

Telegram: Deconstructing One of the Biggest Blockchain Cases of 2020

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The Telegram case is arguably the most important case of 2020 involving the legal classification of blockchain-based digital assets. Because it is often cost-prohibitive for companies to challenge the government in court, the Telegram litigation offered a unique opportunity for the parties to present arguments on several complex legal issues. Given the lack of judicial precedent in this area, as well as the size and profile of the Telegram project, the Telegram case was closely watched by blockchain industry participants and represents a significant development for this emerging market. Here we provide an overview of the case, an analysis of the Court's ruling, details on the final resolutions, and some key takeaways.

Overview of the Telegram Case

Telegram, a global messaging platform, was founded by Russian brothers Nikolai and Pavel Durov in 2013.¹ The platform is popular among cryptocurrency enthusiasts because of its libertarian roots, emphasis on privacy² and group-chat feature, which can host up to 200,000 members per chat group.³ The platform raised \$1.7 billion from 175 initial purchasers ("Initial Purchasers") in a simple agreement for future tokens ("SAFT") offering in early 2018 to finance the launch of its Telegram Open Network ("TON")⁴, a blockchain network that, according to Telegram, would have underpinned a new global cryptocurrency featuring digital tokens called "Grams."⁵

Shortly before Telegram was set to distribute its Gram tokens to investors, on October 11, 2019, the Securities and Exchange Commission ("SEC") filed suit in the U.S. District Court for the Southern District of New York and obtained a temporary restraining

1 SEC v. Telegram Group Inc., Opinion and Order, 19-cv-9439 (S.D.N.Y. 2020) at 4.
2 The network's privacy has been questioned, however, since end-to-end encryption is not available by default. And even if such encryption is enabled, it lacks security, according to privacy experts, because it is "home-grown" with no proof offered that it is truly secure. Karen Chiu, *How Secure Is Telegram*, Abacus News (June 13, 2019), <https://www.abacusnews.com/digital-life/why-telegram-isnt-secure-you-think/article/3014398>; William Turton, *Why You Should Stop Using Telegram Right Now*, Gizmodo (June 24, 2016), <https://gizmodo.com/why-you-should-stop-using-telegram-right-now-1782557415>.
3 Telegram, *Group Chats on Telegram*, Tour: Groups (accessed Feb. 23, 2020), <https://telegram.org/tour/groups>.
4 SEC v. Telegram Group Inc., Opinion and Order, 19-cv-9439 (S.D.N.Y. 2020) at 7-8.
5 *Id.* at 1.

order halting the distribution. The SEC alleged the contemplated distribution of Grams was an unlawful securities offering and explained that the emergency protective order it sought was needed to prevent flooding the U.S. markets with tokens sold in violation of the U.S. securities laws.⁶ At a preliminary injunction hearing, the Court was faced with the question of whether the SEC had shown a substantial likelihood of success in proving that Telegram's plan to distribute Gram's was an offering of securities under the Howey test to which no exemption applies.

At the preliminary injunction hearing, neither side offered live testimony. Based on deposition testimony, exhibits, declarations and a "fulsome" joint stipulation of facts, as well extensive briefing, including amicus briefs, in March 2020, the Court granted the SEC's motion for a preliminary injunction. In June 2020 the parties reached a settlement that in effect amounted to a complete victory for the SEC. As part of the settlement agreement, among other things, Telegram agreed to return more than \$1.2 billion to investors and agreed to pay an \$18.5 million civil penalty.

Unless and until there is a legislative resolution to the question of when tokens are securities, the Telegram case may potentially establish precedent that could have significant effects on the way cryptocurrencies and other blockchain-based digital assets are categorized in the future. Below we provide an overview of the key arguments and events that led up to the Court's decision in this important case.

