INVENTUSLAW
The Global Technology Law Firm

15 MAY, 2020

Telegram – Unwinding of US Capital Raise and the Extra-territorial Application of US Securities Laws

This article was written by Shantanu Surpure , partner at Inventus Law, California.

On May 12, 2020, Telegram founder Pavel Durov announced that that the Telegram Open Network ("TON") project would be discontinued due to the company's ongoing legal dispute with the US Securities and Exchange Commission ("SEC")[1].

This was a dramatic twist to the Telegram narrative. Many issues remain unclear. Central to the matter was Telegram's capital raise from US investors. It is therefore critical to examine Telegram's US capital raising efforts and its implications. Telegram is a private company (Telegram Group Inc. and TON Issuer Inc., collectively "Telegram" or the "Company") widely known for its encrypted messaging application "Messenger".

In early 2018 the Company initiated raising funds to finance its operations and the development of its own blockchain, the "Telegram Open Network" or "TON Blockchain". TON Blockchain was intended to be a proprietary blockchain through which users would be able to trade and exchange "Grams" – the Company's native digital token.

Communication to Telegram Investors:

On April 29, 2020, Telegram announced in a letter to its investors that because it was not able to launch its TON network by the deadline of April 30, 2020, investors would be entitled to a refund of 72% or 110% under the provisions of the Purchase Agreement between Telegram and its investors. In order to receive the 110% refund (the "110% Refund"), investors would have to agree to loan funds to Telegram until April 21, 2021, after which such investors would also have a further option to receive "Grams or potentially another cryptocurrency."

Legal Case and Injunction Against Telegram

However on May 4, 2020, Telegram further specifically updated its US investors that they were required to accept the 72% immediate refund and were not able to participate in the 110% Refund. According to the updated letter from Telegram, i) "This offer [the 110% Refund]is only being made available to offerees outside the United States who are not US persons within the meaning of Regulation S under the US Securities Act of 1933"; and ii) investors were required to indicate whether they are located outside of the United States[3].

The SEC filed a case against Telegram in October 2019 in US federal court in the Southern District of New York[4]. This was followed by a recent preliminary injunction where the court ruled against Telegram on March 24, 2020[5] (the "Injunction").

The Initial Purchasers Purchased Interests in the Grams

In 2018, the Company raised US$1.7 billion by selling interests in Grams to 175 corporate entities and high-net-worth individuals (the "Initial Purchasers") through Purchase Agreements. The Purchase Agreements allowed the Initial Purchasers to receive an allotment of Grams upon the launch of the TON Blockchain. Under the Purchase Agreements, delivery of Grams (and the launch of the TON Blockchain) was supposed to occur no later than October 31, 2019. It was because of this delay that the Company sent the April 29, 2020 letter to its investors.

The Initial Purchasers included US persons and the Company filed a Form D seeking an exemption from SEC registration requirements under Rule 506(c) of Regulation D[6]. The critical part of Rule 506(c) is that all investors must be accredited investors. Accredited investors must meet certain income or net worth criteria as prescribed by Rule 501 of Regulation D.

A Single Transaction/Securities Offering or Two Separate Transactions/Securities Offerings?

Despite the Form D filing made by Telegram, the court found in granting the Injunction that the SEC had shown a "substantial likelihood of success" in proving that Telegram had engaged in an unregistered offering of securities in violation of the US Securities Act of 1933.

The critical legal question at issue is whether i) the interests sold under the Purchase Agreement; and ii) the ensuing delivery of Grams constituted an exempt, unregistered offering. Was there a single transaction and securities offering (which Telegram argued was covered by the Form D filing) or were the Purchase Agreement and the Grams part of two separate transactions and securities offering as argued by the SEC?

Pursuant to the US Supreme Court's "Howey Test", a transaction is an investment contract or security if it involves "a contract, transaction or scheme" whereby an individual (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."[7]

The Purchase Agreements and Distribution of Grams Were Part of a "Common Scheme"

The court examined the various prongs of the Howey Test. The court opined that the "economic reality" was that the Purchase Agreements and the distribution of Grams by the Initial Purchasers to the public via the TON Blockchain were part of a common scheme.

The court found that the SEC would likely prevail in proving that the Purchase Agreements were part of a larger scheme (a "disguised public distribution") demonstrated by Telegram's actions, conduct and statements to offer Grams to the Initial Purchasers with the intent and purpose that these Grams be distributed in a secondary public market (and therefore a separate transaction as discussed above) which constitutes the offering of securities.[8]

Redemption of US Investor Interests

Several previous cases against crypto/blockchain companies have been settled with the SEC including by the companies either paying fines, compensating investors or registering the tokens as securities.[9]

However, it appears from the May 4, 2020 letter that Telegram intends to pursue a path of redemption of the interests sold under the Purchase Agreements by paying US persons back. The redemption of US investor interests may be part of Telegram's strategy.

