Judges in the Southern District of New York Divided on Whether a Token Is a Security: *SEC v. Terraform Labs* and *SEC v. Ripple Labs*

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Key Point

- Just shy of three weeks after Judge Torres held that the digital asset XRP is not itself a security,[1] Judge Rakoff held that the SEC had adequately pled that certain digital assets, such as the UST and LUNA coins, are securities, reflecting divergent approaches that courts are taking towards regulation of digital assets.[2]

The *Terraform Labs* Litigation

The U.S. Securities and Exchange Commission (SEC) brought an action against Terraform Labs and its founder in the U.S. District Court for the Southern District of New York alleging a multibillion-dollar fraud involving the development, marketing and sale of digital assets. The SEC also alleged that the defendants violated laws prohibiting the unregistered sale of securities.

On July 31, 2023, Judge Rakoff denied the defendants' motion to dismiss. In doing so, Judge Rakoff acknowledged that tokens, particularly stablecoins designed exclusively to maintain a one-to-one peg with another asset, might not qualify as securities. However, Judge Rakoff held that the SEC had adequately pled that the defendants promoted the digital assets as profitable investments, and as such, the sale and offering of the assets qualified as securities requiring registration. In doing so, Judge Rakoff overtly rejected Judge Torres's analysis of the *Howey* test in *SEC v. Ripple Labs*. There, ruling on cross-motions for summary judgment, Judge Torres drew a distinction between institutional versus programmatic sales of digital assets—finding that sales to institutional investors constituted a security, while programmatic sales to retail investors did not. Judge Rakoff took a divergent approach, finding that "*Howey* makes no such distinction between purchasers" and explaining that, if the SEC's allegations are true, "the defendants' [sic] 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."

Notably, the two decisions were made at distinct procedural postures. Judge Rakoff afforded deference to the SEC's complaint based on ruling on a motion to dismiss, whereas Judge Torres's findings were made on summary judgment based on a well-developed factual record. Whether the SEC can prove its allegations remains to be seen.

Takeaways

- The competing opinions in the Southern District of New York likely strengthen the prospect of the SEC's appeal of Judge Torres's decision in *SEC v. Ripple Labs*. Moreover, the SEC will likely rely on the *Terraform Labs* opinion in other ongoing litigation, such as its case against Coinbase, where the SEC is poised to file an opposition to Coinbase's motion to dismiss.

- The question of how to classify digital assets is far from resolved. It will be important to continue to monitor both cases for further guidance on the application of the *Howey* test by courts in the Southern District of New York.

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[1] Order, *SEC v. Ripple Labs, Inc.*, No. 20-10832 (S.D.N.Y. July 13, 2023), ECF 874; *see also* Akin's prior client alert covering the decision.

[2] Opinion and Order, *SEC v. Terraform Labs Pte. Ltd.*, No. 23-01346 (S.D.N.Y. July 31, 2023), ECF 51.