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SAFTs May Survive Telegram's Garbled Message

Blockchain start-ups who side-stepped traditional seed round financing in favor of selling future rights to digital tokens will know whether such offerings resulted in federal securities laws violations before springtime blossoms.

Issuers who made such offerings in ostensible compliance with Regulation D could find themselves unexpectedly facing liability. In February 2020, attorneys for the U.S. Securities and Exchange Commission (SEC) will argue in U.S. District Court for the Southern District of New York that Telegram Group Inc. improperly offering investors future rights to digital tokens. The British Virgin Islands company operates an encrypted messaging application popular with cryptocurrency aficionados.

However, the SEC's attempts to discredit this type of offering through enforcement actions may not succeed regardless of the outcome in this case. Among the issues to be determined in the *Telegram* case is whether a popular method of offering accredited investors a future right to receive a to-be-developed digital token in exchange for an immediate payment constitutes an unregistered offering of securities in violation of the Section 5 of the Securities Act of 1933.

Telegram's "SAFT": A well-worn path

In January 2018, Telegram, through its affiliate TON Issuer Inc., commenced offering investors future rights to receive "Grams" through an instrument styled a "Gram Purchase Agreement" pursuant to Rule 506(c) of Regulation D and Regulation S promulgated under the '33 Act.¹ Telegram raised approximately \$1.7 billion from U.S. and foreign investors willing to fund Telegram's ambitions to launch a new cryptocurrency.

While comparable agreements by other issuers come under a myriad of titles, the Gram Purchase Agreements and their relatives are commonly known as Simple Agreements for Future Tokens

(SAFTs), even though many practitioners, cognizant of the SEC's long-held suspicions, avoid using the term.

Telegram was far from the only company offering SAFTs or their equivalent to accredited investors pursuant to Rules 506(b) or (c) in 2018 and earlier.² Depending on the outcome of the *Telegram* case, these entities, even if they attempted to comply with Reg D requirements with respect to offering SAFTs, could find themselves liable for conducting an unregistered offering of securities.

Can SAFTs be separated from tokens?

The SEC filed a complaint against Telegram on Oct. 11, 2019, alleging that its offering of the Gram Purchase Agreements constituted an unregistered offering of securities. The SEC sought a permanent injunction prohibiting the company from issuing the Grams.

The SEC's arguments discounted the premise underlying practitioners' efforts to craft a compliant solution to the regulatory conundrum surrounding digital assets in the U.S., namely that any securities law analysis should evaluate the SAFT separately from the tokens to be issued in the future.

Applying the factors first enunciated in *SEC v. Howey Co.*, 328 U.S. 293 (1946), few would argue that a SAFT is not an "investment contract." However, if such investment contract converts or is redeemed for a legitimate product or service evidenced by a digital token in the future, many contend that the regulatory regime governing securities does not apply once the tokens have been issued.

Past statements by SEC officials lend credence to this position. In his July 2018 remarks, the director of the SEC's Division of Corporate Finance, William Hinman, seemed to support the contention that an investment contract could convert into something no longer subject to SEC oversight, stating:

If the network on which the token or coin is to function is sufficiently decentralized — where purchasers would no longer reasonably expect a person or group to carry out essential managerial or entrepreneurial efforts — the assets

may not represent an investment contract. Moreover, when the efforts of the third party are no longer a key factor for determining the enterprise's success, material information asymmetries recede. As a network becomes truly decentralized, the ability to identify an issuer or promoter to make the requisite disclosures becomes difficult, and less meaningful.

Setting aside whether the Grams could pass this strenuous test if they had been issued by the original deadline of Oct. 31, 2019, the SEC, in its Complaint, does not acknowledge any meaningful difference between the tokens and the Gram Purchase Agreements, the security pursuant to which they were offered, subjecting both to the four-part test set forth in *Howey*.

Telegram argues that the agency's analysis is "fundamentally flawed." Before citing other portions of Hinman's July 2018 speech, Telegram's argues in its response, "The Grams themselves, as distinct from the purchase contracts, will merely be a currency or commodity (like gold or silver) – not a 'security'" when the blockchain supporting the tokens launches.

In pushing back on this theory, the SEC doubled down on its argument that the Gram Purchase Agreements and the Grams were indivisible, writing:

whatever Grams 'will. . . be' at some future date says nothing about what Grams were in 2018 when Defendants offered and sold them without a registration statement, which is the heart of the SEC's claim that a *past* violation of Section 5 has occurred. *Second*, with respect to whatever Grams were in 2018 or what they will be whenever Defendants decide to distribute them, Telegram's mere assertion that Grams 'will. . . be' a 'currency' does nothing to cure the prior violation of law.

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Telegram's fact pattern may not decide the issue

If the SEC's description of the operational state of the Gram network on the anticipated launch date as laid out in the Complaint is compared with prior SEC guidance, it seems likely the Grams

themselves would still qualify as a security on the launch date. According to the SEC's April 2019 "Framework for 'Investment Contract' Analysis of Digital Assets," (the Framework) the Grams could not escape SEC scrutiny as of the contemplated launch date because — at that moment — they could not be used to buy or sell anything.⁴

However, the SEC's argument that the Gram Purchase Agreements and the Grams are one and the same is less compelling if the Gram blockchain, as of the token release, had achieved certain developmental milestones enunciated in the Framework. Leaping over several material practical questions,⁵ the SEC's central premise appears to contradict Director Hinman's observations that a digital asset could evolve from a security into something else. Instead, the SEC states that offering future rights of an unreleased token otherwise compliant with Reg D represents, at the time of sale, an unregistered offering of securities.

