No. 20-1076-cv

IN THE UNITED STATES COURT OF APPEALS

FOR THE SECOND CIRCUIT

UNITED STATES SECURITIES AND EXCHANGE COMMISSION,
Plaintiff-Appellee,
v.
TELEGRAM GROUP, INC., TON ISSUER, INC.,
Defendants-Appellants.

On Appeal from the United States District Court
for the Southern District of New York

BRIEF OF AMICUS CURIAE THE BLOCKCHAIN ASSOCIATION IN SUPPORT OF APPELLANTS

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FRAP 26.1 CORPORATE DISCLOSURE STATEMENT

Pursuant to Federal Rule of Appellate Procedure 26.1, amicus curiae the Blockchain Association states that it is a non-profit, 501(c)(6) organization organized under the laws of the District of Columbia. The Blockchain Association does not have a parent corporation, and because it issues no stock, no publicly held corporation owns 10% or more of its stock.

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INTEREST OF AMICUS CURIAE

The Blockchain Association is a not-for-profit organization that seeks to improve public policy to help blockchain networks, and their users, develop and prosper in the United States. The Blockchain Association seeks to educate policymakers, courts, and the public about how blockchain technology works and how regulatory clarity can bring about a more secure, competitive, and innovative digital marketplace. The Blockchain Association is committed to creating a partnership between industry and government to share knowledge, identify opportunities, and co-create a digital future with more transparency and security. This future holds immense promise for U.S. consumers, investors, and innovators; cryptocurrency alone—one of many applications of blockchain technology—is by itself at least a $200 billion industry. Many other industries also stand to gain from reduced remittance fees, improved supply chains, and other advantages of the technology. The Blockchain Association comprises 27 member companies, which themselves represent billions of dollars in market capitalization and thousands of employees in the United States.[1]

SUMMARY OF THE ARGUMENT

This Court will be among the first to analyze whether, and under what circumstances, blockchain "tokens" or "digital assets" concern a security subject to SEC

[1] All parties have consented to the filing of this brief. No party's counsel authored this brief in whole or in part. No party or counsel for a party contributed money that was intended to fund preparing or submitting the brief. No person other than the amicus curiae and its members and counsel contributed money that was intended to fund preparing or submitting this brief.

enforcement. This question is of critical importance to innovators, investors, users, and regulators. The Court's decision will influence choices about whether, when, and where to roll out planned and future projects. Before filing this action, the Commission had provided limited guidance on how to fund and introduce blockchain networks. But what it *had* said differs drastically from its position in this case and the decision below.

Like many other cryptocurrency projects, Telegram and its counsel structured a two-part fundraising, the first of which complied with existing exemptions for private placements and the second of which involved the delivery of functional assets. The court below nevertheless decided that this compliant sale was part of a "scheme" to effectuate an unregistered securities offering. This appeal, therefore, addresses whether companies may enter into a private placement with sophisticated investors under SEC Rule 506 (Regulation D) to fund a blockchain network and deliver tokens to investors once the network is functional.

The district court erred by conflating Telegram's private placement and the future delivery of blockchain tokens. The two steps are legally and temporally distinct. Indeed, the tokens did not even exist at the time of the private placement. Treating the two steps as one defeats the purpose of the Commission's private-placement rules. Telegram gathered investments in a private placement with a proper Regulation D filing yet the district court has barred Telegram from delivering the fruits of that investment and, even from finishing the harvest.

The funding model used by Telegram and many other blockchain projects reflected the Commission's own statements. The Chairman and the Director of Corporation Finance have both acknowledged that a digital asset "can evolve toward or away from a security." De, *infra* n.10. Contrary to the district court's static approach, "[j]ust because [a particular instrument is] a security today doesn't mean it'll be a security tomorrow, and vice-versa." *Id.*; *see also* Hinman, *infra* n.8. Accordingly, the agreements at issue promised to deliver tokens to accredited investors only once those tokens could be exchanged on a network that is functional, decentralized, and therefore outside the Commission's own understanding of a security. The investment contract and the underlying asset are distinct. "Conflating the two concepts," as one Commissioner anticipated, "has limited secondary trading and has had disastrous consequences for the ability of token networks to become functional." Peirce, *infra* n.13.

Because of the district court's error, the entire blockchain industry may no longer rely on long-standing exemptions that remain available to all other market participants. And the decision below left the industry without any clear indication about when *complying with existing law* amounts to an unlawful "scheme" under *Howey*. Given these far-reaching effects, the Blockchain Association respectfully requests that this Court reverse the ruling below and hold that existing law and Commission guidance properly treat a private-placement contract as distinct from the asset supplied under that contract.

