Court confirms Telegram injunction covers non-US purchasers

Securities Litigation Alert

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In the ongoing enforcement action *SEC v. Telegram Group, Inc. and TON Issuer, Inc.*, Judge P. Kevin Castel has denied an application by Telegram and TON Issuer (collectively, "Telegram") that, if granted, would have allowed Telegram to distribute its cryptocurrency, Grams, to non-US based purchasers. Telegram's application asked the court to limit the scope of the court's recently issued preliminary injunction. The injunction prohibited Telegram from distributing Grams, reasoning that the initial purchasers would likely resell the Grams in a public market that could include US persons. Telegram sought clarification that the order did not prohibit the distribution to foreign initial purchasers. The court rejected Telegram's request, reiterating its finding that Telegram's distribution, even if made only to foreign initial purchasers, would likely result in a distribution back to the US.

The court's opinion provides additional color on highly disputed issues concerning application of securities law to cryptocurrency.

Background

The SEC brought this enforcement action to enjoin non-US based Telegram from distributing its cryptocurrency, "Grams", to 175 sophisticated entities and high-net-worth individuals. In 2018, Telegram sold "Gram Purchase Agreements" to these initial investors, promising to deliver an allotment of Grams upon launch of Telegram's TON Blockchain. In total, Telegram raised $1.7 billion from the initial investors, including over $424 million from 39 US purchasers. Telegram projected a launch by October 30, 2019. On October 11, 2019, the SEC sued Telegram in the SDNY to enjoin the distribution, arguing that Telegram had engaged in an unlawful unregistered distribution of securities to the public through these 175 initial investors, who are, in the view of the SEC, underwriters.

On March 24, 2020, SDNY Judge Castel granted the SEC's motion for a preliminary injunction, adopting the SEC's proposed order "prohibiting the delivery of Grams to the Initial Purchasers." As discussed here, Judge Castel preliminarily agreed with the SEC that the combination of Gram Purchase Agreements, subsequent planned distribution of the Grams to the initial purchasers, and the probable public distribution of the Grams thereafter constituted a "disguised public distribution" of securities in the US without a registration statement. He reasoned, in part, that the SEC had shown a substantial likelihood of success on the merits of its contention that the initial purchasers were underwriters, precluding Telegram from relying on a private placement exemption. Telegram immediately appealed.

Telegram requests clarification that order doesn't prohibit foreign distribution

On March 27, 2020, Telegram wrote a letter to the court requesting clarification of the preliminary injunction, in particular to confirm that the injunction did not apply to Gram Purchase Agreements entered into abroad with non-US investors. Telegram urged the court to apply a "presumption against extraterritorial application" of the US securities laws, established in the Supreme Court case *Morrison v. National Australia Bank Ltd.*

According to Telegram, the US securities laws cover only "transactions in securities listed on domestic exchanges and domestic transactions in other securities," the latter category defined as securities transactions where "irrevocable liability is incurred or title passes within the United States." Telegram argued that with respect to agreements entered into abroad with non-US investors, liability was incurred and title was passed outside the US. Telegram also offered to provide safeguards against redistribution into the US.

The SEC responded by letter, arguing that the parties had already briefed and argued the issue of whether Telegram's offers, sales, and delivery of Grams to non-US purchasers might fit within an exemption to the Securities Act for foreign offerings, including Regulation S, and that Telegram never raised the *Morrison* argument. Accordingly, the SEC characterized Telegram's letter as an impermissible motion for reconsideration of an order that prohibits all distribution of Grams and requires no clarification. The SEC also argued that *Morrison* concerned sales of securities by non-US issuers to non-US purchasers on non-US markets whereas the court here found that the securities at issue included the likely public resale in the US. In response to Telegram's proposed safeguards, the SEC reiterated prior arguments that Telegram could not practically enforce them or prevent flow back into the US.

The court denies Telegram's application

On April 1, 2020, Judge Castel denied Telegrams' application in a short, to the original opinion. The

court rejected Telegram's argument that the sale of Grams was not a "domestic transaction" under *Morrison*. In doing so, the court reiterated its holding that the security at issue was "neither the Gram Purchase Agreement nor the Gram but the entire scheme . . . including the expectation and intention that the Initial Purchasers would distribute the Grams into a secondary public market."

The court also rejected Telegram's proposed safeguards as unworkable for several reasons. First, Telegram did not explain how it could lawfully modify the Gram Purchase Agreements to implement the safeguards. Second, the court found that Telegram likely lacked the practical ability to prevent a foreign initial purchaser from reselling Grams. In support, he noted that the TON Blockchain would grant anonymity to Gram holders and also allowed third parties to build their own wallets.

Finally, the court criticized Telegram for not raising these arguments previously. The court noted that the SEC had proposed the form of order ultimately entered by the court on October 11, 2019, and that Telegram had ample opportunity to raise any ambiguity but did not do so until its March 27, 2020 letter.

Impact

The opinion reinforces the court's belief that the security at issue comprises not only the Grams or Gram Purchase Agreements but the entire transaction − including the anticipated and probable resale of Grams to the public in the US. This is not a new concept; in Howey itself, the court defined the "investment contract" at issue as a coupling of units in a citrus grove development and an associated contract for cultivating and marketing the fruit and remitting the net proceeds. The court's analysis is likely to resurface in cases involving issuers of staged token offerings, such as SAFTs.

The opinion also reiterates the court's consideration of economic and practical realities. Regardless of Telegram's promised safeguards, the court found that the blockchain technology employed would readily facilitate a public market that would be difficult or impossible to restrict. To address this concern, future token creators may want to implement more robust, on-chain solutions to restrict distribution.

What's next

As previously discussed, the Second Circuit will consider these issues again when it decides Telegram's appeal and may provide further insight into securities law issues surrounding digital asset distributions.

If you have questions regarding these issues, please contact one of the authors or your DLA Piper relationship partner.

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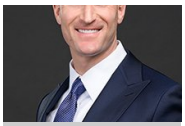

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