The SEC's Position

In its complaint, the SEC argued that the Grams were securities because the Initial Purchasers and subsequent investors expected to profit from Telegram's work, namely "the development of a TON "ecosystem," integration with Messenger, and implementation of the new TON Blockchain."⁷ Additionally, the SEC argued that "[i]nvestors' were also tied to Telegram's profits based on Telegram's significant holdings of Grams."⁸ According to the SEC, there was "an expectation on the part of investors that they will profit if Telegram builds out the functionalities it has promised,"⁹ and

6 Press Release, SEC, SEC Halts Alleged \$1.7 Billion Unregistered Digital Token Offering (Oct. 11, 2019), <https://www.sec.gov/news/press-release/2019-212>.
7 SEC v. Telegram Group Inc., SEC Complaint, 19-cv-9439 (S.D.N.Y. 2020) at 3, 7.
8 *Id.* at 13.
9 *Id.* at 3.

Telegram “led potential investors to understand that it would be Telegram’s and its principals’ and agents’ efforts that would determine the success of the enterprise.”¹⁰

Importantly, the SEC noted that “[o]nce Telegram delivers the Grams to the Initial Purchasers, they will be able to resell billions of Grams on the open market” and “are likely to promptly resell millions of them into the public markets.”¹¹ The SEC alleged “Telegram contemplated that Initial Purchasers would resell their Grams immediately upon delivery, as evidenced by its inclusion of certain lock-up provisions as to some Grams.”¹² The SEC also argued that the \$1.7 billion raised by Telegram in the SAFT sales exceeded the amount of funds needed to develop the TON blockchain.¹³ With regard to the price at which Telegram sold Grams to the Initial Purchasers, the SEC pointed out that the prices were predetermined based on a formula that Telegram designed to ensure that the price of Grams would increase “exponentially” after providing a “deep discount” to the Initial Purchasers.¹⁴

Based on the above factors—and many more cited in the SEC’s complaint and supporting memoranda—the SEC argued that the Grams were investment contracts, and therefore securities, under the Howey test. In brief, the SEC argued that the SAFT sales were investments in a common enterprise because the funds “were pooled for Telegram’s business ventures” and the Initial Purchasers “were led to believe that their fortunes would rise and fall together” with the fortunes of other Initial Purchasers and with those of Telegram.¹⁵ The SEC also argued that the factual record demonstrated that the Initial Purchasers “were led by Telegram to reasonably expect profits, and, specifically, that these profits would derive from the entrepreneurial and managerial efforts of Telegram.”¹⁶

The SEC contended that even the SAFT sales to the Initial Purchasers did not meet the exemption from registration under Rule 506(c) of Regulation D, because Telegram did not “exercise reasonable care” to ensure that the Initial Purchasers were not “underwriters” within the meaning of Section 2(a)(11) of the Securities Act. In this regard, the SEC argued that Telegram did not intend for the Grams to “come to rest” with the Initial Purchasers. Rather, the SEC alleged, Telegram sold the Grams to the Initial Purchasers “with a view to distribute” the Grams to the general public, and thus Telegram began a distribution of securities, “which involves the flow of securities from an issuer through conduits and out to the public at large.”¹⁷ The SEC further argued that Telegram’s imminent planned delivery of the Grams already committed by Telegram to institutional and other large Initial Purchasers was the next step in the broader distribution to public investors.¹⁸ Accordingly, unless a registration statement was filed, the SEC argued that the resale of Grams by the Initial Purchasers and the

larger distribution of additional Grams by Telegram would violate the federal securities laws.¹⁹

Telegram’s Defense

In defense, Telegram argued that its “private placement to highly sophisticated, accredited investors was conducted pursuant to valid exemptions to registration under the federal securities laws and Grams will not be securities when they are created at the time of launch of the TON blockchain.”²⁰ Telegram denied the SEC’s allegations and argued that the Grams, once created and distributed, would function as a medium of exchange similar to bitcoin and ether. Telegram also emphasized its extensive attempts over “more than 18 months of communications” to engage the SEC on the Gram distribution event prior to the SEC’s request for a temporary restraining order to block the distribution.²¹

Telegram disagreed with the SEC’s allegations that the Initial Purchasers were led to expect profits based on Telegram’s ongoing efforts. Telegram cited precedent holding that “when a purchaser is motivated by a desire to use or consume the item purchased . . . the securities laws do not apply.” In this regard, Telegram argued that “[t]he record demonstrates that Grams were developed and marketed principally for their consumptive utility and as a medium of exchange to purchase goods and services.”²²

