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SEC v. Telegram: A Groundbreaking Decision in Cryptocurrency Enforcement?

On March 24, 2020, Judge P. Kevin Castel of the Southern District of New York issued a potentially groundbreaking decision in the matter of *Securities and Exchange Commission v. Telegram Group Inc. et al.*[1] In his decision, Judge Castel tackled an issue that lies at the forefront of the cryptocurrency regulatory space: when are digital assets subject to the securities laws and SEC regulation? In granting its motion for a preliminary injunction, Judge Castel found that the SEC had shown a substantial likelihood of success in proving that Telegram Group Inc. and TON Issuer Inc. (collectively, "Telegram" or the "Company") had engaged in an unregistered offering of securities—in violation of the Securities Act of 1933 (the "Securities Act")—by selling "Grams," a digital token, to certain sophisticated investors.[2] The Court's decision may have a substantial effect on the token industry and the SEC's enforcement efforts in this space—should the decision be upheld on appeal—because of the Court's focus on "economic reality" in piercing through contractual representations and warranties in deciding whether a token sale should be regulated under the securities laws.

[1] Unless otherwise indicated, all docket citations herein refer to the docket in *Securities and Exchange Commission v. Telegram Group Inc. et al*, 19-cv-09439-PKC (S.D.N.Y. Oct 11, 2019).
[2] *See* Dkt. 227 ("P.I. Decision").

Factual Background

Telegram is a private company primarily known for its product "Messenger," an encrypted messaging application with over 300 million users that has gained popularity within the cryptocurrency community. In January 2018, the Company began raising funds to finance its operations and the development of its own blockchain, the "Telegram Open Network" or "TON Blockchain."[3] The TON Blockchain is intended to be a proprietary blockchain across which users will be able to trade and exchange Grams, the Company's native digital token.[4]

What is a blockchain? It is a distributed ledger that tracks the current and historical state of accounts, transactions and/or events occurring on a network of computers, and is maintained by multiple parties, often referred to as validators and miners—who validate transactions occurring among users on the network. Transactions are grouped together over some time interval and posted to the ledger in "blocks," and each block is cryptographically linked to the previous block, creating an unbroken chain of valid transactions.[5]

In 2018, the Company sold interests in Grams to 175 entities and sophisticated, high-net-worth individuals (the "Initial Purchasers") in exchange for dollars or euros (the "Purchase Agreements"). The Purchase Agreements enabled the Initial Purchasers to receive an allotment of Grams upon the launch of the TON Blockchain.[6] Through its offering, the Company raised approximately $1.7 billion and sold 2.9 billion Grams to investors around the globe.[7] Under the Purchase Agreements, delivery of Grams (and the launch of the TON Blockchain) was supposed to occur no later than October 31, 2019.

According to court filings, the parties were in consultation over the Gram launch throughout 2019—with the Company producing documents and information during that period—but on October 11, 2019, the SEC filed an action, moved for a preliminary injunction, and obtained a temporary restraining order.[8] After the SEC commenced litigation, the Company delayed the expected launch date of the TON Blockchain to April 30, 2020. On January 15, 2020, the parties filed dueling motions for summary judgment, with both sides filing opposition and reply briefs in late January.[9] On February 19, 2020, the parties appeared for oral argument on the motions for summary judgment and a preliminary injunction.

The Parties' Positions

The fundamental legal question before the Court was whether the sale of an investment contract—the Purchase Agreements—and subsequent delivery of Grams was an exempt, unregistered offering under the securities laws. Pursuant to the Supreme Court's test in *S.E.C. v. W.J. Howey Co.*, a transaction is an investment contract or security if it involves "a contract, transaction or scheme" whereby someone (1) "invests his money," (2) "in a common enterprise," and (3) "is led to expect profits" (4) "solely from the efforts of the promoter or a third party."[10]

The SEC argued that the Purchase Agreements, and subsequent delivery of Grams, were a single transaction and securities offering under the Securities Act. In making this argument, and in arguing that

