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SEC's Crypto Actions Reinforce Hard Line On Digital Assets

By **John Reed Stark** (October 28, 2019, 5:09 PM EDT)

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This month the U.S. Securities and Exchange Commission initiated three illuminating regulatory and enforcement crypto-related actions, celebrating a virtual Oktoberfest of crypto initiatives and proclamations.

Specifically, the SEC reinforced its cryptocurrency hard line by:

- Filing an enforcement action seeking an emergency temporary **restraining order** against Telegram Group Inc. and its wholly owned subsidiary TON Issuer Inc., halting their $1.7 billion ongoing digital token offering for its failure to register the offering with the SEC;
- Releasing a **joint statement** with the heads of the Commodity Futures Trading Commission and the Financial Crimes Enforcement Network, urging anyone dealing with digital currencies to ensure they are adhering to obligations under anti-money laundering, or AML, and countering the financing of terrorism regulations, or CFT, regardless of what those digital assets are called; and
- Denying Bitwise Asset Management's **bid to launch** a bitcoin exchange-traded fund, stating that the SEC was not convinced the real bitcoin market can be resistant to manipulation or fraud.

Over the past several years, the SEC has steadily risen to become perhaps the most effective and outspoken crypto police force in the world. The SEC has brought a broad range of cryptocurrency-related enforcement actions and turned out a number of thoughtful, forward-thinking and comprehensive regulatory pronouncements.

Concurrently, SEC Chairman Jay Clayton has launched his own anti-crypto crusade, bravely taking center stage and plainly asserting that cryptocurrency tokens looked and acted like securities and were susceptible to fraud and chicanery by insiders, management and better-informed traders and market participants.

This article discusses the SEC's three recent October regulatory and enforcement crypto maneuvers, and offers some thoughts going forward for the cryptocurrency marketplace.

The Telegram TRO

Dating back to as early as 2014, the SEC began bringing enforcement actions relating to cryptocurrency. With its Oct. 11, 2019 filing of SEC v. Telegram Group Inc. and Ton Issuer Inc., which sought a temporary restraining order, or TRO, the SEC has reached yet another crypto-related milestone.

Without alleging fraud by any of the defendants, the District Judge P. Kevin Pastel of the U.S. District Court for the Southern District of New York signed the emergency judicially decreed

temporary restraining order, and also granted the SEC expedited discovery and other emergency relief.

The SEC's sole allegation in the Telegram matter is that the defendants were amid an alleged unregistered, ongoing digital token offering in the U.S. that needed to be stopped dead in its tracks before investors experienced any further harm.

This was quite a victory. The SEC rarely, if ever, has brought an enforcement action involving such a large amount of money without any allegation of a swindle, scam or other form of deception.

Telegram, a popular encrypted messaging app, is used worldwide, including by Hong Kong protesters wishing to cloak themselves against detection and monitoring by authorities. The SEC alleges that both offshore Telegram defendants raised over $1.7 billion from investors, making it one of the largest and most well-known token offerings in crypto history.

According to the SEC's complaint, Telegram and TON began raising capital in January 2018 to finance the companies' business, including the development of their own blockchain — the Telegram Open Network or TON Blockchain — as well as the mobile messaging application Telegram Messenger. Defendants sold approximately 2.9 billion digital tokens called grams at discounted prices to 171 initial purchasers worldwide, including more than 1 billion grams to 39 U.S. purchasers.

Per the SEC, Telegram promised to deliver the grams to the initial purchasers upon the launch of its blockchain by no later than Oct. 31, 2019, at which time the purchasers and Telegram will be able to sell billions of grams into U.S. markets. The complaint alleges that defendants failed to register their offers and sales of grams, which are securities, in violation of the registration provisions of the Securities Act of 1933.

Steven Peikin, co-director of the SEC's Division of Enforcement stated:

> We have repeatedly stated that issuers cannot avoid the federal securities laws just by labeling their product a cryptocurrency or a digital token. ... Telegram seeks to obtain the benefits of a public offering without complying with the long-established disclosure responsibilities designed to protect the investing public.

Telegram Fights Back, But Loses (Badly)

On Oct. 16, Skadden Arps Slate Meagher & Flom LLP, counsel to Telegram, filed **a response** to the SEC that argued the SEC's emergency injunction was a Hail Mary pass, and asked the court to deny the SEC's motion to enforce a post-TRO subpoena. Telegram argued that its upcoming gram token was not a security, and that the SEC should not be able to force the company to produce documents or witnesses about its blockchain project.

