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SEC v. Telegram: Key Takeaways and Implications

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On March 24, 2020, Judge P. Kevin Castel of the U.S. District Court for the Southern District of New York granted the Securities and Exchange Commission's (SEC) request for a preliminary injunction against Telegram Group Inc. and TON Issuer Inc. (collectively, "Telegram"), preventing the distribution of Gram tokens to the Initial Purchasers and thereby delaying the anticipated launch of the TON network on which the Grams would be used. The *Telegram* court found that the relevant contracts and understandings, including the initial sale and distribution of the Grams and possible resale by those early purchasers, were part of a larger scheme to distribute those Grams into a secondary public market in an unregistered offering of securities.[1]

In early 2018, Telegram raised $1.7 billion through private placements of investment contracts pursuant to an exemption from registration under Regulation D of the Securities Act of 1933 in return for the promise to deliver 2.9 billion Grams once it had developed and launched the TON network. Telegram had not planned to conduct a separate public distribution of Grams at the time of the proposed network launch with the exception of a possible air drop of a small portion of the overall 5 billion Grams. The SEC sought to block the distribution of the Grams to Initial Purchasers on the ground that it was anticipated that upon distribution, the Initial Purchasers would act as "underwriters" and resell the Grams into a secondary public market in an unregistered offering of securities. Telegram denied the characterization, asserting that any such resales would be transactions wholly unrelated to the initial sales and distributions and that they would not constitute securities offerings.

In assessing whether there was an offering of securities, the *Telegram* court applied the familiar test laid out in *SEC v. W.J. Howey Co.* (the "Howey Test").[2] The court, however, examined the Gram purchase agreements, anticipated distribution to Initial Purchasers and the presumptive resale of the Grams by the Initial Purchasers as a single, aggregate transaction and distribution rather than independent transactions. Its analysis focused on the "scheme"[3] as of the time of the initial sale of forward contracts or convertible instruments rather than considering anew the facts and circumstances at the time of delivery of the underlying assets or actual resale. On that basis, the *Telegram* court did not find the Grams themselves or the Gram purchase agreements standing alone to be securities. Rather the court concluded that the entire pre-sale scheme as a whole, including the Gram purchase agreements and the accompanying understandings and undertakings made by Telegram, *were* securities.[4] The court's decision, which is already being appealed, rests on the specific facts and circumstances of the Telegram token, network and transactions as evaluated on a preliminary injunction standard. Likely to varying degrees of success, it may distinguish if one seeks to apply it to other projects with different facts and circumstances. As discussed below, however, the Telegram decision may be susceptible to over-simplification and misapplication. If upheld on appeal and not clarified, it could have wide-ranging implications on the token industry and the venture capital model. Accordingly, pending further review of the *Telegram* decision, we suggest below certain areas to mitigate potential risks.

Precedential value remains unclear. The *Telegram* opinion comes out of the influential Southern District of New York, but it is the opinion of a single trial court, rendered on a preliminary injunction standard, and is already subject to an appeal filed by Telegram to the Second Circuit. Additionally, while the SEC enjoins the distribution by Telegram of the Grams to the initial purchasers, the SEC's arguments, accepted by the Telegram court, extended the Howey analysis to include the presumptive unrestricted resale by the initial purchases. The decision appears to be based on the facts at the time of entry into the Gram purchase agreements and the facts and circumstances regarding the development and status of the TON network as of the date of the temporary restraining order granted in October 2019. One should not necessarily extrapolate the court's aggregation of the initial sale and the possible resale as a single scheme constituting an investment contract to projects that may have vastly different facts and circumstances both at the time of an initial sale of forward contracts or convertible instruments and at the time of potential resale by such initial purchasers. As with any case at this stage of the judicial process, it is extremely difficult to know whether different facts would have yielded a different result, but there are certain facts highlighted by the Telegram court that make a different outcome possible.