ARGUMENT

I. DIGITAL ASSETS ARE TREMENDOUSLY IMPORTANT TO U.S. ECONOMIC GROWTH

A. The Promising Blockchain Technology Behind Digital Assets

A blockchain is a database that stores multiple copies of data across many computers in a network. That "distributed ledger" can accurately, securely, and efficiently record any number of different events or transactions according to predetermined rules across an entire network of users. The simplest way to think about a blockchain is as a spreadsheet, ledger, or database that does not rely on a single party to update entries, but that relies on a community or group process for updating and validating the data. Because organizing and updating data has so many uses, blockchains are a general-purpose technology.

Hundreds of innovators—including governments, NGOs, startups, and large public companies like IBM, Microsoft, Amazon, and Walmart—are exploring a wide variety of potential uses for blockchain ranging from election security to drug tracking to identity-fraud prevention.[2] In each of these cases, the key event or transaction is published across the entire network. This makes it nearly impossible for anyone to exploit a single point of vulnerability to falsify, delete, or corrupt information.

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[2] *See, e.g.*, Michael del Castillo, *Blockchain 50: Billion Dollar Babies*, (Apr. 16, 2019), www.forbes.com/sites/michaeldelcastillo/2019/04/16/blockchain-50-billion-dollar-babies/.

As financial ledgers, blockchains can make transactions more programmable and less expensive. Blockchain "smart contracts," for example, can automatically pay a counterparty when a predetermined contractual condition occurs. The contract might automatically transfer the equivalent of a millionth of a cent from a listener to a songwriter for every second a song is played—without any delay, transaction cost, or financial intermediary. Supply-chain monitors built with blockchain can track goods or services around the globe. "Digital assets" or "cryptocurrencies" store and transfer value between parties instantly, without the added costs of intermediaries or the delays common to conventional bank transfers. A health-record application can use blockchain to store data and permit only authorized access, for example specifying that genomic data is available for medical research but not marketing.

As a result of these benefits, policymakers have emphasized the importance of ensuring that blockchain technology can thrive in the United States. A 2018 Joint Economic Committee report urged governments "not [to] prejudge and hinder technological developments."[3] "Blockchain," a bipartisan group of lawmakers recently recognized, "is an example of digital innovation that has the potential to transform a myriad of industries through its ability to improve the transparency, efficiency, and security of transactions and information."[4]

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[3] *The 2018 Joint Economic Report*, at 20–21, 225–26, https://www.congress.gov/115/crpt/hrpt596/CRPT-115hrpt596.pdf.

[4] Joe Mont, *Reps Urge White House to Support Blockchain*, (May 29, 2019), www.complianceweek.com/regulatory-enforcement/reps-urge-white-house-to-support-

B. Digital Assets Built on Blockchain Technology

This appeal concerns perhaps the best-known use of blockchain: cryptocurrency. Bitcoin, the first broadly-adopted cryptocurrency, was meant to do for currency what the Internet did for information: allow people to send value across the globe digitally, instantly, and securely, without the need for intermediaries.

A digital asset or cryptocurrency consists of tokens—an "alphanumeric cryptographic sequence," according to the district court. Order at 38–39. The blockchain records this sequence, which tracks the owners, quantity, and transfers of that digital asset. The code is typically open-source and the ledger is usually administered collectively. That distributed network enhances the security and confidence associated with the digital asset.

Holders of digital assets can transfer them for goods, services, or other currencies. Their worth, like that of any other asset, depends on what people value as an equivalent exchange; and, as with other currencies, including the dollar, the value of a cryptocurrency ultimately rests on people's willingness to trade it for other things. With a sovereign's traditional "fiat" currency, this willingness to exchange is usually automatic; the law dictates the national currency is a proper medium of exchange. A

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blockchain/27167.article. "[B]lockchain," lawmakers have recognized, "ha[s] the greatest potential to take us into the fully fledged technological age." Jemayel Khawaja, *Meet the American Legislators Bullish on Blockchain*, (Feb. 19, 2019) (quoting Rep. Tom Emmer), https://media.consensys.net/blockchain-law-congress-house-senate-2019-133e30fd5dd5.

cryptocurrency, by contrast, has value only if actors in the market are willing to accept the currency—based on its security, efficiency, and acceptance—in exchange for other value.

II. THE APPLICABILITY OF THE SECURITIES LAWS DEPENDS ON THE CHARACTERISTICS OF A SPECIFIC ASSET AT A SPECIFIC TIME

A. Not All Digital Assets Are Alike—and Not All Are Securities

Given the diversity of blockchain use cases described above, the applicability of the securities laws to digital assets is not one-size-fits-all.

