

Securities, Cryptocurrencies, And Swaps: SDNY's Recent Decision Addressing Whether Digital Asset Transactions Are Regulated Securities

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A deep dive into the legal analysis and holding in the recent Southern District decision, *Terraform Labs*. The article examines *Terraform Labs*' application of the *Howey* test to determine whether certain cryptocurrency transactions constitute regulated securities.

Cryptocurrencies are all the rage in securities litigation. Indeed, U.S. Securities and Exchange Commission (SEC) Chair, Gary Gensler, has made it clear that the SEC is doubling down on its commitment to regulating crypto assets. See U.S. Securities and Exchange Commission, Press Release, *SEC Nearly Doubles Size of Enforcement's Crypto Assets and Cyber Unit* (May 3, 2022), <https://www.sec.gov/news/press-release/2022-78> (last visited Dec. 29, 2023) (quoting Gary Gensler).

The law concerning whether cryptocurrency transactions are regulated securities continues to evolve. And the velocity of this evolution was recently depicted in *Sec. & Exch. Comm'n v. Terraform Labs Pte. Ltd.*, No. 23-CV-1346 (JSR), 2023 WL 8944860 (S.D.N.Y. Dec. 28, 2023) ("*Terraform Labs*").

In *Terraform Labs*, Judge Jed S. Rakoff of the United States District Court for the Southern District of New York ("SDNY") granted summary judgment in favor of the SEC on its claims that defendants Terraform Labs Pte. Ltd. ("Terraform") and its CEO, Do Kwon ("Kwon"), offered and sold unregistered tokens to U.S. investors. However, it also granted summary judgment for defendants on the SEC's claims for offering and effecting transactions in security-based swaps.

Notably, in an earlier decision on a motion to dismiss in *Sec. & Exch. Comm'n v. Terraform Labs Pte. Ltd.*, No. 23-CV-1346 (JSR), 2023 WL 4858299, at *14-15 (S.D.N.Y. July 31, 2023) ("*Terraform Labs I*"), Judge Rakoff rejected the approach adopted just months earlier by SDNY Judge Torres in *Sec. & Exch. Comm'n v. Ripple Labs, Inc.*, No. 20 CIV. 10832 (AT), 2023 WL 4507900 (S.D.N.Y. July 13, 2023), *motion to certify appeal denied*, No. 20 CIV. 10832 (AT), 2023 WL 6445969 (S.D.N.Y. Oct. 3, 2023) ("*Ripple Labs*") concerning application of the seminal *Howey* "investment contract" test to determine whether certain crypto assets were regulated securities.

This article examines *Terraform Labs*' application of the *Howey* test to determine whether certain cryptocurrency transactions constitute regulated securities, and the divergent approach between the *Terraform Labs* decision and *Ripple Labs* decision concerning how the type of purchaser buying the cryptocurrency impacts the analysis under the *Howey* Test.

***Terraform Labs*: Facts & Procedural History**

The lengthy *Terraform Labs* decision contains a detailed discussion of the facts and legal analysis related to the SEC's fraud claims against defendants Terraform and Kwon (who—as of Sept. 28, 2023—remained incarcerated in Montenegro). See, e.g., *Terraform Labs* at *17-24. In fact, the May 2022 collapse of the Terraform stablecoin led to what is known as the "Crypto Winter." See, e.g., Maria Gracia Santillana Linares, *Crypto Wrestles With Legal Issues, Scoring a Few Key Victories, In 2023*, Forbes/Forbes Digital Assets (Dec. 27, 2023), <https://www.forbes.com/sites/digital-assets/2023/12/27/crypto-wrestles-with-legal-issues-scoring-a-few-key-victories-in-2023/?sh=3f6952f5545c> (last visited Dec. 29, 2023).

In *Terraform Labs*, the district court also considered the admissibility of opinions/testimony by various experts designated by both the SEC and defendants—which also should be instructive to attorneys engaged in securities litigation involving digital assets. See *Terraform Labs* at *5-12.

