Crypto, Securities Laws, and Judge Rakoff's SEC v. Terraform Labs Decision: A Split Among Judges of the SDNY?

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In July 2023, I wrote about a trial court decision in the Southern District of New York (SDNY) that held that, contrary to the arguments of the Securities and Exchange Commission (SEC), sales of certain crypto assets on exchanges were not subject to US federal securities laws. In late December 2023, however, a decision by a different judge in the same district mostly accepted the SEC's arguments for a broad application of federal securities laws to crypto assets and did not make any distinction as to whether sales were made directly or over exchanges. Although the crypto assets and factual background of each case varied in many respects, the new ruling illustrates the regulatory uncertainty that currently pervades much of the market as a larger case involving Coinbase looms for 2024.

On July 13, 2023, Judge Analisa Torres of the U.S. District Court for the Southern District of New York issued a ruling on a tremendously important issue to the crypto industry – whether offers and sales of crypto assets are securities. To the surprise of some, her decision in *SEC v. Ripple Labs, Inc.* accepted arguments advanced by some industry participants that sales of crypto assets over exchanges were not sales of securities for purposes of U.S. federal securities laws.[1]

Caution was warranted following Judge Torres' ruling. The ruling was more nuanced than some of the news articles discussing it suggested and accepted some SEC arguments that had been challenged by the industry. In addition, the ruling had limited precedential value as a trial court ruling, contained aspects that appeared vulnerable to criticism, and was just one among many court rulings on the topic that we're likely to see in the coming years. The SEC said that it believed aspects of the ruling were wrongly decided and indicated it intended to appeal the decision.

In late December, we saw a ruling from a different trial court judge in the same district – Judge Jed Rakoff – that appeared to reject some aspects of Judge Torres' earlier ruling that industry participants had celebrated. In a ruling on dueling motions for summary judgment, in *SEC v. Terraform Labs Pte. Ltd.,* No. 1:23-CV-01346 (S.D.N.Y. December 28, 2023) (hereinafter *Terraform Labs Pte.*), Judge Rakoff held that there was "no genuine dispute" that the issuances of four (4) crypto assets created by Terraform Labs Pte. Ltd. ("Terraform Labs"), a Singapore-based company, constituted securities for purposes of the Securities Act of 1933.[2]

Judge Rakoff's ruling shows that the SEC's position that existing securities regulations apply to many transactions involving crypto assets cannot be written off quite yet. However, similar to Judge Torres' earlier ruling, the precedential value of Judge Rakoff's decision is limited and there may be aspects of his decision that are vulnerable to critique. This article will summarize and explore Judge Rakoff's ruling and its implications, which are important as the industry and practitioners await a potentially more significant decision in the SEC's ongoing lawsuit against Coinbase, the largest crypto exchange in the US.

Terraform, UST, Luna, wLuna, and MIR

Although the Terraform Labs decision dealt with other issues and other tokens aside from the tokens mentioned above, this article will focus on Judge Rakoff's decision that the four tokens created and

issued by Terraform – UST, Luna, wLuna, and MIR – constituted securities for purposes of federal securities laws.

a. LUNA and wLuna

The court noted that Terraform Labs was founded in April 2018 and launched the Terraform blockchain one year later to record and display transactions of crypto tokens.[3] Terraform Labs coded into its Terraform blockchain one billion tokens of its first token, LUNA.[4] In December 2020, Terraform Labs launched a platform that allowed LUNA holders to create a new version of LUNA, wLUNA, that could be traded on non-Terraform blockchains but that is otherwise identical to LUNA.[5]

Terraform Labs began entering into agreements to sell LUNA to buyers in 2018, before the Terraform blockchain was launched.[6] The agreements referred to an "Initial Token Launch" for LUNA, stated that Terraform Labs "would undertake efforts to generate a secondary trading market for the LUNA tokens", and arguably provided incentives for the initial purchasers to resell LUNA tokens by discounting the purchase price from expected market prices.[7] Following the blockchain launch, Terraform Labs entered into agreements with a US crypto asset trading firm, Jump Crypto Holdings LLC, to improve LUNA's liquidity by loaning to the trading firm tens of millions of LUNA tokens.[8] Terraform Labs also sold LUNA tokens directly to secondary market purchasers on crypto exchanges.[9]