Mutability concept survives. The SEC staff consistently has offered its view that an asset that is indisputably not a security (a token or an orange) may be sold as a security (a *Howey* investment contract) at one point in time, but later may be sold as a non-security as the facts and circumstances change. This transformation could result

from the decentralization of the underlying blockchain project or network, the functionality or utility of the digital asset,[5] or simply the conclusion that "applying the disclosure regime of the federal securities laws to current transactions in [Ether/Bitcoin] would seem to add little value."[6]

On April 3, 2019, the staff of the SEC's Division of Corporation Finance proposed a framework for assessing digital assets[7] that is explicitly premised on the notion that a digital asset issuer and purchaser can and should assess the facts and circumstances of the digital asset and the network at different points in time to determine whether the securities analysis has changed. For example, the staff suggests one should make an assessment upon the initial sale to the purchasers of future rights to the digital asset and again upon any future sale of the digital asset by a purchaser to a third party – to determine whether the offer and sale would still be an offer and sale of a security.[8] The framework clearly reflects the concept that the securities analysis can change over time as the facts and circumstances, i.e., the "scheme," can change.

Additionally, the staff's framework calls for consideration as to whether there is an "Active Participant," i.e., "a promoter, sponsor, or other third party (or affiliated group of third parties) . . . [who] provides essential managerial efforts that affect the success of the enterprise, and investors reasonably expect to derive profit from those efforts." The staff indicates that a digital asset is more likely to be an investment contract where there is an Active Participant at the outset or where one emerges in the future. By referencing this newly created concept of the Active Participant, rather than simply the issuer of a digital asset, the staff appears to suggest that during the course of the development of a digital asset and a blockchain-based network the "scheme" surrounding sale of a digital asset could be an investment contract at issuance, subsequently fail the Howey Test (i.e., it is not a security) and then later become an investment contract again if a new Active Participant provides the essential efforts or set of promises that constitute a "scheme" to satisfy the Howey Test. Quite clearly, this requires an assessment of the nature of the "scheme" at multiple points in time over the development of the underlying network. Unlike a share of common stock that once established will never change in its form, rights or structure, the nature of an investment contract can change, and to determine whether the offer and sale of the underlying asset remains a security, one must repeatedly assess the facts and circumstances of the overall scheme in light of the *Howey* factors.

Indeed, the SEC staff has repeatedly reinforced this concept when addressing Simple Agreements for Future Tokens ("SAFTs"). For example, in his June 14, 2018, speech, Director William Hinman of the Division of Corporate Finance declined to discuss SAFTs in the abstract, but stated, "[I]t is clear that I believe a token once offered in a securities offering can, depending on the circumstances, later be offered in a non-securities transaction."[9] Also shortly after the SEC brought its action to enjoin the Telegram launch in October 2019, a SEC staff member noted expressly that the SAFT model should and could still work so long as resale was tied not just to a set period of time but rather linked to a point in time in which the resale of the underlying token would no longer be a securities transaction.

In *Telegram,* the court rejected Telegram's contention that the *Howey* analysis as to the Grams should be conducted solely at the time of their distribution. Instead, assessing the overall series of agreements, transactions and understandings, the court determined that the *Howey* analysis should be conducted at the time of the execution of the Gram Purchase Agreement with respect to the Telegram Initial Purchasers.[11] Notwithstanding this, however, it also went on to discuss and assess the facts and circumstances and ongoing efforts of Telegram post-launch[12] to show the continued existence of the *Howey* elements. The opinion references a "Bahamas Test" finding that if, immediately after launch "Telegram and its team decamped to the British Virgin Islands…and ceased all further efforts to support the TON Blockchain, the TON Blockchain and Grams would exist in some form but would likely lack the mass adoption, vibrancy and utility that would enable the Initial Purchasers to earn their expected profits." While abandonment of a blockchain project by its creators seems an undesirable test for decentralization, by citing this possible set of facts, the *Telegram* court implicitly acknowledges the concept of mutability and the notion that facts and circumstances may change or revolve with the effect of terminating the "scheme" and thus the existence of a security. This post-launch analysis by the *Telegram* court aligns with the staff's views regarding the possibility that an investment contract security can evolve into a non-security. Despite the court's insistence that the series of transactions should be viewed at the outset, portions of the court's analysis suggest that with each new transaction, the facts and circumstances should be reevaluated to determine whether the *Howey* elements are satisfied.