This article, however, will focus on the legal analysis/holdings as to whether and why the particular cryptocurrency transactions at issue in *Terraform Labs* were held to be regulated securities, and the divergent approach between *Terraform Labs* and *Ripple Labs* as to the application of the *Howey* test in determining whether crypto assets are regulated securities. Where relevant to those topics, additional facts will also be discussed in the legal analysis/holdings section below. NOTE: All internal alterations, quotation marks, footnotes and citations herein are omitted.

The Cryptocurrency Transactions at Issue

Defendant Kwon co-founded defendant Terraform in April 2018. *Terraform Labs* at *1. In April 2019, Terraform and Kwon launched and promoted the Terraform blockchain, to record and display transactions of cryptocurrency tokens, or crypto assets, across computers in a linked network. *Id.*

LUNA & wLUNA: Terraform created and coded into the blockchain at launch one billion tokens of a particular crypto asset, LUNA. Before the blockchain was developed, Terraform entered into agreements to sell LUNA to buyers in exchange for both fiat currency and other crypto assets, such as Bitcoin. Those agreements referred to an “Initial Token Launch,” defined as “the online sale and/or distribution of Tokens by the Vendor [Terraform or its subsidiary Terraform BVI] to the general public in a campaign to be initiated and conducted by the Vendor.” *Terraform Labs* at *2.

In December 2020, Terraform launched a platform allowing LUNA holders to create a “wrapped” version of LUNA, named “wLUNA,” that could be traded on non-Terraform blockchains but was otherwise identical to LUNA—the wLUNA tokens could be exchanged for LUNA tokens. See *id.* at *2 n.2, *14 n.10.

In a tweet on April 7, 2021, Kwon wrote: “A bet on the moon [LUNA] is very simple: it goes up in value (inc. scarcity) the more Terra money is used; it goes down in value (inc. dilution) the less Terra money is used. The moon’s fate in the long run is tied to how widely the money gets used and transacted.”

In another tweet posted that day, Kwon wrote: “But in the long run, \$Luna value is actionable—it grows as the [Terraform] ecosystem grows. As a holder of the [moon], you then have three choices: Sit back and watch me kick ass; Take profits and buy un-valuable assets; Or you can roll up your sleeves and build cool shit.”

Around the same time, SJ Park, Director of Special Projects at Terraform, stated in a videotaped presentation that “[o]wning LUNA is essentially owning a stake in the network and a bet that value will continue to accrue over time.” In a public interview, Jeff Kuan, business development lead at Terraform, explained that “VCs investing in Terra means they’re buying LUNA, which is the ‘equity’ in our co.” *Terraform Labs* at *2.

The price of LUNA increased from under \$1.00 in January 2021 to a high of over \$119 in April 2022, before plummeting to under a penny in May 2022. *Id.*

UST: In December 2019, Terraform created another crypto-asset called UST, which it described as a “stablecoin” whose value was permanently and algorithmically pegged to one U.S. dollar. As part of the algorithm, one UST could always be exchanged for \$1 worth of LUNA, and \$1 worth of LUNA could always be exchanged for one UST.

In March 2021, Terraform launched “the Anchor Protocol,” which it described as a key component of “the Terra money market,” allowing UST holders to earn interest payments by depositing their tokens in a shared pool from which others could borrow UST. *Terraform Labs* at *3.

Terraform publicly announced, in a tweet by Kwon, that “Anchor will target 20% fixed APR,” which was “by far the highest stablecoin yield in the market.” A June 2020 white paper described the Anchor Protocol as “an attempt to give the main street investor a single, reliable, rate of return across all blockchains.”

The Anchor Protocol website stated that “[d]eposited stablecoins are pooled and lent out to borrowers, with accrued interest pro-rata distributed to all depositors.” By May 2022, there were approximately 18.5 billion tokens of UST, 14 billion of which had been deposited in the Anchor Protocol. *Id.*

Mir, the Mirror Protocol, and mAssets: In December 2020, Terraform launched “the Mirror Protocol.” The Mirror Protocol allowed users to obtain “mAssets”—tokens whose value would “mirror” the price of a pre-existing non-crypto asset, such as a publicly traded security. A Mirror Protocol user could mint an mAsset by depositing collateral of 150% or more of the value of the underlying security (the “reference stock”). The holder of the mAsset would thus hold the value of the deposit without holding the underlying reference stock or its attendant ownership interests. *Terraform Labs* at *3.