[3] *See* P.I. Decision at 1.
[4] *See id.* at 5-6.
[5] *See U.S. Securities and Exchange Commission v. Telegram Group Inc. et al*, 20-1076-cv, Dkt. 16 (2d. Cir. 2020).
[6] *See* P.I. Decision at 7.
[7] *See id.* at 1.
[8] *See* Dkt. 6.
[9] *See* Dkt. 71 ("Telegram MSJ"); *see* Dkt. 79 ("SEC MSJ"); *see* Dkt. 93 ("Telegram Opp."); *see* Dkt. 98 ("SEC Opp."); *see* Dkt. 113 ("SEC Reply"); *see* Dkt. 119 ("Telegram Reply").
[10] *SEC v. W.J. Howey*, 328 U.S. 293, 298-299 (1946); *see also United States v. Leonard*, 529 F.3d 83, 88 (2d Cir. 2008)

Grams are a security, the SEC contended that the *Howey* test must be applied to Grams as of the time the Company entered into the Purchase Agreements with the Initial Purchasers.[11] The SEC also contended that the Initial Purchasers were "underwriters," as defined under Section 2(a)(11) of the Securities Act, because they purchased the Grams from the Company "with a view to . . . the distribution of any security."[12] If the SEC was correct, the Company could not assert that its sale of Grams under the Purchase Agreement was exempt, pursuant to Regulation D, from registration under Section 5 of the Securities Act.[13] To support its "underwriter" argument, the SEC explained that the Company structured its agreements to incentivize the Initial Purchasers to sell their Grams quickly—for example, by providing "steep discounts" to early investors.[14]

In walking through *Howey*, the SEC argued that Grams purchasers reasonably expected profits that would be derived from the Company's entrepreneurial efforts.[15] According to the SEC, the Company told investors that the Company's future sales of Grams would increase in price as Grams in circulation increased, and further told investors that it would develop products that would increase Grams' demand and value.[16] On this basis, the SEC argued that even if the Court were to consider the *Howey* analysis to apply only as of the time of the TON Blockchain's launch, the economic realities at play would still render Grams securities because the tokens are vehicles for profit.[17] In sum, as the SEC puts it, "Telegram sold Grams, and Initial Purchasers reasonably viewed and still view them, as the representation of Initial Purchasers' investment in the project and which they hope to sell for profit based on Telegram's past, ongoing, and future efforts."[18]

Telegram has taken an alternative view of when *Howey* ought to be applied to its Grams offering, which is a critical point of disagreement between the parties. In arguing that a *Howey* analysis for the Grams ought to be conducted *following* the launch of the TON Blockchain, the Company asserts that the SEC has conflated two distinct questions: (1) whether the Purchase Agreements at issue were an offering of securities; and (2) whether the underlying Grams were securities when delivered to the Initial Purchasers.[19] The Company admits the first phase—the private sale agreements with the Initial Purchasers—was an offering of securities, though one that is exempt from registration requirements pursuant to Rule 506(c) of Regulation D.[20] An issuer is exempt from registering an offer or sale of securities to accredited investors under Rule 506(c) so long as the issuer takes reasonable care, as defined by Rule 502(d), to ensure that the purchasers are not statutory underwriters.[21]

The second phase—the delivery of Grams at the launch of TON Blockchain—does not, in the Company's view, constitute a securities offering. Rather, at that juncture, Grams are a currency or a commodity, like gold or silver, subject to market forces and the anti-fraud and anti-manipulation protections of the Commodity Exchange Act.[22] The Company argued that during this second phase there would be no investment in a "common enterprise" as required under *Howey*. According to the Company, it made clear

[11] *See* SEC MSJ at 18.
[12] 15 U.S.C. § 77b(a)(11).
[13] *See* SEC MSJ at 28.
[14] *Id.* at 21.
[15] *See id.* at 25.
[16] *Id.*
[17] *See id.* at 26-27.
[18] *See* SEC Reply at 4.
[19] *See* Telegram Opp. at 13.
[20] *See* 17 C.F.R. § 230.506.
[21] *See id.*; *see* 17 C.F.R. § 230.502
[22] *See* Telegram MSJ at 22-23.