The definition of "security" under the Exchange Act includes "investment contracts" as well as other familiar instruments such as stocks and bonds, though it excludes currencies and commodities. *See* 15 U.S.C. § 78c(a)(10). According to the Supreme Court, an "investment contract" requires (1) the investment of money (2) in a common enterprise (3) with a reasonable expectation of profits (4) to be derived from the efforts of others. *SEC v. W.J. Howey Co.*, 328 U.S. 293, 298–300 (1946). The orange-grove interests at issue in *Howey* satisfied these criteria because investors were buying not just land or fruit, but instead the opportunity to receive profits from the efforts of others who promised to use the invested capital to manage the orange grove and sell its fruit. *See id.* The question here is how to apply that WWII-era precedent to a rapidly developing medium of digital exchange.

The variable and fact-specific nature of the *Howey* analysis means some digital assets reflect common investments in a third party's managerial efforts to turn a profit while others do not.[5] Applying *Howey* to novel and varied blockchain projects is not a uniform determination—and the Blockchain Association urges this Court to recognize that variety and nuance in its review of this case.

Some digital assets undoubtedly embody investors' common expectation of profits from the efforts of others. These are properly considered securities subject to the Commission's jurisdiction regarding their marketing, sale, and trading. So-called "security tokens," for example, provide purchasers with a return on the profits from an investment fund. "Equity tokens" represent ownership of a particular asset, like debt or corporate stock.

Other digital assets are just as clearly *not* securities. Some are purely functional assets that allow users to consume goods and services. Gaming and private-jet tokens, for example, merely give holders a stake in the output, rather than equity, of the commercial enterprise.[6] The Commission has similarly acknowledged that two (by far) of the most notable digital assets—Bitcoin and Ether—are not securities. Bitcoin and Either together account for 75% of the market value of all cryptocurrencies, removing most of the market from the securities laws. Holders of these digital assets, the

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[5] *See, e.g.*, *United States v. Zaslavskiy*, No. 17-cr-647, 2018 WL 4346339, at *4 (E.D.N.Y. Sept. 11, 2018) ("Whether a transaction or instrument qualifies as an investment contract is a highly fact-specific inquiry.").

[6] *See, e.g.*, Mark Butler, *SEC Issues Second No-Action Letter for Crypto Sales – This Time for Gamers*, (Aug. 8, 2019), https://www.intelligize.com/sec-issues-second-no-action-letter-for-crypto-sales-this-time-for-gamers/.

Commission has apparently concluded, have no "expectation of return by a third party," with no central party responsible for the success of the enterprise.[7] As the SEC's Director of Corporation Finance William Hinman has acknowledged, "the token—or coin or whatever the digital information packet is called—all by itself is not a security, just as the orange groves in *Howey* were not."[8] "[T]he Supreme Court has acknowledged that if someone is purchasing an asset for consumption only, it is likely not a security." *Id.*

The two assets at issue here reflect this distinction. The privately placed contracts to deliver Grams to investors concededly amounted to investment contracts. That's why Telegram registered the "SAFT" contracts with the Commission under Regulation D and sold them only to accredited investors. The Grams themselves, however, likely would ***not*** be securities—like Bitcoin and Ether—once launched. As the court below recognized, Grams are merely an "alphanumeric cryptographic sequence." Order at 38–39. To the extent such tokens are "utilized by members of a decentralized community connected via blockchain technology," they are "not likely to be deemed a security." *Id.* at 2.

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[7] Bob Pisani, *Bitcoin and Ether are not Securities*, CNBC (June 14, 2018), www.cnbc.com/2018/06/14/bitcoin-and-ethereum-are-not-securities-but-some-cryptocurrencies-may-be-sec-official-says.html.

[8] William Hinman, *Digital Asset Transactions: When Howey Met Gary (Plastic)*, (June 14, 2018), https://www.sec.gov/news/speech/speech-hinman-061418.

B. Whether a Particular Asset Is a Security Can Change Over Time

The Commission also has acknowledged that the status of specific assets under the securities laws can shift over time. A "digital asset can," according to Director Hinman, "over time, become something other than a security." *Id.* "[T]he analysis of whether something is a security is *not* static," and an instrument ceases to satisfy *Howey* when "the network on which the token or coin is to function is sufficiently decentralized." *Id.*[9] Director Hinman's view is supported by *Howey* itself, which recognized its test "embodies a flexible rather than a static principle." 328 U.S. at 299.

Similarly, Commission Chairman Jay Clayton has explained that: "[t]he use [of cryptocurrency] can evolve toward or away from a security …. Just because it's a security today doesn't mean it'll be a security tomorrow, and vice-versa."[10] Chairman Clayton has offered an example of an investor who funds a Broadway play in exchange for presale tickets. The agreement might initially be treated as a security: investors expect profits based on the theatre's ability to produce an attractive show that drives

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[9] Other Commission guidance likewise recognizes that a digital asset may involve "essential tasks or responsibilities performed and expected to be performed by" a "decentralized network." To the extent this involves reliance on the efforts of others, the Commission guidance indicates that does not render a digital asset a security. *See* Framework, *infra* n.22.

