

SEC Wins Injunctive Relief to Prevent Telegram's Distribution of \$1.7 Billion Worth of Cryptocurrency

by Mitzi Chang, Grant P. Fondo, Daniel Roeser, Meghan K. Spillane, Nicole L. Chessari, Zoe Bellars

Speed Read

In a recent decision in *Securities and Exchange Commission v. Telegram Group Inc. and TON Issuer Inc.*, the United States District Court for the Southern District of New York granted a motion for a preliminary injunction by the United States Securities and Exchange Commission (“SEC”), thereby preventing the distribution to purchasers of \$1.7 billion worth of cryptocurrency. That cryptocurrency, called “Grams,” was sold by Telegram Group Inc. (“Telegram”) in 2018 and due to be distributed to purchasers in October 2019.

The court found that the SEC had shown a substantial likelihood of success in proving that “Grams” were a security (specifically, an investment contract) under the test articulated in *SEC v. Howey*, 328 U.S. 293 (1946), which triggered the requirement for Telegram to file a registration statement under the federal securities laws. The court further held that no exemption or safe harbor applied to Telegram’s failure to do so.

Almost immediately after the court’s ruling, Telegram filed a notice of interlocutory appeal seeking reversal by the Second Circuit. With that appeal unlikely to be decided for many months, the future for Grams purchasers is uncertain. They are contractually entitled to a refund of any remaining sale proceeds if the Grams are not distributed by April 30, 2020.

As described in more detail below, this much-anticipated decision (1) describes circumstances under which a cryptocurrency may not be considered a security based on the *Howey* test; (2) emphasizes the court’s focus on the economic realities and structure of the sale and distribution of cryptocurrency in applying the *Howey* test; and (3) demonstrates the limits on the application of exemptions from the registration requirements.

BACKGROUND

In 2018, Telegram—which was formed in 2013 and quickly became known for its Telegram Messenger app—sold \$1.7 billion worth of Grams to 175 entities and high net-worth individuals (the “Initial Purchasers”). Telegram and the Initial Purchasers entered into “Gram Purchase Agreements,” whereby the Initial Purchasers would receive an allotment of Grams upon the launch of the TON Blockchain, a proprietary blockchain developed and overseen by Telegram founders and brothers Nikolai Durov and Pavel Durov. Upon launch, Telegram planned to integrate the TON Blockchain into Telegram’s Messenger application to promote and facilitate a market for Grams.

Telegram sold the Grams in two rounds (“Round One” and “Round Two”). Purchasers in Round One were contractually permitted to resell up to one quarter of their allotted Grams with the remaining three quarters to be free from resale restrictions in three equal tranches 6, 12, and 18 months after the launch of the TON Blockchain. The SEC contacted Telegram with questions about the Round One sales and, shortly thereafter, Telegram filed a Form D claiming an exemption from registration under the Securities Act of 1933 (the “Securities Act”) under Rule 506(c) of Regulation D.¹ Purchasers in Round Two had no contractual lockup

provisions, and consequently, Grams purchased in Round Two could be resold by purchasers immediately upon receipt. Telegram again filed a Form D for the Round Two sales claiming an exemption under Rule 506(c) of Regulation D. Telegram claimed that the Round One and Round Two sales were exempt from registration and did not file a registration statement.

Telegram circulated promotional materials in connection with those sales that included Telegram's plans for promoting Grams as a mass market cryptocurrency and the financial opportunity presented by Grams. The promotional materials stated that purchasers would receive a "private discount" of between 65.2 percent and 72 percent as compared to the price at a subsequent public sale. Ultimately, the Grams were sold at \$0.38 and \$1.33, respectively, with Telegram noting that it expected market price post-launch to be \$3.62.

In October 2019—shortly before Telegram planned to distribute Grams to purchasers—the SEC commenced an enforcement action against Telegram alleging violations of the Securities Act through an unregistered sale of securities and filed a motion for a temporary restraining order seeking to enjoin the distribution. In response, Telegram agreed to delay the distribution until after the parties had an opportunity to fully brief the issues and be heard at an evidentiary hearing.

THE SEC'S MOTION FOR PRELIMINARY INJUNCTION

In January 2020, the SEC moved for a preliminary injunction seeking to enjoin Telegram from releasing the Grams sold to the Initial Purchasers. On February 19, 2020, the court heard oral argument, and on March 24, 2020, the court granted the SEC's motion.