Telegram denied any expectation of profits based on the efforts of Telegram and argued that “Telegram’s “essential entrepreneurial efforts” will have been completed by the time the TON Blockchain is launched and Grams are available for purchase, and it will not occupy any managerial position within the ecosystem.”²³ In this regard, Telegram emphasized that the TON Blockchain code was “completely open source” and pointed to its own public notices, such as its statement that “once the TON Blockchain is launched, Telegram will occupy the same position as any other party with respect to the TON Blockchain, and will not have any control over, any unique rights within, or any responsibility for the management of, the TON Blockchain.”²⁴ According to Telegram, following the launch of the TON blockchain, any expectation of profits on the part of Gram purchasers would be “based on the market value of Grams . . . which . . . will fluctuate due to market factors and not the ongoing efforts” of Telegram.²⁵ In this way, Telegram argued that the market for Grams after launch of the TON blockchain would be more similar to a market for commodities, not securities.²⁶ Telegram also argued that after launch of the TON blockchain, there would be no “common enterprise” for purposes of the Howey test.

Importantly, Telegram argued that “even assuming that the non-existent Grams could be considered “securities” at the time of the Private Placement, that still does not mean they should be considered “securities” following the launch of the TON Blockchain

10 *Id.* at 17.

11 *Id.* at 2-3.

12 *Id.* at 14.

13 *Id.*

14 *Id.* at 2, 21.

15 *SEC v. Telegram Group Inc.*, SEC Memorandum of Law in Support of Emergency Application for TRO, 19-cv-9439 (S.D.N.Y. 2020) at 17.

16 *Id.* at 18-19.

17 *SEC v. Telegram Group Inc.*, SEC Memorandum of Law in Support of Motion for Summary Judgment, 19-cv-9439 (S.D.N.Y. 2020) at 28-29; *SEC v. Telegram Group Inc.*, SEC Complaint, 19-cv-9439 (S.D.N.Y. 2020) at 25.

18 *SEC v. Telegram Group Inc.*, SEC Complaint, 19-cv-9439 (S.D.N.Y. 2020) at 25

19 *Id.* at 28.

20 *SEC v. Telegram Group Inc.*, Telegram Answer, 19-cv-9439 (S.D.N.Y. 2020) at 1.

21 *Id.* at 29, 33.

22 *SEC v. Telegram Group Inc.*, Telegram Memorandum of Law in Support of Motion for Summary Judgment, 19-cv-9439 (S.D.N.Y. 2020) at 25.

23 *Id.* at 28.

24 *Id.* at 29.

25 *Id.* at 30.

26 *Id.* at 31-32.

and for all times thereafter.”²⁷ Here Telegram pointed to guidance from the SEC’s Strategic Hub for Innovation and Financial Technology which provides that in certain contexts, a “digital asset previously sold as a security should be reevaluated at the time of later offers or sales.”²⁸ Finally, Telegram defended the validity of the SAFT sales to the Initial Purchasers as an offering of securities that was exempt from registration under Rule 506(c) of Regulation D.

The Amicus Curiae Briefs

The significance of the Telegram case in shaping the legal regime of digital assets prompted the Digital Chamber of Commerce (“the Chamber”) and the Blockchain Association (“the Association”), two not-for-profit organizations that promote blockchain-based technologies, to file amicus briefs. While the Chamber and the Association took starkly different approaches, they both asked the Court to distinguish between investment contracts, which are securities, and the subject of the investment contracts, which they contended are not securities in every set of circumstances. Notably, their briefs did not attempt to apply the specific facts of the Telegram case to their respective theories.

Ambiguous U.S. Regulatory Regime

According to the Chamber’s brief, outside the United States, blockchain-based digital assets have been categorized as three main types: (1) payment tokens, used as a medium of exchange; (2) utility tokens, which allow users to access a digital resource; and (3) security tokens, which are similar to traditional financial instruments such as debt or equity.²⁹ However, the Chamber pointed out that the U.S. currently lacks a clear regulatory regime to address blockchain-based digital assets. The Chamber argued that legal uncertainty associated with developing non-monetary blockchain use cases is detrimental to the burgeoning blockchain ecosystem in the U.S. and has prevented potential new solutions from entering the market. According to the Chamber, “[i]f each movement of digital assets across any of these blockchain networks constitutes a securities transaction, then the companies operating these systems may need to become registered broker-dealers or another type of regulated financial institution or worse, subject to severe enforcement action.”³⁰ Both the Chamber and the Association urged that digital assets not be presumed to be securities.