to purchasers that Grams do not confer "any equity or other ownership interest in Telegram, any rights to dividends or other distribution rights from Telegram, or any governance rights in Telegram."[23]

Further, the Company reasoned that Grams fail under *Howey* because Grams were designed and promoted for *consumptive* use—not profit—as underscored in the marketing of Grams and disclaimers to investors.[24] While a Gram (much like a baseball ticket) may be purchased with an intent to profit, the Company has said that realization of profit is (1) not what Grams are intended for and (2) not tied to a promise or ongoing effort made by the issuer.[25] Once the TON Blockchain is launched, the Company has represented "the resulting Grams will not carry with them any concurrent or ongoing promises by Telegram to build or develop anything further, and certainly not any promises to perform ongoing essential services."[26] Instead, any improvements or alterations made to TON Blockchain after its launch would be squarely in the hands of the decentralized community of Gram users.[27]

Additionally, the Company contended that "because *Howey* is a *transaction-specific* inquiry, even if Grams could be deemed securities at the time of the Private Placement, there simply will not (and can never) be any 'public distribution' of a security if Grams are no longer securities at the time of the launch (i.e., the earliest time Grams could possibly be distributed to the public)."[28] The Company also noted that the regulatory framework in the cryptocurrency space is unsettled, and that SEC Commissioner Hester Pierce recently stated: "I am concerned about how the SEC has regulated [the digital asset] space, because I believe our lack of a workable regulatory framework has hindered innovation and growth . . . [and] offer[s] no clear path for a functioning token network to emerge."[29]

Prior to issuing his decision, Judge Castel invited the U.S. Commodity Futures Trading Commission to weigh in. In a February 18, 2020 letter, the CFTC made clear that it defines digital currencies as commodities.[30] But it went on to say that "commodities" and "securities" are not necessarily mutually exclusive. In other words, a digital asset that is deemed a commodity may also be a security if the asset is a "security" within the meaning of the Securities Act.[31] The CFTC concluded its letter by writing that it "express[es] no view" on whether the Securities Act applies to Gram tokens.[32]

The Court's March 24 Decision

In a lengthy decision, Judge Castel granted the SEC's motion for a preliminary injunction. While Judge Castel did not decide the parties' respective summary judgment motions, he essentially ruled on the issues at play in those motions. Notably, in his decision, Judge Castel emphasized the need to look to the "economic realities" of the transactions, agreeing with the SEC that the Purchase Agreements and the future delivery and resale of Grams should be viewed in their entirety for purposes of the *Howey* analysis.

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[23] *Id.* at 35.
[24] For example, the Company has pointed to a public notice it published on January 6, 2020, which stated, *inter alia*, that Gram purchasers "should NOT expect any profits based on your purchase or holding of Grams, and Telegram makes no promises that you will make any profits. Grams are intended to act as a medium of exchange between users in the TON ecosystem. Grams are NOT investment products and there should be NO expectation of future profit or gain from the purchase, sale or holding of Grams." *Id.* at 20.
[25] The Company noted, for example, that the Initial Purchasers expressly represented that they were "purchasing the Tokens for [their] own account and not with a view towards, or for resale in connection with, the sale or distribution." P.I. Decision at 42.
[26] *See* Telegram Opp. at 3.
[27] *See id.* at 3-4.
[28] *Id.* at 5.
[29] Telegram MSJ. at 3.
[30] *See* Dkt. 203 at 1.
[31] *See id.* at 2.
[32] *Id.* at 3.

