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SEC wins injunction against Telegram blockchain launch in key ICO case

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(Reuters) - Ruling in a landmark digital currency suit by the Securities and Exchange Commission, U.S. District Judge Kevin Castel of Manhattan issued ([2020 WL 1430035](#)) a preliminary injunction Tuesday, barring the launch of the Telegram Open Network blockchain. The judge held that based on the particular facts surrounding Telegram's plan to distribute a new digital currency to trade on its TON platform, the SEC was likely to succeed in proving that the blockchain's developers engaged in the sale of unregistered securities.

The judge did not provide a clear answer to the key question of whether new digital currencies are themselves securities. But it seems to me that his analysis will make it difficult for blockchain developers to use the promise of cryptocurrency to raise money from U.S. investors.

Telegram has already filed a notice of appeal to the 2nd U.S. Circuit Court of Appeals. Telegram counsel Alex Drylewski of Skadden Arps Slate Meagher & Flom declined to provide a statement on Judge Castel's decision. The SEC did not respond to a request for comment.

The Telegram blockchain's developers – two brothers who founded the widely used encrypted messaging app Telegram – raised \$1.7 billion in two private offerings to institutional investors in 2018. In return, the developers promised that investors would receive 2.9 billion "Grams," a new digital currency that was slated to begin to circulate when the TON blockchain launched. The developers spent \$405 million, according to Judge Castel, to develop the new open-source blockchain, which they said would be faster and more efficient than the Bitcoin and Ethereum platforms.

But last October, with the platform's launch imminent, the SEC sued to shut it down. The commission argued that under the definition laid out in the U.S. Supreme Court's 1946 ruling in [SEC v. Howey \(66 S.Ct. 1100\)](#), Grams were securities that could not be traded without registration at the SEC.

In the expedited litigation before Judge Castel, Telegram's lawyers urged the judge to look separately at the 2018 investment contracts and the prospective trading of Grams that would follow the launch of the blockchain. The investment contracts, they conceded, were securities – but Telegram did not need to register its private 2018 offerings because it only raised money from sophisticated investors and therefore met the SEC requirements for exemption from registration. But the Grams themselves, Telegram argued, were not securities. They were to be widely circulated and traded in decentralized fashion, just like the digital Bitcoin, which the SEC regards as a commodity and not a security.

"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 argued in court filings.

The case highlights a critical challenge for blockchain developers. For the blockchain industry to grow, according to amicus briefs by two trade groups that backed Telegram, developers need to be able to raise capital by promising cryptocurrency. But the

SEC, Telegram and its amici contended, has not provided clear guidance on when digital assets should be considered securities. (For what it's worth, SEC Commissioner Hester Peirce said more or less the same thing in a speech last month.)

In Tuesday's ruling, Judge Castel agreed with Telegram that a new digital currency could conceivably not be subject to securities trading strictures. "In the abstract," he wrote, "an investment of money in a cryptocurrency utilized by members of a decentralized community connected via blockchain technology, which itself is administered by this community of users rather than by a common enterprise, is not likely to be deemed a security under the familiar (Howey) test."

But the Telegram case is not an abstraction, the judge said. He proceeded at considerable length to explain why the eventual trading of Grams could not be disentangled from Telegram's entire plan to develop and launch the new TON blockchain. To boil his reasoning down to its essence, Judge Castel found that investors in the 2018 offerings expected to realize a profit on the Grams they would receive when the blockchain launched. And that prospective profit would depend on actions by Telegram, which promised in offering documents not just to promote the new blockchain on the messaging app but also to hold more than a billion Grams in reserve in case the cryptocurrency's value needed a boost. (The developers later said they'd drop the reserve plans.) Those facts, Judge Castel said, backed the SEC's argument that Telegram's plan, viewed holistically, met the Howey definition for securities.

"The security in this case is not simply the Gram, which is little more than alphanumeric, cryptographic sequence," Judge Castel wrote. "This case presents a 'scheme' to be evaluated under Howey that consists of the full set of contracts, expectations and understandings centered on the sale and distribution of the Gram." (The judge used the word "scheme," echoing the Howey opinion, but noted that he was doing so "in a descriptive, not pejorative, sense.")

Telegram, as I mentioned, has already said it will appeal the preliminary injunction to the 2nd Circuit. I'm sure the company will ask the appeals court to rush its case, considering that it faces an April 30 deadline to pay the TON blockchain investors whatever remains of the \$1.7 billion they put up in 2018. There's also the matter of pending summary judgment motions by both the SEC and Telegram. In Tuesday's opinion, Judge Castel granted the SEC's motion for a preliminary injunction but did not address the summary judgment filings. There's presumably a chance he will have more to say about the ultimate merits of each side's case.

But if Judge Castel's preliminary injunction ruling holds up, it's going to discourage blockchain developers from raising money in the U.S. by pledging digital assets to investors. Under the judge's reasoning, if investors expect blockchain developers to make their investment profitable, the digital tokens that investors receive must be treated as securities – which can't be traded as freely as ordinary currency. Maybe there's a way for developers to disentangle startup investment offerings from subsequent trading of digital assets more convincingly than Telegram. Or maybe the SEC will adopt some form of the three-year safe haven that Commissioner Peirce proposed in her speech last month, allowing new cryptocurrencies some time to become decentralized and widely circulated.

Otherwise, as Telegram's amici warned, blockchain developers are going to have to think twice before looking to the U.S. for capital.

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