[10] Nikhilesh De *et al.*, *SEC Chief Touts Benefits of Crypto Regulation*, CoinDesk (Apr. 6, 2018), https://www.coindesk.com/sec-chief-not-icos-bad/.

ticket demand and value.[11] But once the show has opened, the tickets would not be securities; they would merely allow the holder to access the show, despite the existence of a secondary ticket marketplace. This approach is also consistent with the Commission's well-known acceptance of Bitcoin and Ether as non-securities, based on networks that developed over time.[12]

Commissioner Hester Peirce likewise has recognized that blockchain projects can "mature into a functional or decentralized network that is not dependent upon a single person or group to carry out the essential managerial or entrepreneurial efforts."[13] That makes it not a security under *Howey.* Given this reality, a proposed three-year "safe harbor" would allow time for "the development of a functional or decentralized network, exempted from the registration provisions of the federal securities laws." *Id.*

Fixing the securities status of (future) tokens while the network remains under construction would obviously stunt this maturation. Tokens will struggle to evolve into currencies or commodities—or to ever function as intended—if securities-law restrictions persist regardless of their development.

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[11] Times Talks, *SEC Chairman Jay Clayton & Andrew Ross Sorkin* (Nov. 29, 2018), https://www.timestalks.com/talks/timestalksdealbook-andrew-ross-sorkin-and-s-e-c-chairman-jon-clayton/.

[12] *See* De, *supra* n.10.

[13] Hester M. Peirce, *Running on Empty: A Proposal to Fill the Gap Between Regulation and Decentralization* (Feb. 6, 2020), https://www.sec.gov/news/speech/peirce-remarks-blockress-2020-02-06.

III. DESPITE LIMITED REGULATORY CLARITY, THE COMMISSION'S STATEMENTS ENCOURAGED ADOPTION OF THE SAFT AND RELIANCE ON REGULATION D.

A. The Commission's Lack of Regulation or Guidance Regarding the Securities-Law Status of Digital Assets

Given the wide range of digital assets and uses, and the importance of their categorization under the securities laws, the Commission might have been expected to provide guidance about its approach to their legal status *before* filing an enforcement action. No settled precedent or agency rulemaking addressed whether and when digital assets amounted to securities.[14] Only a few U.S. courts have addressed those critical questions.[15]

Yet the Commission provided little clarity about its own interpretation of the securities' laws application to digital assets. To the extent the Commission addressed the subject at all, its stance was largely inscrutable. Commissioner Peirce has likened the

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[14] This ad hoc approach stands in stark contrast to the Commission's approach to the novel regulatory issues concerning crowdfunding ventures like Kickstarter and Indiegogo. There entrepreneurs solicited public investment to develop a project in return for a share of the profits or specific rewards. In response, the Commission (at Congress' direction) engaged in formal rulemaking to promulgate clear exemptions for crowdfunding. *See* 17 C.F.R. § 227.100, *et seq*. That regulatory clarity enabled the flourishing of this powerful tool for small businesses' capital formation. *See, e.g.*, C. Steven Bradford, *Crowdfunding and the Federal Securities Laws* (Oct. 7, 2011), https://www.sec.gov/info/smallbus/acsec/bradford_crowdfunding.pdf.

[15] When the Commission filed this enforcement action, the few decisions involving digital assets involved blatant fraud; the nature of the digital assets themselves was incidental. *See, e.g.*, *Zaslavskiy*, No. 17-cr-647, 2018 WL 4346339 at *1 ("Defendant … is alleged to have made materially false and fraudulent representations and omissions in connection with two purported virtual currency investment schemes").

SEC's guidance on the question whether digital assets are securities to a Jackson Pollock painting: "splashing lots of factors on the canvas without any clear message."[16] This avant-garde approach has regrettably left policymaking to novel enforcement actions like this one, prejudicing firms trying to comply with the law and depriving the public of any notice or comment. Instead, market participants have been forced to hunt for regulatory clues among the Commission's limited and opaque statements, speeches, no-action letters, closed-door meetings, and settlements.

- **Enforcement:** The Commission has brought a handful of one-off enforcement actions, but even "taken together" with staff guidance, these "offer no clear path for a functioning token network to emerge."[17]

- **Two simplistic no-action letters:** The industry hoped that the Commission might issue no-action letters indicating parameters for tokens' status as non-securities, but only *two* have issued so far involving publicly-available tokens that no one ever thought were securities.[18] One addressed what were effectively airline miles (redeemable for flight services at $1 per token),[19]

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[16] Hester M. Peirce, *How We Howey* (May 9, 2019), https://www.sec.gov/news/speech/peirce-how-we-howey-050919.

