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# Anchor down: SEC looks to stablecoin's connected 'ecosystem' to assert jurisdiction

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As the Securities and Exchange Commission ("SEC") continues to assert jurisdiction over digital assets primarily through enforcement actions, it has placed an unlikely target in its sights — stablecoins. On Feb. 16, 2023, the SEC filed a litigated enforcement action against Terraform Labs and its CEO, Do Kwon, for allegedly devising a multibillion-dollar crypto asset securities fraud that resulted in substantial losses for U.S. retail and institutional investors.

The SEC alleges that, from April 2018 until May 2022, Terraform raised billions of dollars from investors by offering and selling a host of crypto assets that qualify as unregistered "securities," including the algorithmic stablecoin known as TerraUSD ("UST") and the so-called Anchor Protocol.

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The SEC looked at the interplay among crypto assets that comprised the Terraform "ecosystem" rather than individual assets in isolation, and alleged that the value of the ecosystem was dependent on the willingness of investors and the public to buy into the system and the ability of Terraform and Kwon to grow the enterprise.

UST was described as a "stable" form of cryptocurrency because its value was supposedly pegged at a one-to-one ratio with the U.S. dollar. In May 2022, the price of UST plummeted to nearly zero, resulting in the loss of billions of dollars for holders.

The SEC's complaint alleges that Terraform and Kwon publicly marketed UST as a "yield bearing" stablecoin that would provide investors with a 19-20% rate of return on their deposited UST per a blockchain protocol called Anchor. Complaint, *SEC v. Terraform Labs Pte Ltd.*, No. 1:23-cv-01346 (S.D.N.Y. filed Feb. 16, 2023)

In its complaint, the SEC claims that UST is a security within its jurisdiction by alleging that it was an "investment contract" under the Supreme Court's test in *SEC v. W.J. Howey Co.*, 328 U.S. 293 (1946). Specifically, the SEC alleges that the offer and sale of UST involved (i) an investment of money (ii) in a common enterprise (iii) with purchasers possessing reasonable expectation of profits based on the managerial efforts of the defendants.

- **Investment of money**. The SEC argues that users exchanged fiat currency or crypto assets in exchange for UST and deposited their UST in the Anchor Protocol to earn up to 20% in annual returns.
- **Common enterprise**. According to the SEC's complaint, the Anchor Protocol pooled investor funds and lent them out to borrowers to generate returns. The complaint further alleges that all the investors profited equally in proportion to their investment, and the fortune of each investor was tied to the fortunes of the others, as well as to Terraform and Kwon, who both deposited UST in the millions into the Anchor Protocol.
- **Reasonable expectation of profits**. The SEC alleges that defendants fostered this expectation through their efforts to create, develop and maintain the Anchor Protocol, and to fund and manage the "yield reserve" used to pay investors interest on their UST.

The SEC alleged that, in addition to being an investment contract, UST fell within the definition of a security, which includes a "right to subscribe or purchase" another security because it gave investors the ability to subscribe or purchase the LUNA token by converting one UST to one dollar's worth of LUNA over the Terraform blockchain. Securities Act Section 2(a)(1); Exchange Act Section 3(a)(10).

In April 2019, Terraform and Kwon launched the blockchain and created one billion LUNA tokens to offer and sell to investors. The SEC concluded that LUNA was a "security" under *Howey* because purchasers of LUNA invested in the token in the hopes that it would increase in value and that the Terraform ecosystem as a whole would grow through the efforts of Terraform and Kwon.

While it remains to be seen whether the SEC's allegations regarding UST will prevail, one question arising from all this is whether the SEC's analysis surrounding UST may be applicable to other stablecoins in the cryptocurrency industry. The SEC's analysis here offers some guidance on how the agency may approach stablecoins more broadly.

It is important to note that not all stablecoins are created equally. While all stablecoins seek to maintain a peg to some external target value, the strategies for doing so can vary significantly. For example, so-called "algorithmic stablecoins" — which include UST — seek to maintain their peg through an algorithm that ties the value of a stablecoin to another type of cryptocurrency by mimicking supply and demand.

In the case of UST, its stability relied upon the value of LUNA. UST would be created or destroyed in parallel with LUNA. UST holders could exchange one UST for one dollar's worth of LUNA based on LUNA's then-current market price, thereby destroying one UST and creating the requisite amount of LUNA. The same would happen in the reverse.

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On the other hand, some stablecoins seek to maintain their pegs in other ways — for example, by maintaining cash reserves that can be redeemed by the stablecoin holders. Other stablecoins may be backed by commodities such as gold, real estate or metals.

Here, the existence and promotion of the Anchor Protocol appears to have been crucial to the SEC's *Howey* analysis of UST. For example, the SEC's complaint emphasizes that Terraform and Kwon used the yield-bearing Anchor Protocol to generate profits — up to 20% in annual returns — for UST purchasers. These allegations bear similarities to those the SEC has asserted with respect to other yield-bearing products. For example, also last month, the SEC settled charges against another market participant regarding its crypto-staking service, which allegedly promised users annual returns of up to 21%. Complaint, *SEC v. Payward Ventures, Inc.*, No. 23-cv-588 (N.D. Cal. filed Feb. 9, 2023).

These enforcement actions provide some guidance that, where a digital asset issuer makes promises that the asset can be used to passively earn profits in the form of more digital assets or yield, the entire offer may fall within the investment contract definition under *Howey*.

The SEC's recent enforcement activity, including its action in *Terraform*, underscores the agency's focus on a digital asset's ecosystem rather than just the four corners of the digital asset by itself. Indeed, without the Anchor Protocol, it is unclear whether the SEC would have determined that the offer and sale of UST, by itself, constituted a security under *Howey*.

Under circumstances where a stablecoin is offered and sold without any promise of the ability to earn "yield" through a corresponding product or service, and where the issuer does not deploy the assets deposited by users to create a profit for the purchasers, it may be more difficult to establish the reasonable expectation of profits prong of *Howey*.

For that reason, the SEC's theory in *Terraform* appears to be limited to the types of stablecoins that offer the prospect of yield or profits. That is not to say this is the SEC's only theory with respect to stablecoins. Moreover, *Howey* is a notoriously fact- and circumstance-specific inquiry, and there may be a number of ways in which the SEC (or a private plaintiff) could attempt to argue that a stablecoin is offered and sold in a scheme comprising an investment contract, note, or other instrument that may qualify as a security. Thought and care must be given, and experienced counsel should be consulted, to mitigate the risks that a given stablecoin — however it is devised and offered — does not run afoul of federal securities laws.

## About the authors

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