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Insights

SAFTS IN TELEGRAM'S WAKE

Jul 17, 2020

The Simple Agreement for Future Tokens ("SAFT") was once touted as a creative solution to execute "initial coin offerings" ("ICOs") that did not violate federal securities laws. The two-step transaction contemplated by SAFTs was supposed to provide startups an initial infusion of cash by selling accredited investors the right to receive blockchain-based "coins" or "tokens" ("digital assets") when they were issued in the future. ICOs have been targeted by the SEC since 2017, but the SAFTs designers hoped to be spared this scrutiny. As underscored by adverse SEC enforcement activity, including a recent $1.224 billion disgorgement order by a federal district court in the **SEC v. Telegram** case, issuers contemplating offerings of digital assets in the future should consider compliant alternatives to SAFT fundraisings, and past SAFT issuers should consider the mitigation steps outlined below.

Background

Since 2013, both founders and legacy businesses have raised capital for various enterprises through ICOs. The technology's novelty and the absence of clear guidance from regulators created uncertainty regarding the regulatory status of those sales, including whether they constituted securities offerings. In July 2017, the SEC issued The DAO 21(a) Report of Investigation ("DAO Report"),[1] which concluded that the tokens involved were "investment contracts" under the test articulated in **SEC v. W.J. Howey Co.**,[2] and therefore securities under the federal securities laws.[3] The DAO Report explicitly served notice on the digital asset ecosystem that (i) digital assets sold in ICOs constitute "securities" if they would otherwise meet the legal requirements as such; (ii) the federal securities laws therefore apply to the offering, purchase, and sale of such digital assets; and (iii) the SEC would exercise its enforcement authority to sanction violations of the securities laws in the digital asset context.

Several months after release of the DAO Report, a group of lawyers and distributed ledger industry participants published a "white paper" describing the SAFT concept as a way to mitigate digital asset regulatory risks.[4] Under a typical SAFT framework,[5] digital asset issuers first enter into SAFT agreements with accredited investors, who pay for the right to receive digital assets once development of the assets and the blockchain platform and / or ecosystem in which they will function is completed and the assets are issued. No digital assets are issued initially, and the issuer

files a Form D with the SEC claiming a Regulation D exemption (often under Rule 506(c) involving general solicitation) for conducting the rights offering (*i.e.*, the rights are the securities) solely to accredited investors. Issuers then use the offering proceeds to develop the underlying technology. Under the envisioned structure, once development of the assets and associated platform is complete and the technology functional, investors receive the newly-issued digital assets (usually at a discount to their market price). With the technical work completed, the SAFT structure contemplated that the platforms and associated assets would be functional by the time investors accessed them. The hope was that the digital asset issuance might escape regulatory sanction because the assets would have "utility" at the time they were distributed, and the purchasers' interest in the assets could thus be viewed as being for consumptive purposes, rather than investment. Theoretically, if demand for already functional assets could be seen as spurring purchasers' desire to use or consume the assets, any subsequent appreciation in the assets' value would be appropriately viewed as no longer predominantly due to the issuers' efforts (which would largely have been expended during the development period between the rights issuance and release of the digital assets). Under this construct, the SAFT offering assumed that the digital assets themselves would not be regarded as securities at the time of distribution, but rather as a variety of currency or commodity known as "utility tokens."

SEC v. SAFTs?

The SEC made its position on ICOs clear beginning in fall 2017 by filing enforcement actions against REcoin, Plexcorps, and Munchee, followed by Chairman Clayton's statement during a Senate hearing that "I believe every ICO I've seen is a security." The Division of Enforcement then sprung into action, issuing hundreds of subpoenas to digital asset market participants as part of its broader digital asset enforcement push.

