Securities Regulation Daily Wrap Up, ENFORCEMENT—S.D.N.Y.: SEC charges Terraform with selling unregistered crypto asset securities, (Feb 17, 2023)

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When the Terraform stablecoin crashed, investors lost billions.

The SEC has charged Terraform Labs with orchestrating a crypto asset securities fraud that shocked the crypto market when it collapsed. According to the complaint, Terraform and its co-founder Do Hyeong Kwon sold an array of interconnected crypto asset securities in unregistered transactions, raising billions of dollars in the process. In May 2022, Terraform's LUNA token and Terra USD stablecoin crashed in price, dragging the market down and wiping out over $40 billion of total market value. The complaint charges with fraud and selling unregistered securities and seeks remedies that include a bar from participating in crypto offerings (*SEC v. Terraform Labs PTE Ltd.*, February 16, 2023).

Terraform. Terraform Labs PTE Ltd. is headquartered in Singapore but has numerous employees in the U.S. and operates a website that offered and sold securities to U.S. investors. Do Hyeong Kwon co-founded Terraform in 2018 and is its sole director and CEO. Kwon was Terraform's ultimate decision-maker and owned 92% of its shares. A Korean court has issued a warrant for Kwon's arrest, and his current whereabouts are unknown.

Terraform offered and sold an interconnected suite of crypto assets, including its LUNA token and Terra USD ("UST") stablecoin. According to the defendants, UST's value was pegged to the U.S. dollar by an algorithm tying it to LUNA. The Terraform blockchain was launched in 2019, and one billion LUNA tokens were created. UST was first "minted" in 2019 and reached a circulation of approximately 19 billion by May 2022.

Sale as securities. Terraform offered and sold five groups of crypto asset securities (including LUNA and UST) and solicited investors by touting their profit potential. The defendants also touted their efforts to ensure that UST maintained its $1 peg. UST was marketed as a "yield-bearing" stablecoin that would pay up to 20 percent interest through Terraform's so-called "Anchor Protocol." Throughout, Terraform's securities were aggressively marketed in the U.S. via, among other avenues, social media, media interviews, and meetings with investors.

The complaint alleges that from 2018 until May 2022, Terraform engaged in capital fundraising through the unregistered offer and sale of its crypto asset securities. Throughout, the defendants acted to deceive investors. For example, UST was briefly de-pegged from the dollar in May 2021. The defendants said that the peg was restored due to the success of the UST algorithm when, in fact, the defendants had a third party buy large amounts of UST to restore its value. The defendants also falsely told investors that a Korean company was using the Terraform blockchain to process retail transactions.

Collapse. In May 2022, UST again de-pegged from the dollar, and the price did not recover. UST's price fell to nearly zero, and so did the prices of Terraform's other crypto asserts. By the end of the month, the assets were nearly worthless and had lost over $40 billion in combined market value. Institutional investors lost billions and many retail investors lost their lives' savings. Despite these losses, the complaint says that Terraform and Kwon retain valuable proceeds and continue to make transfers from a Bitcoin wallet to a Swiss bank.

Charges. The complaint was filed in the Southern District of New York and contains six claims for relief, charging the defendants with fraud under the securities laws. The defendants are also charged with violating the registration provisions of the Securities Act and offering and selling security-based swaps to non-eligible contract participants. The Commission seeks permanent injunctions, disgorgement, civil penalties, and injunctions barring the defendants from participating in soliciting, offering, or selling crypto securities.

SEC Chair Gary Gensler praised the staff's investigation, noting that the defendants attempted to prevent the agency from obtaining important information. "This case demonstrates the lengths to which some crypto firms will go to avoid complying with the securities laws, but it also demonstrates the strength and commitment of the SEC's dedicated public servants," Gensler said.

Gurbir S. Grewal, Director of the SEC’s Division of Enforcement, said: "Today's action not only holds the defendants accountable for their roles in Terra's collapse, which devastated both retail and institutional investors and sent shock waves through the crypto markets, but once again highlights that we look to the economic realities of an offering, not the labels put on it." Grewal added that "the Terraform ecosystem was neither decentralized, nor finance. It was simply a fraud propped up by a so-called algorithmic "stablecoin"–the price of which was controlled by the defendants, not any code."

Cert. petition. In May 2021, the SEC initiated an investigation against Terraform. Failing attempts at voluntary compliance, the SEC had a process server hand-deliver a subpoena to Kwon, who was in New York City for a blockchain conference, in September 2021. Kwon argued that the SEC violated its Rules of Practice by doing so. Both the district court and Second Circuit concluded that the method of service was in accord with the Rules of Practice, and the defendants had sufficient contacts with the U.S. for the courts to have personal jurisdiction over them. Terraform filed a petition for certiorari with the Supreme Court in October 2022, asking whether serving a corporate official transiently in the U.S. ("corporate 'tag' jurisdiction") was proper.

The case is No. 1:23cv-01346.

Attorneys: James Patrick Connor for SEC.

Companies: Terraform Labs PTE Ltd.

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