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SEC Wins Summary Judgment on *Howey* Issue in Terraform Litigation

On December 28, 2023, Judge Jed Rakoff in the Southern District of New York issued a summary judgment decision in *SEC v. Terraform Labs Pte. Ltd.*, a closely-watched case in the digital asset space.[1] The court agreed with the Securities and Exchange Commission that Terraform's offering of certain digital assets constituted investment contracts under *Howey* and thus were securities. However, the court granted summary judgment to defendants on the SEC's claim that defendants offered security-based swaps and denied summary judgment on the remaining securities fraud claims, finding that their were triable issues of fact that will proceed to trial on March 25, 2024.[2]

Like other decisions in this area, this ruling makes clear that applying the test in *SEC v. W.J. Howey Co.* in the digital asset area requires a fact-specific analysis of *how* the assets were offered or sold, including assessment of the "full set of contracts, expectations, and understandings" relating to those digital assets.

Background

Terraform Labs Pte. Ltd. was a Singapore-based company, founded in 2018 by Do Kwon (Kwon), that developed, marketed, and sold cryptoassets. At issue were four of these assets: "UST," "LUNA," "wLUNA," and "MIR," all created by Terraform and sold directly to institutional investors and through trading platforms to U.S. retail investors.

UST was developed as a stablecoin whose value was algorithmically pegged to the U.S. dollar. Together with UST, Terraform launched "the Anchor Protocol," which allowed UST holders to deposit their tokens into a shared pool and earn interest, paid out in proportion to the amount deposited.

LUNA and its companion token wLUNA were created when Terraform launched its blockchain. Terraform entered into agreements to sell LUNA to institutional investors under which "Terraform would undertake efforts to generate a secondary trading market for the LUNA tokens," including by providing incentives for purchasers to resell the tokens.

MIR was a token that earned fees from asset trades on "the Mirror Protocol," a blockchain technology also created by Terraform. The Mirror Protocol let users trade crypto tokens that reflected the price of preexisting non-crypto assets, such as stocks, by

[1] *SEC v. Terraform Labs Pte. Ltd.*, 2023 WL 8944860 (S.D.N.Y. Dec. 28, 2023) (*Terraform II*).

[2] *Id.* at *25. The court also ruled on the admissibility of the parties' experts at trial, admitting one but rejecting two of defendants' offered experts and admitting both of the SEC's. *Id.* at *5-12.

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depositing collateral worth 150% or more of the value of the underlying security. Like LUNA, Terraform entered into agreements to sell MIR tokens to institutional investors. And, like LUNA, Terraform also loaned MIR tokens to a third party to trade these tokens on a secondary trading platform.

Terraform, Kwon and other officers allegedly touted these assets as investment vehicles through tweets, public statements and widely distributed promotional materials. For example, they stated that "[o]wning LUNA is essentially owning a stake in the network and a bet that value will continue over time," that "Anchor will target 20% fixed [annual percentage return]," and that MIR was "a farmable governance token that earns fees from asset trades" that MIR holders would receive.[3]

Kwon also made statements that Chai, a Korean mobile payment application, used Terraform's blockchain to process transactions.

On May 19, 2021, UST's price fell below $1 because of a market panic. In response, Terraform allegedly engaged a third party, Jump, to buy a large number of UST coins to stabilize the price and artificially restore its $1 peg. But after UST's price stabilized, Terraform stated that the rebound resulted from "algorithmic, calibrated adjustments of economic parameters" rather than "stress-induced decision-making of human agents."

Crisis again hit Terraform later that month. The price of UST and LUNA lost nearly all of their value — $45 billion, according to the SEC — and have not recovered.

The SEC brought an enforcement action against Terraform and Kwon in February 2023, alleging that defendants' sales and distributions constituted unregistered sales of securities in violation of Section 5 of the Securities Act of 1933. An amended complaint added fraud claims under Section 10b-5, alleging schemes and material misstatements relating to both Terraform's alleged intervention after UST's initial price drop and Chai's use of the Terraform blockchain.

Howey Analysis

In assessing whether the digital assets in question were offered as investment contracts, the court first rejected Terraform's invitation to consider the *Howey* test mere "dicta." The court then held that each of the four digital assets at issue met the *Howey* test, relying heavily on the initial sale agreements to institutional investors and defendants' own statements about the assets.

According to the court, Terraform's offering of UST was an investment contract because holders could pool their tokens in the Anchor Protocol — developed and managed by Terraform — which Kwon announced would generate "by far the highest stablecoin yield in the market" and which Terraform's promotional materials stated would generate returns "paid out in proportion" to the initial deposit. The court reached its conclusion even though not all holders of UST used the Anchor Protocol.

Terraform's offering of LUNA was an investment contract because Terraform "pooled" proceeds of LUNA purchasers together, promised that further investment of the proceeds would benefit all LUNA holders, and that defendants' own statements would lead a reasonable investor to expect a profit based on its efforts to keep developing the Terraform blockchain.[4]

Terraform's offering of MIR was an investment contract for reasons similar to LUNA, including that the "proceeds from the sales of the MIR tokens were 'pooled together' to improve the Mirror Protocol" and profits were fed back to investors based on the size of their investment.

In reaching its conclusion, the court stated that the evidence "clearly demonstrates" that "UST in combination with Anchor Protocol constitute[s] an investment contract," that Terraform's arguments on LUNA were "even further off the mark," and that it was "beyond dispute that MIR was a security" and that it "passes the *Howey* test with flying colors."

Defendants unsuccessfully tried to rely on two exemptions from registration. First, they argued that the assets were sold to sophisticated investors and thus were not a public offering. Under this exemption, defendants needed to show that the tokens "come to rest" with sophisticated investors. In other words, that there was no further distribution. But the court, relying on the distribution agreements and defendants' own statements, found that "neither Terraform nor its institutional investors had any intent to simply hold onto [the tokens] without further trades."