In tweets made in April 2021, Terraform Labs' founder and CEO, Do Kwon, stated that LUNA would increase in value the more often that the Terraform blockchain was used, and would decrease in value the less that the Terraform blockchain was used.[10] In addition, a business development lead of LUNA described LUNA as the "equity" in Terraform Labs during a public interview and stated that buying LUNA is the same as investing in Terraform Labs.[11]

b. UST

Terraform Labs created UST in December 2019 and described it as a "stablecoin" with a value that was stated to be permanently and algorithmically pegged to one US dollar.[12] Terraform Labs stated that one UST token could always be exchanged for $1 of LUNA, and vice versa.[13]

Over a year later, in March 2021, Terraform Labs launched the "Anchor Protocol" that allowed holders of UST to deposit UST tokens into a shared pool from which others could borrow the UST.[14] Depositors of UST would be paid interest on their deposits, and Terraform Labs tweeted that the protocol would "target 20% fixed APR."[15] The Anchor Protocol's website stated that deposited UST tokens "are pooled and lent out to borrowers, with accrued interest pro-rata distributed to all depositors."[16] The court noted that as of May 2022, 14 billion UST tokens out of a total 18.5 billion tokens in circulation had been deposited in the Anchor Protocol.[17]

c. MIR

In December 2020, Terraform Labs launched the "Mirror Protocol" which allowed users to obtain tokens (called "mAssets") whose value would "mirror" the price of a pre-existing non-crypto asset, such as a publicly traded security.[18] Because users had to deposit collateral equal to 150% of the value of the underlying security to mint an mAsset, and because the user had to deposit additional collateral when the price of the underlying security rose above the additional buy-in, Judge Rakoff found that mAssets would not lead to profits for their holders and holders did not buy mAssets with the expectation of profits.[19] As a result, Judge Rakoff held that mAssets did not constitute investment contracts or securities.[20]

However, as part of the Mirror Protocol, Terraform Labs created an additional token, MIR, to act as the protocol's governance token. MIR tokens were sold directly by Terraform Labs to purchasers in agreements that did not restrict the purchasers from reselling the MIR tokens.[21] Similar to LUNA, Terraform Labs (i) entered into arrangements with Jump whereby Terraform Labs would loan MIR tokens to Jump to assist with liquidity and (ii) sold MIR tokens on exchanges in addition to direct sales.[22]

The court noted that MIR's value was based on the usage of the Mirror Protocol.[23] In promotional materials sent to potential MIR purchasers, Do Kwon described MIR as a token that "'earns fees from asset trades,'" "'will accrue value from network fees and governance,'" potentially could receive "'trading fee revenues,'" and "would increase in value in tandem with greater usage of the Mirror

Protocol."[24]

The SEC contended that each of LUNA, wLUNA, UST, and MIR constituted securities that Terraform Labs sold without registration and without making use of an available exemption.[25]

The Securities Act, the definition of a "Security", and the *Howey* test

In my previous article on the *Ripple Labs* decision, I walked through each of (a) the Securities Act's prohibition on buying or selling unregistered securities without an available exemption, (b) the definition of a "security" under the Securities Act, (c) the Securities Act's inclusion of an "investment contract" as a security, and (d) the U.S. Supreme Court's definition of an "investment contract" in the context of the Securities Act in its 1946 ruling *SEC v. W.J. Howey Co.*[27] I won't cover that background again, but I recommend reading my previous article if a refresher would be helpful. Again at the center of the decision in *Terraform Labs Pte.* was the definition of an investment contract, which the *Howey* decision defined as a "contract, transaction or scheme whereby a person invests his money in a common enterprise and is led to expect profits solely from the efforts of the promoter or a third party."[28]

Application of the *Howey* Test

Judge Rakoff found that Terraform Labs' sales of each of the 4 crypto assets in question constituted a contract, transaction or scheme involving an "(i) investment of money (ii) in a common enterprise (iii) with profits to be derived solely from the efforts of others."[29]

1. LUNA and wLUNA. Judge Rakoff found that Terraform Labs "pooled" proceeds from LUNA and wLUNA and promised investors that further purchases of these crypto assets "would benefit all LUNA holders."[30] Judge Rakoff found that statements by Terraform Labs' personnel made this structure easy to identify, including statements stating that LUNA is equivalent to the "equity" in Terraform Labs and that owning LUNA gives the purchaser "a stake in the network".[31] Judge Rakoff also noted that Do Kwon stated publicly on Twitter that a buyer of LUNA could "[s]it back and watch [him] kick ass", which Judge Rakoff found to mean that buyers of LUNA could profit through Kwon's efforts alone.[32] As such, in Judge Rakoff's view, Terraform Labs engaged in contracts, transactions, and/or schemes whereby a buyer of LUNA or wLUNA (a) would invest money into Terraform Labs, (b) Terraform Labs would use that money to improve the Terraform blockchain network, and (c) buyers of LUNA or wLUNA would reasonably expect to profit from Terraform Labs' efforts to improve the network.