In sum, the suggestion in *Telegram* that the securities analysis is static and must be made solely at the time of the initial relevant transaction, and only once for purposes of the Initial Purchasers, is contrary to the position the SEC staff has taken on the issues and the guidance it has provided and contrary to the basic tenets of a "facts and circumstances" based test, such as the Howey Test. Further, as discussed above, it appears to be contrary

to the court's own analysis.

Differentiate and disaggregate the "scheme." Under *Howey,* the determination of what constitutes an investment contract is a facts and circumstances inquiry. SEC guidance also dictates that the *Howey* analysis must be assessed at the time of, and with respect to, each offer and sale (or resale). In light of the *Telegram* opinion, despite previously articulated views consistent with a concept of mutability of digital assets, the SEC may be inclined, if it serves the SEC's purpose in enforcement actions, to argue that the separate transactions should be ignored in favor of a general, overall analysis which fixes an immutable *Howey* determination at the time of the first relevant sale involving the underlying asset. This would be an unfortunate collateral consequence of this decision.

In such an event, it will be important to differentiate the alleged security investment "scheme" of early pre-launch purchasers from post-launch purchasers or resales. The *Telegram* decision and the SEC staff's views continue to allow for the concept, upon which a forward purchase agreement or SAFT is based, that (a) digital assets are not securities, and (b) the facts and circumstances that may, at time of sale, give rise to an investment contract, under *Howey* can change such that the Howey factors are no longer met at a later date. If the network is functional and/or decentralized at the time of launch (as the court found was *not* the case in *Telegram*), there can be no "scheme" to sell securities, directly or indirectly, and resale by early purchasers is neither a resale of a security nor a distribution by an underwriter by or on behalf of the issuer.[13] Of course, determining when such metrics have been achieved or circumstances have changed remains challenging and unclear. Projects will need to ensure that they have decentralization or functionality at launch so that a primary issuance or sale of a digital asset at that time will not be deemed an investment contract scheme. Further, early purchasers may need to be restricted or prohibited from transferring digital assets post-launch until additional decentralization and/or additional functionality and further market liquidity not linked to early purchasers' resales has been established.

As the SEC staff members stated even after the SEC had initiated its action against Telegram, if the sale of rights to a digital token involves an investment contract, the digital asset must be subject to transfer restrictions until it is clear that when any such purchaser resells the digital asset, the overlying "scheme" (e.g., the relevant agreements and understanding) will no longer constitute a security. If a forward delivery contract contemplates unrestricted distributions with no restrictions on resale by early purchasers regardless of the characteristics of the "scheme," then members of the staff have stated that they believe that there is significant risk of jeopardizing any applicable exemption for the initial sale of future rights, and that any purchasers of such future rights could be viewed as underwriters. The SEC has taken this position in its actions against both Telegram and Kik,[14] and we expect it will continue to do so given the *Telegram* court's acceptance of this argument.

The *Telegram* court's analysis seems, however, to leave open the possibility that if the resale were to occur not immediately after the launch, as the court assumes will be the case for the Telegram Initial Purchasers, and at market determined prices,[15] then the resale would not be a resale of a security at all and thus no longer part of the distribution of the same security by those deemed statutory underwriters by the *Telegram* court. To counter this potential line of regulatory attack, differentiating facts will be important, but the focus should be on ensuring that at the time of project launch and any resale by early purchasers, the facts and circumstances make clear that there is no longer an investment contract, which may, in some circumstances, serve to terminate or differentiate the original "scheme" asserted by the SEC from characteristics of the offer and sale of the digital asset the time of project launch. In particular, a project must do what it can to achieve, as much possible, the following, among other things: decentralization; functionality; equal market risk among initial purchasers, the issuer and purchasers at launch; liquidity and distributions other than as a result of initial purchaser resale.

