a)(2) and Rule 506(c) of Regulation D. According to Telegram, the exemption would extend until the launch of the TON Blockchain, at which point Grams would become commodities rather than securities and, as such, no longer subject to securities laws.

Here again, however, the court took a broader view of the facts. It found that the "Grams were not intended to come to rest with the" Initial Purchasers, but rather had been intended to "reach a much wider pool" than the Initial Purchasers via their anticipated future Resales to the public. Thus, viewing the Initial Purchases as part of a broader scheme to distribute Grams to the investing public, the court found that the Initial Purchases constituted a "public offering" to which the §4(a)(2) exemption was inapplicable.

The court was equally unsympathetic to Telegram's claim of a Rule 506(c) exemption. Observing that Rule 506(c) required issuers to exercise reasonable care to ensure that purchasers of securities are not "underwriters" within the meaning of §2(a)(11) of the Securities Act, 15 U.S.C. §77b(a)(11), the court found that Telegram had failed to use the requisite reasonable care to ensure that the Initial Purchasers were not "underwriters," noting that §2(a)(11)'s definition of an "underwriter" as "any person who has purchased from an issuer with a view to . . . the distribution of any security." Again viewing the issue in the context of the entire series of transactions from Initial Purchases through Resales, the court concluded that the Initial Purchasers had acquired Grams with an intent to resell them for profit in the secondary market soon after launch of the TON Blockchain. Thus, as "conduits" in a two-part scheme to distribute Grams to the public, the Initial Purchasers amounted to statutory "underwriters" under §2(a)(11), and thus the Rule 506(c) exemption did not apply.

The court also rejected Telegram's further argument that even if the Initial Purchasers were statutory underwriters, the Rule 506(c) exemption still applied because Telegram had exercised reasonable care to ensure that the Initial Purchasers had acquired Grams for their own account and not for the purpose of a distribution. While Telegram argued that the Initial Purchasers' agreements had required them to represent and warrant that they were "purchasing the [Grams] for [their] own account and not with a view towards, or for resale in connection with, the sale or distribution," the court found that these legal disclaimers not only did "not control," but in fact rang "hollow," particularly when considered in light of the "economic realities" of the Initial Purchases, which the court concluded were merely a first step toward the ultimate goal of reselling Grams to a secondary public market following the launch of the TON Blockchain.

No basis to carve out non-US purchasers

Following the preliminary injunction ruling, Telegram — in addition to filing a notice of appeal with the Second Circuit — asked the court to clarify whether the preliminary injunction precluded sales to U.S.-based Initial Purchasers only, or also to the majority of the Initial Purchasers who were not U.S.-based. Telegram argued that because it was a non-U.S. entity whose agreements with non-U.S. Initial Purchasers were entered into outside of the U.S. and governed by foreign law, applying the injunction to cover sales to non-U.S. Initial Purchasers would result in the extraterritorial application of U.S. securities laws.

In a follow-up ruling, the court disagreed and made clear that its preliminary injunction applied to all Initial Purchasers. *SEC v. Telegram Grp.*, 2020 WL 1547383 (S.D.N.Y. April 1, 2020). In addition to faulting Telegram for failing to raise this issue before the preliminary injunction was granted initially, the court again rejected Telegram's attempts to portray the Initial Purchases and the Resales of Grams as involving separate and distinct transactions. The court emphasized that its decision to enjoin sales to Initial Purchasers was based on its view that the "security" at issue was "the entire scheme," including both the sales to the Initial Purchasers and the expectation and intention to have Resales by those Initial Purchasers into a secondary public market.

The court thus concluded that, at least at the preliminary injunction stage, there was sufficient evidence that the intended Resales were "likely to involve U.S. purchasers" and thus the injunction would not result in improper extraterritorial application of U.S. securities law. The court also found Telegram's proposal to implement safeguards to protect against any future Resales into the U.S. market by non-U.S. Initial Purchasers inadequate, noting among other things doubts that these safeguards would really be enforceable, particularly given that the very purpose of the TON Blockchain was to grant anonymity to those who purchase or sell Grams.

The state of SAFTs after 'Telegram'

Telegram's Grams are hardly the only tokens that have been offered under a SAFT structure. What does *Telegram* mean for other offerings that have been based on this structure?

To begin with, it should be noted that *Telegram* is simply a single district court decision, not binding authority on any other court, and is now on appeal in any event (although the future of the appeal may be in doubt given recent reports that Telegram may be abandoning its cryptocurrency project in response to the preliminary injunction ruling). Moreover, it must be viewed in its context of a being a preliminary injunction determination on a limited record rather than a final adjudication on the merits. *Telegram* nonetheless represents the first judicial test for the SAFT concept, and as such it casts at least some degree of doubt on whether or how well using that structure will enable issuers to protect themselves from being subject to U.S. securities laws.

Most notably, the *Telegram* court took issue with the central premise on which SAFTs are based—that token offerings can escape the securities laws by being split on some formal level into two temporally distinct phases, in which the first phase purports to fall under an securities law exemption and the second phase involves fully functional utility tokens being used for a consumptive purpose that should be viewed as having become commodities rather than securities. In reaching its conclusion, the court eschewed viewing the facts through a prism of legal formalism and instead took a holistic view of the entire venture as a single integrated securities transaction, given what the court found were the "economic realities" underlying what the participants were doing.

The court additionally refused to accord dispositive effect to disclaimers and representations that dutifully denied what the court saw as the true reality of what the participants were doing, what was motivating them, and what they hoped to achieve. Because the court thus concluded that the Initial Purchasers were motivated, structurally and otherwise, by the prospect of reaping profits from Resales, that effectively made them "underwriters" and the entire "series of contracts and understandings" a single integrated investment contract "scheme," which under the *Howey* test is subject to the securities laws.

Similar issues about the effect of a SAFT structure and how the court should view what the participants in that structure are doing are being

presented in another hotly-contested case now awaiting decision. Dueling summary judgment motions were filed just days before the *Telegram* ruling was issued in a separate SEC enforcement action pending in the Southern District of New York, *SEC v. Kik Interactive*, No. 1:19-cv-05244 (S.D.N.Y., filed June 4, 2019), where the SEC alleges that a Canadian messaging company, Kik, which offered its “Kin” digital tokens under a SAFT structure, was unlawfully conducting an unregistered securities offering.

Conclusion

We are still in early days in seeing whether the use of some form of SAFT structure can result in utility tokens supported by a functional blockchain platform that will be regarded as “commodities” rather than as “securities” under the regulatory authority of the SEC. The facts of each specific offering will matter, and it will likely take some time and a number of rulings in differing settings before anyone can reliably draw any broad conclusions about if and when a token issuer can protect itself from being subject to the securities laws by using some kind of SAFT structure.

While the conception of the SAFT structure may well have been ingenious, for now *Telegram* provides a warning that token issuers need to proceed with caution and cannot simply assume that the theories on which the SAFT structure is based will prove viable if challenged in court, by the SEC or others.

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