Telegram argued that the SEC was unlikely to prevail on the merits and, therefore, that a preliminary injunction was improper for the following reasons:

- The sale of Grams to the Initial Purchasers, and the later distribution of Grams to them, were two separate and distinct transactions that require different treatment under the federal securities laws.
- Although the sale of Grams to Initial Purchasers was subject to the federal securities laws, that sale was a lawful private placement exempt from registration under Regulation D.
- The distribution of Grams was not subject to the federal securities laws because, upon launch, Grams would have "functional consumptive uses" as commodities (e.g., purchasers could use Grams to purchase goods or services on the TON Blockchain or stake their Grams to become validators).

Conversely, the SEC argued:

- The sale and distribution of Grams to the Initial Purchasers were a single transaction that constituted an investment contract subject to the federal securities laws under the *Howey* test.
- No registration exemption applies because Telegram intended for the 175 Initial Purchasers to act as statutory "underwriters" who, absent an injunction, will soon engage in a distribution of Grams in the public market, whose participants would have been deprived of the information that a registration statement would provide.

THE COURT'S APPLICATION OF THE *HOWEY* TEST

In ruling on the SEC's motion for preliminary injunction, the court began by recognizing:

Cryptocurrencies (sometimes called tokens or digital assets) are a lawful means of storing or transferring value and may fluctuate in value as any commodity would. In the abstract, an investment of money in a cryptocurrency utilized by members of a decentralized community connected via blockchain technology, which itself is administered by this community of users rather than by a common enterprise, is not likely to be deemed a security under the familiar test laid out in *S.E.C. v. W.J. Howey Co.*, 328 U.S. 293, 298–99

(1946). The SEC, for example, does not contend that Bitcoins transferred on the Bitcoin blockchain are securities.

The court explained, however, that “[t]he record developed on the motion for a preliminary injunction presents a very different picture.” Section 2(a)(1) of the Securities Act defines a “security” to include an “investment contract,” as well as investment vehicles like stocks or bonds. 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. Looking at the “economic reality of Telegram’s course of conduct,” the court applied the *Howey* test both to the sale and the distribution of Grams.

Investment of Money

In applying the first prong of the *Howey* test (which Telegram did not dispute), the court found an investment of money because the Initial Purchasers “invested money” by providing dollars or euros to Telegram in exchange for the future delivery of Grams.

Common Enterprise

In applying the second prong of the *Howey* test, the court found a common enterprise because (1) Telegram pooled the investments made by the Initial Purchasers to develop the TON Blockchain (*i.e.*, “horizontal commonality”)^[2] and (2) the ability of each of the Initial Purchasers (and Telegram) to profit depended entirely on the successful launch of the TON Blockchain and Telegram’s reputation (*i.e.*, “strict vertical commonality”).^[3] The court explained that those facts were true both pre-launch and post-launch.

Reasonable Expectation of Profits

In applying the third prong of the *Howey* test, the court found a reasonable expectation of profits by purchasers because (1) “at the time of the 2018 Sales to the Initial Purchasers, a reasonable investor, situated in the position of the Initial Purchasers, would have purchased Grams with investment intent” and (2) “without the expected ability to resell Grams into the secondary market, the \$1.7 billion paid to Telegram would not have been raised.”^[4]

The court relied on the following factual findings in reaching this conclusion:

- ***The Substantially Discounted Sale Price:*** The court found that the sale price of Grams was set at a significant discount to the expected post-launch sale price. The sale prices for purchasers in Round One and Round Two were approximately \$0.38 and \$1.33, respectively, while the expected post-launch price of Grams at launch would be approximately \$3.62 under Telegram’s pricing formula – a premium of 852 percent and 172 percent for purchasers in Round One and Round Two, respectively. That premium provided a substantial opportunity for the Initial Purchasers to profit from the resale of Grams, which was highlighted in the promotional materials. The promotional materials also highlighted the TON Foundation’s ability to support the market price of Grams by repurchasing them if the market price fell to \$1.81, which still would allow Initial Purchasers to profit.
- ***Size and Concentration of Purchases:*** The court found that the size and concentration of purchases of Grams evidenced investment rather than consumptive intent. Specifically, the large amount of capital raised (\$1.7 billion), the large percentage of the total number of Grams sold (58 percent), and the limited number of Initial Purchasers (175) supported the conclusion that Initial Purchasers did not intend to use Grams as a currency.
- ***Profile of Purchasers:*** The court found that the profile of Initial Purchasers suggested that they purchased Grams as an investment rather than for a consumptive use. “In seeking participants for the 2018 Sales, Telegram did not focus on cryptocurrency enthusiasts, specialty digital assets firms, or even mass market

individuals who had a need for an alternative to fiat currency. Instead, Telegram selected sophisticated venture capital firms (and other similar entities) as well as high net worth individuals with an inherent preference (*i.e.*, their business model) toward an investment intent rather than a consumptive use.”

