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# Time Limitations Are the Achilles Heel of Cryptocurrency Securities Class Actions

Many private plaintiffs' cryptocurrency securities class action lawsuits will likely be stopped short because of time limitations.

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On the heels of a landmark ruling in favor of the U.S. Securities and Exchange Commission (SEC), plaintiffs took aim at the virtual currency industry by filing a series of securities class action complaints. Like the SEC, private litigants are primarily alleging that virtual currency companies violated §§5 and 12(a)(1) of the Securities Act of 1933 by engaging in the unregistered sales of securities by launching initial coin offerings (ICOs). But private litigants are not government regulators. Unlike the SEC, private litigants face significant procedural obstacles in bringing unregistered sale of securities claims, including a much shorter statute of limitations. While the SEC has five years to bring suit, plaintiffs accusing virtual currency companies of §§5 and 12(a)(1) violations must do so within one year of their most recent purchase of the subject virtual currency. Even plaintiffs that meet the one-year deadline could still be barred by the statute of repose, which concludes three years following the first "bona fide offering" of the virtual currency. This is significant because some of the most prominent and well-funded ICOs offered "pre-sales" of its virtual currency in 2016 and early 2017, so the time to bring suit for the unregistered sale of securities may have already lapsed. While the SEC has enjoyed some limited success, many private plaintiffs' cryptocurrency securities class action lawsuits will likely be stopped short because of time limitations.

## Virtual Currency and Federal Securities Laws

Since the inception of virtual currency, federal regulators have been laser-focused on the treatment of virtual currency under the federal securities laws. However, the federal government has not yet enacted legislation to clarify the application of federal securities laws to virtual currency. The government has instead relied on the SEC's speeches, no-action letters, policy statements, including the framework described below, and enforcement actions as guidance for the marketplace.

While it may seem strange to apply a 1946 Supreme Court case about orange groves to a budding technology, *SEC v. Howey*, 328 U.S. 293 (1946) remains the controlling authority on whether a sale of virtual currency is an "investment contract," which is one type of offering which falls under the definition of a "security." Under the *Howey* test, an "investment contract" exists when there is (1) an investment of money; (2) in a common enterprise; (3) with a reasonable expectation of profits; (4) to be derived from the efforts of others.

The SEC's position on the treatment of virtual currency has evolved significantly over time. Many consider the SEC's first enforcement action against DAO Token as the first comprehensive guidance. The SEC has stated its various positions through former SEC Director Hinman's speech on June 14, 2018, the Nov. 16, 2018 Statement on Digital Asset Securities Issuance and Trading, the March 7, 2019 letter written by Chairman Jay Clayton, and a series of enforcement actions. On April 3, 2019, the SEC issued its long-awaited guidance for analyzing whether a virtual currency is offered and sold as an investment contract and therefore is a security, titled "Framework for 'Investment Contract' Analysis of Digital Assets (https://www.sec.gov/corpfin/framework-investment-contract-analysis-digital-assets)."

The April 3, 2019 guidance provides no less than 65 factors (inclusive of sub-factors) to consider to determine whether an ICO constitutes an investment contract and thus a security. In general, the SEC indicated that the first and second prongs of the *Howey* test are satisfied by most ICOs: (1) an investment of money; (2) in a common enterprise. According to the SEC, the securities analysis for most ICOs will turn on whether there is a reasonable expectation of profits to be derived from the efforts of others. While the SEC provided 65 different factors to consider, these factors are primarily focused on determining management's level of involvement in the governance and ultimate success of the virtual currency. The SEC described these activities as "essential managerial efforts." The higher the level of "essential managerial efforts," the more likely the SEC will be to determine that the ICO constituted the offering of an investment contract.

## The 'Telegram' Decision

The SEC has brought a number of enforcement actions against companies that launched ICOs. One recent case stands out among the rest as a significant victory for the SEC, and has spurred a series of private class action complaints. That case is *SEC v. Telegram Group*, No. 19-cv-9439, 2020 WL 14300035 (S.D.N.Y. March 24, 2020).

In early 2018, Telegram Group and TON Issuer (Telegram) raised $1.7 billion from 175 sophisticated entities and high-net worth individuals in exchange for Telegram's promise to deliver its virtual currency, Grams. Telegram argued that the Grams were lawful private placements of securities which were exempt from registration. The SEC argued that the 175 initial purchasers were "underwriters," who were going to engage in an unlawful distribution of securities (the Grams) in the public market. The SEC sought a preliminary injunction to halt Telegram from delivering the promised Grams to the 175 initial purchasers.