[17] *See* Hester M. Peirce, *Broken Windows: Remarks before the 51st Annual Institute on Securities Regulation* (Nov. 4, 2019), www.sec.gov/news/speech/peirce-broken-windows-51st-annual-institute-securities-regulation. In December 2017, the agency settled with Munchee, a food-review app developer. In September 2019, the agency settled civil-penalty charges against Block.one. And the Commission has relied on basic fraud theories to sue RECoin, PlexCoin, and AriseBank.

[18] SEC, *Response for Pocketful of Quarters, Inc.* (July 25, 2019) https://www.sec.gov/corpfin/pocketful-quarters-inc-072519-2a1; SEC, *Response for TurnKey Jet, Inc.* (Apr. 3, 2019), https://www.sec.gov/divisions/corpfin/cf-noaction/2019/turnkey-jet-040219-2a1.htm.

[19] TurnKey Jet, Inc., *supra* n.18.

while the other concerned digital arcade tokens developed by a 12-year-old.[20]

- **A single fact-specific report:** By contrast, the so-called DAO Report concerned a particular token that obviously *was* a security. "Decentralized Autonomous Organization" tokens would entitle holders to support, vote on, and profit from business ventures—just like a shareholder.[21] The organization's direct-voting governance structure may have been novel, but its tokens plainly were securities.

- **Open-ended guidance:** The Strategic Hub for Innovation and Financial Technology published an informal framework for analyzing whether digital assets are securities.[22] It set forth a laundry list of 38 factors—many with multiple sub-parts—to "consider in assessing whether a digital asset is offered or sold as . . . a security." This long-awaited Framework immediately met with external and even internal criticism for its complexity.[23] The open-ended Framework stands in stark contrast to the statements from Director Hinman and others, discussed below, that encouraged the industry's adoption of the "SAFT" model.

- **Closed-door meetings:** The Commission has repeatedly tied up individual projects in extensive pre-launch consultations, creating "a body of secret law" with a "lack of transparency and accountability."[24] Though it "binds

[20] Pocketful of Quarters, Inc., *supra* n.18.

[21] *See* SEC Release No. 81207 at 1 (July 25, 2017) ("The holders of DAO Tokens stood to share in the anticipated earnings from these projects as a return on their investment in DAO Tokens."), https://www.sec.gov/litigation/investreport/34-81207.pdf.

[22] SEC, *Framework for 'Investment Contract' Analysis of Digital Assets* (Apr. 3, 2019) https://www.sec.gov/corpfin/framework-investment-contract-analysis-digital-assets. The staff described this framework as "not a rule, regulation, or statement of the Commission," in an apparent attempt to insulate it from judicial review. *Id.*

[23] Zuluaga, *The SEC* Diego *Can't Keep Kik-ing the Crypto Can Down the Road*, Coindesk (June 5, 2019), https://www.coindesk.com/the-sec-cant-keep-kik-ing-the-crypto-can-down-the-road (the framework "turn[ed] the 70-year-old, four-pronged *Howey* test into a 40-point-plus list of potential reasons why the SEC might consider a token offering to be an offering of securities."); Peirce, *supra* n.16 (the framework "could raise more questions and concerns than it answers").

[24] Hester M. Peirce, *Secret Garden: Remarks at SEC Speaks*, (Apr. 8, 2019), https://www.sec.gov/news/speech/peirce-secret-garden-sec-speaks-040819.

> market participants *like* law," it remains "immune from judicial—and even Commission—review." Innovators are "literally told if you want to launch a token, whatever you think you want to do with it, come check with the SEC first."[25]

Against that backdrop of uncertainty and inconsistency, this Court should proceed cautiously. No court should uncritically accept the Commission's "convenient litigating position." *Kisor v. Willkie*, 588 U.S. ----, 139 S. Ct. 2400, 2417 (2019).

B. The Commission's Statements Encouraged Use and Adoption of the "SAFT" Model.

The Commission has, however, offered consistent guidance on one key point: The interests or assets embodied in a blockchain token may change over time, and a token that represents a security at one point in time will not necessarily remain a security. The SAFT (Simple Agreement for Future Tokens) model that Telegram and others have used was designed around that very notion. The Commission's statements have expressly encouraged this model and its reliance on Regulation D private placements.

Innovators and developers unsurprisingly relied on these statements, only to be surprised with enforcement actions. But the enforcement posture in this case, and the district court's position, run the opposite direction of the Commission's prior statements. Indeed, the district court's decision now threatens to preclude use of the very exemption the Commission had encouraged the industry to utilize.

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[25] Kollen Post, *Rep. Warren Davidson: You Have to Defend Money to Defend Freedom* (Oct. 22, 2019), https://cointelegraph.com/news/rep-warren-davidson-you-have-to-defend-money-to-defend-freedom.