However, when the price of the underlying reference stock rose above the holder’s initial buy-in, the holder would need to deposit additional collateral to maintain the mAsset. But for the Mirror Protocol’s governance token, i.e., MIR, its value was based on the Mirror Protocol’s usage. A Terraform subsidiary sold MIR tokens directly to purchasers through “Simple Agreements for Farmed Tokens,” or SAFTs. Those agreements did not restrict purchasers from reselling their MIR tokens in secondary trading markets or to U.S. investors. *Id.*

Terraform also loaned as many as four million MIR tokens to a U.S. crypto asset trading firm, Jump Crypto Holdings LLC (“Jump”), which had received loans of 30 million and 65 million LUNA tokens. *See Terraform Labs* at *2, 3. Kwon announced that Terraform had “agreed to enter a partnership with Jump,” in which Jump would “deploy its own resources to improve liquidity of Terra and Luna.” *Id.* at *2. Jump was required to trade MIR tokens on crypto-asset trading platforms and to provide Terraform with reports of its trading. Terraform also sold LUNA and MIR tokens to secondary market purchasers on Binance and other crypto trading exchanges. *Id.* at *3.

In September 2020, Kwon emailed promotional materials to a potential purchaser, proclaiming that the “Mirror token will accrue value from network fees and governance,” stating that MIR token holders could receive “trading fee revenues,” and included a spreadsheet with a revenue projection table estimating how the price of MIR would increase in tandem with greater usage of the Mirror Protocol.

In a June 2021 presentation, SJ Park, Terraform’s Director of Special Projects, stated that the Mirror Protocol had “grown to two billion [dollars] in total value locked and a billion [dollars] in liquidity.” *Id.*

The Precipitous Fall: On May 23, 2021, UST’s price dropped to around \$0.90. That same day, Kwon had multiple communications with a Jump executive. When asked about those communications at a deposition, that Jump executive (and others) invoked the Fifth Amendment and refused to answer. *Terraform Labs* at *4.

On May 23, 2021, a different Jump executive told employees, “I spoke to Do [Kwon] and he’s going to vest us.” The same day, Kwon told Terraform’s head of business development that he was “speaking to jump about a solution.” *Id.* And that day, Jump purchased large amounts of UST, and UST’s market price was eventually restored to near \$1.00. Later that year, Kwon told Curran that if Jump had not stepped in, Terraform “actually might’ve been fucked.” *Id.*

On May 24, 2021, after UST’s price had largely recovered, Terraform published dozens of tweets describing the benefits of “algorithmic, calibrated adjustments of economic parameters” as compared to the “stress-induced decision-making of human agents in [a] time of market volatility.”

Later that same month, however, Terraform’s crypto assets lost nearly all of their value—according to the SEC, more than \$45 billion—and did not recover. *Id.* at *5.

Procedural History

Soon after the SEC initiated its action against Terraform and Kwon on Feb. 16, 2023, Kwon was criminally indicted for securities fraud, commodities fraud, and wire fraud by the United States Attorney in the Southern District of New York. *United States of America v. Do Hyeong Kwon*, Case No. 1:23-cr-00151-JPC, Indictment (S.D.N.Y. March 23, 2023).

The SEC filed its amended complaint on April 3, 2023, asserting six claims for relief—three of which are relevant to this article: (1) offering and selling unregistered securities in violation of Sections 5(a) and 5(c) of the Securities Act of 1933,

15 U.S.C. §77a, et seq. ("Securities Act") (Count IV); (2) offering unregistered security-based swaps to non-eligible contract participants in violation of Section 5(e) of the Securities Act (Count V); and (3) effecting transactions in unregistered security-based swaps with non-eligible contract participants in violation of Section 6(l) of the Securities and Exchange Act of 1934, 15 U.S.C. §78a, et seq. ("Exchange Act") (Count VI). *Terraform Labs* at *5.