In finding that the series of transactions between the Company and the Initial Purchasers constitutes a security under *Howey*, Judge Castel methodically walked through each prong of the test. First, he noted that there was no dispute amongst the parties about the fact that an investment of money had occurred.[33] Judge Castel next moved to the second prong of *Howey*, opining that investments in Grams constituted investments in a "common enterprise" because both horizontal and vertical commonality were present. Horizontal commonality, "which is established when investors' assets are pooled and the fortunes of each investor is tied to the fortunes of other investors as well as to the success of the overall enterprise,"[34] was present in Judge Castel's view because the Company pooled money from the Initial Purchasers to develop the TON Blockchain and maintain/expand Messenger, and thus "[t]he ability of each Initial Purchaser to profit was entirely dependent on the successful launch of the TON Blockchain."[35] In Judge Castel's view, in the event of the TON Blockchain's failure prior to launch, all Initial Purchasers would be equally harmed insofar as each would lose their opportunity to profit.[36] As a result, Judge Castel noted that "the SEC has made the required showing of horizontal commonality because the record demonstrates that there was a pooling of assets and that the fortunes of investors were tied to the success of the enterprise as well as to the fortunes of other investors both before and after launch."[37] The Court noted that even absent horizontal commonality, strict vertical commonality (which requires that "the fortunes of the investors need be linked only to the efforts of the promoter")[38] had been demonstrated for a substantially similar reason; namely, that investor profits hinged directly on the Company's ability to develop the TON Blockchain and the Company's own fortunes were similarly dependent on its successful launch.[39]

With regard to *Howey*'s "expectation of profit" prong, Judge Castel wrote that "Telegram's offering materials targeted buyers who possessed investment intent."[40] Judge Castel found that "the SEC had shown a substantial likelihood of success in proving that the Initial Purchasers purchased Grams in the 2018 Sales with an expectation of profit in the resale of those Grams to the public via the TON Blockchain."[41] Consequently, according to the Court, "a reasonable investor, situated in the position of the Initial Purchasers, would have purchased Grams with investment intent."[42] Of significance, the Court disregarded the Initial Purchasers' explicit warranties that they were "purchasing the Tokens for [their] own account and not with a view towards, or for resale in connection with, the sale or distribution."[43] Judge Castel found that "[t]he representation and warranty that the Initial Purchasers purchased without a view towards resale rings hollow in the face of the economic realities" of the transaction.[44]

Similarly, in evaluating *Howey*'s "entrepreneurial efforts of another" prong, Judge Castel discounted written disclaimers of the Company's post-launch involvement with the TON Blockchain.[45] Specifically, and despite the Company's disclaimers to the contrary, the Court found "an implicit [] intention on the part of Telegram to remain committed to the success of the TON Blockchain post-launch."[46] Judge Castel emphasized his belief that in order to realize a return on investment, the Initial Purchasers were reliant on "Telegram's efforts to develop, launch, and provide ongoing support for the TON Blockchain and

[33] *See* P.I. Decision at 20.
[34] *Id.*
[35] *Id.* at 21.
[36] *See id.*
[37] *Id.* at 22.
[38] *Id.* at 21 n.7.
[39] *See id.* at 22.
[40] *Id.* at 28.
[41] *Id.* at 24.
[42] *Id.* at 25
[43] *Id.* at 42.
[44] *Id.*
[45] In a January 6, 2020 public notice, the Company wrote: "Telegram and its affiliates have not made any promises or commitments to develop any applications or features for the TON Blockchain or otherwise contribute in any way to the TON Blockchain platform after it launches." Telegram MSJ at 20.
[46] P.I. Decision at 3.