The Commission has been clear about analyzing digital assets as they change over time. For example, during an influential speech in 2018, Director Hinman "emphasize[d] that the analysis of whether something is a security is not static and does not strictly inhere to the instrument."[26] Although the characteristics of a particular SAFT would always be relevant, he made "clear [that] I believe a token once offered in a security offering can, depending on the circumstances, later be offered in a non-securities transaction." *Id.* This was an important statement that innovators and investors took seriously.[27] And it was entitled to respect as reflecting the agency's views. Director Hinman is "the principal advisor to the [Commission] in matters pertaining to" these provisions of the Securities Act. *Cf. Her Majesty the Queen v. U.S. EPA*, 912 F.2d 1525, 1532 (D.C. Cir. 1990) (letter from Acting Assistant Administrator of Air and Radiation constituted position of the agency). "[N]othing . . . provides us reason to question his authority to speak for the [agency]." *Cal. Comms. Against Toxics v. EPA*, 934 F.3d 627, 637 (D.C. Cir. 2019) (reaffirming *Her Majesty the Queen*).[28]

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[26] *See* Hinman *supra* n.8.

[27] *See, e.g.,* Philipp Hacker, *et al.*, *Regulating Blockchain: Techno-Social and Legal Challenges* at 253 (1st ed. 2019) ("Hinman's analysis is broadly consistent with the SAFT white paper's analysis that sales of pre-functional tokens may qualify as securities transactions and, later, when the tokens are functional and sold as useful commodities on a distributed network, no longer qualify as a securities transaction.").

[28] *See also* 17 C.F.R. 200.18 (duties of Director of Corporation Finance). Director Hinman's speech frequently used the word "we," *cf. Her Majesty the Queen*, 912 F.2d at 1532 (giving weight to similar usage of "we"); and it was posted on the Commission's website.

The SEC's Framework for "Investment Contract" Analysis of Digital Contracts expressed a similarly dynamic view of tokens' status. "In evaluating whether a digital asset previously sold as a security should be reevaluated at the time of later offers or sales," the Framework acknowledged, "there would be additional considerations." Framework at 5, 8. The Framework stated explicitly that it was "identif[ying] some of the factors to be considered in determining w*hether and when a digital asset may no longer be a security*." *Id*. at 11 (emphasis added).

The basic principle of a SAFT is premised on the Commission's notion that the *Howey* analysis is time-specific. The SAFT is an investment contract offered by digital asset developers to accredited investors. Accredited investors fund a token project and receive in return the right to a certain number of the project's tokens. But those tokens would be received in the future, once the network is fully functional. Developers "use the funds to develop genuinely functional network, with genuinely functional utility tokens, and then deliver those tokens to the investors once functional."[29] This model aligns with Chairman Clayton's example, discussed above, regarding tickets promised to theatre investors.[30]

Telegram sold $1.7 billion worth of SAFT contracts in a manner consistent with these repeated statements by the Commission. The Commission's enforcement team,

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[29] Juan Batiz-Benet *et al.*, *The SAFT Project: Toward a Compliant Token Sale Framework*, at 1 (Oct. 2, 2017), https://saftproject.com/static/SAFT-Project-Whitepaper.pdf.

[30] Times Talks, *supra* n.11.

however, now wants to take the opposite tack. Unfortunately, the district court agreed. Legal steps that the Commission previously recognized as meriting separate consideration were ultimately treated as "part of a single scheme." Order at 18.

To ignore the Commission's prior statements and permit it enjoin shut down the delivery of Grams—at great cost to Telegram, the investors, and many other projects—constitutes just the sort of "unfair surprise" that an agency should not be permitted to spring on the public. *Cf. Kisor v. Wilkie*, 139 S. Ct. 2400, 2418 (2019).

IV. THE PURCHASE AGREEMENT MODEL USED BY TELEGRAM AND OTHER PROJECTS COMPLIES WITH U.S. SECURITIES LAWS.

A. The Private Placement Is a Lawfully Exempt Security

The Commission's prior guidance is correct, while the decision below is wrong. The SAFT contract model, on which Telegram based its Purchase Agreement for Grams, complies with the letter and spirit of the securities laws. The SAFT investment contract itself was treated as a security. A token developer may contract with accredited investors, relying on Regulation D's Rule 506(c) exemption, and file a Form D disclosing the sale, if necessary.[31] The developer can then use the proceeds to develop the network into a product that provides genuine utility. Once the tokens are functional, the investors receive delivery of the tokens, similar to the way a bond is satisfied by providing the coupon payments and the principal or a futures contract is satisfied by delivery of the commodity. From a policy perspective this makes sense: the pre-functional investors

[31] *See* 17 C.F.R § 230.506(c).

must be able to bear enterprise risk and the eventual token-holders are merely bearing functional-product risk or currency-risk.