The Securities Act regulates initial public offerings of securities. Its objectives are to require that investors receive financial and other significant information concerning securities offered for public sale; and to prohibit misrepresentations and other fraud in the sale of securities to the public. See, e.g., *The Laws That Govern The Securities Industry*, Investor.gov, U.S. Securities and Exchange Commission, <https://www.investor.gov/introduction-investing/investing-basics/role-sec/laws-govern-securities-industry> (last visited Jan. 2, 2024). The Exchange Act created the SEC and granted it power to register and regulate brokerage firms, transfer agents, and clearing agencies, and to regulate the stock markets. See *id.*

Defendants moved to dismiss the amended complaint on various grounds, including the argument that none of the crypto assets at issue was a security. The district court denied the motion to dismiss. *Terraform Labs* at *5. And after discovery closed, both the SEC and defendants moved to exclude the expert witnesses of the other under Federal Rule of Evidence 702. *Id.*

On Nov. 20, 2023, the district court granted the motions to exclude two of defendants' three experts, but denied the motions to exclude defendants' other expert and the SEC's two experts. *Id.* In *Terraform Labs*, the district court explains the reasons for those FRE 702 rulings, *id.* at *5-12, and then—as pertinent to this article—resolves the parties' cross-motions for summary judgment. *Id.* at *12-17.

***Terraform Labs'* Analysis Concerning Crypto Asset Transactions as Securities**

In sum, as it concerns this article, the district court in *Terraform Labs*: (a) granted summary judgment for the SEC on Count IV of the Amended Complaint, involving defendants' unregistered offers and sales of LUNA and MIR in violation of Sections 5(a) and (5c) of the Securities Act; and (b) granted summary judgment for defendants on Counts V and VI of the Amended Complaint, involving the alleged unregistered offers of and transactions in security-based swaps. Although not a topic covered in this article, the district court also denied both sides' cross-motions for summary judgment on the remaining claims of fraud (Counts I-III), and confirmed the jury trial of the remaining claims to commence on January 29, 2024. *Terraform Labs* at *18-23, 25.

Court Reconfirms *Howey* "Investment Contract" Test

In *Terraform Labs*, the SEC argued that four of Terraform's crypto assets—LUNA, wLUNA, UST, and MIR—are securities, as defined in Section 2(a)(1) of the Securities Act for the purposes of the federal securities laws, because they are "investment contract[s]." The district court rejected defendants' arguments that: (i) even if all the SEC's allegations are credited, those assets are not investment contracts as a matter of law; and alternatively (ii) the undisputed facts do not establish that the crypto assets at issue are investment contracts. *Terraform Labs* at *13.

The district court described defendants' first argument as "in effect ask[ing] this Court to cast aside decades of settled law of the Supreme Court and the Second Circuit." *Id.* In so doing, the district court quoted from the seminal decision of *SEC v. W.J. Howey Co.*, 328 U.S. 293 (1946), where the Supreme Court held "in no uncertain terms that 'an investment contract for purposes of the Securities Act means 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.'" *Id.* (quoting *Howey*, 328 U.S. at 298-99).

The district court held that *Howey's* definition of "investment contract" "was and remains a binding statement of the law, not dicta. 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. See, e.g., *Revak v. SEC Realty Corp.*, 18 F.3d 81, 87 (2d Cir. 1994)." *Id.*

Then, the district court concluded that there was no genuine dispute that the elements of the *Howey* test were satisfied for LUNA/wLUNA, UST, and MIR. *Id.*

LUNA & wLUNA: With respect to LUNA and wLUNA, the district court held that the undisputed evidence substantiated that defendants “pooled” the proceeds of LUNA purchases together and promised that further investment through these purchases would benefit all LUNA holders. Thus, the investors were joined in a common, profit-seeking enterprise. *Terraform Labs* at *14. With the *Howey* test in mind, the district court also noted:

- “Kwon and others made specific, repeated statements that would lead a reasonable investor in LUNA to expect a profit based on defendants’ efforts to further develop the Terraform blockchain.”
- “Terraform’s business development lead, Jeff Kuan, stated in a 2021 public interview that ‘investing in Terra means ... buying LUNA, which is the ‘equity’ in our co.’”
- Terraform’s head of communications, Brian Curran, remarked in a June 2021 public interview that “[o]wning 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.”
- “In a similar vein, Terraform’s Director of Special Projects, SJ Park, stated in a videotaped presentation around the same time that ‘[o]wning LUNA is essentially owning a stake in the network and a bet that value will continue to accrue over time.’”
- “Kwon himself wrote in a public Tweet that ‘\$Luna value is actionable — it grows as the [Terraform] ecosystem grows.’”
- “In Kwon’s own words, a holder of LUNA could simply ‘[s]it back and watch [him] kick ass.’”