Amici Argue Relevant Case Law Supports Finding Not All Digital Assets Are Securities

According to the amici, a digital asset is “merely an electronic record,” which is not, per se, a security.³¹ The amici argued that the data this digital record represents is separate and distinguishable from any investment contract that may be used as an instrument for fundraising. According to the amici, the court in *Howey*, which emphasized substance over form, said as much when it provided the current framework for analyzing investment contracts. The amici emphasized that the investment contracts subject to litigation in the *Howey* case were securities, but the underlying assets

themselves, orange groves, were not.

Both amici, therefore, contended that while investment contracts used to raise funds for digital assets are securities, the analysis is separate and distinct from that to be applied to the digital asset itself. In other words, the amici argued that the fact a digital asset is the subject of an investment contract does not necessarily indicate that the underlying digital asset is itself a security. Therefore, the amici argued that the characteristics of the underlying digital assets should be analyzed separately from the facts and circumstances underlying the scheme used to promote the digital assets.

The amici pointed out that in *Howey*, the court observed it was the promise by the promoters to cultivate the small plots of land that created the financial incentive with which to lure investors—not the grove of oranges itself, which alone had no real utility or worth. Citing *Forman*, another well-known case, the amici argued that “when a purchaser is motivated by a desire to use or consume the item purchased . . . the securities laws do not apply”³² and the item is not considered a security, even if the framework used to facilitate its sale is or was a security.

Varying Approaches Proposed

The Chamber suggested a two-pronged analysis when considering whether a digital asset is a security. According to the Chamber, the first step is to determine whether there is an investment contract underlying the transaction at issue. If there is an investment contract, then the securities laws are triggered. If not, then whether the subject of the investment contract—here the underlying token—is itself a security becomes the question on which the analysis turns. The Chamber argued that this two-pronged approach faithfully applies the *Howey* test, which “examines the economic realities of a contract, transaction, or scheme—not the characteristics of the asset that is the subject of such a contract, transaction, or scheme.”³³

The Association argued that other economic realities of a transaction also may indicate that a digital asset is not a security. According to the Association, when distribution and promotion of a digital asset are sufficiently distributed or decentralized, no third party can be said to promote such asset. In making this argument, the Association quoted a popular speech by the SEC’s Director of the Division of Corporate Finance William H. Hinman, who said that “a digital asset can, over time, become something other than a security” when, for example, “the network on which the token or coin is to function is sufficiently decentralized.”³⁴ According to the Association, circumstances such as this may support the conclusion that digital assets, specifically cryptocurrencies, are not inherently securities.

SEC Files Expert Reports

The SEC filed three expert reports in the Telegram case, with testimony opining that the network is not decentralized and that a reasonable investor would have purchased the tokens with

²⁷ *Id.* at 40.

²⁸ *Id.*

²⁹ Brief for The Chamber of Dig. Commerce as Amicus Curiae Supporting Defs. at 4–5, *SEC v. Telegram Grp.*, No. 19-cv-9439 (S.D.N.Y. Jan. 21, 2020) ECF No. 85 (Chamber Amicus), available at <https://digitalchamber.org/wp-content/uploads/2020/01/Chamber-of-Digital-Commerce-Amicus-Brief-1.21.20.pdf>.

³⁰ *Id.* at 6.

³¹ *Id.* at 9.

³² *United House Found., Inc. v. Forman*, 421 U.S. 837, 852–53 (1975).

³³ Chamber Amicus, *supra*, at 9.