On March 24, 2020, the court agreed with the SEC and granted the injunction. The court held that the SEC showed a substantial likelihood of success in proving that the agreements between Telegram and the 175 initial purchasers were "investment contracts" and thus constituted the unregistered sale of securities. Consistent with the SEC's

April 3, 2019 framework, central to the court's securities analysis was its finding that there was "an implicit (though formally disclaimed) intention on the part of Telegram to remain committed to the success of the TON Blockchain post-launch." Id. at *2.

On the "efforts of others" prong, the court determined that the investors' "dependence on Telegram to develop, launch, and support the TON Blockchain is sufficient to find that the Initial Purchasers' expectations of profits was reliant on the essential efforts of Telegram." Id. at *15. The court also considered the fact that Telegram's popular messaging application was key to the mass adoption of Grams as a virtual currency and that Telegram promised to integrate the Grams into the messaging application. Id. at 17. Ultimately, the court concluded that Telegram would be the "guiding force" behind the blockchain in the immediate post-launch period and so the "initial 175 purchasers possess a reasonable expectation of profit based upon the efforts of Telegram because these purchasers expect to reap whopping gains from the resale of Grams in the immediate post-launch period." Id. at *2.

The court rejected Telegram's defense that the sale to the initial investors was exempt from registration, holding that it was "a disguised public distribution." Id. at *19 (quoting *SEC v. Cavanagh*, 155 F.3d 129, 132 (2d Cir. 1998)). This was because the Grams were not intended to "come to rest" with the initial investors, "but instead were intended to move from the Initial Purchasers to the general public" so the court ruled that none of Telegram's stated exemptions applied. Id. at *19.

While the SEC has had some success in cryptocurrency enforcement actions and obtaining consent orders in the past, the *Telegram* decision reverberated in the virtual currency community. In *Telegram*, the SEC moved swiftly and aggressively. The SEC quickly obtained a temporary restraining order, conducted expedited discovery, and won a preliminary injunction motion. The SEC halted a well-funded and highly popular virtual currency ICO in its tracks.

## Difficulties in Seeking To Capitalize on the SEC's Success

For the last few years, there have been an increasing number of relatively unsuccessful securities lawsuits filed against virtual currency companies. The *Telegram* decision apparently emboldened the plaintiffs' bar into filing a series of securities class action complaints against virtual currency companies. In our view, many of these lawsuits will be faced with significant—and successful—defenses by virtual currency companies. In particular, statute of limitations and statute of repose defenses may be the Achilles Heel of many securities class actions concerning ICOs.

Following *Telegram*, there have been a flood of securities class-actions filed in the U.S. District Court for the Southern District of New York against some of the virtual currency industry's largest and most well-funded ICOs and virtual currency exchanges. These lengthy complaints generally allege either that ICOs constituted the unregistered offering and sales of securities under §§5 and 12(a)(1) of the Securities Act or that virtual currency exchanges failed to register as an exchange or broker-dealer.

Unlike the SEC, private plaintiffs are subject to very high pleading standards, statutes of limitations, statutes of repose, and other procedural and substantive impediments. Class action securities defendants maintain an arsenal of defenses at their disposal. For example, §11 standing requirements restrict plaintiffs to purchasers who participated in, or can trace to, the primary offering. One interesting question in this context will be whether blockchain facilitates or obscures this tracing requirement. The Securities Act also limits damages pursuant to a statutory calculation and permits a "negative causation" affirmative defense. In particular, negative causation defenses may be relevant to claims that followed the collapse in the broader digital token market. While a variety of substantive defenses exist, one of the most significant impediments for ICO securities class action plaintiffs is the time within which a plaintiff must bring a claim.

While the SEC enjoys a five-year statute of limitations, private plaintiffs must bring unregistered securities claims "within one-year after the violation upon which it is based." See 15 U.S.C. §77m. Given this relatively short time period, it is not surprising that even in the nascent stages of virtual currency class action securities litigation, courts have been dismissing untimely cases. In the few cases which have spoken on the issue, courts have started the clock on the statute of limitations with the plaintiff's most recent purchase of the virtual currency. In *Fabian v. LeMahieu*, the court dismissed a securities class action arising out of an ICO because the lawsuit was filed outside of the "one-year period [which] began to run on the date of plaintiff's last purchase of Nano Coins." No. 19-cv-54, 2019 WL 4918431, at *8 (N.D. Cal. Oct. 4, 2019). Another virtual currency securities class action was dismissed because "the clock on the limitations period begins on the date the unlawful sale occurred" and "without an allegation as to when the plaintiffs purchased their respective tokens, the court is unable to determine whether their claims fail as time-barred." *Beranger v. Harris*, No. 18-cv-05054, 2019 WL 5485128, at *5 (N.D. Ga. April 24, 2019).