Id.

Thus, citing *Howey*, 328 U.S. at 299, the district court concluded that a person could invest their “money in a common enterprise” and be “led to expect profits solely from the efforts of the promoter or a third party,” namely, Terraform and Kwon himself. *Id.*

UST: The district court rejected defendants’ argument that UST on its own was not a security because purchasers understood that its value would remain stable at \$1.00 rather than generate a profit. *Terraform Labs* at *13. Again with the *Howey* test in mind, the district court noted:

- “March 2021, holders of UST could deposit their tokens in the Anchor Protocol, which defendants’ efforts developed and which Kwon himself publicly announced would generate ‘by far the highest stablecoin yield in the market,’ with a ‘target’ of ‘20% fixed APR.’”
- “On May 11, 2021, Terraform wrote in a promotional Tweet that the Anchor Protocol would allow ‘third parties to seamlessly integrate 20% yield on \$UST to expand stable savings opportunities to a greater audience.’”
- “A 2020 white paper described Terraform’s work on the Anchor Protocol as ‘an attempt to give the main street investor a single, reliable, rate of return across all blockchains.’”
- “Once launched, returns from the Anchor Protocol were indeed paid out in proportion to the amount of UST tokens a person or entity had deposited.”
- “The Anchor Protocol website stated that ‘[d]eposited stablecoins are pooled and lent out to borrowers, with accrued interest pro-rata distributed to all depositors.’”
- “Terraform promoted in an October 2021 Tweet that it had configured its website to allow deposits of UST into the Anchor Protocol ‘directly from the Terra Station desktop wallet.’”

- “A Terraform manager, Matthew Cantieri, led a team that worked on the Anchor Protocol. His responsibilities included the ‘strategic direction of the protocol, user adoption, making sure that people were accountable for product roadmap items, [and] working with Do [Kwon] and the team on what those products should be.”
- “By May 2022, there were approximately 18.5 billion tokens of UST, 14 billion of which had been deposited in the Anchor Protocol.”

Id. at *13-14.

Thus, once again citing *Howey*, 328 U.S. at 300, the district court concluded that the “above undisputed evidence clearly demonstrates that UST in combination with the Anchor Protocol constituted an investment contract,” and held that “it is of no legal consequence that not all holders of UST deposited tokens in the Anchor Protocol....” *Id.* at *14.

MIR: For similar reasons, the district court also concluded that “the evidence shows beyond dispute that MIR was a security” *Terraform Labs* at *15. Once again with the *Howey* test in mind, the district court noted:

- “[T]he proceeds from sales of the MIR tokens were ‘pooled together’ to improve the Mirror Protocol,” and “[p]rofits derived from the use of the Mirror Protocol were fed back to investors based on the size of their investment.”
- “Terraform described MIR as a ‘governance token that earns fees from asset trades’ on the Mirror Protocol that Terraform launched.”
- “A Terraform press release at the launch of the Mirror Protocol touted that ‘[b]y adding the Mirror governance token—MIR—to liquidity pools, MIR holders can earn 0.25% from trading fees.”
- “Although Terraform labeled ‘the protocol [as] decentralized,’ it explained that ‘the team behind Terra contributed most of the core development work behind the Mirror.’”
- “Kwon himself sent promotional materials to a potential MIR purchaser, including a spreadsheet with a revenue projection table estimating how the price of MIR would increase as a result of greater usage of the Mirror Protocol.”
- “Terraform also described to potential investors its efforts to strengthen the Mirror Protocol, such as ‘deploying its UST reserves to make the markets for mAssets for the first year of the protocol,’ building the Mirror Protocol website and hiring a firm to audit Terraform’s code for doing so, and publishing ‘dashboards’ showing the Mirror Protocol’s growth.”
- “In a public question-and-answer session, Terraform’s Community Lead, Aayush Gupta, stated on behalf of Terraform that the company was ‘very upbeat on our marketing campaign’ and was ‘doing [its] best with its global suite of talent and organizing stuff like trading competitions and referral campaign to increase visibility for Mirror.’”
- “In an April 2021 interview, Terraform’s head of communications, Brian Curran, stated that Terraform intended to launch a ‘V2’ of the Mirror Protocol, which would bring ‘several major improvements,’ and that Terraform planned to expand the Mirror Protocol ‘beyond SE Asia and the typical US market.’”
- “Terraform employed a ‘product manager’ for the Mirror Protocol and retained an administrative key to provide software updates to it.”
- “Terraform used proceeds from the sale of MIR, which it pooled, ‘to make payments for services, salary, and operations.’”