- **Lockup Restrictions:** The court found that the lockup restrictions for purchasers in Round One, which did not exist for purchasers in Round Two, incentivized an investment intent and undermined any consumptive use. In addition, those lockup restrictions had the effect of granting “an exclusive window for the Round Two Purchasers—who paid considerably more per Gram—to resell Grams and profit from their investment before Grams owned by Round One Purchasers could be sold into the market and thereby place downward pressure on the price of Grams.” Moreover, the lockup restrictions “tend to negate the likelihood that a reasonable Round One Purchaser purchased Grams for consumptive use. Simply put, a rational economic actor would not agree to freeze millions of dollars for up to 18 months . . . if the purchaser’s intent was to obtain a substitute for fiat currency.”
- **Intent of Initial Purchasers:** The court found that prospective and actual purchasers had a stated intent to profit based on e-mails and internal memoranda produced in the litigation. That subjective intent was not dispositive but informed the court’s conclusions with respect to the objective intent of reasonable purchasers.

Efforts of Others

In applying the fourth prong of the *Howey* test, the court found that profits were to be derived from the efforts of others because, “at the time of the 2018 Sales, a reasonable Initial Purchaser’s expectation of profits from their purchase of Grams was based upon the essential entrepreneurial and managerial efforts of Telegram.”

The court relied on the following factual findings in reaching this conclusion:

- **Telegram’s Commitment to Support the TON Blockchain:** The court found that Telegram’s support was necessary to the success of the TON Blockchain and Grams. The court concluded that the “Initial Purchasers’ dependence on Telegram to develop, launch, and support the TON Blockchain is sufficient to find that the Initial Purchasers’ expectation of profits was reliant on the essential efforts of Telegram.”
- **Integration with Telegram Messenger:** The court found that the integration of the TON Blockchain with Telegram’s pre-existing Messenger platform and user-base was essential to the success of the TON Blockchain and Grams. The court concluded that, “[a]t the time of the 2018 Sales, Telegram’s stated goal of developing Grams into the first mass market cryptocurrency was plausible, to Telegram, the Initial Purchasers, and the wider market, because of Messenger and its enormous user base.” By promoting that integration, Telegram created a “reasonable expectation in the minds of the Initial Purchasers that their anticipated profits were dependent on Telegram’s essential post-launch efforts.”
- **Grams for Founders/Development Team:** The court found that granting one percent of all Grams for Telegram’s founders and another three percent for the development team, subject to a four-year lockup period, incentivized their continued support for the TON Blockchain and Grams. Those grants aligned the interests of the founders and developers with the long-term success of the project such that they would continue to guide it.

THE COURT’S ANALYSIS OF EXEMPTIONS FROM REGISTRATION

The court next analyzed whether the exemptions from registration raised by Telegram applied to the sales of Grams. Telegram argued that Section 4(a)(2) of the Securities Act exempted Telegram from filing a registration statement because the Initial Purchasers were all sophisticated investors. In addition, Telegram argued that Rule 506(c) of Regulation D exempted Telegram from filing a registration statement because

Telegram had conducted a reasonable inquiry into the investment intent of each Initial Purchaser and obtained express representations and warranties that each Initial Purchaser was purchasing Grams for its own account and not with a view towards sale, distribution, or resale. The court concluded that neither exemption applied to the sale of Grams.

Section 4(a) of the Securities Act

Section 4(a)(2) of the Securities Act exempts from registration “transactions by an issuer not involving a public offering.” The court found that, although Grams were sold only to sophisticated investors, that alone was insufficient to qualify for the exemption. Telegram’s goal was to establish Grams as the first mass market cryptocurrency and, to that end, Telegram intended for Grams to be resold by the Initial Purchasers into the public market. Telegram sought out purchasers, such as major venture capital firms, who would sell their allocations of Grams quickly to earn a profit; and Telegram created economic incentives for Initial Purchasers to sell their Grams after the TON Blockchain launched. The court concluded that, as a result, the sales of Grams constituted a public offering and the exemption under Section 4(a)(2) was inapplicable.

