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Message To Telegram: Economic Realities Control

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Introduction

The United States District Court for the Southern District of New York has issued two highly anticipated and significant rulings in the high-profile dispute between the Securities and Exchange Commission ("SEC") and Telegram Group Inc. ("Telegram"). The main rulings are: the offer and sale of Telegram's cryptocurrency, "Grams," involved a "scheme" to distribute securities subject to the registration requirements of the Securities Act of 1933;[1] and the Court's ruling that its preliminary injunction regarding sales or resales of Grams applies to U.S. and non-U.S. purchasers of Grams.[2]

The District Court Focused on the Economic Realities of Telegram's "Scheme"

Telegram and its principals sold two tranches of Grams in 2018. In Round One, Telegram sold approximately 2.25 billion Grams at a price of approximately $0.38 per Gram to 81 purchasers for $850 million, which included $385.5 million from 34 U.S. purchasers. In Round Two, Telegram sold approximately 700 million Grams at approximately $1.33 per Gram to 94 purchasers for $850 million, which included $39 million to U.S. purchasers. Round One and Round Two purchasers are referred to as the "Initial Purchasers."

Telegram claimed that the sales were securities exempt from registration under the Securities Act by Rule 506(c) of Regulation D. The funds raised were to be used to develop the Telegram Open Network ("TON") Blockchain on which the Grams would later function as a cryptocurrency. The initial purchasers of Grams would not receive their Grams until the TON was operational. At that point, the Gram owners could resell their Grams on the TON. Round One purchasers, however, were subject to additional "lockup" restrictions that limited the portion of their Grams that could be resold for various periods after they received their Grams. Round Two purchasers did not have such restrictions. Telegram was prepared to launch the TON and distribute the Grams to the Initial Purchasers in October 2019. After the SEC commenced litigation, the distribution date was extended to April 30, 2020.

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1 http://business.cch.com/srd/SECvTelegram032420.pdf ("Opinion").

2 https://www.law360.com/dockets/download/5e84c6d0518a520a7e652e37?doc_url=https%3A%2F%2Fecf.nysd.uscourts.gov%2Fdoc1%2F127126662664&label=Case+Filing

As the Court expressed it, "the foundational question is whether Telegram's contract, transaction, or scheme amounts to an offer or sale of a security." If so, the offer and sale of Grams was required to be registered under the Securities Act unless an exemption was available. The Court conducted its analysis using the Supreme Court's approach in *S.E.C. v. W.J. Howey*[3] and subsequent decisions to examine whether the instruments were "investment contracts." The four elements of the *Howey* test are: (1) an investment of money; (2) in a common enterprise; (3) with a reasonable expectation of profit by investors; and (4) derived from the entrepreneurial or managerial efforts of others.

The core of Telegram's argument was that Grams were not investment contracts requiring registration because there were two distinct sets of transactions at issue. In its view, the first set of transactions was the offers and sales to the "interests in Grams" sold to the Initial Purchasers, which Telegrams concedes were securities for which it claimed an exemption from registration pursuant to Rule 506(c) of Regulation D. Telegram argued that a second and distinct set of transactions will be the delivery of the newly-created Grams to the Initial Purchasers upon the launch of the TON Blockchain and that, upon launch, Grams would have "functional consumptive uses" and would be a commodity not subject to the securities laws.

Applying the *Howey* analysis, the Court found that the series of understandings, transactions, and undertakings between Telegram and the Initial Purchasers were investment contracts and, therefore, securities. The Court rejected Telegram's bifurcated view of the Gram distribution process. According to the Court, *Howey* and its progeny teach that the application of the securities laws turns on the "economic realities" of Telegram's course of conduct, and that the facts must be considered at the time that the transaction took place, together with the knowledge and the objective expectations of the parties at that time. Rather than two distinct sets of transactions, the Court viewed the offer and sale of the Grams as a "scheme" to distribute securities to the public, and one that checked each of the elements of the *Howey* test:

> The economic reality of Telegram's course of conduct is straightforward and rather easily understood. Telegram entered into agreements and understandings with the Initial Purchasers who provided upfront capital in exchange for the future delivery of a discounted asset, Grams, which, upon receipt (and the expiration of the lockup periods for Round One Purchasers), would be resold in a public market with the expectation that the Initial Purchasers would earn a profit. A reasonable Initial Purchaser understands and expects that they will only profit if the reputation, skill, and involvement of Telegram and its founders remain behind the enterprise, including through the sale of Grams from the Initial Purchasers into the public market.[4]

The Court found that the structure, purpose, and marketing of Grams all pointed to a scheme to obtain seed capital from Initial Purchasers who would be rewarded when they sold their Grams into the secondary market at a profit. The secondary market, i.e., the value of Grams on the TON Blockchain, would be derived from the initial discount at which the Grams were sold, the expected

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3 328 U.S. 293 (1946).

4 Opinion at 17.

reference price of Grams at launch of $3.62, price support mechanisms operated by Telegram, and the promised integration of Grams and the TON Blockchain with Telegram Messenger (Telegram's globally popular messaging app with a user base of approximately 300 million). The economic reality was that Initial Purchasers bought Grams for investment rather than consumptive use.

Having found that Telegram had offered and sold securities without registration, the Court then determined that Telegram did not qualify for the Rule 506(c) exemption. Telegram argued that the Initial Purchasers were "sophisticated purchasers" and therefore the sales did not involve a public offering under Section 4(a)(2) of the Securities Act.