Id.

Accordingly, the district court concluded that “defendants cannot meaningfully dispute that they led holders of MIR to expect profit from a common enterprise based on Terraform’s efforts to develop, maintain, and grow the Mirror Protocol—in other words, that MIR passes the *Howey* test with flying colors.” *Id.*

Court Holds Defendants Offered and Sold Unregistered Securities

The district court then granted summary judgment to the SEC on Count IV of the Amended Complaint because defendants offered and sold LUNA and MIR as unregistered securities, in violation of Sections 5(a) and 5(c) of the Securities Act. *Terraform Labs* at *15. In so doing, it recognized that “Section 5 requires that securities be registered with the SEC before any person may sell or offer to sell such securities.” *Id.* (quoting *SEC v. Cavanagh*, 445 F.3d 105, 111 (2d Cir. 2006)). It also recognized that, to prove liability under Section 5, the SEC must show “(1) lack of a registration statement as to the subject securities; (2) the offer or sale of the securities; and (3) the use of interstate transportation or communication and the mails in connection with the offer or sale.” *Id.* (quoting *Cavanagh*, 445 F.3d at 111 n.13).

Since defendants only contested the second element, the district court focused on that element and found that Terraform sold LUNA tokens directly to institutional investors through sales agreements that expressly contemplated Terraform’s development of a secondary market. *Terraform Labs* at *15. In that regard, the district court noted, among other things:

- “In a fundraising update in December 2018, Terraform co-founder Daniel Shin wrote that Terraform had ‘begun exchange listing discussions given token listing is a precondition for [the] Terra/Luna ecosystem to operate.’”
- “Similarly, as Terraform provided loans of tens of millions of LUNA tokens to trading firm Jump, Kwon announced Terraform’s expectation that Jump would ‘improve liquidity of LUNA in secondary trading markets.’”

Id.

The district court found that Terraform’s offers and sales of MIR were similar. In that regard, the district court noted:

- “A Terraform subsidiary sold MIR tokens directly to purchasers through ‘Simple Agreements for Farmed Tokens,’ or SAFTs.... Those agreements did not restrict purchasers from reselling their MIR tokens in secondary trading markets or to U.S. investors.”
- “Terraform also loaned up to 4 million MIR tokens to Jump, in an agreement that expressly required Jump to trade MIR tokens on crypto asset trading platforms and to provide Terraform with reports of its trading.”
- “Terraform also sold both LUNA and MIR tokens to secondary market purchasers on Binance and other crypto trading exchanges.”

Id. at *16.

Furthermore, the district court held that defendants did not satisfy their burden of proving any exemptions from registration. *Id.* Importantly, and as further discussed below concerning *Terraform Labs*’ divergence from the SDNY’s earlier decision in *Ripple Labs*, the district court rejected defendants’ argument that their distributions of LUNA and MIR were not public offerings because they only sold directly to sophisticated investors. In so doing, the district court held that defendants failed to show that they “intended” the LUNA and MIR tokens “to come to rest with” those sophisticated investors. *Id.* (quoting *SEC v. Telegram Grp. Inc.*, 448 F. Supp. 3d 352, 380 (S.D.N.Y. 2020)).