Second, defendants argued that the assets were not sold or offered within the United States, which would make them exempt under Regulation S. The court found that the defendants provided "no evidence" to support that contention.

Takeaways

The court's decision offers key insights, both legal and practical.

First, the Court's application of *Howey* focused on *how* the crypto assets were offered — not whether any of the crypto assets, in and of themselves, are securities. The *Terraform* decision relied heavily on the court's earlier decision on defendants' motion to dismiss (*Terraform I*), which more fully addressed (and rejected) many of defendants' arguments that *Howey* was

[3] *Id.*

[4] *Id.* at *14. The court held that Terraform's offering of wLUNA was an investment contract because it was "just a variation" on LUNA and "could be exchanged for LUNA tokens." *Id.* at 14 n. 10.

not met. *Terraform I* laid out a detailed *Howey* framework, under which it is the "promise to share in the profits generated by [the promotor's efforts] that transformed the transaction from a mere sale of property into ... an investment contract."[5]

In *Terraform I*, the court emphasized that *Howey* turns on "the means by which [the assets] were offered or sold,"[6] and "decline[d] to erect an artificial barrier between the tokens and the investment protocols with which they are closely related."[7] While some language in the latest decision, taken out of context, could be used to support an argument that the tokens themselves are securities, this conclusion may not be accurate when *Terraform I* and *Terraform II* are read together.

Second, companies in the crypto asset space should pay close attention to the agreements they enter into regarding secondary distributions, as well as the statements they, and their officers, make to the public. The agreements allegedly entered into by Terraform, which encouraged secondary trading and did not mention restrictions on U.S. sales, made it difficult for the defendants to argue that they relied on exemptions to registration under U.S. securities laws. The public statements made by Terraform and its officers were also critical to the court's *Howey* analysis regarding both the common enterprise and the expectation of profits prongs.

The UK Digital Securities Sandbox: Relaxing the Regulatory Environment for UK Fintechs

The U.K.'s new Financial Services and Markets Act 2023 (Digital Securities Sandbox) Regulations 2023 (Regulation) took effect on 8 January 2024, creating the framework for the Digital Securities Sandbox (DSS). It is the first of the U.K.'s financial market infrastructure (FMI) sandboxes created pursuant to powers given to HM Treasury under the Financial Services and Markets Act 2023.

What is the Digital Securities Sandbox?

The DSS is a relaxation of regulations intended to provide greater flexibility for firms to develop and test the use of new technologies in financial markets, reducing regulatory barriers that might otherwise inhibit technological transformation in financial services firms.

What is the scope of the DSS?

The activities covered by the DSS are:

a. operating a trading venue (specifically, a multilateral trading facility, an organized trading facility or a recognized investment exchange); and

b. notary, settlement and maintenance services (*i.e.*, activities of a central securities depositary) in connection with an "FMI sandbox instrument."

"FMI sandbox instruments" includes transferrable securities, money-market instruments, units in collective investment undertakings and emission allowances, but excludes derivatives.

Who can participate in the DSS?

Direct participants ("Sandbox Entrants") must have a legal entity established in the U.K. and comprise one of the following:

a. a recognized investment exchange that is not an overseas investment exchange;

b. a recognized central securities depositary;

c. an authorized multilateral trading facility;

d. an authorized organized trading facility; or

e. any other person determined by the appropriate regulator.

The Regulation contemplates other DSS participants, including users of Sandbox Entrants' services], as well as those providing services to Sandbox Entrants. As a result, the modified legislative framework within the DSS (summarized below) will also apply to those participants in connection with the activities of the relevant Sandbox Entrant.

Who's in charge?

While the DSS has been established under powers given to HM Treasury, the Financial Conduct Authority (in relation to trading venues) and the Bank of England (in relation to notary, settlement and maintenance services) are tasked with operating the scheme.

Their role includes approving applications to participate in the DSS and supervising participants, as well as the making of rules and procedures in connection with DSS arrangements, together with the modification of any technical standards necessary for the implementation and operation of the DSS.

How does this impact existing legislation?

The Regulation sets out a number of modifications to, and disapplies provisions of, existing legislation for DSS participants in connection with DSS activities, and with respect to regulators for the purposes of operating the scheme. Affected legislation

[5] *Terraform* I, at *11.

[6] *Id.*

[7] *Id.* at *12.

includes the U.K. central securities depositories regulation (Regulation (EU) No 909/2014), the Financial Services and Markets Act 2000, the Companies Act 2006 and the Uncertified Securities Regulations 2001.

When will the DSS come to an end?

The DSS is intended to last for five years, but HM Treasury may extend the scheme. The government has said that any legislative amendments made for the DSS can be adopted permanently to avoid any legislative gaps in the process that may be disruptive and costly to DSS participants. Based on that, it is expected that participants will exit the DSS through two possible routes:

a. They continue to operate under a permanently amended U.K. legislative framework (which may require an affirmative procedure via Parliament); or

b. They will wind down their activities in the DSS (*e.g.*, where there has been insufficient progress toward a new legislative regime, where the participant has decided to cease the relevant undertaking, or where they have failed to meet the requirements of the regulators).

What can we expect?

As set out above, the regulators are empowered to prescribe further rules for the DSS, but those have not yet been issued. Once applications are in, and the DSS is in operation, it will fall on HM Treasury to report to Parliament on any legislative changes flowing from the DSS. A report is required by January 10, 2028 (*i.e.*, a year before the DSS is expected to close).

The DSS was established in recognition that the current U.K. legislative framework is not designed with distributed ledger technology in mind, opening the door to legislation promoting technological change in the U.K. financial services sector.

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