However, in a declaration the same day, Telegram consented to the TRO and agreed that it would "not offer, sell or deliver grams to any person or entity for a period of five (5) months, ... and shall provide thirty (30) calendar days' notice to the SEC before offering, selling, or delivering Grams to any person or entity following the five month period."

Telegram's surrender and complete capitulation allowed for the preliminary injunction hearing to be postponed until Feb. 18–19, 2020. Meanwhile, expedited discovery continues, which will likely become an onerous and costly burden for Telegram, and could reveal further inculpatory or exculpatory evidence.

Even though Telegram has now consented to the SEC's TRO, promising to halt its offering until the February 2020 preliminary injunction hearing, it is still worth reviewing the SEC's response to Skadden's original opposition motion, which the SEC filed in the form of an Oct. 17 letter to the court. The SEC's letter reveals just how strongly the SEC believes in its position, and gives Skadden a preview of things to come.

In the detailed letter, the SEC reiterated that Telegram has violated the securities laws by selling grams, which are securities under the Securities Act, to certain investors, including buyers in the U.S., without any applicable exemption from registration. The SEC insists that Telegram has not

only violated the U.S. securities laws, but also stresses that the company is likely to violate the law again.

As an aside, Skadden’s Oct. 16 declaration also attached email correspondence between the SEC and Skadden, offering a rare glimpse into the desperate flurry of communications from Skadden to the SEC, all occurring amid the harsh reality of the impossible schedule of court-ordered expedited discovery facing the defendants. In the emails, Skadden attempts to convince the SEC to slow everything down, but the SEC refuses, reminding Skadden of looming expedited discovery deadlines.

Telegram Contacts its Investors

According to several online crypto publications, since the SEC TRO, Telegram has sent at least two emails to investors.

In the first email to investors, reportedly dated Oct. 16,Telegram explained that the SEC lawsuit has rendered the timing of its token offering unachievable, and asked investors to grant the company an extension to get its network running.Telegram further offered investors the chance to approve a date change, adding that if the majority of Telegram’s token holders disagree with the delay, they will receive 77% of their investment back.

In a second investor email on Oct. 19, Telegram encouraged investors to view the February 2020 SEC hearing as a positive step, while maintaining that the company will not distribute grams until that time.

According to Cointelegraph, Telegram stated in the letter:

> The February hearing is different from the one previously scheduled for October 24, because in the February hearing Telegram anticipates asking the court to rule on the core argument that Grams are not securities. The October 24 hearing, in contrast, was only to consider whether a delay should have been mandated, without conclusively resolving the core argument.

Whether Telegram’s questionable spin on the SEC TRO passes the straight-face test is beside the point. Clearly, the SEC is digging in on its cryptocurrency crackdown, remaining dogged and engaged. Furthermore, the rigorous requirements of expedited discovery are now underway for Telegram, and could even lead to additional charges. In short, Telegram has a serious, and very expensive, fight on its hands.

The SEC, CFTC and FinCEN Joint Statement on Digital Assets

On Oct. 11, the SEC, CFTC and FinCEN released an unusual and rare joint statement urging anyone dealing with digital currencies to ensure they are adhering to obligations under AML and CFT regulations, regardless of what those digital assets are called.

The joint statement addressed the various labels and terminologies that are used to describe digital currencies, clarifying that their regulatory treatment is determined by the underlying facts, circumstances, uses and economic realities, and not the label or terminology used to describe them.

The joint statement emphasized that all financial firms under each of the three regulators' purview must meet their AML and CFT obligations under the Bank Secrecy Act.

The joint statement also explained that AML/CFT requirements for broker-dealers “apply very broadly and without regard to whether the particular transaction at issue involves a ‘security’ or a ‘commodity’ as those terms are defined under federal laws."

Cryptocurrency Firms, AML, CFT and KYC

The joint statement is clearly a shot across the bow for cryptocurrency trading exchanges and other platforms. Adhering to AML, CFT, know-your-customer, or KYC, and the rest of the alphabet soup of rigorous financial regulatory requirements, requires among other things:

soup of rigorous financial regulatory requirements, requires among other things:

- Meticulously recording transactions;
- Definitively knowing who customers are;
- Independent testing of BSA/AML compliance;
- Rigorous personnel training; and
- Promptly and efficiently reporting suspicious activity to law enforcement.

Yet given the identification and verification challenges associated with the global locations, pseudo-anonymity, encryption, decentralization and historically criminal tendencies of typical cryptocurrency users, cryptocurrency intermediaries face extraordinary challenges meeting AML/CFT/KYC obligations.

For cryptocurrency firms, the joint statement is yet another stark reminder that FinCEN's AML requirements, combined with state law money services business licensing and bonding requirements, create a hefty, burdensome and onerous federal and state regulatory burden, and concern for crypto intermediaries.