Rule 506(c) of Regulation D

Rule 506(c) of Regulation D exempts from registration transactions that meet certain conditions, including that the issuer “exercise reasonable care to assure that the purchasers of securities are not underwriters” under Section 2(a)(11) of the Securities Act, which defines an “underwriter” as “any person who has purchased from an issuer with a view to . . . the distribution of any security.” That “exercise [of] reasonable care” requires a “[r]easonable inquiry to determine if the purchaser is acquiring the securities for himself or for other persons.”

The court found that, although Telegram sold Grams only to accredited investors and required a representation and warranty in each Gram Purchase Agreement that Initial Purchasers were “purchasing the Tokens for [their] own account and not with a view towards, or for resale in connection with, the sale or distribution,” Telegram nevertheless failed to exercise reasonable care. Telegram did not conduct a reasonable inquiry to determine that Initial Purchasers were not functioning as “mere conduits to the general public.” In addition, the representation and warranty in the Grams Purchase Agreement “rings hollow in the face of the economic realities of the 2018 Sales.” The court concluded that, therefore, the Initial Purchasers had been transformed into the functional equivalent of statutory underwriters; the sales of Grams to those Initial Purchasers constituted the first step in an ongoing “disguised public distribution” of securities; and the exemption under Rule 506(c) was inapplicable.

KEY TAKE-AWAYS

The court’s decision includes several key take-aways for companies operating and investing in digital currency + blockchain, including:

- The court recognized circumstances under which a cryptocurrency may not be considered a security based on the *Howey* test—e.g., an investment of money in a cryptocurrency utilized by members of a decentralized community connected via blockchain technology, which itself is administered by this community of users rather than by a common enterprise.
- The court focused on the economic realities and structure of the sale and distribution of cryptocurrency in applying the *Howey* test.
- The court limited the application of exemptions from the registration requirements.

^[1] Offerings that satisfy the conditions of Regulation D are deemed to be transactions not involving a public offering under Section 4(a)(2) of the Securities Act.

^[2] Horizontal commonality is established when investors' assets are pooled and the fortunes of each investor are tied to the fortunes of other investors, as well as the success of the overall enterprise.

^[3] Strict vertical commonality requires that the fortunes of investors be tied to the fortunes of the promoter.

^[4] In so doing, the court rejected Telegram's arguments that (1) because Grams would have "functional consumptive uses" (e.g., to store or transfer value), they would be a commodity not subject to the federal securities laws and (2) there could be no expectation of profit in light of Telegram's disclaimers and public statements emphasizing the consumptive use of Grams and denying any expectation of profit.

CONTACTS:

Mitzi Chang

Partner

+1 415 733 6017

mchang@goodwinlaw.com

Grant P. Fondo

Partner

+1 650 752 3236

+1 415 733 6000

gfondo@goodwinlaw.com

Daniel Roeser

Partner

+1 212 459 7276

droeser@goodwinlaw.com

Meghan K. Spillane

Partner

+1 212 459 7193

mspillane@goodwinlaw.com

Nicole L. Chessari

Counsel

+1 650 752 3281

nchessari@goodwinlaw.com

Zoe Bellars

Law Clerk

+1 212 459 7361

zbellars@goodwinlaw.com

© 2020 Goodwin Procter LLP. All rights reserved. This informational piece, which may be considered advertising under the ethical rules of certain jurisdictions, is provided with the understanding that it does not constitute the rendering of legal advice or other professional advice by Goodwin Procter LLP, Goodwin Procter (UK) LLP or their attorneys. Prior results do not guarantee similar outcome.

Goodwin Procter LLP is a limited liability partnership which operates in the United States and has a principal law office located at 100 Northern Avenue, Boston, MA 02210. Goodwin Procter (UK) LLP is a separate limited liability partnership registered in England and Wales with registered number OC362294. Its registered office is at 100 Cheapside, London EC2V 6DY. A list of the names of the members of Goodwin Procter (UK) LLP is available for inspection at the registered office. Goodwin Procter (UK) LLP is authorized and regulated by the Solicitors Regulation Authority.

IRS Circular 230 Disclosure: To ensure compliance with requirements imposed by the IRS, we inform you that any U.S. tax advice contained in this informational piece (including any attachments) is not intended or written to be used, and may not be used, for the purpose of (i) avoiding penalties under the Internal Revenue Code or (ii) promoting, marketing or recommending to another party any transaction or matter addressed herein.