

1/24/20 Alison Frankel's On The Case 21:15:51

Alison Frankel's On The Case  
Copyright (c) 2020 Thomson Reuters

January 24, 2020

In SEC case v. blockchain developer **Telegram**, trade groups demand clearer standards

(Reuters) - The blockchain and digital asset trade groups Blockchain Alliance and Chamber of Digital Commerce filed amicus briefs this week in the Securities and Exchange Commission's closely-watched case against the blockchain developer **Telegram**, calling for U.S. regulators and judges to clarify when cryptocurrency transactions trigger federal securities laws – or else risk leaving the U.S. behind as the multibillion-dollar industry develops.

"The SEC's lawsuit ... raises novel questions regarding whether companies are forbidden from raising funds from sophisticated U.S. investors, under well-established regulatory provisions, to build blockchain networks," wrote the Blockchain Alliance's lawyers at Squire Patton Boggs. "Before filing this action, the SEC had provided no clear rules regarding these questions. And what little guidance it had offered differs drastically from both existing law and its position in this case."

The SEC filed a suit and a motion for a restraining order ([2019 WL 6704096](#)) last October in federal court in Manhattan, seeking to halt the launch of **Telegram's Telegram** Open Network, or TON, blockchain platform. (**Telegram**, which was started by the Russian entrepreneur Pavel Durov, is best known as an encrypted messaging app that is popular with digital currency enthusiasts.) In the SEC's account, **Telegram** breached securities laws by raising \$1.7 billion to develop the TON blockchain in an unregistered private offering. Investors were slated to receive the lion's share of the digital assets, known as Grams, that would eventually be used on the platform. (Telegram anticipated launching the platform with up to 5 billion Grams, of which 2.9 billion were pledged to investors in the blockchain.)

The SEC regards Grams as a security – like a stock certificate - under the decades-old test that the U.S. Supreme Court established in 1946's *SEC v. W.J. Howey* (328 U.S. 293). In the commission's view, Telegram was required to register its offering to investors because it was selling securities in what was anticipated to become a public, global market for Grams. The Commission's position is that Grams will remain securities if the TON blockchain launches, which would mean that every transaction conducted in Grams would be subject to U.S. securities laws.

"A Gram represents an asset," the SEC said in its Jan. 15 motion for summary judgment. "Here, when sold to the investors, that asset was an investment contract. And, upon the launch of the TON network, that asset will remain an investment contract."

Telegram's lawyers at Skadden Arps Slate Meagher & Flom contend that the SEC is wrong about the nature of Grams. The digital asset, they said, is not itself a security. It's a medium of exchange, a cryptocurrency like Bitcoin or Ether, both of which, according to **Telegram**, the SEC regards as commodities rather than securities. In **Telegram's** portrayal, it conducted a private offering to sophisticated, accredited investors, satisfying the SEC's requirements for exemption from registration.

The SEC, it argued in its Jan. 15 summary judgment brief, has conflated **Telegram's** private offering – which did involve investment contracts but was not required to be registered – with the digital assets investors will receive when the blockchain platform goes public. "**Telegram** has always treated the purchase agreements as investment contracts (and thus securities), but that does not mean the underlying Grams themselves, which do not exist yet and will be used, bought and sold by the public following the launch of the TON blockchain, are also 'securities,'" the company said.

A centerpiece of **Telegram's** case is the SEC's alleged failure to provide clear guidance on how securities law applies to blockchain technology and digital assets. The company asserts in an affirmative defense to the SEC's complaint that regulators

have not supplied constitutionally sufficient notice that its actions would be construed as a violation of securities laws. The SEC has not engaged in any sort of formal rulemaking on digital assets, Telegram said, and SEC staff members and even commissioners have sent conflicting and contradictory messages to the blockchain industry.

"The application of Howey to digital assets raises unique issues that require more specific guidance to avoid trapping the unwary," the company said. "But to date, the SEC has failed to provide consistent and meaningful guidance on whether and how it will regulate cryptocurrencies like Grams."

This week's amicus briefs echoed **Telegram's** message. The Digital Chamber of Commerce brief, filed by Sidley Austin, emphasized **Telegram's** point that courts and regulators must distinguish between investment contracts involving cryptocurrency, which may well be securities, and the currency itself, which need not be. The **Telegram** case, the Chamber said, provides an prime opportunity for U.S. District Judge Kevin Castel of Manhattan to clarify that crucial distinction. Without such clarification, "software developers, retailers, healthcare providers, advertising companies and others may not be able to develop or use blockchain technology without unintentionally triggering the U.S. federal securities laws every time a digital asset is used as part of their network — which would result in severe and adverse consequences," the brief warned. "The risk of violation is too great."

The Blockchain Association's brief has a more confrontational tone, arguing that the SEC has left the industry frustrated and confused. "The SEC has provided little clarity about its own interpretation," the brief said. "As a result, the industry has been forced to hunt for regulatory clues among the SEC's conflicting statements, Commissioner and staff speeches, no-action letters, closed-door meetings with the SEC, and nonprecedential settlements ... Against that backdrop of uncertainty and inconsistency, courts should give no deference to the SEC's litigation positions."

Telegram counsel Alexander Drylewski of Skadden said in an email statement that the company is glad for the amicus support: "The position taken by these industry groups underscores the importance of this case, which will have enormous consequences for the application of the U.S. securities laws to this new and emerging area of technological innovation."

An SEC spokeswoman declined to comment, but the commission addressed Telegram's arguments about its alleged failure to provide guidance to the industry in a motion to strike that affirmative defense. The SEC said that it has consistently held the position that cryptocurrency and blockchain transactions are subject to securities laws, pointing to its publicly issued 2017 report addressing the sale of digital "Dao Tokens" ([2017 WL 7184670](#)). "The SEC's message to issuers in this space was clear: the use of distributed ledger or blockchain technology to raise capital does not alter the need to comply with the federal securities laws," the commission said in its filing.

If there was any doubt that Telegram knew of the risk that Grams would be considered securities, the SEC said, it should be dispelled by admissions from the company's CEO that he knew about the Dao report and received warnings to look out for regulatory potholes. Telegram even changed its plans for a public offering of Grams because of regulatory concerns, the SEC said – showing that the company was on notice that its actions could be problematic.

Trial in the case is scheduled to begin next month.

(Reporting by Alison Frankel)

---- **Index References** ----

Company: SIDLEY AUSTIN LLP; SKADDEN ARPS SLATE MEAGHER AND FLOM LLP

News Subject: (Corporate & Business Law (1XO58); Funding Instruments (1FU41); Judicial Cases & Rulings (1JU36); Legal (1LE33); Regulatory Affairs (1RE51); Securities Law (1SE59))

Industry: (Financial Services (1FI37); Financial Services Regulatory (1FI03); Investment Management (1IN34); Securities Investment (1SE57); U.S. Securities Act of 1933 (1US58))

Region: (Americas (1AM92); New York (1NE72); North America (1NO39); U.S. Mid-Atlantic Region (1MI18); USA (1US73))

Language: EN

Other Indexing: (Grams; Alexander Drylewski; W.J. Howey; Kevin Castel; Pavel Durov; Skadden)

Keywords: (OCC:OLRTXT); (N2:US)Keywords:

Word Count: 1186

---

End of Document

© 2020 Thomson Reuters. No claim to original U.S. Government Works.