2. UST. Judge Rakoff appeared to grant that Terraform Labs had a stronger argument that its sales of UST were not investment contracts compared to LUNA. Both Terraform Labs and the SEC agreed that UST was not "on its own … a security because purchasers understood that its value would remain stable at $1.00 rather than generate a profit", which meant that the element of the *Howey* test requiring an expectation of profits to be derived solely from the efforts of others would not be met.[33] However, Judge Rakoff noted that holders of UST could deposit their tokens in the Anchor Protocol that was developed by Terraform Labs and earn profits through Terraform Labs' efforts from the protocol.[34] Therefore, Judge Rakoff found that Terraform Labs' issuance of UST in combination with the Anchor Protocol constituted an investment contract.[35]

3. MIR. Judge Rakoff appears to have considered MIR as an easier case similar to LUNA. Proceeds from the sales of MIR were "pooled together" by Terraform Labs to improve the Mirror Protocol, and profits derived from the public's use of the Mirror Protocol were distributed back to MIR owners based on the size of their investment.[36] Although Terraform Labs referred to the Mirror Protocol as "decentralized" in some documentation, in other instances, it said that Terraform Labs contributed most of the development work for the protocol and described Mirror Protocol as an important part of the Terraform Labs' business.[37] Therefore, similar to LUNA and wLUNA, in Judge Rakoff's view, Terraform Labs engaged in contracts, transactions, and/or schemes whereby a buyer of MIR (a) would invest money into Terraform Labs, (b) Terraform Labs would use that money to improve the Mirror Protocol, and (c) buyers of MIR would reasonably expect to profit from Terraform Labs' efforts to improve the Mirror Protocol.

Observations and Implications

1. Potential Criticisms to Judge Rakoff's Ruling.

- Crypto Tokens are Commodities, not Securities. In motions seeking to dismiss the SEC's lawsuit against it, Coinbase has argued that the SEC is seeking to turn "simple asset sales" into securities.[38] Coinbase likened the sale of certain crypto assets to a baseball card company selling baseball cards,[39] or Ty selling Beanie Babies.[40] The buyers of those assets pay money to a common enterprise that will pool the proceeds, and the enterprise may use the proceeds in part in ways that may improve a secondary market for the baseball cards or Beanie Babies (such as through marketing expenditures, hosting conferences, reporting on resale values, or similar actions). In the Supreme Court's *Howey* decision, it was the combination of the sale of orange grove plots along with the service contract that constituted an investment contract, and the Supreme Court implied that the offer and sale of an orange grove plot alone would not constitute a security.[41]

In *Terraform Labs Pte.,* Judge Rakoff acknowledged that certain crypto assets alone may not constitute securities.[42] However, Judge Rakoff held that Terraform Labs' offer and sale of LUNA and wLUNA tokens constituted investment contracts in part due to various statements by Terraform Labs that likened LUNA and wLUNA to "equity" in Terraform Labs and stated that buyers of those tokens could profit through efforts that Terraform Labs alone would undertake.[43] In the case of MIR, Terraform Labs stated that holders of those tokens could earn fees from revenues generated from the Mirror Protocol,[44] which makes the argument in favor of security characterization much stronger. It will be worth watching how subsequent courts adjudicate claims by industry participants that the tokens in question constitute assets, analogous to baseball cards or Beanie Babies, rather than investment contracts, and how much weight those courts give to any of the factors identified by Judge Rakoff in his ruling.

- Absence of any post-sale contractual undertaking. Another argument that Coinbase makes its motion to dismiss the SEC's lawsuit against it is that in order to constitute an investment contract, there must actually be a "contract" that applies post-sale and involves an undertaking by the issuer to deliver future value.[45] Coinbase argues that the requirement of a "contract" is built into the term used in the Securities Act, and points to certain case law and prior briefs from the SEC in support of its position.[46] Although the *Howey* decision stated that an investment contract could be either a contract, scheme, or transaction,[47] Coinbase responds that the Supreme Court's use of the term "scheme" was intended to allow courts to analyze the economic reality of an arrangement when issuers or promoters broke up offers into multiple, seemingly disparate agreements or contracts to determine if the entire arrangement constituted an investment contract.[48]

Judge Rakoff's ruling would seem to fly against that argument by citing several statements that Terraform Labs personnel made, but which statements did not form part of any contract with buyers of tokens issued by Terraform Labs, as evidence in favor of investment contract status. Coinbase's motion to dismiss would appear to treat these statements as "extra-contractual utterances" that should not be viewed as part of the investment contract analysis.[49] However, Judge Rakoff also pointed to the agreements that Terraform Labs made with direct purchasers of LUNA whereby Terraform Labs agreed to undertake efforts to create a secondary trading market for LUNA tokens.[50] We'll have to see how the *Coinbase, Inc.* court analyzes this argument from Coinbase.

