20-1076-cv

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

PAGE PROOF BRIEF FOR DEFENDANTS-APPELLANTS

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CORPORATE DISCLOSURE STATEMENT

Pursuant to Federal Rule of Appellate Procedure 26.1, Defendants-Appellants certify as follows:

1. TON Issuer Inc is a directly or indirectly wholly owned subsidiary of Telegram Group Inc.

2. Telegram Group Inc. is a privately held company that has no parent corporation, and no publicly held corporation owns 10% or more of its equity.

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INTRODUCTION

Nearly seventy-five years ago, the Supreme Court established the principle that a "contract, transaction or scheme whereby a person invests his money in a common enterprise and is led to expect profits solely from the efforts of the promoter or a third party" is an investment contract subject to regulation as a security under the federal securities laws. *SEC v. W.J. Howey Co.*, 328 U.S. 293, 298-99 (1946). That principle is designed to ensure that such a person receives the protections of the securities laws, including the disclosure requirements that attend registration of a security. Remarkably, the district court granted the SEC's request to block Defendants from issuing their digital currency, called Grams, on the ground that the "public needs [securities law] protection" (Opinion and Order dated March 24, 2020 ("Order"), ECF No. 277, at 41) without ever addressing whether any public purchasers of Grams — those who purportedly need that protection — would be purchasing securities.

Equally remarkable, the SEC led the district court down this fundamentally flawed path by arguing that the only transactions relevant to the *Howey* analysis were the initial purchase agreements ("Purchase Agreements"), which Telegram privately entered into back in 2018 with a select group of highly sophisticated, accredited investors (the "Private Investors"). Critically, *Defendants expressly treated these Purchase Agreements as investment contracts*, and offered them pursuant to valid exemptions from registration under Regulation D and Regulation S of the Securities Act of 1933. Defendants did so because they recognized that they were offering the Private Investors an opportunity to invest in a common enterprise with the expectation of profit based on Telegram's promise to build the Telegram Open Network ("TON") Blockchain platform on which Grams are to be used as a new digital currency to purchase goods and perform digital applications. If successful in building the platform, Telegram promised to create Grams on the system and deliver them to the Private Investors as a return on their investment. Defendants thus have *conceded* that the Private Investors reasonably expected to profit from their investments in the Private Placement.

As Defendants have further explained, however, *future sales* of Grams by the Private Investors to members of *the public* on the secondary market following the launch of the TON Blockchain will *not* constitute investment contracts under *Howey* because those future transactions — as distinct from the Purchase Agreements through which the TON Blockchain was initially built — will occur under very different facts and circumstances, and will not carry any ongoing promises by Telegram to undertake "essential managerial efforts" leading to an expectation of profits. To the contrary, as Telegram repeatedly informed the Private Investors and the public at large, once the TON Blockchain is built and launched, it will be an entirely open-source and "decentralized" platform over which Telegram cannot exercise any ongoing managerial control, but rather will be in the hands of the community of dispersed third-party developers and users. The economic reality is that, at that point in time, Gram purchasers in the market will not be participating in any common enterprise with Telegram or reasonably expect to profit based on any ongoing managerial efforts of Telegram. Rather, Grams will function like any other currencies or commodities, able to be bought, sold or used and their value determined based on market forces of supply and demand.

The district court nevertheless enjoined the distribution of Grams to the Private Investors, based on those Private Investors' eventual sale of Grams to the public, solely on the ground that the *Private Investors* expected profits from Defendants' efforts back in 2018. Under this erroneous framework, the district court concluded that Defendants were engaged in an "ongoing" distribution of securities *to the public* — but, fatally, did not even analyze (let alone decide) whether transactions involving Grams will be securities if and when Grams are created and actually sold to the public. The district court's order thus failed to recognize — and the SEC has refused to acknowledge — that if future public purchasers of Grams will not be entering into investment contracts under *Howey*, then by definition there will *not* be a public distribution of a security. And the expectations of the *Private Investors* when entering into the pre-launch Purchase

Agreements say nothing about the expectations of *future purchasers* of Grams under dramatically different circumstances.

It is well-established that the *Howey* test is a transaction-based inquiry; an asset that may constitute a securities offering in one setting (when, for example, it is coupled with a promise of profits based on the promoter's essential managerial efforts) but may *not* constitute a securities offering in other circumstances where such promises are lacking. (*Infra* pp. 27-28.) The district court initially recognized as much, stating that a digital currency by itself, "utilized by members of a decentralized community connected via blockchain technology," like Bitcoin, "is not likely to be deemed a security" under *Howey*. (Order at 2.) But the district court then proceeded to ignore its own observation, failing to analyze future transactions in Grams under *Howey* at the point when Grams would exist and be sold to the public. (*See id.* at 39 n.13.)

Had the district court conducted the proper analysis that *Howey* mandates, it would have been clear that the SEC failed to establish any "ongoing" violation of the securities laws justifying a preliminary injunction. As the record reflects, any public purchaser who buys Grams post-launch will not have entered into any contract or agreement with Defendants, will not have been given any promises of investment returns, dividends, income or the like, and will not have received any commitments by Telegram to undertake any post-launch efforts to further improve the TON Blockchain, which will be open source and can be built upon by anyone.

Having failed to conduct the relevant inquiry, the district court's assertion that the "public needs [securities law] protection" lacks any legal and factual basis. It also bears emphasis that post-launch purchasers will not be without protection when buying Grams in the market: digital assets are commodities subject to anti-fraud and anti-manipulation enforcement by the U.S. Commodity Future Trading Commission ("CFTC"), as both the SEC and CFTC recognize.

By freezing the *Howey* analysis at the time of the 2018 Private Placement, the district court has frozen technological innovation in the United States. Under the district court's reasoning, it will be virtually impossible to build digital networks on which a digital currency could flourish, as one SEC Commissioner recently warned and multiple amicus curiae explained below. (*Infra* pp. 34-35.) That this result was reached at the behest of the SEC is particularly ironic, given that the SEC's litigation position here is contrary not only to decades of case law interpreting *Howey*, but to repeated public statements from the agency's own leadership, including the SEC Chairman himself. (*Infra* p. 33.)

The district court's preliminary injunction order rests upon a fundamentally flawed analysis, untethered to the case law and contrary to common sense, and will have a profound chilling effect on private capital formation in the United States if not rectified. The order should be reversed.

JURISDICTIONAL STATEMENT

This district court has subject matter jurisdiction over this action pursuant to 28 U.S.C. § 1331 and Sections 20(b), 20(d) and 22 of the Securities Act. 15 U.S.C. §§ 77t(b), 77t(d) and 77v. This Court has jurisdiction over this appeal pursuant to 28 U.S.C. § 1292(a)(1). (*See* Order.)

Defendants filed a timely notice of appeal on March 24, 2020.

ISSUES PRESENTED

1. Did the district court err in applying its *Howey* analysis exclusively to the Purchase Agreements between Telegram and the Private Investors, which Defendants expressly treated as investment contracts, as opposed to analyzing future transactions in Grams by public purchasers once the TON Blockchain has been built and launched?

2. Did the district court commit legal error in concluding that Defendants' Private Placement was not exempt from registration under Rule 506 and Section 4(a)(2) on the theory that the Private Investors were "underwriters" engaged in a "public distribution" of Grams without ever analyzing, let alone deciding, whether post-launch Grams sold to public purchasers will constitute investment contracts?

STATEMENT OF THE CASE

Although the underlying technology at the heart of this case is novel and complex, the legal issues presented are narrow and straightforward. In 2017, Telegram's team of developers and computer programmers set out to create a new distributed ledger technology and digital currency. To achieve that goal, Defendants searched for legally compliant ways to raise the funds necessary to build their project. Recognizing, as many others have, the atmosphere of uncertainty surrounding the application of the U.S. securities laws to the newly emerging digital asset space, Defendants took a cautious approach. Contrary to other cryptocurrency projects that have been the subject of SEC enforcement actions, Defendants never sold any digital assets to the public through a so-called "Initial Coin Offering." Rather, Defendants entered into private Purchase Agreements with accredited investors through which Telegram promised to build the TON Blockchain, and if successful, to create Grams on the system and distribute them to the Private Investors as a return on their investment.

At the same time, Defendants built maximum flexibility into the project and engaged with the SEC to receive guidance regarding its details. For over eighteen months, Defendants voluntarily produced thousands of pages of documents, submitted numerous legal memoranda, and answered hundreds of questions. When the SEC provided limited feedback, Defendants made changes to the project to address the concerns expressed.

On October 11, 2019 — just weeks before Defendants were contractually required to launch the TON Blockchain or return the unspent funds to the Private Investors — the SEC rushed into court and filed an "emergency application" for a preliminary injunction enjoining the launch of the TON Blockchain and Defendants' distribution of Grams to the Private Investors. Defendants agreed not to sell or distribute Grams until the district court could rule on the SEC's request. On February 19, 2020, following several months of expedited discovery, the court heard oral argument. On March 24, 2020, the court granted the SEC's motion for a preliminary injunction, prompting this appeal.

