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SEC Wins Digital Asset Decision

Court Endorses the Application of *Howey* to Digital Assets and ICOs and Issues Injunction Barring Distribution of Telegram's Grams

SUMMARY

In a decision issued this week in *SEC v. Telegram Group Inc.*, the federal district court in the Southern District of New York granted the SEC's motion for an injunction to halt the distribution of digital tokens that were to be the foundation of a new digital currency on a newly developed blockchain technology.

The Court's decision arose out of an ongoing litigation brought by the SEC against Telegram Group Inc. and TON Issuer Inc. regarding their plan to distribute digital tokens known as "Grams" and launch them as a new digital currency. In accordance with the SEC's previously announced framework for analyzing whether digital assets are securities, the Court applied what it characterized as the "familiar test" from *SEC v. W.J. Howey Co.* and concluded that the sophisticated investors who initially purchased interests in Grams and funded the development of the associated blockchain technology were effectively underwriters who intended to distribute securities by reselling their Grams to the general public after the currency launched. Thus, the Court held that Telegram's distribution of Grams was not exempt from registration requirements under section 4(a)(2) of the Securities Act or Rule 506(c) of Regulation D.

The Court's willingness to follow the SEC's lead and apply *Howey* flexibly to digital assets based on its view of the "economic reality of Telegram's course of conduct" shows that companies must carefully consider how to structure future initial coin offerings and other digital asset sales and distributions to avoid potentially running afoul of registration requirements.

THE COURT'S DECISION

In 2018, Telegram Group Inc. and TON Issuer Inc. (collectively, "Telegram") sold interests in 2.9 billion Grams in two tranches, allegedly earning \$1.7 billion from the two groups of initial purchasers (primarily high net worth individuals and venture capital firms). Telegram filed a Form D for each of the two offerings, claiming an exemption from registration requirements under Rule 506(c). The contracts governing the sale of these initial offerings provided that Grams would be distributed to initial purchasers at a later date, if and when Telegram launched its anticipated blockchain technology on which Grams would function, the TON Blockchain. After the launch of the TON Blockchain, initial purchasers would be able to use Grams as stores of value or to resell, subject to certain lock-up periods that temporarily restricted the rights of the first group of initial purchasers.

On October 11, 2019, the SEC filed a complaint alleging that Grams are securities and that Telegram failed to register the offering of Grams in accordance with the Securities Act. In its decision on March 24, 2020, the Court granted the SEC's motion to enjoin Telegram from issuing Grams, finding that the SEC had "shown a substantial likelihood of success in proving that Telegram's present plan to distribute Grams is an offering of securities . . . to which no exemption applies."

In opposing the SEC's motion, Telegram argued that, although its initial sales of "interests in Grams" were subject to the securities laws (but exempt from the registration requirements), the transaction that is relevant for evaluation by the Court is the subsequent delivery of Grams to initial purchasers. Telegram argued that the latter transaction would not be subject to securities laws because, after the launch of Grams as a digital currency, Grams would have "functional consumptive uses" and would, therefore, be commodities and not securities.

The Court rejected this argument and stated that, under *SEC v. W.J. Howey Co.*, 328 U.S. 293 (1946), the initial investors' purchases of "interests in Grams" and their subsequent sales of Grams to the public must be analyzed together as part of "a single scheme." The Court then applied the four pronged *Howey* test, which provides that "a contract, transaction or scheme" is an "investment contract," and therefore a "security" subject to the securities laws, when 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."

Conceding there was an investment of money, Telegram argued that Grams did not satisfy the other elements of the test because, after the launch of the TON Blockchain, there would be no "common enterprise" (*i.e.*, pooling of funds from Gram purchasers and *pro rata* distribution of profits). Further, Telegram argued that, after the launch of the TON Blockchain, there would be no "expectation of profit" from its efforts because the TON Blockchain, and therefore Grams, would succeed or fail based on the efforts of a decentralized community.

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Without addressing in detail Telegram’s nuanced arguments, the Court focused on the initial purchasers’ relationship with Telegram and held that the securities laws applied to all aspects of Telegram’s distribution of Grams. The Court found that a “common enterprise” existed because “Telegram pooled the money it received from the Initial Purchasers” to “develop the TON Blockchain.” Thus, the “ability of each Initial Purchaser to profit” by selling their Grams was “entirely dependent on the successful launch of the TON Blockchain.” The Court also found that initial purchasers had an expectation of profit because, among other reasons, they purchased Grams at a discount to their expected face value at launch. Rejecting the notion that initial purchasers acquired Grams for “consumptive use,” the Court focused on the lockup provisions applicable to the first tranche of Grams and concluded that “a rational economic actor would not agree to freeze millions of dollars for up to 18 months (following a lengthy development period) if the purchaser’s intent was to obtain a substitute for fiat currency.” Lastly, the Court held that initial purchasers’ expectations of profit were derived from “the essential efforts of another” because “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 TON Blockchain and Grams.”