- UST. One argument against Judge Rakoff's holding that Terraform Labs' sales of UST constituted securities is that a buyer of UST was not required to deposit their UST into the Anchor Protocol. Judge Rakoff cited the US Supreme Court in *Howey* by stating that "it is of no legal consequence that not all holders of UST deposited tokens in the Anchor Protocol, and thus that some holders 'chose not to accept the full offer of the investment contract.'"[51] In other words, by combining sales of UST with the Anchor Protocol, Terraform Labs was offering an investment contract, regardless of whether some purchasers only bought the UST and passed on the Anchor Protocol. However, as the decision notes, Terraform Labs did not introduce the Anchor Protocol until well over a year after it began issuing UST.[52] Therefore, a persuasive argument could

be made that Terraform Labs was not engaging in the offer or sale of investment contracts by selling UST to buyers during the period from December 2019, when UST was launched, until March 2021, when the Anchor Protocol was launched.

2. Contrast with Ripple Labs. Judge Rakoff never cited Judge Torres' Ripple Labs decision in his recent Terraform Labs ruling. However, Judge Rakoff also appears to have given no weight to any of the arguments that Judge Torres accepted in her July 2023 decision that certain sales of XRP were not securities transactions.

In his earlier opinion rejecting Terraform Labs' motion to dismiss, Judge Rakoff appeared to reject certain distinctions that Judge Torres made between primary sales of crypto assets to institutional investors and secondary market sales to retail investors of crypto assets.[53] Judge Torres held that secondary market sales of XRP tokens issued by Ripple Labs were not securities transactions in part because purchasers of XRP in secondary market sales had no reasonable basis to expect that Ripple Labs would use proceeds from XRP sales in a manner that would increase the price of XRP.[54] Judge Rakoff disagreed, noting that *Howey* makes no distinction between purchasers in that manner.[55] Judge Rakoff noted that the test of whether a reasonable investor would expect profits to be derived from the efforts of others was an objective test based on what a "reasonable" investor would believe, not what a specific purchaser actually believed.[56]

Although Judge Rakoff did not repeat this analysis in his latest decision, his ultimate findings and his description of the *Howey* test indicate that his position remained unchanged from the summer. Therefore, the split between judges on the SDNY may need to be resolved by the Second Circuit Court of Appeals.

3. Stablecoins could be treated differently than other crypto assets. Judge Rakoff held that Terraform Labs' issuances of UST tokens were securities based on purchasers' ability to invest the UST tokens with Terraform Labs' Anchor Protocol.[57] If Terraform Labs had issued UST tokens without Anchor Protocol, his opinion seems to indicate that the tokens would not have been securities. Therefore, his opinion may boost the argument that so-called "stablecoins" and other tokens that are not intended to increase in price or value are not securities and not subject to securities laws.

4. Major Questions Doctrine. Terraform Labs appears not to have raised the "major questions doctrine" as a defense in the most recent decision by Judge Rakoff, but they did cite the doctrine in their attempt to have the SEC's case dismissed earlier in 2023. In Judge Rakoff's July 2023 decision on Terraform Labs' motion to dismiss, he rejected the application of the major questions doctrine to the *Terraform Labs* case.[58] Judge Rakoff noted that the Supreme Court has applied the doctrine only to attempts by regulators to "'regulate a significant portion of the American economy' that has 'vast economic and political significance'" without express Congressional authorization,[59] and he rejected the characterization of the crypto industry as being a portion of the American economy with "vast economic and political significance."[60] In addition, Judge Rakoff said that the SEC's role in regulating securities is not "to exercise vast economic power over the securities markets," but rather was "simply to assure that they provide adequate disclosure to investors."[61] In its separate litigation, Coinbase is arguing that the major questions doctrine compels the SEC's enforcement action against it to be dismissed,[62] and it will be worth watching whether the court in the *Coinbase, Inc.* litigation finds Judge Rakoff's reasoning to be persuasive.

