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SEC Telegram Injunction Is A Wakeup Call For Token Investors

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March 24, Judge P. Kevin Castel of the U.S. District Court for the Southern District of New York potentially dealt a major blow to the Simple Agreement for Future Token framework by granting the U.S. Securities and Exchange Commission's request for an injunction against Telegram Group Inc.'s and TON Issuer Inc.'s planned $1.7 billion Gram token distribution and follow-on sale.

As the first litigated case to test the theory underlying the SAFT, this case could have significant implications which may set an important precedent for the industry. One of the most significant parts of the court's decision is its holding that Telegram SAFT investors are statutory underwriters and therefore Telegram's SAFTs are not entitled to the exemption from registration in Rule 506(c) of Regulation D under the Securities Act of 1933.

The legal implications of that holding may give pause to issuers and participants in token offerings who executed SAFTs and will likely garner the attention of the plaintiffs bar.

Background

The SEC commenced its action against Telegram on Oct. 11, 2019, alleging that Telegram's planned offering of Grams violates the registration requirements of Sections 5(a) and 5(c) of the Securities Act and requested a temporary restraining order against Telegram.[1] After months of intensive discovery, both parties' filed cross motions for summary judgment and issued this order a little over a month later.

At the center of the dispute is whether issuers of digital tokens can avoid registering their sale with the SEC by issuing them pursuant to SAFTs. SAFTs are instruments, typically issued to sophisticated investors prior to the development of the underlying functionality of the tokens, that convert into digital tokens upon completion and launch of the functionality.

While in many cases issuers treat SAFTs as securities and offer and sell them pursuant to the exemption from registration in Rule 506(c) of Regulation D under the Securities Act, they have typically taken the position that the digital tokens that are later distributed upon conversion of the SAFTs, when the development of the underlying functionality is complete, are not securities and not part of an integrated offering.

The issuer's theory is typically that once use cases exist for the tokens, they no longer constitute securities, but rather utility tokens that can be distributed as commodities or currency without being subject to regulation as securities by the SEC. Hence issuers claim that there should be no integration between the initial SAFT offering and any future token conversion or resale of tokens.

The status of the SAFT itself was not at issue in this case as Telegram conceded its SAFTs are securities. What was at issue, however, is whether Telegram's planned creation and distribution of Grams to the SAFT investors, after the use cases have been developed (i.e., the functional consumptive uses of Grams), and the subsequent resale of Grams to the public by the purchasers of the SAFTs, constitute an integrated offering and sale of securities subject to regulation by the SEC.

Telegram argued that its SAFTs and the Grams were not part of an integrated offering but rather must be separately analyzed from the SAFTs under the federal securities laws. Telegram also noted that the SAFT investors warranted and represented to Telegram that they were purchasing Grams for their own account and "not with a view towards, or for resale in connection with, the sale or distribution."

The SEC took the position that the SAFTs and the issuance of the Grams were part of an integrated offering and that the time delay between the SAFTs and issuance of the tokens is immaterial.

In particular, the SEC alleged that Telegram's SAFTs are not entitled to the benefit of an exemption from registration (e.g., Rule 506(c) of Regulation D) because Telegram did not intend the Grams to come to rest with the SAFT investors and upon delivery of the Grams to the SAFT investors, those investors, functioning as statutory underwriters, intended to resell the Grams in the secondary markets thereby completing Telegram's unregistered offering.

The Court's Reasoning

Judge Castel's 44-page opinion methodically dismissed Telegram's arguments and adopted those of the SEC. The court looked beyond the representations in the SAFTs, focusing almost exclusively on the economic realities of the Gram distribution scheme.

In its most consequential holding the court adopted the SEC's argument and held that Telegram's sale of Grams to the SAFT investors were not entitled to the benefit of an exemption from the registration requirement under either Section 4(a) or Rule 506(c).

As a recap, Rule 506 of Regulation D states that "[o]ffers and sales of securities by an issuer that satisfy the conditions [of this Rule] shall be deemed to be transactions not involving any public offering within the meaning of section 4(a)(2) of the [Securities] Act."

Crucially, Rule 506(c) requires, among other things, that the sales satisfy Rule 502(d). In pertinent part, Rule 502(d) requires that the issuer "exercise reasonable care to assure that the purchasers of the securities are not underwriters within the meaning of section 2(a)(11) of the [Securities] Act." Section 2(a)(11) defines an underwriter as "any person who has purchased from an issuer with a view to ... the distribution of any security."

The court dismissed Telegram's claims that it complied with Rule 502(d) through the provision in its SAFT requiring the investors to represent and warrant that they were "purchasing the Tokens for [their] own account and not with a view towards, or for resale in connection with, the sale or distribution."

The court reasoned that "in evaluating [the] economic reality of this scheme, legal disclaimers do not control" and that the "representation and warranty that the [SAFT investors] purchased without a view towards resale rings hollow in the face of the economic realities." The court further reasoned that "[t]he economic reality of Telegram's course of conduct is straightforward and rather easily understood."

The court was unequivocal, "find[ing] as a fact that the economic reality is that the Gram Purchase Agreements and the anticipated distribution of Grams by the [SAFT investors] to the public ... are part of a single scheme," and therefore, the SAFT investors which "acted as mere conduits to the general public, are underwriters."

SAFT Investors as Underwriters

The vourt's opinion will undoubtedly reverberate through the cryptocurrency industry. In particular, Judge Castel's determination that the Telegram SAFT investors are underwriters may be the biggest game-changer as it could carry significant legal implications for SAFT issuers and investors; implications that likely were not contemplated when the investors entered into the Telegram SAFTs.

By deeming SAFT investors to be underwriters, Judge Castel and the SEC have converted the role of the SAFT investors from passive to active. That conversion may carry significant legal implications ranging from SEC enforcement actions to private plaintiff litigation.

For example, the SEC, relying on this precedent, may name SAFT investors as defendants in future actions against SAFT or token issuers in which it alleges that the issuers and defendants offered and sold unregistered securities.

SAFT investors should also be aware that they may be named as defendants by private litigants claiming that they offered and sold unregistered securities under Section 12(a)(1) of the Securities Act.[2] Depending on the facts and circumstances, SAFT purchasers (as statutory underwriters) may also face disclosure liability under Sections 11 and 12(a)(2) of the Securities Act, as well as fraud liability under Rule 10b-5 of the Exchange.

Judge Castel's decision does not contemplate these potential risks. But given the plaintiff's bar's interest in the digital asset industry, it is advisable that all SAFT participants review any resulting risk exposure.

Conclusion

This case is far from over. In fact, there have already been noteworthy developments since the March 24 ruling: Telegram filed a notice of appeal the same day that the court granted the SEC's request for a preliminary injunction. Three days later, on March 27, Telegram asked the court to clarify whether the scope of the preliminary injunction applies only to U.S.-based SAFT investors.

On April 1, the court denied Telegram's request and left in place the injunction prohibiting the distribution of Grams to all SAFT investors, including those outside of the U.S. Amid all this are reports of developers and Telegram SAFT investors contemplating using the code that Telegram previously published to launch the blockchain without Telegram's involvement which itself raises a myriad of novel legal questions.

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[1] Telegram is the owner and operator of the popular mobile messaging application "Telegram Messenger."

[2] Section 12(a)(1) of the Securities Act provides that:

Any person who … offers or sells a security in violation of [Section 5] … shall be liable … to the person purchasing such security from him, who may sue either at law or in equity in any court of competent jurisdiction, to recover the consideration paid for such security with interest thereon, less the amount of any income received thereon, upon the tender of such security, or for damages if he no longer owns the security.