Grams."[47] As Judge Castel stated, "Telegram's offering achieved its success because of its stated intention to integrate the TON Blockchain with Messenger in order to encourage the widespread use of Grams."[48]

In addition to finding that the Company's offering was of a security, Judge Castel agreed with the SEC that the token sale—and whether an exemption was appropriate—must be evaluated at the time of agreement and not at the time the Grams were delivered. Judge Castel found that the SEC had "shown a substantial likelihood of success in proving that Telegram sold Grams to the Initial Purchasers with the purpose and intent that those Grams then be distributed by the Initial Purchasers into a secondary public market."[49] In Judge Castel's view, the purpose of the Company's coin offering was for the Initial Purchasers to resell Grams on the open market. Because Judge Castel found that Grams were securities, the "economic reality" of the transaction meant that the Initial Purchasers were "statutory underwriters"—who would be effecting a public distribution—and thus, no exemption was available under Regulation D.[50] On this point, Judge Castel emphasized the SEC's argument regarding the Company's discounts: "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. . . would be resold in a public market with the expectation that the Initial Purchasers would earn a profit."[51] Again, in looking at the "economic reality" of the offering, Judge Castel discounted the warranty by the Initial Purchasers that they were "purchasing the Tokens for [their] own account and not with a view towards, or for resale in connection with, the sale or distribution thereof."[52] Accordingly, Judge Castel held that: "Examining the totality of the evidence and considering the economic realities, the Court finds that the SEC has shown a substantial likelihood of success in proving that the 2018 Sales were part of a larger scheme, manifested by Telegram's actions, conduct, statements, and understandings, to offer Grams to the Initial Purchasers with the intent and purpose that these Grams be distributed in a secondary public market, which is the offering of securities under *Howey*."[53]

Following Judge Castel's ruling, the Company filed an interlocutory appeal to the Second Circuit.[54] On March 27, 2020, the Company filed an emergency motion for an expedited appeal in light of the TON Blockchain's upcoming April 30, 2020 launch date—the SEC has opposed the motion—and immediately submitted its substantive appellate brief challenging Judge Castel's decision, along with supporting briefs from *amici curiae*.[55] The Company also submitted letters to the Court on March 27 and March 31, 2020, seeking clarification—and requesting a finding—that the preliminary injunction does not apply to the delivery of Grams to foreign investors outside the U.S. The SEC opposed the Company's request, contending that the Company's application is a motion for reconsideration that should be rejected and that the injunction applies to the delivery of Grams to "any person or entity" wherever located.[56] On April 1, 2020, Judge Castel issued an order denying the Company's application, emphasizing that the "security" at issue was comprised of the "Purchase Agreements and the accompanying understandings and undertakings" by the Company, including, in the Court's view, the Initial Purchasers' intention to "distribute Grams into a secondary public market."[57] Further, Judge Castel found, *inter alia*, that the "intended resale of Grams" would "likely [] involve U.S. purchasers," "any restriction as to whom a foreign

[47] *Id.* at 32.
[48] *Id.* at 33.
[49] *Id.* at 39.
[50] *See id.* at 42-43.
[51] *Id.* at 17.
[52] *Id.* at 42.
[53] *Id.* at 38.
[54] *See* Dkt. 228.
[55] *See U.S. Securities and Exchange Commission v. Telegram Group Inc. et al*, 20-1076-cv, Dkt. 39 (2d. Cir. 2020).
[56] *See* Dkt. 229-30, 232-33.
[57] Dkt. 234.

Initial Purchaser could resell Grams would be of doubtful real-world enforceability," and the Company's arguments were untimely.[58]

Implications

The Court's preliminary injunction ruling is a significant development in an area of securities enforcement that is largely unsettled. Indeed, Judge Castel's decision to pierce through to the "economic realities"—notwithstanding the warranties and/or representations in the Purchase Agreements—in assessing whether the tokens are securities under *Howey* and sold without a registration exemption, could have wide-ranging implications even beyond the digital token space. Further, the Company's appeal could prompt the Second Circuit to be the first appellate court to address the application of registration provisions to digital tokens. Clearly, Judge Castel's decision—should it be upheld on appeal—and the SEC's intensifying enforcement efforts in the cryptocurrency space, could have a significant impact on the ability of companies to create, promote, and support digital assets in a flexible manner. Accordingly, industry participants should take note of this litigation, the Court's holistic view of the Gram token offering, and the case's ultimate outcome on appeal.

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[58] *Id.*