The SEC Bitwise ETF Denial

On Oct. 9, the SEC denied Bitwise Asset Management's bid to launch a bitcoin ETF, stating in its order:

> The Commission is disapproving this proposed rule change because, as discussed below, NYSE Arcahas not met its burden under the Exchange Act and the Commission's Rules of Practice to demonstrate that its proposal is consistent with the requirements of Exchange Act Section 6(b)(5), and, in particular, the requirement that the rules of a national securities exchange be ‘designed to prevent fraudulent and manipulative acts and practices.

After the SEC's Bitwise rejection, the SEC has only one bitcoin ETF proposal currently sitting before it, filed by Wilshire Phoenix LLC and NYSE Arca Inc.

Meanwhile, according to an Oct. 9 news release, Bitwise remains surprisingly upbeat about its progress and promises to reapply.

Had the SEC granted Bitwise's ETF application, the SEC would have been encouraging and facilitating Main Street investor trading in the oft-manipulated, federally unregulated, chaotic, secretive and fractured international cryptocurrency marketplace. Clearly, the shadowy world of cryptocurrency would have taken on an air of legitimacy that the SEC is simply not ready to sanction.

Looking Ahead

Historically, the SEC has successfully kept itself above the fray when it comes to partisan wrangling and bickering, especially when it comes to investor protection. But in the last several years, political infighting has unfortunately become more common among SEC commissioners.

For instance, consider the current fiasco at the Public Company Accounting Oversight Board, which apparently is rooted in a disagreement over regulatory priorities. One board member, Kathleen Hamm, was not reappointed after serving barely two years of the tail end of a five year term, despite her willingness to stay on.

Hamm was not only a universally heralded board member, but she was also endorsed by the Council of Institutional Investors and the CFA Institute. Normally this sort of term extension is an automatic.

Instead, the SEC replaced Hamm with a far less experienced White House aide and former Republican Senate Banking Committee staffer, and then anointed conservative libertarian SEC Commissioner Hester Peirce to serve as the primary supervisor of the PCAOB board members. Yes, the same SEC Commissioner Pierce, who in addition to her support for bitcoin ETFs, is also an outspoken proponent of rolling back compliance with Section 404(b) of the Sarbanes-Oxley Act.

Departing PCAOB senior employees — some of whom claim that they were pushed out — were reportedly even bullied into signing nondisparagement agreements in exchange for six months of continued compensation. Unheard of for a government agency, nondisparagement agreements are suspicious, to say the least, and perhaps even unenforceable.

Meanwhile, the PCAOB has issued 27% fewer audit-inspection reports this year; has not had a permanent general counsel or enforcement director for 16 months; and has around 50 permanent positions currently vacant. This odd PCAOB gerrymandering and slowdown offers a rare glimpse into the political tensions and fractures within the SEC, and seems like an ominous sign for the SEC enforcement program.

However, thanks to Clayton, with respect to issues of cryptocurrency, the SEC has thankfully remained true to its roots as the investor's advocate. The chairman's steady stream of crypto-related enforcement actions; multiple crypto-related public statements, speeches and regulatory pronouncements; and thoughtful collaboration with other regulatory agencies, have been both heroic and relentless.

Clayton clearly understands the dark side of cryptocurrency. Moreover, Clayton has spent the bulk of his entire professional lifetime counseling companies regarding corporate finance and market infrastructure. He therefore undoubtedly also appreciates the virtual driver's-ed film of possible securities law violations rampant within the cryptocurrency marketplace, raising legal questions and regulatory issues from every angle.

My take is that so long as Clayton chairs the SEC, the cryptocurrency market will thankfully remain stuck and temporized by aggressive SEC enforcement. Furthermore, all cryptocurrency market players should take heed, especially the lawyers who serve as counsel for crypto-related transactions.

By allowing their crypto clients to peddle unlawful securities and violate a broad range of securities laws, lawyers are failing in their role as gatekeepers. Just consider the many aggrieved parties involved in the Telegram digital coin offering, who already probably paid millions in legal fees. Now, Telegram is stuck with the massive costs associated with the TRO, which will undoubtedly add millions or even tens of millions of dollars to its legal bills.

By providing the kind of legal advice that can land a client into the SEC's investigative, regulatory and prosecutorial crosshairs, lawyers risk more than just their reputations and livelihoods. Sooner or later cryptocurrency players who become SEC defendants are going to turn on their lawyers and begin pointing fingers.

Not a pretty picture no matter what the crypto lawyer's defense, and no matter how much the crypto lawyer's good faith.

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