Even though it may constitute a breach under the Gram Purchase Agreements, if Telegram withheld Grams until they could satisfy the conditions specified in the Framework, the SEC's central thesis withers.⁶ The goalposts for a functional digital token (i.e. that elusive holy grail of a "utility token") may be narrow according to the SEC, but the agency has established the distance between the uprights through its Framework and prior statements.

While Telegram agreed to an order barring the release of the Grams until at least the February court date, the company's efforts to further build out the network and develop commercial uses for Grams in the interim will complicate the SEC's arguments.

The name may change, but the instrument survives

In the meantime, if SAFTs (or whatever clever name is adopted next) are sold only to accredited investors properly informed of the numerous risks involved, with the exception of the token space's regulatory murkiness, it will mirror those surrounding early-stage capital in other unproven technologies. That will leave many practitioners puzzling over why this instrument should spark the

SEC's ire.

The agency apparently has accepted the widespread usage of Simple Agreements for Future Equity (SAFEs), which only deliver returns to early-stage investors in the unlikely event that a start-up survives as a going concern to reach the next funding milestone.

Betting on a start-up to eventually deliver a functional token may involve long odds, but judgment on the market's value of an investment (assuming risks are disclosed, and sales restricted to those the SEC has deemed capable of assuming them) falls outside the SEC's purview.

The SEC may have been able to sustain their argument that the Gram Purchase Agreements constituted an unregistered offering of securities, if the Grams had launched as scheduled on Oct. 31, 2019, and no real opportunity to use them to pay for goods or services existed. However, by the time the two sides appear in court next year, the litigants may be facing a decidedly different fact pattern.

If the facts remain static, the SEC's argument that Telegram's offering of the Gram Purchase Agreements constituted an unregistered sale of securities may withstand judicial scrutiny, but such a decision does not immediately discredit all prior or existing SAFT offerings. In fact, the SEC's central argument would not even be properly vetted in such a situation. Only with the delivery of a digital asset satisfying the Framework's criteria by Telegram or another SAFT issuer can the SEC truly test its theory.

Until such time, expect to see issuers continuing to file Form Ds claiming an exemption under Rule 506(b) or (c) for an offering of future rights in digital tokens — just don't expect them all to use the word "SAFT."

What should issuers be thinking about in the meantime?

Realistic deadlines are important.

As issuers and investors grew more realistic in the months following the initial 2017 heyday of investment in blockchain technology, the

early SAFTs with a six-month “deadline date” to deliver a functioning platform appear overly optimistic in hindsight. Achieving the standards outlined in the Framework is a daunting task, and developers and investors must each accept a realistic development timeframe.

An MVP will not satisfy the SEC.

As evidenced by both Telegram and the SEC’s complaint against Kik Interactive Inc., a digital token must meet the Framework’s standards upon its issuance to SAFT purchasers.⁷

Consider variable/rolling lock-up periods.

The quantities in which a token is offered and sold is an important Framework factor in determining whether it will be deemed a security. Therefore, issuers should consider committing to delivering tokens to SAFT purchasers gradually as token use grows on the network.

Investors are likely more flexible than regulators.

Given the continuing regulatory uncertainty, SAFT purchasers may be more inclined to extend deadlines (as opposed to pursuing claims against an issuer) than the SEC is to modify its guidance set forth in the Framework and elsewhere. While it may be a time-consuming process for issuers to obtain consent from far-flung investors, this process may prove more practical than facing SEC enforcement actions.

For more information, contact [Courtney Rogers Perrin](#) or [Gray Sasser](#) of Frost Brown Todd’s [Blockchain and Digital Currency](#) team.

¹ See [TON Issuer Inc. Form D, Notice of Exempt Offerings of Securities \(Feb. 13, 2018\)](#); [TON Issuer Inc. Form D, Notice of Exempt Offerings of Securities \(Mar. 29, 2018\)](#).

² See <https://www.sec.gov/edgar/searchedgar/companysearch.html> for Form Ds filed between January 1, 2018 and October 31, 2019, revealing more than 100 containing the term “simple agreement for

future tokens;" also see <https://www.marketwatch.com/story/ico-promoters-more-careful-but-still-using-sec-back-door-to-raise-funds-2019-04-02>.

3 Letter from the SEC to the SDNY, *SEC v. Telegram Group Inc. & TON Foundation, Inc.*, No. 19 Civ. 9439 (PKC), Docket No. 9, at 2 (Oct. 17, 2019).

4 While the Framework lays out a multiplicity of factors to consider when applying *Howey* to the offer and sale of digital assets, the Framework does not provide much insight on which factors may be more determinative. The Framework, however, is more succinct when it comes to tokens claiming to be cryptocurrencies. Per the Framework, a token representing a unit of virtual currency will not be a security if the token "can immediately be used to make payments in a wide variety of contexts, or acts as a substitute for real (or fiat) currency," without "first having to convert it to another digital asset or real currency," and which "operates as a store of value that can be saved, retrieved, and exchanged for something of value at a later time."

5 Among the most important practical questions not addressed above is how can Grams or any virtual currency ever become accepted as payment if the SEC views "airdrops" and pre-launch discussions with trading platforms as equivalent to a public offering of unregistered securities?

6 For example, if the Grams, when released, are not securities it is tough to see how the SEC would have jurisdiction to control the means or methods of their distribution, undercutting the SEC's allegations that the Gram Purchase Agreements involve "the flow of securities from an issuer through conduits and out to the public at large," see Complaint at ¶ 99.

7 In its [June 2019 complaint against Kik](#), the SEC alleges: "Kik developed the stickers based on an effort to create a hypothetical 'use' for the tokens, which Kik believed was relevant to whether Kik's sale of Kin [the digital token] were securities transactions under the securities laws."

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