Terraform’s own repeated statements about developing a liquid secondary market for LUNA, and its express requirement that Jump trade MIR on exchanges—and even that Jump provide reports to Terraform about that secondary trading—make plain that neither Terraform nor its institutional investors had any intent to simply hold onto LUNA or MIR without further trades. It is immaterial that the vesting period in certain sales agreements “precluded immediate resale” or “that LUNA was not listed on any trading platform at the time of the purchases” by those institutional investors.

Terraform Labs at *16.

The district court also rejected defendants’ argument that certain sales agreements for LUNA were exempt from registration under Regulation S, which states that Section 5’s reference to offers and sales refers only to those “that occur within the United States,” 17 C.F.R. §230.901, because defendants pointed to no evidence showing that they reasonably

believed “at the commencement of the offering” that there was “no substantial U.S. market interest” or that they took any steps to prevent resale of LUNA and MIR into the U.S. market. *Terraform Labs* at *16.

The Court Holds Defendants Did Not Offer Or Effect Transactions In Security-Based Swaps

Nonetheless, the district court granted summary judgment for defendants on Counts V and VI of the SEC’s Amended Complaint, wherein the SEC alleged that defendants offered unregistered security-based swaps to noneligible contract participants, in violation of Section 5(e) of the Securities Act, and effected transactions in security-based swaps with non-eligible contract participants, in violation of Section 6(f) of the Exchange Act. *Terraform Labs* at *17. Although the SEC did not argue that an mAsset is itself a security, it did argue that defendants offered and effected transactions in security-based swaps by creating and maintaining the Mirror Protocol through which others could mint mAssets. The district court rejected this argument and held that an mAsset does not satisfy the statutory definition of a security-based swap. *Id.*

As explained by the district court, the Commodity Exchange Act defines a “swap” as “any agreement, contract, or transaction ... that provides on an executory basis for the exchange ... of 1 or more payments based on the value or level of 1 or more ... securities ... and that transfers, as between the parties to the transaction, in whole or in part, the financial risk associated with a future change in any such value or level without also conveying a current or future direct or indirect ownership interest in an asset.” *Id.* (quoting 7 U.S.C. §1a(47)(A)(iii)). As relevant to the case before it, the district court explained that a “security-based swap” is such a swap that “is based on ... a single security.” *Id.* (quoting 15 U.S.C. §78c(a)(68)).

The district court held that an mAsset did not meet the statutory definition of a security-based swap because, “crucially,” there was no transfer of financial risk. More specifically, the district court held:

[A] user cannot profit from holding an mAsset because his deposit must always exceed the value of the underlying reference security. If the user fails to deposit sufficient additional collateral, the mAsset will be lost.... [T]he fact that the minter of an mAsset bears financial risk from his own choice to deposit collateral, which could lead to the loss of that collateral, does not mean that any of that risk was ‘transfer[red]’ to him by a counterparty in a transaction.”

Id. (citing 7 U.S.C. §1a(47)(A)(iii)).

A Tale of Two Judges In the SDNY: *Terraform Labs* v. *Ripple Labs*

In *Terraform Labs* (as discussed above) and, more particularly, in an earlier decision denying defendants’ motion to dismiss (i.e., *Terraform Labs I* at *14-15), Judge Rakoff rejected the application of the *Howey* “investment contract” test to crypto assets by Judge Torres just a few months earlier in *Ripple Labs*.

More specifically, Judge Rakoff in *Terraform Labs I* rejected the approach adopted by Judge Torres in *Ripple Labs*, which distinguished between “programmable” crypto-asset sales on exchanges (held by Judge Torres not to be securities), and sales to institutional investors (held by Judge Torres to be securities). See *Terraform Labs I* at *15. In so doing, Judge Rakoff stated:

*There [in Ripple Labs], that court found that, “[w]hereas ... [i]nstitutional [b]uyers reasonably expected that [the defendant crypto-asset company] would use the capital it received from its sales to improve the [crypto-asset] ecosystem and thereby increase the price of [the crypto-asset],” those who purchased their coins through secondary transactions had no reasonable basis to expect the same. Id. at ——— – ———, 2023 WL 4507900 at *11-12. According to that court, this was because the re-sale purchasers could not have known if their payments went to the defendant, as opposed to the third-party entity who sold them the coin.*

