



Court grants SEC's motion for preliminary injunction against Telegram's sales of Gram cryptocurrency; Telegram appeals

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In the ongoing enforcement action *SEC v. Telegram Group, Inc. and TON Issuer, Inc.*, SDNY Judge P. Kevin Castel has granted the SEC's motion to preliminarily enjoin Telegram and TON Issuer (collectively, "Telegram") from distributing its cryptocurrency, "Grams," to 175 sophisticated entities and high-net-worth individuals. The court concluded that the SEC is highly likely to succeed on its claim that Grams are securities subject to US securities laws and that the sale of Grams was a securities offering which was not exempt from registration requirements in the US. For now, Telegram cannot distribute Grams to those who purchased the digital assets for a total price of \$1.7 billion. While Telegram has already appealed the injunction, the prohibition on distribution remains in place for now.

Given the court's national prestige and the opinion's in-depth analysis on the application to digital assets of the investment contract test laid out in the Supreme Court's *SEC v. W.J. Howey* opinion, the decision is likely to significantly impact digital asset sales in the US.

Background

Prior to its foray into digital assets, Telegram was well known as the creator of Telegram Messenger, a popular messaging app with over 300 million global users. Despite its widespread popularity, however, Telegram Messenger has never generated any revenue.

In 2017, Telegram began work on the TON Blockchain and its native token, the Gram. The Gram was to eventually serve as a currency on the Telegram Messenger platform. According to Telegram's White Paper, the supply of Grams would be limited to five billion, which would be held by Telegram. The White Paper also provided that the Grams would be sold pursuant to a formula that set a "Reference Price." Should the market price of Grams fall below half the Reference Price, Telegram had discretion to support the price by repurchasing Grams.

In 2018, Telegram sold "interests in Grams" to 175 entities and high-net-worth individuals. These "Gram Purchase Agreements" entitled the initial purchasers to receive an allotment of Grams upon launch of the TON Blockchain. Each Purchase Agreement contained representations and warranties from the purchaser that they were buying for investment purposes only and did not intend to distribute the Grams.

Telegram sold these Gram Purchase Agreements in two rounds. Round One comprised the sale of 2.25 billion Grams to 81 purchasers for \$850 million, which included \$385.5 million from 34 US purchasers. The Round One purchase agreements included a re-sale lockup which nonetheless allowed for phased sales of the Grams over an 18 month period post launch. In Round Two, Telegram sold approximately 700 million Grams to 94 purchasers for \$850 million, which included \$39 million from five US purchasers. In contrast to the Round One purchases, Round Two purchases had no lockup. In total, Telegram raised \$1.7 billion from the sale of approximately 2.9 billion Grams.

Telegram projected a launch by October 30, 2019. Shortly before launch, the SEC sued Telegram to enjoin the distribution, arguing that Telegram had engaged in an unlawful, unregistered distribution of securities (the Grams) to the public through these 175 purchasers, who are, in the view of the SEC, underwriters. Telegram's distribution of Grams was put on hold while the SEC and Telegram presented their cases to the court.

The decision

In finding that the SEC is likely to succeed on its claim that Grams constitute securities, Judge Castel proceeded through *Howey's* four-pronged analysis. After briefly noting that all parties agreed that the first part of the test, an investment of money, was satisfied, the court explained that the SEC had satisfied its burden to show a substantial likelihood of success on each of the other prongs of the *Howey* test:

Existence of a common enterprise: the SEC sufficiently established that the fortunes of Gram purchasers were tied to each other (horizontal commonality) and the purchasers' fortunes were tied to the success of Telegram (vertical commonality).

Expectation of profit: the court concluded that Telegram and Gram purchasers had profit motives based on Telegram's promotional materials and other activities (such as promised price support and integration with Messenger), the targeting of buyers with investment intent, and the stated intent of many buyers. The court did not find Telegram's numerous disclaimers of no investment intent and its public statements emphasizing consumptive use of Grams as persuasive in light of the totality of the facts in the record.