³⁴ Brief for the Blockchain Assoc. as Amicus Curiae Supp. Defs. at 7, *SEC v. Telegram Grp.*, No. 19-cv-9439 (S.D.N.Y. Jan. 21, 2020) ECF No. 91 (Association Amicus), available at <https://drive.google.com/file/d/1GxQpN-CJQWkcJiu2gq490F6LBvuZpXHG/view>.

an expectation of profit. First, Carmen A. Taveras, a Ph.D. in economics who is a financial economist at the SEC, offered her conclusions that (i) the reference price of Grams is expressed by an exponential formula, which is a function of the total number of Grams in circulation (each subsequent Gram is sold for a higher price than the previous Gram by at least one billionth of a dollar); (ii) Gram investors received significant discounts on the expected reference price at launch; and (iii) the TON reserve's ability to buy and sell Grams per the reference price formula is insufficient to guarantee market price stability of Grams.³⁵ Second, Maurice P. Herlihy, a Ph.D. in computer science, examined the code of the "testnet" version of the TON blockchain and opined that it "lacks critical components that would be required in a fully developed and running system" and that the TON blockchain "is not yet mature enough" to support the apps and services as described in Telegram's publicly released documents.³⁶ Finally, Patrick B. Doody, who is a blockchain data scientist at Integra, a forensic data analytics and economic consulting firm, analyzed Telegram's offering and opined that it was reasonable for a purchaser to buy Grams with the expectation of profit to be derived from Telegram's efforts in developing TON's blockchain ecosystem.³⁷

CFTC Declines to Opine on Securities Analysis

On Feb. 18, the Commodities Futures Trading Commission ("CFTC") sent a letter to the judge presiding over the Telegram case, the Honorable P. Kevin Castel, stating that in its view, blockchain-based digital assets are commodities.³⁸ The letter acknowledged that these digital assets may also be securities but pointed out that such analysis is within the proper purview of the SEC, not the CFTC. The CFTC declined to offer analysis on the securities issue, citing the Commodity Exchange Act, which provides a savings clause that recognizes the authority of the SEC on this point.

The Hearing

On February, 19, 2019, the SEC and Telegram's attorneys participated in a hearing before Judge Castel in the U.S. District Court for the Southern District of New York to argue the merits of the SEC's motion for a preliminary injunction to stop the distribution of Gram tokens. At the outset of the hearing, Judge Castel made clear that "[o]ne of the issues that is not presented in this case and that no one has argued is that cryptocurrencies are inherently securities."³⁹

35 Decl. of Carmen A. Taveras in Supp. of Pl.'s Mot. For Summ. J. on Liab., at 3, *SEC v. Telegram Group, Inc.*, No. 19-cv-09439 (S.D.N.Y. Jan. 27, 2020), ECF No. 116, available at <https://www.johnreedstark.com/wp-content/uploads/sites/180/2020/01/Taveras-Declaration.pdf>.

36 Decl. of Maurice P. Herlihy in Supp. of Pl.'s Mot. For Summ. J. on Liab., at 4, *SEC v. Telegram Group, Inc.*, No. 19-cv-09439 (S.D.N.Y. Jan. 27, 2020), ECF No. 117, available at, <https://www.johnreedstark.com/wp-content/uploads/sites/180/2020/01/Herlihy-Declaration.pdf>.

37 Decl. of Patrick B. Doody in Supp. of Pl.'s Mot. For Summ. J. on Liab., at 3, *SEC v. Telegram Group, Inc.*, No. 19-cv-09439 (S.D.N.Y. Jan. 27, 2020), ECF No. 115, available at <https://www.johnreedstark.com/wp-content/uploads/sites/180/2020/01/Doody-Declaration.pdf>.

38 CFTC Letter to the Honorable P. Kevin Castel, *SEC v. Telegram Group, Inc.*, No. 19-cv-09439 (S.D.N.Y. Feb. 18, 2020), ECF No. 203, available at <https://www.docdroid.net/okmUUBS/cftc-letter-in-telegram-case.pdf>.

39 Tr. of Oral Arg. at 4:18–20, *SEC v. Telegram Group, Inc.*, No. 19-cv-09439 (S.D.N.Y. Jan. 19, 2020) ("Oral Argument"), available at <https://www.johnreedstark.com/wp-content/uploads/sites/180/2020/02/K2JAASECF.pdf>.