Through 2017 and 2018, digital asset issuers increased SAFT issuance several fold, moving away from traditional ICOs, which had been targeted by the SEC. Filecoin, the first project to use the SAFT structure, raised more than $257 million through its August – September 2017 SAFT offering to fund its still-ongoing technical development. Factors that potentially account for its escaping regulatory scrutiny (to this point) include (i) its issuer, Protocol Labs, was part of the group that conceived of SAFTs, and has been adamant that they can be executed compliantly if the transactions' fundraising period remains completely separate from the underlying digital assets' issuance, and the issuer disengages from the digital asset platform when the assets are issued (perhaps accounting for the ongoing delay in issuance of Filecoin while the technology continues to be developed); and (ii) purchasers will use Filecoin's FIL digital asset to compensate providers of unused file storage space for utilizing that excess capacity, demonstrating an actual utility. It remains to be seen whether the SEC will continue to ignore Filecoin once FIL is actually issued to the market.

Even at this early juncture, some commentators were dubious as to whether the SAFT improved the legal status of ICOs.[6] Shortly after Filecoin debuted the SAFT concept with its rights offering,

Intangible Labs raised $133 million in the initial exempt-offering step of its spring 2018 SAFT, aimed at developing its Basis digital asset. In December of the same year, the issuer decided to return the capital to its investors and terminate the project after receiving legal advice that certain of the tokens it would issue in the second step of its SAFT would be considered securities.[7] Intangible Labs believed that its plans to offer both a 'bond' and 'share' version of the Basis token might create regulatory problems, stating "Unfortunately, having to apply U.S. securities regulation to the system had a serious negative impact on our ability to launch Basis."[8] Recent SEC enforcement activity and corresponding case law have validated these concerns and issuers should be wary of utilizaing the SAFT framework.

The Latest Salvos: Telegram Injunction and Kik Litigation

Telegram was the creator of a digital messaging platform, and planned to use the SAFT exempt offering to fundraise for developing its Telegram Open Network ("TON") Blockchain and the Gram digital assets used for payments thereon. The Telegram SAFT's initial fundraising step was an exempt offering in late 2017 and early 2018 of rights agreements to receive the Grams once they were issued in the future. The SEC sued Telegram in October 2019, filing an emergency action that sought a temporary restraining order and preliminary injunction to prohibit Telegram from completing the issuance of its digital asset, called "Grams."[9] On March 24, 2020, following expedited discovery and a hearing, the U.S. District Court for the Southern District of New York ("SDNY") granted the SEC's Motion for a Preliminary Injunction against Telegram.[10] The SEC argued that the two steps of the SAFT were really one integrated offering and that investors made the decision to purchase the Grams tokens (not just the future rights to receive them) at the time of the exempt offering, based on Telegram's marketing efforts. The SEC further argued that the Grams themselves (not just the rights sold in the SAFT's initial transaction) were securities because investors were motivated to purchase the right to receive them based on an expectation of profit upon resale, as well as Telegram's intention to remain the "guiding force" behind the TON Blockchain. The SEC also maintained that the Grams lacked the restrictive legend they should have had as exempt securities, while contending that the "economic reality" of Telegram's SAFT was that the rights offering to accredited investors was part of a larger scheme to distribute Grams into the secondary public market. According to the SEC, the accredited purchasers had acted as "underwriters," such that Telegram was not entitled to rely on the exemption it claimed under Rule 506(c) of Regulation D, because the offering was a disguised public offering rather than a private placement. Conversely, Telegram argued that the underlying Grams were currency and not securities, and their status as securities should be judged in the future when delivered to the initial purchasers as functional utility tokens. Telegram viewed the anticipated secondary-market sale of Grams by the initial purchasers as private transactions wholly unrelated to the SAFT transactions. The Court ultimately sided with the SEC and granted its motion for a preliminary injunction. In doing so, the Court ignored the formalities underlying the SAFT design, concluding that Grams were securities rather than merely instruments that stored or transferred value. Further, the Court ruled

that it was likely that the intended and expected resale of Grams into the public market via the SAFT offering amounted to the distribution of unregistered securities through two integrated transactions. In its final judgment issued in June 2020, the Court ordered Telegram to pay a civil penalty of $18.5 million and disgorge $1.224 billion to investors as part of its settlement.[11]