STATEMENT OF FACTS

I. Blockchains and Digital Currencies

A blockchain is a distributed ledger, which records the current and historical state of accounts, transactions and/or events. Multiple parties, often referred to as validators, miners and/or nodes, (Defendants' Local 56.1 Statement ("Def. 56.1"), ECF No. 75, ¶¶ 1-3), manage and operate a blockchain network. (*Id.* ¶ 4.) Transactions are grouped over some time interval and posted to the ledger in "blocks," and each block is cryptographically linked to the previous block, creating an unbroken chain of valid transactions. (*Id.* ¶¶ 7-8.) In this respect, many blockchains are described as "decentralized," meaning that any ongoing governance and oversight of the ledger is not conducted by a single or centralized source, but rather administered collectively by a dispersed community of network users. This decentralized structure eliminates any central point of failure and encourages wider participation in the development of the blockchain code, which typically is open source and thus available to all. (*Id.* ¶¶ 9-12.)

Digital currencies are native units of account on blockchains and serve as incentives for decentralized users to contribute to the platform by "validating" transaction blocks. (*Id.* ¶¶ 17, 19-20.) Like traditional fiat currencies, digital currencies are used to store value and as a medium of exchange that can be transferred among users on the platform, but do not require any central authority or intermediary. (*See id.* ¶¶ 21, 24.) Together, blockchains and digital currencies facilitate forms of commerce that historically have been cost prohibitive or functionally challenging with traditional forms of currency. (*Id.* ¶ 32.) Examples of currently available cryptocurrencies are Bitcoin, which is native to the Bitcoin blockchain, and Ether, which is native to the Ethereum blockchain. (*See id.* ¶¶ 22-23.)

II. <u>Telegram Seeks To Create a More Useable Blockchain</u>

A. Telegram and Its Founders

In 2013, Pavel Durov and Dr. Nikolai Durov launched an encrypted messaging application ("Telegram Messenger") that today has a reported 300 million monthly users. (Def. 56.1 ¶¶ 42-43.) Pavel is the CEO of Telegram and the founder of the popular social media site VKontakte ("VK"). (*Id.* ¶¶ 36-37, 45.) Nikolai is the Chief Technology Officer of Telegram and an accomplished mathematician and programmer who has won two World Championships in programming and three Gold Medals in the International Mathematical Olympiads, among other achievements. (*Id.* ¶ 41.)

Pavel and Nikolai determined that technological limitations inherent in existing digital currencies, including slow transaction speeds, inability to scale, and poor user interfaces, were limiting their widescale adoption for consumptive use. (*Id.* ¶ 46.) They set out to design a new distributed ledger technology that could give rise to a mass-market cryptocurrency and would improve upon the speed, scalability, and ease of use of existing digital currencies, so that consumers would more widely adopt and use it. (*Id.* ¶¶ 46-48.)

B. The TON Blockchain and Grams

In 2017, the Telegram team began developing a new distributed ledger called the "TON Blockchain." (*See* Def. 56.1 ¶ 49.) If successfully launched, the TON Blockchain will support a native digital currency called Grams.

(*Id.* ¶ 52.) Telegram designed the TON Blockchain so that Grams will be immediately useable as (i) tender for commercial transactions on the TON Blockchain; (ii) stakes for validators to validate transactions on the platform; (iii) capital for lending to validators and others; and (iv) voting power required to support or oppose changes in the TON Blockchain code. (*Id.* ¶ 56.) Grams are also designed to power decentralized applications ("dApps") and smart contracts that are built onto the TON Blockchain. (*Id.* ¶ 58.)

If the TON Blockchain is launched, it will be a decentralized system with open-source code, meaning anyone can access it to build upon the platform. (*See id.* ¶ 51.) Once launched, the TON Blockchain will have no central governing body or management, but rather will be self-sufficient and maintained by the community of validators. (*Id.* ¶ 72.) Telegram will not have any superior rights to any third parties using the system. (*Id.* ¶¶ 72-73.) Moreover, Telegram has committed to not hold any Grams post-launch, and any Grams held by Telegram's employees will be precluded from being used for any voting or validating. (*Id.* ¶¶ 87-88, 90.) Neither Telegram nor its employees will have any ability to change the TON Blockchain code, its validation processes or its parameters; rather, all such changes require a consensus vote of two-thirds of the validators. (Expert Report of Stephen B. McKeon, ECF No. 102-1, ¶¶ 188-93; Def. 56.1 ¶¶ 87, 90.)

C. Telegram Conducts a Private Placement To Fund the TON Blockchain

To build the TON Blockchain, Telegram needed to raise funds. After initially considering both a private and public offering, Telegram raised $1.7 billion in funds exclusively through a global private placement (the "Private Placement"), in which Defendants entered into the Purchase Agreements with select, accredited investors, and through which Telegram promised to develop the TON Blockchain and deliver Grams to the investors only upon successful launch of the platform. (Def. 56.1 ¶¶ 96-07, 103, 106.) The Private Placement was conducted in accordance with Rule 506 of Regulation D (for U.S. purchasers) and Regulation S (for non-U.S. purchasers) under the Securities Act. (*Id.* ¶ 107.) The investors were highly sophisticated and of high net worth, with an average investment of approximately $10 million. (*Id.* ¶ 100.)

The Private Placement was executed in two $850 million rounds in February and March 2018. (*Id.* ¶¶ 108-09, 113-14.)

D. The Private Placement Materials

In connection with the Private Placement, Telegram distributed certain documents to potential purchasers under expectations of confidentiality. (Def. 56.1 ¶¶ 160-62.) In one such document, Defendants explained that "[t]he blockchain ecosystem needs a decentralized counterpart of everyday money – a truly mass market cryptocurrency." (*Id.* ¶ 164.) Additionally, Telegram provided to Private Investors a document titled "Certain Risks Associated with the Purchase, Sale and Use of Grams" ("Risk Disclosures"). (*Id.* ¶ 166.) In the Risk Disclosures — which each Private Investor warranted to have read and understood — Telegram emphasized that Grams themselves were not intended to be securities but were instead intended for consumptive use, stating that "*Grams are intended to act as a medium of exchange between users in the TON ecosystem*. *Grams are not investment products*." (*Id.*¶¶ 179-80 (emphasis added).)

These documents also explained that Telegram would not be responsible for the continued enhancement of the TON Blockchain following its launch. (*See, e.g.*, JX9, ECF No. 72-9, at 20 ("Telegram will serve as a launch pad for TON, ensuring its technological superiority and widespread adoption at launch. *But the future of TON is in the hands of the global open-source community.*" (emphasis added); *see also* JX7, ECF No. 72-7, at 19; Def. 56.1 ¶ 184 ("Neither Telegram nor the Issuer has any fiduciary or other obligation to use the funds generated by the token sale for the benefit of the purchasers.").)

While Telegram imposed confidentiality obligations on the prospective purchasers with respect to the above materials, some were leaked by parties other than Defendants and also publicly filed by the SEC when it instituted this action. Prior to Telegram's Public Notice (*see infra* pp. 19-20), Telegram was careful not to publicly comment on any of these materials or otherwise make any statements about the details of the anticipated project to the public, particularly because of the flexibility it maintained with respect to the details of the project. (Def. 56.1 ¶ 218.)

E. The Purchase Agreements

Telegram entered into Purchase Agreements with each of the Private Investors. The Purchase Agreements explained that Telegram intended "to create and issue a new cryptocurrency called 'Grams' ('Tokens') following the development and launch of a new blockchain platform (the 'TON Network')," and that the purchasers were contracting to "subscribe for Tokens [*i.e.*, Grams]." (Def. 56.1 ¶ 194.) The Purchase Agreements stated that they would terminate if the TON Blockchain was not ready to successfully launch by October 31, 2019, at which point any unspent funds would be returned to the Private Investors. (*Id.* ¶ 201.)[1]

Defendants placed express limitations on the ability of Private Investors to transfer their Purchase Agreements or their interests in Grams before the launch of the TON Blockchain. Specifically, the Private Investors could not: "offer, pledge, sell, . . . or otherwise transfer or dispose of, directly or indirectly, the investment contract represented by this Purchase Agreement *or any Tokens*"

[1] After the SEC brought its action, this date was extended to April 30, 2020, by agreement of a majority of the Private Investors. (Def. 56.1 ¶ 202.)

until at least the launch of the TON Blockchain platform. (*Id.* ¶ 203 (emphasis added).) The Round 1 Purchase Agreements contained a further "Lock-Up" provision that provided for these restrictions to be released in increments following the launch. (*Id.*) All Purchase Agreements contained the following prominent language on their very first page:

> **NOTICE TO RESIDENTS OF THE UNITED STATES**
>
> THE OFFER AND SALE OF THIS SECURITY HAS NOT BEEN REGISTERED UNDER THE U.S. SECURITIES ACT OF 1933, AS AMENDED (THE **"U.S. SECURITIES ACT"**), OR UNDER THE SECURITIES LAWS OF ANY U.S. STATES. THIS SECURITY MAY NOT BE OFFERED, SOLD OR OTHERWISE TRANSFERRED, PLEDGED OR HYPOTHECATED EXCEPT PURSUANT TO AN EFFECTIVE REGISTRATION STATEMENT UNDER THE U.S. SECURITIES ACT OR IN A TRANSACTION EXEMPT FROM THE REGISTRATION REQUIREMENTS OF THE U.S. SECURITIES ACT AND APPLICABLE STATE SECURITIES LAWS.

