



Thursday, 11 June, 2020

The Digital Regulator

# Telegram, or the strategic importance of regulators

In May 2020, Telegram ended<sup>link1</sup> its cryptocurrency project, the Telegram Open Network (TON), and gave up<sup>link1</sup> fighting the U.S. Securities and Exchange Commission (SEC), which had halted the project last year. One month before, Facebook had re-issued<sup>link1</sup> its cryptocurrency project Libra under revised terms, following an implicit global regulatory halt<sup>link1</sup> last year. Several less prominent projects suffered a similar fate over the last three years (due to either enforcement or fear of it).

Promoters of cryptofinance and blockchain projects must consider upfront regulators as a key strategic element, not as a mere compliance variable. Traditional finance has learned this the hard way over the last 15 years.

## Telegram underestimated US regulators and the definitional ambiguity of US securities law

Telegram's initial coin offering (ICO) took place in early 2018. It raised USD 1.7 bn from purchasers globally (including from the US) and promised the delivery of Gram coins (and related blockchain products) by the end of October 2019 under the contractual terms 'Simple Agreement for Future Tokens' (SAFT). However, the SEC halted the ICO the same month, arguing that Telegram had violated the Securities Act of 1933. The legal dispute that followed was settled in a US court on 24 March 2020, following which Telegram abandoned the project and withdrew its appeal over the decision.

The story is only complete, however, if we recall that on 11 December 2017, the SEC<sup>1</sup> urged ICO promoters and their advisers 'to engage with the SEC staff to aid in their analysis under the securities laws' before 'promoting or touting the offer and sale of coins'.

✓ *The TON ICO (2018)* – Telegram raised funds in its ICO in 2018 to finance the development and operations of a proprietary blockchain termed the 'TON Blockchain'. The TON Blockchain was intended to allow users to trade and exchange Grams, the company's native digital token. During the ICO, the company sold 2.9 billion Grams to

175 entities and sophisticated, high-net-worth individuals across the globe—including 39 US purchasers—at a discounted price, in exchange for dollars or euros. This sale occurred under the terms of the SAFT. The SAFT contract was introduced in 2017 as a forward contract allowing ICO projects to sell tokens in the US to accredited investors. The SAFT builds on the assumption that tokens that do not yet exist are not securities. The delivery of the Grams and the launch of the TON Blockchain was supposed to be completed by 31 October 2019.

- ✓ *The SEC halt (2019)* – On 11 October 2019, the SEC issued a temporary restraining order against two of Telegram’s offshore entities for conducting an alleged unregistered and ongoing Grams digital token offering that had raised about USD 1.7 bn of investor funds – including from US investors. The SEC claimed that Grams are securities and that the entities had failed to register their offers with the SEC, violating the registration provisions of the Securities Act of 1933. In particular, the company allegedly failed to provide investors with information regarding Grams and Telegram’s business operations, financial condition, risk factors, and management that the securities law requires. The SEC leveraged the Howey test<sup>link1</sup>, introduced in 1946 in the US to determine whether investment contracts are securities, which then must register with the SEC. According to the Howey test, a transaction is classified as an investment contract subject to SEC registration if a person invests their money in an enterprise and is led to expect profits solely from the efforts of the promoter of the project or a third party.
- ✓ *The NY Court decision (2020)* – Following the SEC halt, Telegram agreed that the private sale agreements with the initial purchasers was an offering of securities. It argued that the sale was nonetheless exempted from SEC registration requirements, claiming that the phase of delivery of Grams at the launch of TON Blockchain did not constitute a securities offering; rather, it constituted a delivery of currencies or commodities. During this phase, there would be no investment in a common enterprise and Grams would not confer any equity or other ownership interest in the Company or any rights to dividends from the Company or governance rights in it, Telegram stated. On 24 March, however, the NY Court decided<sup>link1</sup> that Grams sales to the initial purchasers did not fall within an exemption and thus constituted a violation of the US

securities law. On 22 May, Telegram withdrew its appeal over the court decision, suspending the project for the foreseeable future.

The Telegram ICO took place in a period that saw considerable regulatory developments in the crypto and blockchain spaces. The ICO financing method itself became popular during the second half of 2017 and was swiftly followed by global regulatory pronouncements warning investors about the risks involved, as well as by intensive work by regulators to assess and decide the terms and conditions of such financing processes and coin introductions.