Prohibition on Distribution of Grams to Non-US Investors

In a letter to the court, Telegram (through its counsel) requested that the court clarify whether the Injunction applied only to US investors. The Company stated that it is willing to specifically wall off US investors through safeguards including requiring covenants from non- US investors prohibiting non-US investors receiving Grams from engaging in US resales and other technological digital wallet methods[10].

The court, however, did not subscribe to this argument and denied Telegram's application for clarification of whether Gram distributions could be made to non-US investors as the injunction already prohibited Gram distributions. The court referred back to the "common scheme" analysis of the Injunction. The court stated that the "intended resale of Grams by Telegram's conduits into the secondary market is likely to involve US purchasers"[11].

Extra-territorial Application of US Securities Laws and Implications

Telegram asserted that the Injunction should not extend to non-US Initial Purchasers because it would result in the extra-territorial application of US securities laws, citing *Morrison v National Australia Bank Ltd., 561 U.S. 247 (2010)*[12]. The court rejected this argument and submitted that the "transactional test" in *Morrison* would be satisfied.

Morrison was a landmark US Supreme Court decision because it established what appeared to be a test for determining the extent to which US securities laws apply to transactions with international components and rejected the earlier used "conduct/effects" tests.

Pursuant to the "transactional test" in Morrison "§10(b) of the Securities and Exchange Act of 1934 (the primary anti-fraud provision) applies only to "(i) transactions in securities listed on domestic exchanges; and (ii) domestic transactions in other securities." The court found that the resale of Grams would likely involve US purchasers and therefore result in a domestic transaction.

The court referred to the form of injunction language which specifically established a prohibition on "delivering Grams to ***any*** person or entity or taking any other steps to effect any unregistered offer or sale of Grams"[13] – any person being a US or non-US person.

The implications on capital raising (and specifically capital raising involving the US or US investors) for blockchain related transactions must be considered. The US has a long established history of venture capital funds and other investors and therefore is an attractive large and deep market for raising capital.

However, as the Telegram case demonstrates, US courts may take a holistic view of a transaction structure (ie, the "common scheme") and US securities laws may be implicated in transactions with international components.

---

[1] CoinDesk "Telegram Abandons TON Blockchain Project After Court Fight With SEC", May 12, 2020; https://www.coindesk.com/telegram-abandons-ton-blockchain-project-after-court-fight-with-sec

[3] CoinDesk "Telegram Withdraws Offer to Repay Investors with Gram Tokens", May 4, 2020; https://www.coindesk.com/telegram-withdraws-offer-to-repay-investors-with-gram-tokens

[4] Securities and Exchange Commission v. Telegram Group Inc. et al, 19-cv-09439-PKC (S.D.N.Y. Oct 11, 2019)

[5] Case 1:19-cv-09439-PK Document 227; Opinion and Order

[6] Crowd FundInsider "Telegram Files New Form D with SEC Indicating $1.7 Billion Will be Raised", April 2, 2018; https://www.crowdfundinsider.com/2018/04/131248-telegram-files-new-form-d-with-sec-indicating-1-7-billion-will-be-raised/

[7] Securities and Exchange Commission v. W.J. Howey, 328 US 293, 299-299 (1946)

[8] Case 1:19-cv-09439-PK Document 227; Opinion and Order, page 38

[9] Quartz "Crypto companies are settling with the SEC, but that's not stopping them", October 3, 2019; https://qz.com/1720295/after-4b-ico-block-ones-24m-sec-settlement-lets-it-keep-building/

[10] CoinDesk "Telegram Hopes It Can Still Sell Tokens to Non-US Investors After Court Ruling", March 30, 2020; https://www.coindesk.com/telegram-hopes-it-can-still-sell-tokens-to-non-us-investors-after-court-ruling

[11] Case 1:19-cv-09439-PK Document 234; Opinion and Order, page 2

[12] Case 1:19-cv-09439-PK Document 234; Opinion and Order, page 1

[13] Case 1:19-cv-09439-PK Document 234; Opinion and Order, page 3

INVENTUSLAW
The Global Technology Law Firm

Key contact:

Shantanu Surpure
Partner
Silicon Valley
shantanu@inventuslaw.com