(*Id.* ¶ 193.)

In the Purchase Agreements, the purchasers expressly warranted, among other things, that:

- the Purchaser is "purchasing the Tokens for its own account and not with a view towards, or for resale in connection with, the sale or distribution thereof"; and
- "the Purchaser is entering into . . . this Purchase Agreement and purchasing . . . Tokens for its own account and not for the benefit of any other person."

(*Id.* ¶¶ 200, 209-10.) The Private Investors gave these and other warranties at the time of the Purchase Agreements and must repeat them at the time of launch as a condition precedent to any delivery of Grams, ensuring that Private Investors did not sell their interests in the Private Placement or in Grams before launch of the TON Blockchain. (*Id.* ¶ 212.)

III. <u>Development of the TON Blockchain</u>

The TON Blockchain was fully built and ready to be launched by October 31, 2019. (*See* Def. 56.1 ¶ 21.) Since that date, Defendants have continued to develop certain non-essential, "nice-to-have" features that could be used on the platform. (*Id.* ¶¶ 221-22.) Defendants have made it clear, however, that Telegram is under no commitment to further develop applications in connection with the TON Blockchain after launch. (*Id.* ¶ 223.) To that end, Defendants represented that they are not required to, and indeed may never, create further products for the TON Blockchain following its launch. (*Id.* ¶ 224.)

Defendants have also disclosed that Telegram will not have any control over the direction of the TON Blockchain following its launch. (*Id.* ¶ 73.) Rather, like many other blockchain platforms operating today, the source code for the TON platform will be completely open source, allowing anyone in the world to build applications and smart contracts on the system. Following launch, Defendants will stand in the exact same position as any other third-party user — with the ability, but not the obligation, to develop further platform applications. (Public Notice, Drylewski Declaration Exhibit 3 ("Drylewski Ex. 3"), ECF No. 73-

3.) The record reflects that numerous third parties have already developed, or begun to develop, a multitude of applications and services in connection with the TON Blockchain and Grams. (Def. 56.1 ¶¶ 273-74.)

A. The TON Foundation

Telegram originally contemplated the creation of a not-for-profit organization, called the "TON Foundation," to promote and support the TON Blockchain in a role similar to that of other digital asset foundations, like the Bitcoin and Ethereum Foundations. (Def. 56.1 ¶¶ 186, 225.) Telegram disclosed to Private Placement purchasers (and later the public, *see infra* p. 19), however, that the TON Foundation may never be established. (Def. 56.1 ¶¶ 186, 225-28.)

If established, the TON Foundation would be governed by a board consisting of a majority of independent directors. (*Id.* ¶¶ 233-35.) The TON Foundation's role would be limited to (1) publishing non-binding opinions and research regarding the TON Blockchain's development and policy; (2) providing small rewards of Grams to users of the TON Blockchain to promote the consumptive use of Grams; and (3) in certain circumstances, selling Grams in the market to attempt to dampen upward price volatility in the event that the market price for Grams gets too high to be used as a functional currency. (*Id.* ¶¶ 236-38.)

[2] If the TON Foundation is established in the future, it will not have any ability to change the TON Blockchain code, and, if the TON Foundation were to hold Grams, none of them could be used for voting or validating. (*Id.* ¶¶ 244-45.)

B. The TON Beta Version and Anticipated Validators

In anticipation of the TON Blockchain's launch, Telegram released a test version ("Beta Test Version") to the public, which allows any third party to view and test the TON Blockchain's open source code and security features, and to develop and test applications for the platform before its launch. (Def. 56.1 ¶¶ 256-59.) At least 36 independent parties have established validator nodes on the Beta Test Version (Expert Report of Maurice P. Herlihy ("Herlihy Report"), ECF No. 122-9, ¶ 33) — more than the amount necessary for launch (Defendants' Response to SEC's Local 56.1 Statement, ECF No. 120-9, ¶ 349) — and many others, including Private Investors, have expressed interest in becoming validators once the TON Blockchain is launched (*see* Ex. B to SEC Letter dated February 10,

[2] Specifically, the TON Foundation would have the option to sell Grams by comparing the Reference Price and market price of Grams. In the event that the market price of Grams exceeds the Reference Price, the TON Foundation may elect (but is not required) to sell Grams where the lowest acceptable bid price would be the Reference Price. (Def. 56.1 ¶ 239.) The Reference Price is determined by a formula based on the total number of Grams in existence. (*Id.* ¶ 240.) It does not bear any relationship to, or dictate in any way, the market price for Grams following launch of the TON Blockchain, which will be determined by market forces, such as supply and demand. (*Id.* ¶ 243.) The TON Foundation also was initially intended to be able to buy Grams from the market to dampen downward price volatility in the event that the market price for Grams got too low to be used as a functional currency. (*Id.* ¶ 247.) Defendants removed this feature pre-litigation due to concerns raised by the SEC. (*Id.* ¶ 248.)

2020, ECF No. 180; TON Community Foundation Amicus Brief ("TCF Brief"), ECF No. 195-1, at 12-13).

Moreover, robust testing and development of the TON code by third parties continues to this day, despite the shadow cast by this lawsuit. (Def. 56.1 ¶¶ 256-75; *see also* TCF Brief at 9-14.) There have been numerous public reports, websites and articles regarding the third-party development of applications and services for the TON Blockchain. (Def. 56.1 ¶ 273.)

IV. <u>Public Communications With Future Gram Purchasers</u>

On January 6, 2020, Telegram published "A Public Notice About the TON Blockchain and Grams" ("Public Notice") in response to the unauthorized disclosure of the Private Placement materials and the SEC's disclosures and assertions in this lawsuit. (*See* Drylewski Ex. 3.) The Public Notice reemphasized Telegram's earlier statements that Grams are designed to be used as a medium of exchange and not as an investment vehicle. (*See id.*) The Public Notice stated, among other things:

- "Telegram and its affiliates have not made any promises or commitments to develop any applications or features for the TON Blockchain or otherwise contribute in any way to the TON Blockchain platform after it launches. In fact, it is possible that Telegram may never do so."

- "[I]t is Telegram's goal and hope that the **decentralized community of third party developers** and others will contribute to the TON ecosystem through the development of applications and smart contracts. It will be the sole responsibility of **third**

> **parties** and the community to adopt and implement such applications or smart contracts on the TON Blockchain in the manner they choose."

- Gram purchasers "should **NOT** expect any profits based on your purchase or holding of Grams, and Telegram makes no promises that you will make any profits. Grams are intended to act as a **medium of exchange** between users in the TON ecosystem. Grams are **NOT** investment products and there should be **NO** expectation of future profit or gain from the purchase, sale or holding of Grams."

- "Grams do **NOT** represent:

    - Any equity or other ownership interest in Telegram or its affiliates
    - Any rights to dividends or other distribution rights from Telegram or its affiliates
    - Any governance rights in Telegram or its affiliates."

(*Id.* at 1-2 (emphasis in original).) Telegram's Public Notice was made available online and through Telegram's website and social media accounts. (Def. 56.1 ¶¶ 279-80.)

V. <u>Procedural History</u>

On October 11, 2019, the SEC filed this action and an emergency application for a preliminary injunction. On March 24, 2020, after hearing argument on the parties' motions for summary judgment and the SEC's application for preliminary injunction, (*see* Feb. 19, 2020 Hearing Transcript ("Hearing Transcript")), the district court granted a preliminary injunction.

The district court held that the SEC showed a substantial likelihood of success in proving that the distribution of yet-to-be-issued Grams to the Private

Investors is actually a "public distribution" of securities under the *Howey* test. (Order at 3.) The court concluded that the Purchase Agreements are part of a "larger scheme" to distribute Grams into a secondary public market. (*Id.* at 2.)