Potential erosion of Rule 144 Safe Harbor. As noted above, the *Telegram* court chose not to disaggregate the various agreements and understandings and instead viewed them as one overall "scheme" to be assessed at the time of entry into the Gram Purchase Agreement. The *Telegram* court assumes that purchasers only entered into the Gram Purchase Agreements on the basis that they would be able to profit upon resale of the Grams to the public. As a result, the court found, they could not make the representations required of Regulation D that they were purchasing without a view toward distribution. The court also found that Telegram did not do enough to ensure that the purchasers were not purchasing for resale. Indeed, the *Telegram* court concludes that Telegram did quite the opposite and actually encouraged and facilitated resale as a means of profit such that it was obvious and a foregone conclusion that the Initial Purchasers would resell to the general public immediately after launch (for those with no lock-up) or as soon as the lock-up expired. On this basis, the *Telegram* court deemed the Initial Purchasers to be statutory underwriters, acting simply as conduits between the issuer and the general public and that the "scheme" was not complete until the Grams "come to rest" with the general public – in effect a *de facto* indirect public offering.

This approach, however, ignores that the Securities Act itself mandates that an offer and sale of a *security* occur for the provisions of Section 5 to apply.[16] Thus one must assess, based on *Howey*, at a particular point in time of a proposed offer and sale whether a security is, in fact, to be sold. But the *Telegram* court has, on its face, ignored this premise by claiming that the distinct agreements, understandings and transactions, including resale by the Gram holder, are all part of a single distribution. As discussed above, the Howey Test should be applied at the time of sale for every sale to be consistent with law, regulation and SEC guidance.

The *Telegram* opinion suggests that because Initial Purchasers purchased large amounts of Grams at a price lower than the expected public market price in the future, and that such investment was speculative, that all Initial Purchasers must be underwriters and that the initial sale of future rights followed by a likely subsequent sale to the public must be part of a single transaction. This treatment also disregards existing safe harbors for resale transactions provided by Rule 144 and relies on principles of case law that pre-dated the adoption of Rule 144. As used in Section 2(a)(11), "distribution" is a term of art and is not defined in the Securities Act. But at its core, being an underwriter requires that there be an offer or sale and actual distribution, i.e., resale, by those holding restricted securities, per Section 2(a)(11). If there is no subsequent sale by the initial purchasers, there can be no ongoing distribution and therefore no underwriter status under Section 4(a)(1). The *Telegram* court, and the SEC in its arguments to the court, ignore these principles, which have created certainty in our private capital markets for early investors in companies that hope they may later be able to resell the securities, via an IPO, private secondary sale or an acquisition for many multiples of their original investment. Applying the *Telegram* court's use of the economic realities of the transaction would cast a very real pall on these transactions too.

Conclusion. The complexity of the arguments asserted by the SEC against Telegram and the findings of the *Telegram* opinion continue to demonstrate the opacity of the regulatory landscape and highlight the risk to the industry of retroactive, selective enforcement rather than principles based guidance from the SEC. It continues to be difficult to draw broader conclusions or extrapolate rules or principles from enforcement actions that, as the Telegram court notes, are specific to the facts of a particular project and digital asset. Further, as discussed above, there are key issues to be addressed and clarified on appeal, particularly concerning the potential for a security to change into a non-security as facts and circumstances change over time and thus the need to conduct a separate analysis for each new transaction.

