

Crypto and the Regulators: Will the Revolution Get Rules?

Crypto currency began with the notion of getting “off the grid” – escaping the regulators and not being regulated. Over time that notion has transmuted. Now platforms trading crypto assets proclaim that the “revolution needs rules,” touting the notion that they are in fact regulated.

As these ideas continue to transform, regulators such as the SEC, CFTC and FinCEN struggle to apply traditional securities, commodity and money changing law principles to the experiments in the marketplace. The SEC, for example, has brought a series of actions arguing that many crypto asset offerings involve the sale of a security, subject to the registration provisions of the Securities Act. The CFTC claims the coins are commodities and subject to certain provisions of the commodity laws. FinCEN has issued a release concerning the lack of transparency for some types of transactions.

The SEC’s most recent action in this area seems to bring these themes together. The case centers on the digital asset known as “Grams,” being offered by the owners and operators of mobile messaging application Telegram Messenger. The preliminary offerings have raised billions of dollars, according to the offering materials, for an about to launch solicitation and planned network expansion. Perhaps more importantly, Grams tie to a world-wide encrypted communication system built on the notion of secrecy and total privacy – no cooperation with regulators because the revolution does not need rules, just secrecy. *SEC v. Telegram Group Inc.*, Civil Action No. 19 Civ. 9439 (S.D.N.Y. Filed Oct 11, 2019).

The complaint

Defendant Telegram Group Inc. is a privately-owned British Islands firm based in Dubai, UAE. Its primary product is Messenger, a private, encrypted messaging application with about 300 million monthly users, popularly known as the cryptocurrency world’s preferred messenger app. TON Issuers Inc., a named Defendant, is also a BV Islands firm, owned by Telegraph Group. It is based in Tortola. Telegram is owned by Dr. Nikolai Durov and

Related Capabilities

- Securities & Financial Services Litigation & Enforcement

his brother, Pavel. Both are Russian citizens. Pavel resides in Nevis where he is also a citizen. Dr. Durov is the Chief Technology Officer of Telegram. The TON Foundation, controlled by the brothers, is a Cayman Islands non-profit, dedicated to promoting and supporting the TON Blockchain.

The Durov brothers launched a version of Telegram Messenger in late 2013. Users of the service were told that it is “free and will always be free”-- it will not sell advertisements. More importantly, users were assured that their privacy is taken seriously and that the company will “never give third parties access to your data.” Users can have secret chats since there is “disappearing content” and the use of encrypted data transmitted over multiple servers. The first generation, however, did not have the capability to replace high volume transaction mechanisms like credit cards and fiat currency.

By late 2017 the brothers were prepared to launch the next generation of Telegram. It was touted as capable of operating on decentralized applications at a massive scale. The new iteration, called “Telegram Open Network” or “TON,” was designed to host the next-generation of multi-blockchain systems. Telegram described the system as “always [an] expanding and contracting decentralized supercomputer and value transfer system.” Initial investments were solicited to launch.

Over a three - month, period beginning in January 2018, Telegram entered into Gram Purchase Agreements with Initial Purchasers. The agreements called for TON Issuer Inc., a subsidiary of Telegram, to issue a new cryptocurrency called “Grams.” A new blockchain platform would be launched known as “TON Network.” Investors purchased Grams for delivery following the completion of the TON Blockchain. After completion of that project, investors would be reimbursed less expenses.

The initial offerings were conducted in two phases. Together about 2.9 billion Grams were sold in exchange for \$1.7 billion. Over \$400 million was raised in the U.S.

Telegram noted that the Gram Purchase Agreement is an investment contract. The agreement cautioned U.S. based investors that the offer and sale of the security – referencing the Agreement – was not registered under the Securities Act of 1933 and cannot be transferred absent an effective registration statement. Grams, however, are not securities, according to Telegram. Grams are a currency.

Investors were told that the Grams would appreciate in value over time. This would come not from the ability to exchange them for goods and services which was not existent, but from the build-out of the ecosystem or the TON Network. The series of documents used in connection with the offerings noted that the capital raised from the initial solicitations would be pooled and used over time in connection with the development of the network. Subsequent issuances of Grams would be priced at a premium to those acquired in the initial offerings. Investors had a collective, shared interest in the success of the buildout in view of the potential for the pooled assets to appreciate. The offering materials committed to deliver the Grams and launch the TON Blockchain by no later than October 31, 2019.

In March 2019 Telegram released a beta version of the TON Blockchain. The network was designed to test the functionality of TON and Grams. This test was important to the ultimate delivery of the Grams in the Fall 2019.

A critical requirement of the proposed TON Network and Blockchain is numerosity. Widespread distribution and use of Grams across the globe is key to fulfilling the promise of the initial offerings: “[B]y definition, the TON Blockchain can only become truly decentralized (as contemplated and promoted in the Offering Documents) if Grams holders *other than* the original purchasers actually stake Grams and, thereby, act as ‘validators’ of transactions on the TON Blockchain,” according to the SEC’s complaint (emphasis original). This is because if only the original Grams purchasers stake their holdings, the TON Blockchain would, by definition, become centralized.

Defendants are currently preparing for the next offering, needed in part, to fund the continued development of the network as the October 31, 2019 deadline approaches -- early costs were privately funded in part by a person in Buffalo, New York.

The Commission asserts that the markets are about to be flooded with unregistered securities which essentially will disappear once issued and sold. The complaint alleges violations of Securities Act Sections 5(a) and 5(c). Earlier this week the Court granted the Commission’s request for a temporary freeze order.

Comment

While the revolution may not want or need rules, there is a veritable alphabet soup of regulators watching and waiting to assert jurisdiction. Grams and the TON Blockchain thread together the promise of the crypto revolution and a possible nightmare for regulators. The tokens promise to be “off the grid” with a world-wide messaging system that is encrypted and assures complete privacy. For those interested in avoiding the watch of the regulators it appears to be the long sought safe haven.

For the regulators this may be a key challenge. For the SEC the system has what appears to be a security – a contract the brother-owners admit is an investment contract that is being sold apparently outside the confines of the securities laws. The claim that the Grams are currency appear designed to keep it beyond the reach of the SEC.

The CFTC may claim that Grams are a commodity. In the past the agency has stated that coins involved in crypto offerings are commodities subject to their jurisdiction. That does not mean, however, that those coins must be registered. Since the contracts under which they are purchased promise delivery, they are not futures contracts. Rather, they appear to be forward contracts which are outside the reach of the registration provisions of the commodity laws.

FinCEN may claim that the Grams and/or their related agreements are subject to the money changing laws. In that instance they may have to be registered, opening the prospect of disclosure which would be contrary to the underlying purpose of the system.

The battle lines are drawn. The actual revolution may now begin.