In concluding that Defendants have engaged in an "ongoing" public distribution of securities, the district court examined the details of the Private Placement and the expectations of the Private Investors in entering into the Purchase Agreements. In doing so, the district court held that the SEC satisfied the *Howey* test because the Private Investors, by entering into the Private Placement, participated in a common enterprise with an expectation of profits based on the managerial efforts of Telegram. (*See, e.g.*, *id.* at 21 ("The ability of each Initial Purchaser to profit was entirely dependent on the successful launch of the TON Blockchain."); *id.* at 22 ("Each Initial Purchaser's anticipated profits were directly dependent on Telegram's success in developing and launching the TON Blockchain."); *id.* at 29 ("The Court's finding that the Initial Purchasers had a reasonable expectation of profit . . ."); *id.* at 32 ("[T]he Initial Purchasers were entirely reliant on Telegram's efforts . . .").)

Having decided that the Private Investors had entered into investment contracts — a point Defendants did not and do not dispute — the district court never analyzed, let alone determined, whether post-launch public purchases and sales of Grams on the secondary market will constitute investment contracts. To the contrary, the district court made clear that it was not making that determination, stating: "Even if the Court adopted Telegram's theory and evaluated Grams upon the launch of the TON Blockchain, it does not necessarily follow that Telegram's analysis under the *Howey* factors at launch is correct and, thereby, that Grams are not a security." (*See id.* at 39 n.13.)

The district court further concluded that the exemptions from registration on which Defendants relied to conduct the Private Placement were not available to them based on the same analysis. According to the court, because the Private Investors had entered into the Private Placement with an intent to eventually sell Grams in the secondary market, they were effectively "underwriters" of a public distribution of securities. (*Id.* at 39-40.) Again, the district court reached this conclusion without ever analyzing whether Grams would be investment contracts at the time of future offers or sales to the public following launch of the fully built TON Blockchain.

SUMMARY OF ARGUMENT

The district court committed reversable error when it concluded that "Telegram's present plan to distribute Grams is an offering of securities" to secondary market purchasers without even analyzing, much less determining, that Grams will be investment contracts at the time they are created and offered to the public. As a result of this fatal flaw, the district court analyzed the entirely *wrong* *transactions* under *Howey*, focusing exclusively on the characteristics of the Private Placement and the expectations of the Private Investors at that time. The error in this analysis is highlighted by the fact that Defendants have always treated the Private Placement as a securities offering and the Purchase Agreements as investment contracts.

While the district court appeared to recognize the well-established principle that *Howey* is a transaction-specific test, it proceeded to ignore the distinct facts, circumstances and economic realities of future offers and sales of Grams to public purchasers, including the public purchasers' reasonable expectations following the launch of the TON Blockchain (at which point Telegram will have no ongoing commitments or managerial role). By deeming post-launch transactions with public purchasers irrelevant to the question of whether a public distribution of securities will occur, the district court contravened longstanding case law applying *Howey*.

In adopting this blinkered approach, the court accepted the SEC's arguments, which are contrary to public statements by numerous high-ranking SEC officials, including the SEC Chairman, which have emphasized that an instrument may be an investment contract at one point given the totality of facts and circumstances at that time, but that same instrument may *not* be an investment contract at another point based on the facts and circumstances existing at that other time. As a result, the district court failed to answer the only question that matters: whether transactions in Grams following the launch of the TON Blockchain will constitute investment contracts. This failure compels reversal.

The district court's holding that the Private Placement was not exempt from registration suffers from the same flaw. That holding is based on the mistaken view that the Private Placement was in fact a "public distribution" of securities and the Private Investors were statutory "underwriters." But, by definition, there will not be a "public distribution" of securities, and Private Investors will not be "underwriters," if future transactions in Grams on the secondary markets do not involve a statutory security. In focusing exclusively on the expectations of Private Investors at the time of the Private Placement in 2018, the district court thus concluded that Defendants were engaged in a public distribution of a security *regardless* of whether Grams will be securities at the time they are available to public purchasers. This result cannot be squared with the law or common sense.

When the district court's incorrect analytical framework is set aside, the undisputed record reflects that the SEC cannot meet its burden to show a violation of the securities laws. Indeed, the SEC cannot establish under *Howey* that future Gram purchasers following the launch of the TON Blockchain will have a reasonable expectation of profits based on the essential managerial efforts of

Telegram (*infra* pp. 39-49), or that such purchasers will be participating in a common enterprise (*infra* pp. 49-53).

Accordingly, had the district court reached the relevant question here, it would have been compelled to conclude that the SEC failed to establish that post-launch market transactions in Grams themselves, divorced from the Purchase Agreements through which they were initially offered to the Private Investors, will not be investment contracts. This Court should accordingly reverse and remand with directions to deny the SEC's motion for a preliminary injunction.

STANDARD OF REVIEW

A district court's grant of a preliminary injunction is typically reviewed for abuse of discretion. *See Somoza v. N.Y.C. Dep't of Educ.*, 538 F.3d 106, 112 (2d Cir. 2008) (vacating preliminary injunction); *Mastrovincenzo v. City of New York*, 435 F.3d 78, 88 (2d Cir. 2006) (same). "The District Court necessarily abuses its discretion when its decision rests on an error of law." *Somoza*, 538 F.3d at 112.

However, *de novo* review is appropriate when the district court's ruling on a preliminary injunction resembles a final decision on the merits or has the effect of a permanent injunction finally resolving the issue. *See Hsu ex rel. Hsu v. Roslyn Union Free Sch. Dist. No. 3*, 85 F.3d 839, 852-53 (2d Cir. 1996); *Romer v. Green Point Sav. Bank*, 27 F.3d 12, 16 (2d Cir. 1994). Here, the district court's preliminary injunction decision both resembles a final decision on the merits and has the effect of a permanent injunction finally resolving the issue.

Regardless, preliminary injunctive relief is "an extraordinary and drastic remedy, one that should not be granted unless the movant, by a *clear showing*, carries the burden of persuasion." *Moore v. Consol. Edison Co. of N.Y., Inc.*, 409 F.3d 506, 510 (2d Cir. 2005) (emphasis added). "[A] preliminary injunction can have very serious consequences," and thus, "the more onerous . . . the burdens" of the injunction sought, the "more persuasive [the] showing of [the SEC's] entitlement" to relief must be. *SEC v. Unifund SAL*, 910 F.2d 1028, 1039 (2d Cir. 1990).

As set forth below, the SEC did not carry its burden under either the appropriate *de novo* standard of review or the abuse of discretion standard, and the district court's order rests on a clear error of law.

ARGUMENT

I. THE DISTRICT COURT FAILED TO ANALYZE THE CORRECT TRANSACTIONS AND PURCHASERS UNDER *HOWEY*

The district court committed a fundamental legal error when it granted the preliminary injunction without ever analyzing whether future sales of Grams to the public will constitute investment contracts. By basing its entire ruling on the expectations of the Private Investors in 2018, (*see* Order at 18-38), the district court misapplied *Howey* and contravened decades of precedent requiring that

Howey be applied on a transaction- and offer-specific basis. Because the SEC cannot show entitlement to a preliminary injunction unless *public purchases* of Grams post-launch are investment contracts, and because the district court never analyzed that critical question, its order granting a preliminary injunction is legally unsound and should be reversed.

A. *Howey* is Transaction- and Offer-Specific

An investment contract "involves an investment of money in a common enterprise with profits to come solely from the efforts of others." *Howey*, 328 U.S. at 301; *see also United Hous. Found., Inc. v. Forman*, 421 U.S. 837, 852 (1975). Critically, the *Howey* test is *transaction-specific* and applies to the facts, circumstances and economic realities existing at the time of each transaction. As a decision affirmed by this Court explained, the *Howey* test "must be examined as of the time that the transaction took place, together with the knowledge and objective intentions and expectations of the parties *at the time*." *SEC v. Aqua-Sonic Prods. Corp.*, 524 F. Supp. 866, 876 (S.D.N.Y. 1981), *aff'd*, 687 F.2d 577 (2d Cir. 1982) (emphasis added).

Thus, an instrument that may be an investment contract in one context or transaction can be a non-investment contract in another context or transaction as circumstances change, including the way in which the instrument is offered and sold. As the Supreme Court explained in *Marine Bank v. Weaver,* "*[e]ach* *transaction* must be analyzed and evaluated on the basis of the content of the instruments in question, the purposes intended to be served, and the factual setting as a whole." 455 U.S. 551, 560 n.11 (1982) (emphasis added); *see also SEC v. United Benefit Life Ins. Co.*, 387 U.S. 202, 207, 209 (1967) ("[W]e must assess independently" under *Howey* two portions of the same contract that constitute "[t]wo entirely distinct promises" and whose "operation is separated at a fixed point in time."); *Ring v. AXA Fin., Inc.*, 483 F.3d 95, 100 (2d Cir. 2007) ("[W]e must disaggregate separate promises of a product or transaction.").