According to Judge Castel, "there would be no basis under *Howey*" to argue that cryptocurrencies are inherently securities.⁴⁰

During the hearing, the SEC and Telegram both presented arguments on the "economic realities" of the Gram tokens and the events surrounding their sale. The SEC argued, in part, that Telegram's sale of Grams via SAFTs and its planned distribution of Grams "is really one transaction" for the purpose of investment, not consumptive use.⁴¹ Telegram disagreed, arguing that the SAFT sales and the distribution of Gram tokens should be viewed separately, with the former being considered a securities offering and the latter sales of commodities. Telegram also argued, in part, that any managerial efforts by the Telegram team with respect to Grams were "temporary or transitory" and did not "rise to the level of a *Howey* promise making an investment contract."⁴²

Judge Castel framed the issue as a "disagreement as to when does the court look at this transaction, at the moment of launch or at the moment the purchase agreements are entered into."⁴³ According to Judge Castel, an issue that he would consider is whether the TON network would survive if "Telegram Group and its senior team were to depart the scene" at the time of the SAFT purchase agreements and separately at the time of the TON network launch.⁴⁴ Judge Castel noted the parties' different positions on when the TON network should be considered decentralized. Telegram argued decentralization exists at "the instant of launch," and the SEC argued "it will not exist then but may very well exist at some point in the future."⁴⁵

At the end of the hearing, Judge Castel extended the temporary restraining order. This prevented Telegram from distributing its Gram tokens until the Court rendered a decision on the SEC's motion for a preliminary injunction. Judge Castel indicated that he would rule on the motion prior to April 30, which is the date that Telegram was required to launch the TON network, according to its SAFT agreements.

The Court's Ruling

On March 24, Judge Castel granted the SEC's motion for a preliminary injunction. In its ruling, the Court conducted a fact-intensive inquiry and largely adopted the approach advocated by the SEC, based on the particular facts and circumstances in this case, and viewed the transactions as a single distribution, starting with the private placements of Grams purchase contracts (agreements to deliver Grams upon launch of the TON Blockchain) to accredited investors in 2018, through the intended delivery of Grams to those Initial Purchasers at launch of the TON Blockchain and ultimately the sales by those Initial Purchasers in the secondary marketplace. The Court looked at the series of transactions, undertakings and understandings in their totality and applied the *Howey* test (discussed below) at the time the offers and sales were made to the Initial Purchasers.

40 *Id.* at 4:21–22.

41 *Id.* at 36:10–37:1.

42 *Id.* at 41:6–12.

43 Oral Argument, *supra*, at 7:11–13.

44 *Id.* at 7:19–25.

45 *Id.* at 41:2–4.

Preliminary Injunction Standard

To obtain a preliminary injunction, the SEC must make a substantial showing of the likelihood of success in proving a current violation of the securities law and a substantial showing of a risk of future harm in the absence of such an injunction. The SEC is not required to show risk of irreparable injury or the unavailability of remedies at law, as is required of private litigants.

Telegram argued that the purchase contracts were separate and distinct from the Grams, and the Howey test should be applied to each individually—in the case of the purchase contracts, at the time of their sale, and in the case of the Grams, at the time of their distribution upon launch of the TON Blockchain. The Court, however, made a finding of fact that the Gram purchase agreements and the anticipated distribution of Grams by the Initial Purchasers to the public via the TON Blockchain are part of a single scheme, and it applied the Howey test collectively to the contracts, expectations and understandings centered on the sales and distribution of the Grams, viewed at the time of the investment by the Initial Purchasers in 2018.

The Court found that “[t]he Grams would not and were not intended to come to rest with the Initial Purchasers but instead were intended to move from the Initial Purchasers to the general public.” According to the Court, “this two-step process represents a public distribution and the Initial Purchasers, who acted as mere conduits to the general public, are underwriters.” The Court emphasized the importance of the economic realities of the transactions and gave weight to implied understandings and reasonable expectations over explicit disclaimers.

The Howey Test

It is generally accepted that the Howey investment contract test is the proper framework under which to assess whether blockchain-based token offerings constitute securities offerings. As adopted by the U.S. Supreme Court, a contract, scheme or transaction is deemed an investment contract, and thus a security, if it involves (1) an investment of money (2) in a common enterprise (3) with the expectation of profit (4) from the essential efforts of another.