Id. at *15. In rejecting Judge Torres’ approach, Judge Rakoff reasoned:

Howey makes no such distinction between purchasers. And it makes good sense that it did not. That a purchaser bought the coins directly from the defendants or, instead, in a secondary resale transaction has no impact on whether a reasonable individual would objectively view the defendants’ actions and statements as evincing a promise of profits based on their efforts. Indeed, if the Amended Complaint’s allegations are taken as true—as, again, they must be at this stage—the defendants embarked on a public campaign to encourage both retail and institutional investors to buy their crypto-assets by touting the profitability of the crypto-assets and the managerial and technical skills that would allow the defendants to maximize returns on the investors’ coins.

Id.

Conclusion

Thus far, courts across the country have applied the *Howey* test to determine whether certain cryptocurrency transactions are regulated securities. But the law continues to evolve.

In fact, at the time of this article, neither *Terraform Labs* nor *Ripple Labs* has been reviewed by the Second Circuit. On the one hand, if Judge Rakoff’s view is decided to be correct, then Judge Torres’ approach could be rendered an anomaly to the extent it treated only cryptocurrency sales to institutional investors as being subject to the requirements of registration under federal securities laws.

On the other hand, despite it being criticized by Judge Rakoff, the *Ripple Labs* decision could be used (at least for the time being) to argue that the sale of crypto assets—under certain circumstances—are not regulated securities.

Accordingly, practitioners should continue to monitor both the *Terraform Labs* decision and the *Ripple Labs* decision for further guidance on the application of the *Howey* test in the SDNY (and perhaps the Second Circuit and other courts) to determine whether similar digital asset transactions are regulated securities in the SDNY. See, e.g., *Patterson v. Jump Trading LLC*, No. 22-CV-03600-PCP, 2024 WL 49055, at *12 (N.D. Cal. Jan. 4, 2024) (citing both *Terraform Labs* and *Terraform Labs I*).

Moreover, regulation may come from the states. For example, on October 13, 2023, California Governor Gavin Newsom signed two bills into law that will impose substantial obligations on companies engaged in virtual currency activities. Taking effect on July 1, 2025, the new law establishes a framework for the licensing and oversight of businesses that engage in “digital financial asset.”

The first bill ([AB 39](#))—i.e., the California Digital Financial Assets Law (“DFAL”)—provides for a virtual currency licensing regime with similarities to New York’s virtual currency regulations that require entities conducting virtual currency business activity in New York to obtain a “BitLicense” (or a charter under the New York Banking Law). Dovetailing with the DFAL, the second bill ([SB 401](#)) regulates “digital financial asset transaction kiosks,” which are generally defined as devices that are “capable of accepting or dispensing cash in exchange for a digital financial asset.”



Securities, Cryptocurrencies, And Swaps: SDNY's Recent Decision Addressing Whether Digital Asset Transactions Are Regulated Securities

Among other things, the DFAL provides that a person with a pending license application may be issued a conditional license if the applicant holds a license to conduct virtual currency business activity pursuant to the New York BitLicense regulations (23 NYCRR Part 200), provided that the New York license was issued or approved no later than January 1, 2023. In addition, licensees are subject to various disclosure requirements, largely based on the New York BitLicense regulations.

It is also worthy to note that on Jan. 10, 2024, SEC Chair Gensler announced the approval of the first U.S.-listed exchange traded funds to track bitcoin—"a watershed for the world's largest cryptocurrency and the crypto industry." Hannah Lang and Suzanne McGee, *US SEC approves bitcoin in ETFs in watershed for bitcoin, crypto market*, Reuters (Jan. 10, 2024), <https://www.reuters.com/technology/bitcoin-etf-hopefuls-still-expect-sec-approval-despite-social-media-hack-2024-01-10/> (last visited Jan. 10, 2024). Nonetheless, Mr. Gensler has stated that "the agency does not endorse bitcoin, which is risky and volatile." *Id.*; see also Patrick Donachie, *SEC Approves 11 Bitcoin ETFs*, WealthManagement.com (Jan. 10, 2024), <https://www.wealthmanagement.com/etfs/sec-approves-11-bitcoin-etfs> (last visited Jan. 10, 2024).

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