Despite this settled law, the district court collapsed two very different types of transactions, offers and purchasers: (1) the Private Placement through which the Private Investors paid money in exchange for Telegram's express promise to build the TON Blockchain and, if successful, repay the investors in Grams through which the investors hoped to profit; and (2) the separate, future transactions of Grams on the open market following launch of the TON Blockchain, which will not carry with them any of the attendant promises or commitments embodied in the Purchase Agreements:

Private Placement (2018) vs. **Future Public Sales (2020)**

Private Placement (2018)

* Pooling of funds
* Promise to build working platform
* Promise to create and distribute Grams upon launch
*Price set by Defendants

* **Treated as securities offering**

Future Public Sales (2020)

* **NO** raising or pooling of funds
* **NO** promise of ongoing efforts
* **NO** promise of profits
* **NO** contracts
* **NO** dividends
* Price dictated by market forces

Telegram has always treated the Private Placement as a securities offering and the Purchase Agreements as investment contracts. (Defendants' Summary Judgement Brief, ECF No. 71, at 39.) This is because the Private Investors were supplying risk capital in exchange for Telegram's contractual promise to build the TON Blockchain, which gave rise to an expectation of profit in the form of the Grams that would be delivered to the investors upon a successful launch. But because this transaction was expressly treated as an investment contract (and offered only to private, accredited investors under exemptions to registration), the district court's exclusive focus on the *Private Investors'* expectation of profits in order to conclude that there would be a subsequent *public distribution of securities,* without any analysis of Grams themselves at that later point in time, is both perplexing and erroneous. (Order. at 18-38.)[3]

The decision in *SEC v. Koscot Interplanetary, Inc.*, 497 F.2d 473 (5th Cir. 1974), on which the SEC relied below, is instructive. (SEC Summary Judgment Brief, ECF No. 79, at 27.) There, the Fifth Circuit determined that a

[3] In conducting its *Howey* analysis, the district court misconstrued Telegram's position and the point in time when the Purchase Agreements conclude and subsequent transactions in Grams will occur. According to the court, "Telegram argues that a second and distinct set of transactions will be the delivery of the newly created Grams to the Initial Purchasers upon the launch of the TON Blockchain." (Order at 17). But this was not Telegram's argument. Rather, the delivery of the Grams to the Initial Purchasers was the conclusion of the Purchase Agreements, bringing the Private Placement to an end. (*See* JX11, ECF No. 72-11, § 7.1 (noting that the Purchase Agreements terminate upon issuance of Grams).) It is the post-launch public purchases of Grams that are the "second and distinct" transactions required to be analyzed.

pyramid scheme involving the sale of cosmetics constituted an "investment contract" under *Howey*. *Koscot*, 497 F.2d at 476-77. In doing so, the Fifth Circuit drew a clear distinction between "the distribution of cosmetics" by themselves, on the one hand, and the "marketing of cosmetics and the recruitment aspects of Koscot's enterprise," on the other. *Id.* at 475. Notably, the SEC itself argued that these two aspects were "*separable* and that *only the latter* are within the definition of a security." *Id.* (emphasis added). The court agreed, holding that the "case-law countenances the fragmented approach which the SEC presses upon us." *Id.* at 476.

The "fragmented approach" urged by the SEC in *Koscot* has been routinely assumed, if not expressly adopted, in every case involving purported investment contracts. Courts focus on the agreement between the promoter and investors at the time of each offer, not the underlying asset that is the subject of the offering. *See Wals v. Fox Hills Dev. Corp.*, 24 F.3d 1016, 1018 (7th Cir. 1994) (analyzing contracts for sale of land units, not lots themselves); *Schwartz v. Bache & Co.*, 340 F. Supp. 995, 998-99 (S.D. Iowa 1972) (analyzing contracts for sale of nickel rather than underlying nickel); *Sinva, Inc. v. Merrill, Lynch, Pierce, Fenner & Smith, Inc.*, 253 F. Supp. 359, 367 (S.D.N.Y. 1966) (analyzing contracts for sale of sugar, not sugar itself); *Kemmerer v. Weaver*, 445 F.2d 76, 79 (7th Cir. 1971) (analyzing contract to care for, breed and resell beaver, rather than beaver itself).

Indeed, in *Howey*, the Supreme Court held that the "investment contract" at issue was the "offering [of] an opportunity to contribute money and to share in the profits of a large citrus fruit enterprise managed and partly owned by [defendants]," rather than the actual orange groves themselves. 328 U.S. at 299-300. Thus, under *Howey*, any subsequent purchases of oranges or orange groves without an accompanying service contract would have been analyzed separately and would surely not have been deemed investment contracts.

The district court misinterpreted *Howey* on this point, stating that "although the land purchase contracts and the service contracts were separate agreements that took effect at different points in time and a purchaser was not mandated to enter into both, the Court analyzed the entirety of the parties' interaction, finding that the whole scheme comprised a single investment contract." (Order at 18.) To the contrary, the *Howey* Court's finding of an investment contract was based on the fact that the two contracts *were offered together at the same time*, thus giving rise to a securities offering requiring registration. *See Howey*, 328 U.S. at 300. If the service contract in *Howey* had been offered only at a later point in time, after the purchasers had been sold the land contract alone, this plainly would not have been sufficient to render the land contract itself an investment contract. *See, e.g.*, *Salameh v. Tarsadia Hotel*, 726 F.3d 1124, 1131

(9th Cir. 2013) (sale of hotel condominiums was not securities offering despite later offer of rental management agreement relating to same condominiums).

Like the service contract in *Howey*, Telegram treated the Purchase Agreements as investment contracts and offered them pursuant to exemptions from registration. Yet, just like the land in *Howey* or the cosmetics in *Koscot*, the Grams themselves that may be offered and sold to the public following launch of the TON Blockchain will lack any corresponding promises of profits based on Telegram's essential managerial efforts. By collapsing these two distinct offers, time periods, and purchasers into "a single scheme," the district court's order flouts decades of jurisprudence and leads to the illogical result that future sales of Grams to public purchasers are a "public distribution" of securities *even if Grams themselves are not investment contracts at that time*. (Order at 18.)

The district court embraced that result, expressly acknowledging that it was *not* making any determination whether Grams would be securities at the time they are actually sold to public purchasers, (*Id.* at 39 n.13). This omission is fatal to the district court's analysis and contrary to the law; accordingly, the order should be reversed.

B. The District Court's Analysis Is Contradicted by the SEC's Own Positions and Public Statements

In determining that its exclusive focus on the Private Placement was appropriate, the district court was led astray by the SEC, which advanced a position contrary to its own high ranking officials and Strategic Hub for Innovation and Financial Technology ("FinHUB"). SEC Chairman Jay Clayton has publicly stated that the determination of whether a digital asset is an investment contract must be analyzed at each distinct point in time. As he explained, "[t]he use [of cryptocurrency] can *evolve* toward or away from a security," and thus "[j]ust because [a particular instrument is] a security today doesn't mean it'll be a security tomorrow, and vice-versa." Nikhilesh De & Mahishan Gnanaseharan, *SEC Chief Touts Benefits of Crypto Regulation,* CoinDesk (Apr. 6, 2018 11:58 UTC), https://www.coindesk.com/sec-chief-not-icos-bad/ (last visited May 24, 2018).

In illustrating this concept, Chairman Clayton offered an analogy that is apt here: Broadway tickets. The Chairman has explained that an agreement to fund the production costs of a Broadway play in return for tickets to the show may be an investment contract under *Howey*, as investors are pooling their money in a common enterprise to build a production in exchange for an asset that, if the venture is successful, will have value that may very well lead to profit. But once the play is up and running, Clayton explained, the tickets themselves would merely provide access to the play and would not be an investment contract, even if some may purchase those tickets with a view towards reselling them on a secondary market for profit. At that point in time, the production has largely been completed and the work of the promoter is less crucial to the success of the play — "you are not growing the business, *the business exists*."[4]

SEC Director William Hinman agreed with this transaction-specific approach, stating: "the analysis of whether something is a security *is not static and does not inhere to the instrument.*" William Hinman, *Digital Asset Transactions: When Howey Met Gary (Plastic)* (June 14, 2018). As he explained, a digital asset like Grams "all by itself is not a security, just as the orange groves in *Howey* were not. . . . But under certain circumstances, the same asset can be offered and sold in a way that causes investors to have a reasonable expectation of profits based on the efforts of others." *Id.* And that same asset "may *no longer* represent a security offering" once "the network on which the token or coin is to function is sufficiently decentralized." *Id.* This approach was recently supported by SEC Commissioner Peirce as well, who noted that 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." (Hester M. Peirce, *Running on Empty: A Proposal to Fill the Gap Between Regulation and Decentralization* (Feb. 6, 2020).)