The SEC was particularly active during the fourth quarter of 2017. It summarised in an official statement on 11 December 2017 the various pronouncements it had made in the preceding months, stating that ‘the structures of initial coin offerings ...involve the offer and sale of securities and directly implicate the securities registration requirements and other investor protection provisions of our federal securities laws’. It cautioned market participants ‘against promoting or touting the offer and sale of coins without first determining whether the securities laws apply to those actions’. It also encouraged ‘market participants and their advisers to engage with the SEC<sup>2</sup> staff to aid in their analysis under the securities laws’ before promoting an ICO to US purchasers.

In conclusion, it is of paramount importance, for the success and viability of digital projects, to consider regulators as a major strategic variable in projects—before launch as well as during implementation. History shows that those who choose a different approach are likely to incur delays and additional costs (such as Facebook’s Libra), and, in the worst case, outright withdrawal of the project (such as Telegram’s TON Blockchain) or regulatory enforcement action.

## Other noteworthy developments

*Swiss Parliament adopts<sup>link1</sup> DLT framework. Switzerland to become the first major nation to provide full legal certainty to crypto and blockchain businesses*

- ✓ A Swiss Parliamentary commission unanimously adopted the distributed ledger technology (DLT) framework proposed by the Federal Council. The Federal Council adopted the framework in November<sup>link1</sup> 2019. The framework aims to increase legal certainty, remove barriers to entry for applications based on DLT/blockchain, and reduce the risk of abuse. The commission made few changes to the Federal Council's plan regarding access to data and the simplification of administrative aspects for small trading systems. As a next step, the National Council, the priority council for this object, will examine it during the summer session 2020.

*Several new jurisdictions have become crypto-friendly. Globally, several steps have been taken towards crypto and blockchain adoption.*

- ✓ Ukraine<sup>link1</sup> – The Ministry of Digital Transformation published a crypto draft law called 'On Virtual Assets' in response to the Ukrainian Financial Action Task Force's (FATF) June 2020 deadline. The draft bill aims to promote legal clarity regarding the status of crypto assets, their circulation, and issuance in the country. The consultation ended on 5 June.
- ✓ Albania<sup>link1</sup> – The country has introduced a law regulating the conditions for licensing all crypto activities in the country, as well as preventing abusive practices in the market. The law aims to combat money laundering through digital assets. This makes Albania the third country in the EU (after Malta and France) to establish a legal framework for cryptocurrencies.
- ✓ Croatia<sup>link1</sup> – The local supervisory authority (HANFA) has approved a passive bitcoin investment fund, clearing the way for the first regulated, crypto alternative asset fund

in Croatia.

- ✓ Antigua and Barbuda [link1](#) – The Caribbean nation has passed the ‘The Digital Assets Business Bill 2020’ to regulate cryptocurrency companies that are launching their operations on the island.
- ✓ Qatar [link1](#) – The local Central Bank stated that it is formulating a financial technology (fintech) regulatory approach supporting the use of blockchain applicatio [link1](#)ns.
- ✓ Vietnam [link1](#) – The Ministry of Finance has established a research group charged with studying and making policy proposals regarding cryptocurrencies and virtual assets. The group shall help the country stay abreast of new developments within the rapidly evolving blockchain sector.

#### *China released the e-Yuan*

- ✓ The Chinese Central Bank has released the e-Yuan [link1](#). However, it did not provide details about how the cryptocurrency will be integrated into the country’s financial mechanisms nor on its extent of decentralisation, other than stating that its circulation will be controlled by the state and only authorised brokers and banks will be able to sell it initially. Based on smart contracts, the e-Yuan shall allow China to track assets and liabilities and ensure that multiple loans are not secured by the same collateral. Overall, the announcement signals China’s intention to assume and retain a leadership position in the area of central bank digital currencies.

## Conclusion

In a new digital endeavour, the business design, implementation, and technical aspects are the most exciting parts, which are often ranked over all other features by passionate promoters. Yet, the still-young history of cryptofinance shows that many good businesses and technical plausible business cases fail for regulatory reasons. Telegram is a prominent example. The delays encountered by Facebook’s Libra are another illustration. Regulatory

enforcement or fear of it have claimed several victims in many jurisdictions. The important point to be learned is that regulation is a variable determining the success of a digital project as much as business and technical considerations.

The period under review provided evidence of continuing crypto adoption, with new favourable regulations adopted in several jurisdictions.

<sup>1</sup> <https://www.sec.gov/news/public-statement/statement-clayton-2017-12-11>

<sup>2</sup> <https://www.sec.gov/news/public-statement/statement-clayton-2017-12-11>

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