The Court then rejected Telegram’s arguments that it was nonetheless exempt from registration requirements. Telegram argued that its initial sales of Grams were exempt from registration requirements pursuant to section 4(a)(2). The Court held that section 4(a)(2) was inapplicable because Telegram intended that Grams be distributed to the public by initial purchasers based on its “goal” of establishing Grams as “the first mass market cryptocurrency,” as well as the discounts and other economic incentives Telegram built into the sales of Grams to initial purchasers, who would have understood that they could profit only by selling their Grams to the public. The Court also rejected Telegram’s argument that the exemption in Rule 506(c) applied. Telegram argued that it exercised “reasonable care to assure that the purchasers of the securities are not underwriters,” by including in the purchase agreements a representation and warranty that any purchase was “for [the investor’s] own account and not with a view towards, or for resale in connection with, sale or distribution.” The Court concluded that this representation “rings hollow in the face of the economic realities” of the sales, given Telegram’s ultimate goal of distribution to the public.

In light of the Court’s endorsement of the SEC’s approach in this case, companies can expect the SEC will continue to closely scrutinize digital asset transactions using its previously announced framework.¹ Further, given the Court’s treatment of Telegram’s initial purchasers as “underwriters,” based on a “substance over form” analysis of several purportedly distinct transactions, companies will need to carefully scrutinize the structure and economic substance of potential digital asset distributions to ensure compliance with registration requirements.

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¹ See SEC FinHub Publishes Framework for Analyzing Digital Assets Under Howey (April 5, 2019), <https://www.sullcrom.com/sec-finhub-publishes-framework-for-analyzing-digital-assets-under-howey>

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CONTACTS

New York

Robert E. Buckholz	+1-212-558-3876	buckholzr@sullcrom.com
Catherine M. Clarkin	+1-212-558-4175	clarkinc@sullcrom.com
Robert W. Downes	+1-212-558-4312	downesr@sullcrom.com
John Evangelakos	+1-212-558-4260	evangelakosj@sullcrom.com
Jared M. Fishman	+1-212-558-1689	fishmanj@sullcrom.com
C. Andrew Gerlach	+1-212-558-4789	gerlacha@sullcrom.com
David J. Gilbert	+1-212-558-4680	gilbergd@sullcrom.com
Joseph A. Hearn	+1-212-558-4457	hearnj@sullcrom.com
Kathleen S. McArthur	+1-212-558-4321	mcarthurk@sullcrom.com
Ryne V. Miller	+1-212-558-3268	millery@sullcrom.com
Rebecca J. Simmons	+1-212-558-3175	simmonsr@sullcrom.com
William D. Torchiana	+1-212-558-4056	torchianaw@sullcrom.com
Frederick Wertheim	+1-212-558-4974	wertheimf@sullcrom.com

Washington, D.C.

Eric J. Kadel, Jr.	+1-202-956-7640	kadelei@sullcrom.com
Robert S. Risoleo	+1-202-956-7510	risoleor@sullcrom.com

Los Angeles

Patrick S. Brown	+1-310-712-6603	brownp@sullcrom.com
Alison S. Ressler	+1-310-712-6630	resslera@sullcrom.com

Palo Alto

Sarah P. Payne	+1-650-461-5669	paynesa@sullcrom.com
John L. Savva	+1-650-461-5610	savvaj@sullcrom.com

SULLIVAN & CROMWELL LLP

London

Kathryn A. Campbell	+44-20-7959-8580	campbellk@sullcrom.com
John Horsfield-Bradbury	+44-20-7959-8491	horsfieldbradburyj@sullcrom.com
John O'Connor	+44-20-7959-8515	oconnorj@sullcrom.com
Stewart M. Robertson	+44-20-7959-8555	robertsons@sullcrom.com
Evan S. Simpson	+44-20-7959-8426	simpsons@sullcrom.com

Paris

William D. Torchiana	+33-1-7304-5890	torchianaw@sullcrom.com
----------------------	-----------------	--

Frankfurt

Krystian Czerniecki	+49-69-4272-5525	czernieckik@sullcrom.com
---------------------	------------------	--

Sydney

Waldo D. Jones Jr.	+61-2-8227-6702	jonesw@sullcrom.com
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Tokyo

Izumi Akai	+81-3-3213-6145	akai@sullcrom.com
Keiji Hatano	+81-3-3213-6171	hatanok@sullcrom.com

Hong Kong

Garth W. Bray	+852-2826-8691	brayg@sullcrom.com
Chun Wei	+852-2826-8666	weic@sullcrom.com