Yet this enforcement action bizarrely attacks the decision to use an investment model designed expressly to *comply* with the Commission's own regulations. Nothing in the securities laws or precedent suggests that an issuer cannot enter into an investment contract with accredited investors under Regulation D and deliver the resulting products to those accredited investors in satisfaction of those contracts. The district court thought its "single scheme" analysis settled everything without requiring analysis of what Grams will be at the time of delivery because it was evident that SAFT purchasers would be receiving their returns in the form of Grams. Order at 18. But that approach merely begs the question whether Grams would be securities after the network launches—a critical point on which the opinion can only speculate. Similarly, the fact that investors make returns by receiving a product at a discount shows only that they invested in generating the product. Just as a theatre can provide returns to its investors (Chairman Clayton's analogy) by distributing discounted tickets for the show without the tickets themselves being securities.

The SAFT allows only accredited investors to invest before the network is functional. The SAFT framework seeks to ensure that the appropriate laws apply to the elements of a token sale: when developers agree on the SAFT with investors, they are usually selling a security subject to the investor-protection laws. And when the tokens are ultimately distributed, the risks that investor-protection laws mitigate are absent. The network is functional, the developers have already expended their efforts, and future purchasers cannot expect profits based on the efforts of others subject to disclosure requirement. This approach to developing a blockchain harmonizes the Commission's dual mandates of investor protection and capital formation.

This approach is also aligned with the Commission's repeated observation that a security can give rise to a non-security.[32] As Director Hinman has explained, blockchain innovators might "conduct the initial funding through a registered or exempt equity or debt offering and, once the network is up and running, distribute or offer blockchain-based tokens or coins to participants who need the functionality the network and digital assets offer." *Id.* "This allows the tokens or coins to be structured and offered in a way where it is evident that purchasers [of the tokens after the network launch] are not making an investment in the development of the enterprise." *Id.*

B. The Not-Yet-Existent Grams Are Not Securities

The district court refused to consider whether Grams, the asset that SAFT purchasers will receive and be able to resell, would constitute securities on their own. They clearly would not.

[32] Director Hinman has discussed "how a digital asset can, over time, become something other than a security" when, for example, "the network on which the token or coin is to function is sufficiently decentralized." He has further emphasized that "the analysis of whether something is a security is not static and does not strictly inhere to the instrument." Hinman, *supra* n.8.

As the district court did recognize, "a cryptocurrency utilized by members of a decentralized community connected via blockchain technology, which itself is administered by this community of users . . . is not likely to be deemed a security under the familiar [*Howey*] test." Order at 2. That is true for multiple reasons, but the lack of a common enterprise is enough.

"Horizontal commonality," this Court's standard way of assessing the existence of a common enterprise, requires "the tying of each individual investor's fortunes to the fortunes of the other investors by the pooling of assets, usually combined with the pro-rata distribution of profits." *Revak v. SEC Realty Corp.*, 18 F.3d 81, 87–88 (2d Cir. 1994). That plainly will not exist for any post-launch sales of Grams to public purchasers, since the proceeds of those sales will go to individual holders of Grams, not Telegram. See Telegram Br. at 49–50. Those initial public purchasers, of course, could resell the Grams or exchange them for goods of services. There is no common fund where the proceeds from exchanges of Grams will be deposited.

Nor would there be "strict vertical commonality," a mode of common enterprise that this Court has not foreclosed. This type "requires that the fortunes of investors be tied to the fortunes of the promoter." *Revak*, 18 F.3d at 88. The district court found such fortunes to be sufficiently tied—without citing a single case—because "Telegram would also suffer critical reputational damage if the TON Blockchain failed prior to or after launch." Order at 23. This makes little sense. Companies always face reputational harm if the products and services they offer fail. This says nothing about whether those products and services are securities. Returning to Chairman Clayton's example, a Broadway play that fails spectacularly on opening night will damage the reputation of the theatre company and hurt the resale value of tickets it has sold to future shows. But that does not place the theatre company in strict vertical commonality with every person who purchased a ticket.

Besides commonality, "reliance on the efforts of others" will be lacking for post-launch Grams. Once the network exists, it will be independent of its creators and managers. Assuming tokens are launched after network maturity, public holders of Grams would have no expectation of profits and receive no protection from Exchange Act disclosure regarding the activities of managers no longer involved in the asset they hold. Initial private and future public purchasers of Grams, therefore, are fundamentally distinct in ways the decision below entirely overlooks.

V. THE DISTRICT COURT'S CONFLATION OF PRIVATE PLACEMENTS AND THE UNDERLYING ASSETS FURTHER DESTABILIZES THE BLOCKCHAIN MARKET AND SECURITIES LAWS

A. The District Court Ignored the Commission's Prior Position and the Public's Reliance

Despite the status of the SAFT and Grams discussed above, the court circumvented the applicable exemptions and guidance by analyzing the initial investment and future distribution of Grams as a single scheme. It ruled that the Regulation D sales were improper because initial purchasers might improperly sell their Grams after the network launch. Presumably, the court was concerned about *potential* sales into the secondary market before the network is decentralized—though the Order did not make its reasoning clear. It made no findings identifying an existing U.S. secondary market, prior sales to non-accredited investors, or the current state of the Gram network.

