Securities Regulation Daily Wrap Up, ENFORCEMENT—S.D.N.Y.: Judge rejects Ripple approach, Terraform will face fraud charges, (Aug 1, 2023)

By Rodney F. Tonkovic, J.D.

Ripple made waves, but will its legacy be short-lived?

Less than one month after the decision in *SEC v. Ripple Labs* created a storm of commentary, another SDNY judge has stirred the pot further by rejecting *Ripple's* approach. In finding that Terraform's crypto assets are securities, Judge Rakoff declined to draw a distinction between the various coins based on their manner of sale. In doing so, he explicitly rejected the approach used by the judge in *Ripple*, reasoning that *Howey* sensibly makes no distinction between purchasers. The court denied Terraform's motion to dismiss in its entirety (*SEC v. Terraform Labs Pte. Ltd.*, July 31, 2023, Rakoff, J.).

In February 2023, the SEC charged Terraform with orchestrating a multi-billion-dollar crypto asset securities fraud. 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 UST stablecoin crashed in price, dragging the market down and wiping out over $40 billion of total market value. The Commission charged Terraform with fraud and selling unregistered securities and seeks remedies that include a bar from participating in crypto offerings.

Ripple ruling. On July 14, 2023, a district judge sitting in Manhattan issued an opinion in *SEC v. Ripple Labs*. The judge applied the *Howey* test and concluded that "programmatic" sales of tokens to retail investors were not "investment contracts" and thus securities under the federal securities laws, but sales made to institutional investors were.

In a July 18 memorandum to the court in this case, Terraform asserted that *Ripple* would be "fatal" for the SEC. According to Terraform, the same reasoning applies to the tokens at issue, and that there are key differences that distinguish its institutional sales from those found to be securities in *Ripple*. For its part, the SEC disagreed, arguing that much of *Ripple* supported its claims as to the institutional sales, while the holding on retail sales conflicted with *Howey* by creating an artificial distinction between the two types of investors.

Ripple rejected. The court found that the SEC adequately pleaded that each of Terraform's products are either "investment contracts" or confer a right to purchase another security. Applying *Howey*, the court first determined that the purchasers were investing in a common enterprise. For example, the UST tokens were "pooled" in the so-called Anchor Protocol and were expected to generate profits through Terraform's managerial efforts; this established a horizontal commonality between the defendants and UST investors. A similar horizontal commonality existed for Terraform's other tokens because proceeds from their sales were used to improve the Terraform blockchain in a way that would increase the value of the purchasers' tokens.

Under *Howey*, investors must also have a reasonable expectation of profits, and the court found that the SEC showed that in this case. Terraform repeatedly touted the profitability of the Anchor Protocol and encouraged investors to unload their UST tokens into that vehicle. Purchasers of other products were similarly urged to buy coins such as the LUNA token because the profits would be fed back into the Terraform ecosystem and would, in turn, increase the value of the coins.

At this point, Judge Rakoff noted that he declined to distinguish between any of the coins based on their manner of sale. Rejecting *Ripple's* reasoning, Judge Rakoff said that *Howey* makes no distinction between purchasers, and, in this case, Terraform's promise of profits would have reached, and motivated, secondary-market purchasers as much as institutional investors. "Simply put," the judge said, "secondary-market purchasers had every bit as good a reason

to believe that the defendants would take their capital contributions and use it to generate profits on their behalf."

Registration and fraud. Having found that the tokens were securities, the court went on to find that the SEC adequately pleaded that their offer and sale amounted to distributions of unregistered securities. The SEC further showed that Terraform offered, sold, and effected security-based swaps—in its mAssets—to non-eligible participants.

Finally, the SEC's fraud counts survived the motion to dismiss. The court said that, for the purposes of a motion to dismiss, the SEC adequately pleaded that Terraform misrepresented the crypto assets' utility on the "Chai" platform by fabricating transactions to make it look like Chai users were using Terraform's products. The Commission also pleaded a misstatement or omission with respect to the May 2021 "de-pegging" incident wherein Terraform allegedly hid the fact that a third-party had stabilized the token's value. The agency also demonstrated that Terraform had a motive to mislead, as the truth would decrease the tokens' value.

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

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