Four days before the injunction was granted in **Telegram**, and before a different judge in the SDNY, the SEC and digital platform Kik Interactive Inc., issuer of the Kin token, filed cross motions for summary judgment. The SEC initially sued Kik in June 2019, claiming that its 2017 offering, a portion of which was conducted as a SAFT, was an issuance of unregistered securities.[12] In its court filings, Kik relied on many of the same arguments as Telegram, including that at time of issuance Kin tokens would have functional utility and act as a currency on a not-yet-developed decentralized ledger. The digital assets would thus be viewed as purchased for consumption of their utility rather than for investment purposes. To that end, Kik has contended that Kin tokens had multiple types of utility when they were issued. The SEC maintains however, as it did against Telegram, that the initial sale of rights agreements to accredited purchasers was integrated with both the subsequent issuance of Kin and a public sale of the tokens that was conducted concurrently. As in **Telegram**, the SEC argued that the status of the digital assets as "utility tokens" at the time of distribution was irrelevant, and the initial exempt offering date was the correct time to analyze the assets as securities.

In both cases, the SEC's argument for analyzing the digital asset's status as securities at the time of the SAFT's rights offering transaction was based, in part, on the contention that neither issuer's offering qualified for the Rule 506(c) exemption from registration (as each had claimed). In the SEC's view, the purported two transactions envisioned by the SAFT were really all one unregistered public offering to which no valid exemption applied. The SEC has also argued that the **Kik** court should apply the same reasoning to the Kin offering as was applied in **Telegram**. However, it's possible the **Kik** court could reach a different outcome due to differentiating factors. As opposed to Grams, Kin have already been issued and are being utilized for some of their advertised functionality. This may weaken the SEC's claim that Kin lacks utility or that Kik's ongoing efforts will be 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).[13] These concerns 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.[14]

Takeaways

The above cases make clear that the SEC continues to focus enforcement resources on digital asset financing events, and will marshal the economic reality and integration doctrines in doing so. This focus may intensify for SAFT offerings in the wake of the SDNY's Order in **Telegram**, a critical consideration for potential future SAFT issuers. Issuers who have executed SAFTS in the past should also analyze them in light of the SEC's concerns expressed in **Telegram**, and determine if mitigation measures are needed to limit potential exposure to enforcement actions and private litigation. One potential mitigation option is rescinding token offerings under Section 12(a) of the Securities Act of 1933 or relevant state law and issuing new exempt instruments. This may protect investors from civil liability under the law of many states, but provides no cover against claims under federal law[15] or against enforcement actions by state authorities. Any issuer considering rescission must also analyze whether holders of their digital assets could satisfy any relevant exemptions from registration, since the rescission involves reselling the security back to the issuer. Another mitigation option is conducting an exchange offer for consideration or new digital assets, [16] the offering of which would need to be registered or to satisfy an exemption from registration. Whatever mitigation steps past SAFT issuers might choose, the SEC has made clear that it will continue to monitor SAFT offerings and pursue enforcement actions actions as appropriate.

Bryan Cave Leighton Paisner LLP advises all varieties of market participants regarding compliant fundraising methods utilizing digital assets and cryptocurrencies, and provides SEC and CFTC regulatory and enforcement counsel regarding those instruments.

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1. Securities & Exchange Cmn., Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934: The DAO, Exch. Act. Rel. No. 81207 (Jul. 25, 2017), https://www.sec.gov/litigation/investreport/34-81207.pdf.

2. **SEC v. W.J. Howey Co.**, 328 U.S. 293, 301 (1946).

3. The DAO Report reached this conclusion by determining that the instruments involved an investment of money in a common enterprise with a reasonable expectation of profits to be derived from the entrepreneurial or managerial efforts of others. **See SEC v. Edwards**, 540 U.S. 389, 393 (2004); **SEC v. W.J. Howey Co.**, 328 U.S. 293, 301 (1946); **see also United Housing Found., Inc. v. Forman**, 421 U.S. 837, 852-53 (1975) (The "touchstone" of an investment contract "is the presence of an investment in a common venture premised on a reasonable expectation of profits to be derived from the entrepreneurial or managerial efforts of others."). This definition embodies a "**flexible rather than a static principle**, one that is capable of adaptation to meet the countless and variable schemes devised by those who seek the use of the money of others on the promise of profits." **Howey**, 328 U.S. at 299 (emphasis added).