Yet the district court nonetheless held that "economic reality" meant Grams eventually "would be resold in a public market with the expectation that the *Initial Purchasers* would earn a profit." Order at 17 (emphasis added). The SAFT "and the anticipated distribution of Grams by the Initial Purchasers to the public," according to the court, are in reality part of "a single scheme." *Id.* at 17–18. Because of these potential downstream effects, Telegram's upstream reliance on the Regulation D exemption was deemed invalid.

This conflation of distinct securities law concepts is at odds with the securities laws, the industry's reliance interests, and the Commission's own expressed views. Regulation D offerings commonly envision some re-sale by the accredited investors who buy first. But that does not mean that the upstream investor is an underwriter or the downstream sale is a securities offering. Each must be analyzed independently based on the facts at the time. "The 'contract, transaction or scheme' by which the token is sold may constitute an investment contract; but, the object of the investment contract—the token—may not bear the hallmarks of a security. ***Conflating the two concepts has limited secondary trading and has had disastrous consequences for the ability of token networks to become functional***." Peirce *supra* n.13 (emphasis added).

This is the very sin the Commission and the district court committed in this case. The district court conflated Telegram's sale of a security to accredited investors—under the SAFT—with the future sale of Grams to the public.

B. The District Court's Opinion Created Unnecessary Uncertainty About the Status of Digital Assets

The Order does not dispute that the SAFT investors are accredited, and it acknowledges that the Grams alone are not securities. *See* Order at 2, 16, 38–39. Yet the district court declared that when SAFT investors sell their Grams, they will be acting as underwriters distributing securities. Order at 42. If so, then a public buyer after launch must be purchasing a security. What that security is, the district court did not say. Somehow the district court determined that the public sale of Grams will involve a securities distribution without even identifying what the security will be.

This dissonance contrasts with the Commission's prior position, which harmonized its own rules: a digital asset sale might represent an investment contract at one stage (the SAFT under Regulation D) but cease to be a security at a later point (as decentralized and consumptive commodity). *See supra* § II.B, p.10. This reflects the reality of developing a decentralized network over time, as Chairman Clayton, Commissioner Peirce, and Director Hinman have all acknowledged. If an SEC-registered investment contract cannot fund the development of a decentralized token network without rendering those tokens regulated securities, then the tokens' utility as a currency is diminished from the outset. That would defeat the purpose of building a blockchain network, as the agency has blessed in the case of Bitcoin and Ethereum, and as the agency's pronouncements purport to envision for future tokens as well. It also could call into question the proposal for a three-year safe harbor.

If—as the Commission has repeatedly said—a blockchain token may be sold in circumstances that can represent a security at one point in time and a non-security asset later in time, it is important to have clear lines between each regime. It will be difficult, to say the least, for people to use and trade digital assets if their status as a security is uncertain. The case of Grams should be apparent; Telegram has structured the Gram network so that post-launch Grams do not constitute securities. The decision below, regrettably, obscured that distinction by signaling that sales of post-launch Grams by SAFT investors would involve securities. When those Grams would cease to be securities is entirely unclear—an uncertainty that will be highly detrimental to blockchain development.

C. The District Court's Opinion Created Unnecessary Uncertainty About Regulation D.

Even assuming Grams would be "securities" when the network is launched, that does not necessarily invalidate Telegram's reliance on Regulation D. There are numerous ways that private investors can sell securities purchased in private placements without violating U.S. securities law. For example, private investors could sell Grams after holding them for more than 12 months under Rule 144 without being "underwriters." *See* 17 C.F.R. § 230.144(b)(1)(i). They could sell Grams to other accredited investors pursuant to a valid Regulation D exemption. Or they could sell Grams in foreign jurisdictions where U.S. law does not apply. *See United States v. Morrison*, 529 U.S. 598 (2000). By conflating the private placement of investment contracts and future sales of Grams, the district court either prematurely rejected, or simply ignored, numerous ways of complying with U.S. securities law.

CONCLUSION

The Blockchain Association respectfully requests that this Court reverse the decision below, and ensure its ruling is narrowly tailored to avoid casting doubt over Regulation D offerings not before the court.

Dated: April 3, 2020

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Dated: April 3, 2020

/s/ Keith Bradley
Keith Bradley

CERTIFICATE OF SERVICE

I hereby certify that on April 3, 2020, I electronically filed the foregoing with the Clerk of the Court for the United States Court of Appeals for the Second Circuit by using the CM/ECF system for service on all registered participants.

/s/ Keith Bradley
Keith Bradley

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