Even if a class plaintiff can allege that its purchases are within the one-year statute of limitations period, virtual currency companies also have a "statute of repose" defense. For unregistered securities claims, "[t]he three-year [statute of repose] period is an absolute limitation which applies whether or not the investor could have discovered the violation." *Jackson Nat'l Life Ins. v. Merrill Lynch & Co.*, 32 F.3d 697, 704 (2d Cir. 1994). Courts that have ruled on this issue have applied the "first-offered" rule enunciated by the Second Circuit, holding that the three-year statute of repose begins on the virtual currency's "first bona fide offering." See *Zakinov v. Ripple Labs*, No. 18-cv-6752, 2020 WL 922815, at *8 (Feb. 26, 2020) (citing *Stolz Family Partnership L.P. v. Daum*, 355 F.3d 92 (2d Cir. 2004)). When an offering is "bona fide" turns on when the alleged security was "truly (genuinely) being offered to the public." *Stolz*, 355 F.3d at 99.

Courts have yet to determine what stage during the life-cycle of an ICO constitutes a "bona fide offering." In *Ripple Labs*, on a motion to dismiss a securities class action, the court could not decide on the record presented whether the defendant Ripple's initial sales of its virtual currency with specific third-parties or entities constituted a "bona fide" offering. *Ripple Labs*, 2020 WL 922815, at *10. The court "caution[ed] that, once the parties have developed a factual record, it may revisit its determination on whether defendant made their first bona fide [virtual currency] offer to the public before or after August 6, 2016." Id. Most ICOs are pre-funded. Funding is often provided by what is commonly referred to as "pre-sales." In "pre-sales" investors provide funds—either virtual currency or fiat—in exchange for the promised delivery of (discounted) virtual currency when the ICO is eventually launched. If the courts were to determine that such pre-sales were the "first bona fide offering," the statute of repose defense would be a substantial weapon for virtual currency companies that raised funds in 2016 and early 2017. This is important because it is well-known that a substantial number of well-funded ICOs initiated pre-sales in 2016 and early 2017, and it is likely that the "statute of repose" could provide a complete defense for lawsuits arising out of those ICOs.

We will have to see how the courts will handle the recently filed securities class actions, but many of them appear to allege claims based on virtual currency purchases that are outside of the statute of limitations. Perhaps recognizing that there are statute of limitations and statute of repose issues, the plaintiffs in the series of securities class actions that were most recently filed cite to the April 3, 2019 SEC framework and the fact that a prominent well-respected virtual currency company that launched an ICO agreed to a consent order with the SEC on Sept. 30, 2019. The class action complaints allege that "prior to that time, a reasonable investor would not have believed that these Tokens were securities that should have been registered with the SEC." While we can foresee plaintiffs' arguments, the few cases on point state that the statute of limitations is triggered at the time the plaintiff purchased the virtual currency—and not the date by which a plaintiff would have believed that the ICO violated securities registration laws. We don't anticipate that this plaintiffs' argument will prevail, given that the purchase of the alleged security has long been considered the triggering point for statute of limitations and repose deadlines in securities litigation based on the unregistered sale of securities. See, e.g., *In re Merrill Lynch Auction Rate Sec. Litig.*, No. 10-cv-0124, 2012 WL 1994707, at *4 (S.D.N.Y. June 4, 2012) ("Courts therefore interpret the statute to bar claims filed more than one year after the purchase of the securities at issue."), aff'd, 505 F. App'x 14 (2d Cir. 2012).

## Conclusion

How the courts will deal with certain virtual currency class actions remains to be seen. The court's determination of what constitutes a "bona fide offering" in the lifecycle of an ICO will significantly expand or restrict virtual currency securities class actions. If the court were to determine that "pre-sales" constitute a "bona-fide" offering, many of the world’s most prominent and well-funded virtual currency companies would be armed with a strong statute of repose defense. While these plaintiffs sought to piggy-back on the SEC’s recent success in court, we believe that, for many civil plaintiffs, this argument will lead to dismissals.

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