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

The SEC's FinHUB, a unit dedicated to digital assets, has agreed as well. In its published "Framework for 'Investment Contract' Analysis of Digital Assets," FinHUB purported to provide guidance to developers for determining whether a particular digital asset is an investment contract under *Howey*. (FinHUB, Framework for "Investment Contract" Analysis of Digital Assets, https://www.sec.gov/corpfin/ framework-investment-contract-analysis-digital-assets (last modified Apr. 3, 2019) [hereinafter Framework].) Critically, the Framework splits its investment contract analysis into two different points in time: first, when the digital asset is originally offered; and second, when a "digital asset previously sold as a security *should be reevaluated* at the time of later offers or sales." (*Id.* (emphasis added).) Accordingly, under FinHUB's own proposed analysis, a digital currency that may have been offered through an investment contract in one setting may no longer be considered a security "at the time of later offers or sales." (*Id.*)

This view comports with those of the CFTC's Office of General Counsel, which, at the request of the district court, submitted a letter explaining that digital assets are generally considered commodities and noting that "[i]t is possible that an asset that is a commodity may be a security at one point in time, but not another." (CFTC Letter dated February 18, 2020 ("CFTC Letter"), ECF No. 203, at 1-2.)[5]

Despite this clear and consistent emphasis on the need to analyze digital transactions separately at each time of offer and sale, the district court's order eschewed this approach. By applying *Howey* only to the 2018 Private Placement and expectations of the Private Investors, and then concluding that this analysis was dispositive as to whether there will be a "public distribution of securities" when Grams are sold to public purchasers in the future, the district court committed a fundamental legal error that should not allowed to stand.

C. The District Court Erred in Holding that Defendants' Private Placement Was Not Exempt

The district court's focus on the wrong transactions also resulted in its erroneous holding that Defendants had not established an exemption to registration for the Private Placement under of Sections 5(a) and 5(c) of the Securities Act. (*See* Order at 39.) The district court's conclusion that these private transactions were in fact a "public distribution" lacks any basis because the district court admittedly did not

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[5] *See also* SEC Amicus Brief submitted in *Liberty Property Trust v. Republic Properties Corp.*, 577 F.3d 335, 341 (D.C.Cir. Aug. 21, 2009) (advocating for application of *Howey* analysis to time period following completion of IPO, as that time period focused on "the expectations as to how the business *will* operate"); SEC Amicus Brief submitted in *In re HealthSouth Sec. Litig.*, No. CV-03-BE-1500-S. Dkt. No. 580, at 10-11 (N.D. Ala. Nov. 28, 2006) (arguing that exempt sale of securities in a private placement, followed by a public follow-on exchange transaction, should not be treated as a single transaction, and noting that "there is nothing inherently nefarious about seeking to avoid Commission review" through a two-step process of private and then public offerings).

analyze (let alone conclude) that sales of Grams to public purchasers would involve investment contracts. (*Supra* pp. 20-22.) Without such analysis or finding, the district court lacked any cogent rationale for finding a registration violation at the time of the Private Placement. In other words, if Grams are not deemed "securities" at the time they are created and sold to public purchasers, by definition, there can be no "public distribution" of a statutory security. But the district court admittedly did not perform this analysis (*see* Order at 39 n.13) — a fatal shortcoming.

Of course, any public distribution of securities requires that a "security" be publicly distributed. *See* 15 U.S.C. § 77e(c). Relatedly, the text of the statute itself dictates that for the purchasers to be deemed underwriters, what they distribute must be a "security." *See* 15 U.S.C. § 77b(a)(11) ("The term 'underwriter' means any person who has purchased from an issuer with a view to, or offers or sells for an issuer in connection with, *the distribution of any security* . . . .") (emphasis added). As explained above, (*see supra* p. 14), Grams may never be distributed (which means that under the SEC's distortion of the Securities Act, one can be found liable for a "public distribution" of securities even where no securities were sold or even existed). The district court disregarded this common sense reality and instead held that Telegram's Private Placement is in fact a public distribution of a security irrespective of whether

Grams will be securities when distributed. This conclusion finds no basis in logic or the law.[6]

The district court's analysis also ignored that Defendants met their obligation to take reasonable care, as defined by Rule 502(d), to ensure that the purchasers could not sell any interests in Grams until after the launch, at which time any subsequent sales of Grams would *not* constitute investment contracts. 17 C.F.R. § 230.506; 17 C.F.R. § 230.502; *see also infra* Part II. Again, the district court never determined that Grams will be securities at the only point in time at which the Private Investors would be permitted to sell them. This was reversible error.

II. GRAMS ARE NOT INVESTMENT CONTRACTS WHEN PROPERLY ANALYZED AT THE TIME OF PUBLIC SALE

A proper assessment of whether Grams will be investment contracts at the time they are created and sold to public purchasers makes clear that they will not be securities because (1) public purchasers will not have an expectation of

[6] The illogic of the district court's conclusion is highlighted by the fact that there exist numerous ways in which Private Investors may comply with the federal securities laws without being deemed "underwriters" engaged in a distribution even if Grams are deemed to be "securities" at the time of the launch. For example, Rule 144 under the Securities Act provides that a purchaser who has held a security for more than 12 months may sell the security in the market without being an "underwriter." 17 C.F.R. § 230.144(b)(1)(i); 37 Fed. Reg. 596 (Jan. 14, 1972) (Rule 144 holding period ensures that purchasers "have assumed the economic risks of investment and therefore are not acting as conduits for the sale to the public of unregistered securities"). Thus, even accepting the theory that Grams were sold as securities on the date of the Purchase Agreements, given that more than 12 months has passed since that time, purchasers could freely transfer or sell the Grams at launch.

profits based on Telegram's activities following launch; and (2) public purchasers will not participate in any "common enterprise" involving post-launch Grams.

A. Public Purchasers Will Not Expect Profits Based on Defendants' Essential Managerial Efforts

1. From the Beginning, Grams Were Designed and Promoted for Consumptive Use

"What distinguishes a security transaction . . . is an investment where one parts with his money in the hope of receiving profits from the efforts of others, and not where he purchases a commodity for personal consumption." *Forman*, 421 U.S. at 858; *see also Frederiksen v. Poloway*, 637 F.2d 1147, 1150 (7th Cir. 1981). Similar to Bitcoin (which the SEC has concluded is not a security),[7] Grams were designed from the outset to be a store of value and means of payment for goods and services. (*See supra* p. 10; Def. 56.1 ¶ 55.) Additionally, like Ether (another digital currency that the SEC has recognized is not a security), Grams were designed to have consumptive utility as a means for powering decentralized applications and smart contracts built on the TON Blockchain. (Def. 56.1 ¶¶ 58.) In fact, the record reflects that numerous third parties have already begun to develop such applications and uses for Grams in the TON ecosystem (*see supra*

[7] *See* Letter to Cipher Technologies Management LP, Brent J. Fields, Assoc. Dir., Disclosure Review and Accounting Office, Sec. Exch. Comm'n (Oct. 1, 2019), https://www.sec.gov/Archives/edgar/data/1776589/ 999999999719007180/filename1.pdf.

pp. 16-17), efforts that underscore the consumptive nature of Grams. *See Frederiksen*, 637 F.2d at 1150.

Defendants' marketing of Grams to future public purchasers has been consistent with the digital asset's original design. In its Public Notice, Telegram stressed that "Grams are intended to act as a **medium of exchange** between users in the TON ecosystem"; that potential public purchasers should have "NO expectation of future profit or gain from the purchase, sale or holding of Grams"; and that "Grams won't help you get rich." (Drylewski Ex. 3 at 2.) This is also consistent with Defendants' statements to Private Placement purchasers that Grams were being developed as "a cryptocurrency used for regular value exchange in the daily lives of ordinary people . . . a decentralized counterpart of everyday money – a truly mass market currency." (Def. 56.1 ¶ 164.) As the design and marketing of Grams illustrate, the impetus for their development was to resolve the issues that plagued others' attempts to develop a useful, mass-market cryptocurrency — slow transaction speeds, inability to scale, and poor user interfaces. (*Id.* ¶ 46; *see also* JX7 at 4.) Defendants identified these issues as the problem they were attempting to solve with Grams — namely, to create a digital currency that would actually be used for consumptive purposes, not speculative investor gains.