Derived from the efforts of others: the court reasoned that Gram purchasers were relying on Telegram's efforts for profits because Telegram used the purchase price to fund development of the network, which would continue to require Telegram's support even after launch.

On the issue of whether there was a public offering, Judge Castel rejected Telegram's argument that the only securities sold were the initial Gram Purchase Agreements. He reasoned that *Howey's* definition of "investment contract" includes a "scheme," which may incorporate a full set of contracts and transactions. Here, Judge Castel found that the combination of Gram Purchase Agreements, subsequent planned distribution of Grams by purchasers with an intent to resell, and the likely subsequent public distribution of Grams constituted such a "scheme," specifically a "disguised public distribution." He also rejected that the initial Gram Purchase Agreements fell within an exemption for private placements. He concluded that, despite the contractual disclaimers, the SEC had shown a substantial likelihood of success on the merits

on its contention that the 175 initial purchasers were underwriters due to their intent to resell Grams as exemplified by agreement terms that specifically permitted unrestricted resale of Grams over time and that offered a discounted price for the Grams. The court thus concluded that Telegram intended subsequent distribution into the secondary public market as part of its goal to establish Grams as “the first mass market cryptocurrency.”

Impact of the decision

SEC v. Telegram is the only case to date in which a defendant has engaged fully with the SEC on the issues of whether a digital asset is a security and whether a sale structure involving a contract for future delivery of a digital asset to sophisticated purchasers provides an exemption from registration. The court’s reasoned opinion on these and the other issues presented in the case is likely to influence future cases and will strengthen the SEC’s enforcement efforts in this area.

Of particular significance:

- Courts will look beyond legal documents such as private placement memoranda and their disclaimers to scrutinize what they perceive as the actual nature of digital asset sales. The opinion emphasizes that the proper analysis of whether there is an offer of a security under the *Howey* test requires analysis of the economic reality of the transaction as a whole including extrinsic evidence; the court rejected Telegram’s claim that the purchase agreements for Grams were separate from the Grams sold pursuant to those agreements. Instead, the court viewed the purchase agreements and the future delivery and resale of Grams “in their totality” as part of “single scheme.”
- Consistent with that approach, the court evaluated the securities law questions at the time of the initial purchase agreements despite Telegram’s assertion that whether Grams were securities should be evaluated under *Howey* at the time of their actual distribution. This approach may give pause to digital asset promoters who hope to escape securities regulation by relying on SEC statements in the Framework and elsewhere suggesting that assets can shed classification as securities as their networks mature and decentralize.
- The two-step process of selling to initial Gram purchasers who then had the opportunity to sell to the general public (even after the passage of time) was seen by the court as a public distribution with the initial Gram purchasers serving as underwriters because they were conduits to the general public. The representations and warranties of those purchasers that they were purchasing only for their own account and not with a view to distributing the Grams was insufficient to overcome the economic reality of the transaction.
- The anticipated functionality of Grams was insufficient to avoid the determination that the SEC was likely to succeed in demonstrating that Grams are securities. This part of the analysis will make it harder for developers of utility tokens to assert that such tokens are exempt from the reach of US securities laws.
- The existence of lock-ups in some of the purchase agreements was viewed by the court as negating the likelihood that a purchaser was acquiring Grams for consumption as opposed to investment. What may have been an effort to avoid a conclusion that the transaction was a public offering was not seen as such by the court.
- The analytical approach outlined by the SEC Staff in its April 2019 Framework for “Investment Contract” Analysis of Digital Assets (discussed here and here) (“Framework”) remains an effective roadmap for how the SEC and at least one court will analyze digital assets.

What’s next

Telegram’s immediate interlocutory appeal to the Second Circuit Court of Appeals suggests that another court may weigh in on these issues this year.

In the interim, Judge Castel’s decision is likely to influence other courts assessing similar issues.

Market participants should pay attention to the court’s opinion and the Framework when assessing whether and how to distribute digital assets that the SEC may view as securities.

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

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