4. See J. Batiz-Benet, **The SAFT Project: Toward a Compliant Token Sale Framework** (Oct. 2, 2017), https://saftproject.com/static/SAFT-Project-Whitepaper.pdf.

5. N.B., the SAFT framework is modeled after the SAFE format (Simple Agreement for Future Equity) itself a relatively recent fundraising mechanism whereby an investor obtains the right to receive a certain amount of equity in the company in the future in exchange for an up-front investment, though without initially specifying the share price. Receipt of the equity is often triggered by the occurrence of a specific event (such as an acquisition, financing, or the like), at a conversion rate based on a discount or valuation cap.

6. Anthony Zeoli, **Initial Coin Offerings: Why the SAFT is Dead …** (Mar. 26, 2018), https://www.crowdfundinsider.com/2018/03/131044-initial-coin-offerings-why-the-saft-is-dead/.

7. Nader Al-Naji (CEO), Letter to Basis Community (Dec. 13, 2018), https://www.basis.io/.

8. **See id.**

9. Complaint, **SEC v. Telegram Grp. Inc.**, No. 19-cv-9439 (S.D.N.Y. Oct. 11, 2019), https://www.sec.gov/litigation/complaints/2019/comp-pr2019-212.pdf.

10. **SEC v. Telegram Grp. Inc.**, No. 19-cv-9439 (S.D.N.Y. Mar. 24, 2020) (opinion and order granting preliminary injunction), https://www.sec.gov/litigation/complaints/2019/comp-pr2019-212.pdf.

11. **SEC v. Telegram Grp. Inc.**, No. 19-cv-9439 (S.D.N.Y. Jun. 26, 2020) (final judgment), https://www.sec.gov/news/press-release/2020-146.

12. Complaint, **SEC v. Kik Interactive Inc.**, No. 1:19-cv-05244 (S.D.N.Y. Jun. 4, 2019), https://www.sec.gov/news/press-release/2019-87.

13. See Complaint, **SEC v. Telegram Grp. Inc.**, No. 19-cv-9439, at 3, 10, 28 ("many [Gram] purchasers' identities will be shrouded in secrecy"; Gram transactions will be executed on "unregulated markets ... that promise anonymity and encryption capability to mask transactions" making it "difficult, if not impossible, to trace who has purchased Grams"; and the ability to transfer Grams would be integrated into Messenger's disappearing content platform, and although mandating that users fulfill "Know Your Customer/Anti-Money Laundering" requirements was contemplated, Telegram will have no access to this information, has stated it will never provide this information to third parties or governments, and the information may be effectively useless in any case because it may be impossible to identify user identities in Grams' secondary markets). Neither the SEC's Complaint nor Motion for Summary Judgment in **Kik** expressed similar concerns.

14. CFTC, FinCEN, SEC, Public Statement, **Leaders of CFTC**, **FinCEN**, **and SEC Issue Joint Statement on Activities Involving Digital Assets** (Oct. 11, 2019), https://www.sec.gov/news/public-statement/cftc-fincen-secjointstatementdigitalassets.

15. See Section 14 of the Securities Act of 1933 (person cannot be obligated to waive rights regarding compliance with the federal securities laws' registration provisions); **Stoiber v. SEC**, 161

F.3d 745 (D.C. Cir. 1998), **cert. denied**, 119 S.Ct. 1464, 143 L.Ed.2d 549 (1999) (rescission offer provides no protection against SEC sanctions).

16. See Section 14(e) of the Securities Exchange Act of 1934.

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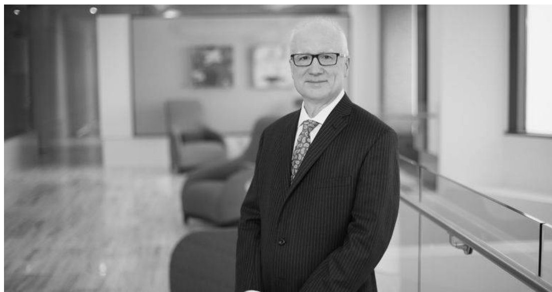

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