The Court stated that the public offering analysis did not end there because "Telegram did not intend for the Grams to rest with the Initial Purchasers," but "built economic incentives into the 2018 Sales … to ensure that the Initial Purchasers resold Grams soon after launch." The Court noted that one requirement of Rule 506(c) is that the issuer "exercise reasonable care to assure that the purchasers of the securities are not underwriters within the meaning of section 2(a)(11) of the [Securities] Act." Telegram failed to satisfy this requirement in two respects.

First, the Initial purchasers were "underwriters" because they bought Grams with an intent to resell them for profit in the secondary market soon after launch of the TON Blockchain. Therefore, Telegram's two-step process represented a public distribution, with the Initial Purchasers acting as mere conduits to the general public. Second, Telegram argued that, even if the Initial Purchasers were statutory underwriters, Telegram's Purchase Agreement with them that included a warranty and disclaimers that they were not purchasing with a view to sale or distribution. The Court found that the argument "rings hollow in the face of the economic realities of the 2018 Sales."

Based on its analysis, the Court issued the preliminary injunction requested by the SEC on March 24, 2020. Telegram filed a notice of appeal in the Second Circuit Court of Appeals on the same day.

Telegram's Application to Narrow the Scope of the Injunction

On March 27, 2020, Telegram sought to clarify – that is, narrow – the scope of the preliminary injunction to only "Purchase Agreements with U.S.-based investors." Telegram argued that the injunction "ought not to reach those Initial Purchasers who are not U.S.-based because it would result in the extra-territorial application of the U.S. securities laws," citing the U.S. Supreme Court's decision in *Morrison v. National Australia Bank Ltd.*[5] The Court rejected Telegram's request on substantive and procedural grounds.

Substantively, the Court said that Telegram missed the point of the Court's analysis in issuing the injunction: the "security" in this case was not the Gram Purchase Agreement or the Gram itself; rather, it was "the entire scheme that comprised the Gram Purchase Agreements and the accompanying understandings and undertakings made by Telegram, including the expectation and intention that the Initial Purchasers would distribute Grams into a secondary public market." The Court also

5 561 U.S. 247 (2010).

noted that "the intended resale of Grams by Telegram's conduits into the secondary market is likely to involve U.S. purchasers and would likely satisfy *Morrison's* transactional test." The Court also rejected Telegram's proposal, advanced by Telegram for the first time on its motion to narrow the scope for the injunction, to take steps to prevent resales of Grams by non-U.S. Initial Purchasers to U.S. purchasers. The Court doubted whether existing purchase contracts could be modified. It also noted that the TON Blockchain was designed to grant anonymity to purchasers and sellers of Grams, and so "any restriction as to whom a foreign Initial Purchaser could resell Grams would be of doubtful real-world enforceability."

Procedurally, the Court said that Telegram's argument for a clarification was "less than straightforward." The Court noted that the injunction contained the same terms that the SEC had requested in October 2019. If Telegram objected to the scope of the requested injunction, it had ample time to do so. However, "Telegram raised no objection to the form of the injunction and never cited the Morrison case." Accordingly, the Court denied Telegram's application by order on April 1, 2020, although it noted that Telegram had not waived a defense of extra-territorial application of the securities laws as to the ultimate resolution on the merits.

Some Possible Implications of the Court's Opinion

Is the SAFT approach unworkable now?

Depending on the facts and circumstances, the Court's decision will make it more difficult for digital token issuers to argue that securities sold to raise capital can be transformed at a later date into "utility" digital assets that are not securities. In the Simple Agreement for Future Tokens ("SAFT") model, investors are sold securities, often "investment contracts" that fund development of a utility (such as a Blockchain platform or network) that will be accessible by using "utility tokens," that is, tokens whose only use is to obtain access to the goods or services available on the platform. In return for supplying capital, the investors receive the right to receive utility tokens when the platform and the tokens become fully functional. At that point, the investo rs' rights in the SAFT automatically convert into a right to delivery of the tokens. SAFT purchasers are typically entitled to the number of units of the token equal to the investors' purchase amount divided by a discount price. In other words, the investor obtains tokens at a discount to the issuance price of the utility tokens upon launch of the platform. SAFTs generally are considered investment contracts and securities under the Securities Act of 1933.

As noted, the SAFT paper contemplates an automatic conversion of the token securities into utility tokens upon the occurrence of an event, that is, the launch of the platform. The Court's decision shows that disproving a "scheme" to distribute securities could prove difficult if initial investors have a reasonable expectation of profit through the resale of their token securities in the public market.[6]

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6 We previously suggested that SAFT might be amended to give the issuer the right to mandatorily rescind the capital-raising securities when the platform became fully operational, and thereafter issue only utility tokens, https://www.blockchainlawcenter.com/newsitem/news/updating-saft-breaking-the-security-utility-token-conundrum-543/. That might avoid the "continuous or integrated scheme" that the Court found regarding the Initial Purchaser interests in Telegram.

Can improvements be made to an operational cryptocurrency platform?

The issue of platform improvements that enhance the value of the platform's tokens remains problematic. The Court in *Telegram* found "the reasonable expectation of profit from the efforts of others" prong of the *Howey* test satisfied by the expectation of Initial Purchasers that Telegram would use its developing Messenger app to enhance the TON Blockchain platform. But must a platform be frozen in time, or there be no secondary market for the tokens, to avoid securities registration issues regarding its sale of tokens? What is "fully operational" such that tokens are solely for use on the platform although the functionality of, or improvements to, the platform may make the tokens attractive to new purchasers? Of course, the nature of the marketing of such "utility" tokens and the degree of issuer support of a resale market for the tokens could trigger a *Howey* analysis.