As to the four-factor Howey test application, the Court found the following:

The parties did not dispute that there was an *investment of money*.

The Court concluded that the SEC made a substantial showing of horizontal commonality and strict vertical commonality to establish a *common enterprise*.

The Court found, based on the totality of the evidence, that a reasonable Initial Purchaser would have purchased Grams with investment intent and an *expectation of profit*, and it made findings that (1) \$1.7 billion paid to Telegram would not have been raised but for the expected ability to resell Grams into the secondary market; (2) Grams were sold at a significant discount compared with the expected price after launch, and Telegram promoted the TON Foundation’s power to support the market price of Grams; (3) the size and concentration of their Gram purchases indicate that the Initial Purchasers purchased with investment, not consumptive, intent; and (4) the lockups negated the likelihood that a simple

agreement for future tokens, or SAFT, purchaser bought Grams for consumptive use. The Court also cited several examples of testimony from actual Initial Purchasers that indicated they purchased the Grams as investments.

The Court found that the SEC showed a substantial likelihood of success in proving that at the time of the 2018 sales, a reasonable Initial Purchaser’s expectation of profits from the purchase of Grams was based on the *essential entrepreneurial and managerial efforts of Telegram*, and it made findings that (1) Grams do not exist and did not exist at the time of the 2018 sales; (2) SAFT purchasers provided capital to fund the TON Blockchain’s development in exchange for the future delivery of Grams, which they expect to resell for a profit; (3) the offering materials stated Telegram’s commitment to developing this project, making Initial Purchasers entirely reliant on Telegram’s efforts to develop, launch and provide ongoing support for the TON Blockchain and Grams; (4) investors knew that the integration of the TON Blockchain with Telegram Messenger, which was advertised by Telegram, represented the key to Grams’ mass adoption and expected Telegram to use Telegram Messenger to encourage the growth of the TON ecosystem; and (5) a lockup period imposed on critical employees indicates they will play a critical role in the ongoing success of the entity.

The Court spent significant time discussing the factual background that would give rise to a reasonable expectation of continued management efforts through and following launch, so it appears implied that expectations regarding post-launch managerial efforts continue to be very important to the analysis. Supporting this view, the Court explained that “Telegram, as a matter of fact rather than legal obligation, will be the guiding force behind the TON Blockchain for the immediate postlaunch period while the [Initial Purchasers] unload their Grams into the secondary market.”

In another passage, the Court noted that “to realize a return on their investment, the Initial Purchasers were entirely reliant on Telegram’s efforts to develop, launch, and provide ongoing support for the TON Blockchain and Grams,” and continued on to “find ... that if, immediately after launch, Telegram and its team decamped to the British Virgin Islands, where Telegram is incorporated, 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 huge profits.”

Statutory Underwriters

With respect to the SAFT sales to the Initial Purchasers, the Court found that Telegram failed to carry its burden of demonstrating a valid exemption from registration either under section 4(a)(2) of the Securities Act or Rule 506(c) of Regulation D, which generally provide an exemption from registration for securities offered in private sales to accredited investors. Instead, the Court found that “[o]n the evidence presented” the SAFT sales were part of “a disguised public distribution.” According to the Court, “Telegram did not intend for Grams to come to rest with the 175 Initial Purchasers but to reach the public at large via post-launch resales by the Initial Purchasers.” The Court therefore found that “Telegram’s sale of Grams to the Initial Purchasers, who will function as statutory underwriters, is the first step in an ongoing

public distribution of securities.” The Court also found that “Telegram failed to use reasonable care to ensure that the Initial Purchasers were not underwriters.”

The Settlement Order

On June 26, the SEC announced that it had “obtained court approval of settlements with Telegram Group Inc. and its wholly owned subsidiary TON Issuer Inc. to resolve charges that Telegram’s unregistered offering of digital tokens called “Grams” violated the federal securities laws.” Telegram did not admit or deny the allegations in the SEC’s complaint. However, Telegram “consented to entry of a final judgment enjoining it from violating the registration provisions of Sections 5(a) and 5(c) of the Securities Act of 1933.” Under the settlement agreement, Telegram “agreed to return more than \$1.2 billion to investors and to pay an \$18.5 million civil penalty.” The settlement agreement also required Telegram, for the next three years, to notify the SEC “before participating in the issuance of any digital assets.”