Notes

1. *SEC v. Telegram Group Inc.*, No. 1:19-cv-09439-PKC (S.D.N.Y. March 24, 2020) (opinion and order granting preliminary injunction) (the "Telegram Injunction").
2. *SEC v. W.J. Howey Co.*, 328 U.S. 293, 298–99 (1946) (defining an investment contract as "a contract, transaction or scheme whereby a person (1) invests his money (2) in a common enterprise and (3) is led to expect profits solely from the efforts of the promoter or a third party").
3. Citing *Howey,* the Telegram court notes that an investment contract is a "contract, transaction or scheme" and uses the term "scheme" in a descriptive rather than a pejorative sense. Telegram Injunction at 39 (citing *Howey*, 328 U.S. at 298–99).
4. The *Telegram* court reiterated this finding in its denial of Telegram's subsequent request for clarification, *SEC v. Telegram Grp. Inc.*, 2020 WL 1547383, at *1 (S.D.N.Y. Apr. 1, 2020) ("[T]he 'security' was neither the Gram Purchase Agreement nor the Gram but 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.")
5. A transaction does not fall within the scope of the securities laws when a reasonable purchaser is motivated to purchase by a consumptive intent." Telegram Opinion, at 25 (citing *SEC v. Edwards*, 540 U.S. 389, 394 (2004) and *United Housing Foundation, Inc. v. Forman*, 421 U.S. 837, 852 (1975)).
6. William Hinman, Director, Division on Corporate Finance, *Digital Asset Transactions: When Howey Met Gary (Plastic)*, Remarks at the Yahoo Finance All Markets Summit: Crypto (June 14, 2018) (the "Hinman Speech").
7. SEC Division of Corporation Finance, *Framework for "Investment Contract" Analysis of Digital Assets* (Apr. 3, 2019), (the "April 3 Framework").
8. The April 3 Framework provides specific factors designed to evaluate "whether a digital asset previously sold as a security should be reevaluated at the time of later offers or sales."
9. *See* Hinman Speech.
10. Jennifer A. Zepralka, Chief, Office of Small Business Policy, Division of Corporation Finance, SEC (panelist), *Financing Issues Facing Late-Stage Private Companies and Smaller Reporting Companies* Practicing Law Institute, 51st Annual Institute on Securities Regulation: Financing Issues Facing Late-Stage Private Companies and Smaller Reporting Companies (November 4, 2019). We understand that similar

comments were made by SEC staff member and FinHub Member Amy Starr, Chief Advisor for FinTech Capital Markets, Division of Corporation Finance, SEC, at Fordham Law Blockchain Regulatory Symposium in November 2019.

11. The *Telegram* court looked to the "series of understandings, transactions and undertakings at the time they were made" to find such "scheme" between Telegram and the Initial Purchasers to be an investment contract satisfying the Howey Test. Telegram Injunction at 18-19. The *Telegram* court continues to examine the facts and circumstances and the intent of the Initial Purchasers at the time they made their investments in 2018.
12. Telegram Injunction (citing M. Todd Henderson & Max Raskin, "A Regulatory Classification of Digital Assets: Toward an Operational Howey Test for Cryptocurrencies, ICOs, and Other Digital Assets," 2 Colum. Bus. L. Rev. 443, 461 (2019) (proposing a "Bahamas Test")).
13. In *Telegram*, there was no sale or other meaningful distribution by Telegram directly to the public. That point likely influenced the court's determination that the sale to the Initial Purchasers was part of a disguised public offering.
14. Telegram Injunction at 1; *SEC v. Kik Interactive, Inc.*, No, 19-cv-05244-AKH, (March 20, 2020), Dkt 58. at 49 (memorandum in support of the SEC's motion for summary judgment).
15. With respect to Grams, market price would be subject to a minimum price guaranteed to result in profit due to price stabilization formulas controlled by Telegram and promised its Initial Purchasers.
16. Section 5 of the Securities Act makes it unlawful, without a registration statement then in effect to utilize instruments of interstate commerce to affect the offer or sale of a security.

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