5. A larger ruling on the horizon may help clarify crypto's regulatory status. Judge Rakoff's *Terraform Labs* opinion takes a different view than Judge Torres' earlier opinion in *Ripple Labs* as on the regulatory status of crypto assets. As discussed above, in June 2023, the SEC charged Coinbase, Inc. with operating an unregistered securities exchange, and Coinbase has pushed back stating that none of the crypto assets cited in the SEC's complaint constitute investment contracts or securities.[63] Many of the arguments made by the parties are similar to those presented in the *Terraform Labs* case. The *Coinbase, Inc.* litigation is pending in the SDNY, but before a different judge – Judge Katherine Polk Failla. How she rules on Coinbase's pending motion to dismiss the SEC's complaint, and whether she cites either or both of the opinions of Judge Torres and Judge Rakoff, may provide insight into which judge's arguments are proving more persuasive.

Endnotes

1. SEC v. Ripple Labs, Inc., 1:20-cv-10832, ECF No. 874 (S.D.N.Y. July 13, 2023) (hereinafter Ripple Labs).
2. Terraform Labs Pte. at 36.
3. *Id.* at 3.
4. *Id.*
5. *Id.*
6. *Id.* at 4.
7. *Id.*
8. *Id.* at 4-5.
9. *Id.* at 8.
10. *Id.* at 5.
11. *Id.* at 6.
12. *Id.* at 6.
13. *Id.* The court noted that in May 2021, the price of UST fell below $1, and Terraform Labs subsequently reached agreement with Jump whereby Jump would purchase a large quantity of UST to restore its value to $1 and be released from certain vesting conditions on receiving additional LUNA tokens that were included in prior agreements. Id. at 11-12. If true, this would contradict the supposedly "permanent" and "algorithmic" peg of UST to $1. In May 2022, shortly after Do Kwon again described the UST protocol as algorithmic, all of Terraform Labs' crypto assets, including UST, lost nearly all of their value. Id. at 12-13.
14. *Id.* at 6-7.
15. *Id.* at 7.
16. *Id.*
17. *Id.*
18. *Id.*
19. *Id.* at 8.
20. *Id.*
21. *Id.*
22. *Id.*
23. *Id.*
24. *Id. at 8-9.*
25. *Id.* at 36.
26. Joseph Allen, Crypto and the SEC v. Ripple Labs, Inc. Decision: What Did the Court Actually Say?, JD SUPRA, July 28, 2023, https://www.jdsupra.com/legalnews/crypto-and-the-sec-v-ripple-labs-inc-2271509/.
27. 328 U.S. 293 (1946) (hereinafter Howey).
28. *Id.* at 298-99.
29. Terraform Labs Pte. at 37.
30. *Id.* at 39.
31. *Id.* at 40.
32. *Id.* at 41.
33. *Id.* at 38.
34. *Id.*
35. *Id.* at 39.
36. *Id.* at 41.
37. *Id.* at 42.
38. SEC v. Coinbase, Inc. et al., 1:23-cv-04738, Motion to Dismiss filed by Coinbase, Inc. (S.D.N.Y Aug. 4, 2023) (hereinafter Coinbase, Inc. Motion to Dismiss), at 14.
39. *Id.* at 7.
40. *Id.* at 17.
41. Howey at 299-301.
42. See, e.g., Terraform Labs Pte. at 38 (acknowledging that UST tokens on their own were not securities).
43. *Id.* at 40.
44. *Id.* at 41-42.
45. Coinbase, Inc. Motion to Dismiss at 7-10.
46. *Id.*
47. Howey at 298-99.
48. Coinbase, Inc. Motion to Dismiss at 10-12.
49. *Id.* at 12.
50. Terraform Labs Pte. at 4.
51. *Id.* at 39 (citing Howey at 300).
52. *Id.* at 6.
53. SEC v. Terraform Labs Pte. Ltd., No. 1:23-CV-01346 (S.D.N.Y. July 31, 2023) (hereinafter Terraform Labs Pte. 1), at 40-41.
54. Ripple Labs at 23-24.
55. Terraform Labs Pte. 1 at 41.
56. *Id.* at 38.
57. Terraform Labs Pte. at 39.
58. Terraform Labs Pte. 1 at 23-24.
59. *Id.* at 19-21.
60. *Id.* at 21-22.
61. *Id.* at 22.
62. Coinbase, Inc. Motion to Dismiss at 21-25.
63. *Id.* at 6-17.