As another example, Defendants have promoted the TON Foundation as a means by which to sell Grams into the market if the market price of Grams were to get too high and exceeded a theoretical "Reference Price" determined based on the total number of Grams in circulation. (JSF ¶¶ 143-46, 152.) The avowed purpose of this function is to *lower* the market price of Grams, to support their use as an everyday currency and to *negate* the expectation of large investor returns.[8]

The district court disregarded these statements as mere "disclaimers," but in so doing ignored the Supreme Court's directive that offerings must "be judged as being what they were represented to be." *SEC v. C. M. Joiner Leasing Corp.*, 320 U.S. 344, 353 (1943). In *Joiner*, the defendant promoter sold land leases that contained oil drilling rights. The promotional materials touted the profits that purchasers could obtain from such drilling, and the purchase price of the lots reflected that economic reality. The Supreme Court emphasized that if the promotional materials had "omitted the economic inducements of the proposed and promised exploration well it would have been a quite different proposition." *Id.* at 348. Thus, as the Court explained, the analysis as to whether an offering is a security turns on the "character the instrument is given in commerce by the terms of the offer." *Id.* at 352-53.

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[8] While the district court pointed to Defendants' early contemplated plan for the TON Foundation to buy Grams from the market if the market price got too low, it downplayed that Defendants agreed to remove that function after consultation with the SEC. (*See* Order at 10; *see also supra* n. 2.)

Since *Joiner*, courts have placed significant weight on the actual words and promises of the promoter in conducting the *Howey* analysis. *See, e.g.*, *SEC v. Life Partners, Inc.*, 87 F.3d 536, 546 (D.C. Cir. 1996); *see also Demarco v. Lapay*, 2009 WL 3855704, at *9 (D. Utah Nov. 17, 2009) (due to disclaimer in sale agreement, "even if representations were made, it was inappropriate for Plaintiff to rely on them and, without subsequent or collateral agreement, no investment contract can exist."); *Salameh v. Tarsadia Hotels*, 2011 WL 1044129, at *6-7 (S.D. Cal. Mar. 22, 2011), *aff'd*, 726 F.3d 1124 (9th Cir. 2013); *Garcia v. Santa Maria Resort, Inc.*, 528 F. Supp. 2d 1283, 1292-93 (S.D. Fla. 2007).

Even where promotional materials contain a mix of both investment and consumptive inducements, courts have found there to be no investment contract under *Howey*. For example, in *Davis v. Rio Rancho Estates, Inc.*, the plaintiff bought arid land in New Mexico with an expectation of profits based on the ongoing efforts of the promoter to develop and improve the land. 401 F. Supp. 1045, 1050 (S.D.N.Y. 1975). The court held that, although the themes of investment potential and consumptive use were "interwoven" throughout the promotional materials, the transaction at issue was not an investment contract because the materials "place[d] more emphasis on development of a residential community than on purchase as an investment." *Id.* at 1049. The same is true here.[9] Critically, the SEC admitted below that the evidence in the record is "*insufficient*" to demonstrate what a reasonable public purchaser might expect based on Telegram's public statements about its future intentions. (SEC Opposition to Summary Judgment Brief, ECF No. 98, at 9.)[10] As a result, the SEC conceded that it cannot be entitled to a preliminary injunction on this basis.

2. Any Expectation of Profits Will Not Be Based on Telegram's "Absolutely Necessary" Managerial Efforts

Even assuming that some public purchasers may expect to profit from their future acquisition of Grams, such expectations would not reasonably be based on the ongoing efforts of Defendants following launch of the TON Blockchain. This prong of *Howey* is satisfied only where "the efforts made by those other than the investor are the *undeniably significant ones*, those *essential* managerial efforts which affect the failure or success of the enterprise." *SEC v. Glenn W. Turner Enters., Inc.*, 474 F.2d 476, 482 (9th Cir. 1973) (emphasis added). As this Court

[9] Rather than address these issues, the district court created a straw man by stating that Defendants argued that the *Private Investors* "bought Grams with the expectation to use them as a currency." (Order at 24.) In fact, Defendants have admitted that the Private Investors invested money in the Private Placement with profit motive, which is irrelevant to whether *future Gram purchases* in the open market when the TON Blockchain is operational are investment contracts. (Defendants' Brief in Opposition to Summary Judgment, ECF No. 93, at 4; *see also* Hearing Transcript at 47:10-22.)

[10] Despite this admission, and despite the SEC waiving its right to an evidentiary hearing on the issue, the district court improperly found that Telegram intended to "remain committed to the success of the TON Blockchain post-launch," contrary to Telegram's express representations to the contrary. (Order at 3.) This contested issue could not be, and should not have been, decided in the SEC's favor under such circumstances. *See, e.g.*, *Charette v. Town of Oyster Bay,* 159 F.3d 749, 755 (2d Cir. 1998).

has explained, such efforts must be "*absolutely necessary* to the turning of the promised profit." *See Glen-Arden Commodities, Inc. v. Costantino*, 493 F.2d 1027, 1035 (2d Cir. 1974) (emphasis added). Indeed, the managerial efforts must be so necessary that, without them, "the investments would be virtually worthless." *Bender v. Cont'l Towers Ltd. P'ship*, 632 F. Supp. 497, 501 (S.D.N.Y. 1986); *see also Glenn W. Turner*, 474 F.2d at 482 (efforts must be the "*sine qua non*" of expected profits).

Here, at the time of launch when Grams will be created, Telegram's "essential managerial efforts" (i.e., successfully building the TON Blockchain) will have been completed, and from that point forward Telegram has expressly disavowed any ongoing managerial position within the decentralized system. (*See, e.g.*, Def. 56.1 ¶¶ 73, 224.) If there were any doubt on this point, Defendants dispelled it in their Public Notice, in which they stated that "[o]nce [the platform] launches, Telegram won't be obligated to maintain the platform or create any apps for it. *It's possible we never will*." (Drylewski Ex. 3 at 1 (emphasis added).) Defendants further explained that "once the TON Blockchain is launched, Telegram will occupy the same position as any other party with respect to the TON Blockchain, and will not have any control over, any unique rights within, or any responsibility for the management of, the TON Blockchain." (*Id.* at 2).

These statements are not surprising, because the TON Blockchain's code is completely open source and purchasers of Grams would reasonably expect that a decentralized community of third-party developers and others will contribute to the TON ecosystem by adding applications and smart contracts. And, as the record reflects, there already is strong interest from third parties to build their own applications and products using Grams on the TON Blockchain platform. (Def. 56.1 ¶¶ 273-74.) In these circumstances, even the district court appeared to recognize that Grams would not be securities, though it inexplicably never actually addressed post-launch Gram purchases. (*See* Order at 2 ("[A]n 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 . . . is not likely to be deemed a security under the familiar [*Howey*] test.")); *see also Rodriguez v. Banco Central Corp.*, 990 F.2d 7, 11 (1st Cir. 1993) (no investment contract where buyers were given "strong and repeated suggestions that the surrounding area would develop into a thriving residential community" because "the evidence did not show that the promoter or any other obligated person or entity was promising the buyers to build or provide anything").

In any event, even if Telegram were to build additional applications and use cases for Grams on the TON Blockchain following its launch – and it has not made *any* promises or commitments to do so – courts decline to find "investment contracts" when the promoter maintained non-essential involvement that is not the "sine qua non of the scheme" to make profits. *See Glenn W. Turner*, 474 F.2d at 482. As the court in *Davis* held:

> If defendants in fact built roads and other improvements, this is not the type of managerial service contemplated in *Howey* . . . Defendants did not promise to run the development and distribute profits to the plaintiff, as did the operators of the orange groves in *Howey*. There was no management contract between plaintiff and defendants, nor were defendants obligated by the Purchase Agreement to perform any such services.

Davis, 401 F. Supp. at 1050.

The district court recognized that Telegram's post-launch efforts would not be "essential" to the project, stating that if Telegram's team "decamped to the British Virgin Islands, where Telegram is incorporated, and ceased all further efforts to support the TON Blockchain, the TON Blockchain and Grams would exist in some form but would likely lack the mass adoption, vibrancy, and utility that would enable *the Initial Purchasers* to earn their expected huge profits." (Order at 32.) This is recognition that (1) the TON Blockchain can function without Defendants' essential efforts, and (2) any non-essential efforts by Defendants would be to increase the *consumptive* utility of Grams (as opposed to pure investment profit).

Moreover, nowhere in *Howey* or its progeny can one find a requirement that a promoter or developer of a product must "decamp" and never have any involvement in order to avoid the "investment contract" label. That is contrary to this Court's view that *Howey* requires the managerial efforts to be "absolutely necessary to the promised profits." *Glen-Arden*, 493 F.2d at 1035. Indeed, courts have routinely found there to be no investment contract even where the promoter maintained significant involvement in the project. *See, e.g.*, *SEC v. Belmont Reid & Co.*, 794 F.2d 1388, 1391 (9th Cir. 1986) (no investment contract although promoter made commitments to protect investors from inability to deliver gold coins or sharp decline in the world price of gold); *Noa v. Key Futures, Inc.*, 838 F.2d 77, 79 (9th Cir. 1980) (no investment contract where promoter agreed to refine the purchased silver, guaranteed its purity and agreed to repurchase it at any time and store it at the customer's request for up to a year at no cost). Under these decisions, any far more limited ongoing involvement by Telegram post-launch cannot turn a digital asset like Grams into securities.

