Securities Regulation Daily Wrap Up, BLOCKCHAIN—S.D.N.Y.: SEC gets important crypto win in SDNY Terraform ruling, (Jan 2, 2024)

By Lene Powell, J.D.



The court's ruling adds to the body of precedent that certain types of crypto assets are securities, providing clarity for market participants and clearing the way for trial on fraud and other issues.

Crypto firm Terraform Labs and its founder Do Kwon sold unregistered securities, a federal district court ruled. Judge Rakoff of the Southern District of New York held as a matter of law that there was no genuine dispute that crypto tokens issued by Terraform were securities and investment contracts under the *Howey* test. Significantly, the court found that a stablecoin was a security in combination with another protocol and that "staking" provided the basis for finding a token was a security (*SEC v. Terraform Labs Pte. Ltd.*, December 28, 2023, Rakoff, J.).

The court also denied summary judgment on the issue of fraud, allowing the case to proceed to trial on that issue. In addition, the court granted the defendants' motion for summary judgment on the issue of unregistered securities-based swaps and denied motions by both sides to exclude expert testimony.

***Howey* still good law.** The court first held that the *Howey* test for securities still holds.

" *Howey's* definition of 'investment contract' was and remains a binding statement of the law, not dicta," wrote the court. "And even if, in some conceivable reality, the Supreme Court intended the definition to be dicta, that is of no moment because the Second Circuit has likewise adopted the *Howey* test as the law."

Terraform crypto tokens were securities. Next, the court found that all the Terraform crypto tokens at issue were securities. The UST, LUNA, wLUNA, and MIR tokens satisfied the *Howey* test: an (i) investment of money (ii) in a common enterprise (iii) with profits to be derived solely from the efforts of others.

UST stablecoin. The SEC did not dispute that the UST stablecoin on its own was not a security, because purchasers understood that its value would remain stable at $1.00 rather than generate a profit. However, the court agreed with the SEC that UST *was* a security in combination with the "Anchor Protocol," which pooled USTs deposited by customers and paid out interest pro-rata according to amount deposited.

LUNA and wLUNA. The court also found that "staking" practices for LUNA and wLUNA, which involved pooling and promises of profit, established that the defendants and investors were joined in a common, profit-seeking enterprise.

Here, the court pointed to statements by Terraform executives about LUNA staking:

- "Investing in Terra means . . . buying LUNA, which is the 'equity' in our co."
- "Owning LUNA is equivalent to owning a stake in the transaction fees of a network like Visa" because "[a]ll the transaction fees from Terra stablecoins are distributed to LUNA stakers in the form of staking rewards."
- "Owning LUNA is essentially owning a stake in the network and a bet that value will continue to accrue over time."
- "$Luna value is actionable—it grows as the [Terraform] ecosystem grows."

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- A holder of LUNA could simply "[s]it back and watch [him] kick ass."

MIR, Finally, the court found that the MIR token was a security for similar reasons.

Terraform described MIR as a "governance token that earns fees from asset trades" on the Mirror Protocol that Terraform launched. Proceeds from sales of the MIR tokens were pooled together to "improve the Mirror Protocol," and profits derived from the use of the Mirror Protocol were fed back to investors based on the size of their investment.

Although Terraform labeled the protocol as "decentralized," it explained that "the team behind Terra contributed most of the core development work behind the Mirror." The defendants also promoted MIR and encouraged the expectation of profit.

"MIR passes the *Howey* test with flying colors," wrote the court.

Sales of unregistered securities. Next, the court found there was no genuine dispute that the defendants engaged in the sale of unregistered securities in violation of Sections 5(a) and 5(c) of the Securities Act.

- Terraform sold LUNA tokens directly to institutional investors through sales agreements that expressly contemplated Terraform's development of a secondary market.
- The terms of those agreements provided a built-in incentive for secondary resale because Terraform sold LUNA to initial investors at discounts of up to, and sometimes more than, 40%.
- Terraform's offers and sales of MIR were similar.
- Terraform also sold both LUNA and MIR tokens to secondary market purchasers on Binance and other crypto trading exchanges.
- There was no evidence that Terraform took steps to determine whether those trading platforms were available to U.S. investors.
- Terraform did not show that the tokens were exempt from registration.

Summary judgment for SEC. The court granted summary judgment to the SEC on the issue of the sale of unregistered securities.

Other issues. Finally, the court:

- Granted the defendants' motion for summary judgment on the issue of transactions in security-based swaps with noneligible contract participants, in violation of Section 6(l) of the Exchange Act. Here, the court applied both the Exchange Act and the Commodity Exchange Act to find that the mAssets token was not a security-based swap.
- Denied the SEC's motion for summary judgment on the issue of fraud, finding a genuine dispute of material fact.
- Denied both sides' motions to exclude experts.

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This is case No. 23-cv-1346 (JSR).

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Companies: Terraform Labs Pte Ltd.

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