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IS THERE LIFE FOR SAFTS AFTER THE TELEGRAM CASE?

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The final act in the saga between Telegram Group Inc. (“Telegram”) and the SEC was the June 26, 2020 court approval of the SEC's settlement with Telegram, in which Telegram agreed to pay a civil penalty of $18.5 million and disgorge $1.224 billion to investors related to what the SEC claimed was an illegal unregistered public offering of securities. This followed the court granting the SEC’s requested temporary restraining order in October 2019 (on an emergency basis) to prevent Telegram’s issuance of $1.7 billion in blockchain-based instruments (“digital assets”) known as “Grams.”

The abrupt termination of Telegram’s offering is particularly notable for the SEC’s treatment of the Simple Agreement for Future Tokens (“SAFT”) offering framework, which its designers thought was a creative solution to conduct “initial coin offerings” (“ICOs”) without triggering U.S. securities registration requirements. The two-step transaction contemplated by SAFTs was envisioned as enabling startups to secure an initial infusion of cash by selling in a private placement to accredited investors the right to receive digital assets when they were issued in the future. The digital asset community has been watching the Telegram case, hoping SAFTs would be spared the enforcement scrutiny that the SEC gave to ICOs. However, recent SEC enforcement activity, including the order in **SEC v. Telegram**, suggests the SEC is viewing SAFTs as another breed of ICO, and successfully persuading federal courts to join that viewpoint.

Designers of the SAFT framework touted it as a potential avenue to issue digital assets without requiring registration as a securities offering. It was contemplated that SAFTs could be viewed as two separate transactions: (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 private placement offering; and (ii) after the digital assets function as promised (achieving “utility”), an issuance and distribution of the assets to the initial rights purchasers. In this second transaction step, the investors’ interest in the digital assets were intended to be characterized as for consumptive use, rather than investment purposes; as a result, participants took the position that the instruments would not be considered securities under the familiar analysis from SEC v. W.J. Howey Co. and its progeny. It was thought that the only securities issued under the SAFT structure were the “rights” sold to accredited investors in the first transaction. Under this construct, once issued in the second transaction, the digital assets themselves might not be considered securities due to their functional utility. They would be freely tradable on digital asset exchanges, which could similarly fall outside SEC regulation if the digital assets being traded were considered “commodities” rather than “securities.” Given heavy SEC enforcement activity against ICOs beginning in fall 2017, the SAFT structure gained popularity as an alternative that the SEC had not yet alleged would violate the securities laws.

SAFT offerings in 2017 and 2018 met with mixed results, as some floundered under the regulatory burden presented by heightened scrutiny of digital assets, while others had initial success raising capital and continue to develop their assets and platforms (thus far avoiding SEC scrutiny). Two high-profile issuers, Telegram and Kik Interactive, chose the SAFT framework to issue their digital assets, but met a swift regulatory response by the SEC in enforcement actions filed in the U.S. District Court for the Southern District of New York (“SDNY”).

The SEC sued Telegram in October 2019, filing an emergency action that sought a temporary restraining order and preliminary injunction to restrain Telegram from completing the second step of its SAFT by issuing and distributing Grams. On March 24, 2020, following expedited discovery and a hearing, the court granted the SEC’s motion for a preliminary injunction. Ignoring the formality on which the SAFT framework was premised, the court held that it was likely that Telegram could not rely on its claimed exemption from registration because accredited investors who purchased the SAFTs intended to resell the digital assets upon their issuance and distribution, and Grams lacked the required restrictive legends. Without a valid exemption, both the rights and the underlying digital assets were analyzed as securities at the time of the initial sale to accredited investors. This point in time (*i.e.*, at issuance of the rights) was earlier than envisioned by the SAFT framework, and was before Grams and the underlying TON blockchain platform were sufficiently developed and functional. At this earlier time, the SEC argued (and the court accepted), investor interest in them would be solely for investment purposes, rather than consumptive purposes. Absent functional utility for the Grams, the court concluded the digital assets were securities because Gram purchasers were motivated by profit from an expected resale, and Telegram’s stated intent to continue supporting the TON platform and Grams was key to creating secondary-market demand for them (and generating investor profit).

Four days before entry of the **Telegram** preliminary injunction, and before a different judge in the SDNY, the SEC and digital platform Kik Interactive Inc. (“Kik”), issuer of the Kin token, filed cross motions for summary judgment. The SEC initially sued Kik in June 2019, claiming that its 2017 Kin offering, partially conducted via SAFTs, was an illegal issuance of unregistered securities. Kik has relied in court filings on many of the same arguments as Telegram, including that at time of issuance its digital assets 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. The SEC maintains, as it did against Telegram, that the initial sale of rights agreements to accredited investors was integrated with the subsequent public sale of Kin tokens, and together constituted an illegal unregistered sale of securities. As in the **Telegram** case, the SEC argued that the status of the tokens as "utility tokens" at the time of subsequent distribution was irrelevant – *i.e.*, the relevant time to analyze the nature of the tokens for purposes of the securities laws was when the initial investment decision was made at the time of the rights offering.

Even though the SEC has argued the **Kik** court should apply the same reasoning to the Kin offering as was applied in **Telegram**, the court could reach a different outcome due to differentiating factors. For example, unlike Grams in the **Telegram** case, Kin tokens have already been issued and are being utilized for some of their advertised functionality, potentially weakening the SEC's claims that Kin lacks utility or Kik's ongoing efforts are needed to support the token (rather than any subsequent appreciation in value being attributed predominantly to market forces acting in a decentralized network). In addition, while the SEC complaint highlighted underlying public policy concerns regarding purchaser anonymity and money laundering risks in **Telegram** (which involved a $1.7 billion offering by an offshore issuer), similar concerns were not included in the agency's filings and may not be present to the same degree in **Kik** (a $100 million offering by a Canadian issuer). These issues were underscored by the joint statement of the SEC, CFTC, and Department of the Treasury's Financial Crimes Enforcement Network ("FinCEN") on anti-money laundering controls applicable to digital asset market participants, which was released on October 11, 2019 – the same day the SEC filed its **Telegram** Complaint.

The above cases make clear that the SEC continues to focus enforcement resources on digital asset financing events, as well as emphasizes that the SEC continues to employ the economic reality and integration doctrines when they serve its purposes. The **Kik** litigation remains of great interest as a test case for the SEC's approach in the context of already-issued digital assets that display some functional utility (though the perfect test would involve already-issued tokens with fully functional utility). Digital asset issuers should analyze past SAFT fundraisings and determine measures to limit potential exposure to SEC enforcement actions and private litigation. Possible mitigation options include rescinding token offerings under Section 12(a) of the Securities Act of 1933 and relevant state law and issuing new exempt instruments. Alternatively, issuers may conduct exchange offers for cash, or new digital assets, the offering of which would need to be registered or would need to satisfy an exemption from registration. Though the **Kik** case is still pending, in the wake of the final judgment in **Telegram**, any legitimacy the SAFT structure was thought to have has been seriously undermined and its use as a way to avoid registration under the U.S. securities laws has been all but eliminated.

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