3. <u>Any Expectation of Profits Based on Speculative Trading is Insufficient.</u>

Finally, the fact that some public purchasers may seek to engage in speculative trading of Grams in order to make profits in the secondary market does not and cannot transform Grams into an investment contract under *Howey*. Courts consistently hold that profits generated by speculative trading are insufficient to create an expectation of profits under *Howey* — and, indeed, could be applied to any commodity or speculative consumer good (like baseball cards or comic books). *See, e.g.*, *Belmont Reid*, 794 F.2d at 1391 (no investment contract where "purchasers in this case had as their primary purpose to profit from the anticipated increase in the world price of gold"); *see also Sinva, Inc. v. Merrill, Lynch, Pierce, Fenner & Smith, Inc.*, 253 F. Supp. 359, 367 (S.D.N.Y. 1966). This is because "[a]n investor who has the ability to control the profitability of his investment," such as having the decision-making authority concerning when and whether to buy or sell to generate profits, "is not dependent upon the managerial skills of others." *Gordon v. Terry*, 684 F.2d 736, 741 (11th Cir. 1982).

Since the parties agree that the value of post-launch Grams will be determined by market forces (JSF ¶ 170), the generation of profits (or losses) will be entirely under the purchaser's control as a function of their decision when to buy and sell Grams. As a result, that purchaser will rely on itself for profits and will not rely upon, or have any expectation of, profits based on the essential managerial efforts of Defendants. (Def. 56.1 ¶¶ 252-55.) This is the antithesis of an investment contract and, in this regard, the predominant role of market forces makes clear that Grams are more akin to commodities. *See Commodity Futures Trading Comm'n v. McDonnell*, 287 F. Supp. 3d 213, 217 (E.D.N.Y. 2018); *In re Coinflip, Inc.*, 2015 WL 5535736, at *2 (CFTC Sept. 17, 2015).[11]

[11] On this score, the Supreme Court has held that the availability of another federal regulatory scheme to protect investors is a factor that weighs against extending the federal securities laws. *See Marine Bank v. Weaver*, 455 U.S. 551, 558-59 (1982); *Int'l Bhd. Of Teamsters, Chauffeurs,*
(cont'd)

B. There Will Not Be A "Common Enterprise" in Grams Following Launch

Similarly, with the proper focus under *Howey* on the post-launch purchase of Grams by public purchasers, it is clear that there will be no common enterprise in Grams. As this Court has held, a common enterprise can be established by showing "horizontal commonality," which is when "each individual investor's fortunes [are tied] to the fortunes of the other investors by the pooling of assets, [which is] usually combined with the pro-rata distribution of profits." *Revak v. SEC Realty Corp.*, 18 F.3d 81, 87-88 (2d Cir. 1994). Although this Court has not resolved the question, other courts have indicated that a common enterprise may also be established by showing "strict vertical commonality," which is when the "fortunes of investors [are] tied to the *fortunes* of the promoter." *Id.*[12] Neither test is met here with respect to post-launch Grams.

1. No Horizontal Commonality

First, while the district court found horizontal commonality among the *Private Investors* based on the terms of the Private Placement, that conclusion is

Warehousemen & Helpers of Am. v. Daniel, 439 U.S. 551, 569-70 (1979); *see also Walsh v. Int'l Precious Metals Corp.*, 510 F. Supp. 867, 872-873 (D. Utah 1981) (declining to "stretch the protection of the securities laws" where CFTC had "filled the protective regulatory gap"). *See supra* pp. 5, 35-36 (describing CFTC enforcement authority over commodities)).

[12] This Court has rejected a third test for commonality, called "broad vertical commonality," which requires only that the fortunes of the investors be linked to the managerial efforts of the promoter. *Id*. at 87-88.

irrelevant to whether there will be a common enterprise among future public purchasers. The pooling of the *Private Investors'* funds cannot create horizontal commonality with respect to the *public purchasers* following launch; indeed, that very pooling only highlights that public purchasers, whose purchase proceeds will go to disparate individual Gram holders, are differently situated.

While the district court also concluded that "the plain economic reality is that, post-launch, the Grams themselves continue to represent the Initial Purchasers' pooled funds" (Order at 21), this cannot be squared with the factual record. It is undisputed that Grams do not represent any equity or other ownership interest in Telegram, any rights to dividends or other distributions from Telegram, or any governance rights in Telegram. (*Id.* ¶ 180; Drylewski Ex. 3.) Telegram used the Private Investors' pooled funds to build the TON Blockchain and expressly reserved the right to use the remaining funds however it saw fit, without any legal, contractual or other commitment to spend them in connection with the TON platform. (Order at 9.)

By contrast, as noted above, the money paid by public purchasers to acquire Grams on the open market following launch will not be pooled by anyone — they will go to whomever is selling the Grams in the market and may be used by the seller for any purpose. Without pooling, this Court has held there can be no horizontal commonality. *See Revak*, 18 F.3d at 88.

Moreover, the purchase of Grams by public purchasers is an *individual* enterprise, in which purchasers can decide how long they wish to hold the Grams, whether to use the Grams to pay for smart contracts or other goods and services, to accept them as payment, to stake them and earn more Grams by acting as validators on the system, or when to exchange Grams for fiat currency or other digital currency. (Def 56.1 ¶ 254.) Any profits from Grams would not be shared but would be specific to that purchaser based on the timing and nature of his or her decisions. (*Id.* ¶ 255.); *see McCurnin v. Kohlmeyer & Co.*, 340 F. Supp. 1338, 1341 (E.D. La. 1972) (no "common enterprise" where "[t]he expectation of profit arises solely from the speculative hope that the market price of the underlying commodity will vary in [the investor's] favor, permitting purchase or sale at a profit"); *Noa*, 638 F.2d at 80; *Berman v. Dean Witter & Co.*, 353 F. Supp. 669, 671 (C.D. Cal. 1973).

2. No Vertical Commonality

In concluding that there was strict vertical commonality, the district court again improperly focused on the relationship between Private Investors and Telegram in the context of the Private Placement. But none of the factors identified by the district court establishes strict vertical commonality between Defendants and future public purchasers.

First, the district court's conclusion that Telegram may hold the TON Reserve (Order at 23), is not supported by the record and, in any event, cannot create strict vertical commonality with public purchasers of Grams. The TON Reserve will be held by an independent, non-profit organization called the TON Foundation (to the extent it is established; if it is not, the Grams in the TON Reserve will be permanently locked and not accessible by Telegram or anyone else). (*Supra* pp. 17-18; *see also* Hearing Transcript at 67:16-68:4.) Even more fundamentally, the mere holding of a similar asset by the promoter and investors is not enough to satisfy strict vertical commonality.

For example, in *Marini*, the investor's and promoter's ownership of the same coins did not "establish[] the existence of strict vertical commonality." *Marini v. Adamo*, 812 F. Supp. 2d 243, 257-58 (E.D.N.Y. 2011). Instead, the promoter could sell its coins independently and generate profits, irrespective of whether the investor sold its own coins and received any profits. Conversely, the promoter could sell its coins at a loss that would not be suffered by the investor if she does not also sell at that time. The same reasoning applies to post-launch Grams here — a point that the district court ignored entirely.

The district court's finding that Defendants would suffer "reputational damage" if the TON Blockchain were to fail after launch also cannot support a finding of strict vertical commonality. The district court did not cite any cases to support this proposition. That is unsurprising: reputational damage falls far short of the requisite interdependence of promoter and investor fortunes. *See, e.g.*, *Copeland v. Hill*, 680 F. Supp. 466, 468 (D. Mass 1988) (no vertical commonality based on fact that promoter "guaranteed the coins' authenticity . . . [and] stood to lose money if they selected coins that were not authentic"). If a concern over reputational damage were sufficient to create strict vertical commonality, this would potentially sweep within the definition of common enterprise virtually any traditional commercial activity performed by a reputable product manufacturer. Accordingly, had the district court correctly focused on future public purchasers rather than the Private Investors, it could not have concluded that the SEC established vertical commonality.

CONCLUSION

For the foregoing reasons, the Court should vacate the district court's Order granting the SEC's motion for a preliminary injunction.

Dated: New York, New York
March 27, 2020

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CERTIFICATE OF COMPLIANCE

Pursuant to Fed. R. App. P. 32(g), the undersigned counsel hereby certifies that this brief complies with the type-volume limitations set forth in Fed. R. App. P. 32(a)(7)(B).

1. Exclusive of the exempted portions of the brief, as provided in Fed. R. App. P. 32(f), the brief contains 12,694 words, including headings, footnotes, and citations.

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CERTIFICATE OF SERVICE

I hereby certify that on March 27, 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 appellate CM/ECF system.

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