Takeaways

It is important to remember that the Telegram case represents just one court’s view and is based on a very fact-specific inquiry. However, given the Court’s apparent deference to the SEC’s positions on the facts at hand, and the lack of judicial precedent in this area, the blockchain industry should pay close attention to this decision.

Regardless of whether a court applies the Howey test to the entire series of transactions as a single larger distribution, the analysis of whether a blockchain token is a security appears to continue to turn, in large degree, on the factual question of whether or not there are reasonable expectations of significant post-launch efforts from the management team such that the fourth prong of the Howey test would be satisfied. In the Court’s view, those expectations should be viewed through the lens of the Initial Purchasers at the time of their investment. Under the view that Telegram advocated for, but the Court rejected, those expectations should have been measured from the perspective of the purchasers of Grams at and following launch of the TON Blockchain. Notably, the Court found Telegram’s post-launch efforts sufficient on their own to satisfy the fourth prong of the Howey test. Underlying the Court’s analysis seemed to be the lack of decentralization and the significance of Telegram’s efforts post-launch, particularly with respect to the Gram’s integration with Messenger, as well the lack of a consumptive use of the Gram upon launch.

The Telegram court’s approach, if broadly adopted, could prove very challenging for those attempting to launch decentralized networks involving blockchain-based tokens. In a typical sale of

purchase agreements for future delivery of tokens to accredited investors, the purchasers almost certainly will expect to profit from the efforts of the management or promotional group in the prelaunch period. In the post-launch period, accredited investors that receive tokens will inevitably seek to further distribute those tokens at some point. In this regard, the Telegram court’s decision demonstrates a tension between the need to distribute tokens as part of a network launch, and the Court’s finding that the intent toward further distribution resulted in the accredited investors being deemed underwriters. Another key issue, and one that the Court did not directly address, is the distinction between management’s prelaunch efforts and post-launch efforts and the significance of the post-launch efforts to the analysis.

It remains to be seen how much precedential value will be provided by this decision as blockchain industry actors continue to structure programs designed to navigate the regulatory ambiguity.⁴⁶ At one end of the spectrum, most would acknowledge that purchase agreements sold to Initial Purchasers constitute investment contracts under the Howey test—the Initial Purchasers are investing at an early stage of a project, hoping to profit from the efforts of the management group that will build and launch the network using the funds raised. At the other end of the spectrum, at some point when a network is fully developed and operating, the purchase and use of tokens may be sufficiently consumptive in nature and/or the network may be sufficiently decentralized that at least the third and/or fourth prong of the Howey test would not be satisfied. The gap between the two ends of this spectrum creates significant uncertainty for those seeking to launch decentralized networks involving blockchain-based tokens. This regulatory Catch-22 was described by SEC Commissioner Hester Peirce on February 6 in her speech outlining a safe harbor proposal for blockchain tokens.⁴⁷

Lastly, it is worth noting that the Court cited various facts and circumstances unique to the Telegram case that were relevant to the Court’s analysis under the last three prongs of the Howey test. This underscores that the particular facts and circumstances are very important to the analysis—which is perhaps the key takeaway from the overall case and decision in Telegram.

⁴⁶ For example, another federal court rejected the argument that the Telegram decision was binding precedent in an SEC enforcement action against Kik Interactive Inc., noting during a summary judgment hearing: “I think that there is no binding precedent one way or another.” That court’s subsequent decision reiterated that, while the Telegram decision was “instructive,” it was unique to its distinctive facts. Opinion and Order on Motions for Summary Judgment at 9, *SEC v. Kik Interactive Inc.*, No. 19 Civ. 05244 (AKH) (Sept. 30, 2020), ECF 88.

⁴⁷ Commissioner Hester M. Peirce, *Running on Empty: A Proposal to Fill the Gap Between Regulation and Decentralization*, U.S. Securities and Exchange Commission, Speeches (February 6, 2020), <https://www.sec.gov/news/speech/peirce-remarks-blockress-2020-02-06>.

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