OPINION

Kim, Kab Lae

Implications of Recent U.S. Federal Court's Ruling on Terra-LUNA Case: Focused on Howey Test

The U.S. District Court for the Southern District of New York (the "Court") has recently issued a ruling recognizing the sale of LUNA as a securities offering. The ruling is expected to be an important reference for the Terra-LUNA case in Korea. The definition of investment contract securities, established under the comprehensive regulatory framework of Korea's Financial Investment Services and Capital Markets Act (FSCMA), draws heavily from the criteria outlined in the "U.S. Howey test". The Court's determination of LUNA's securities nature holds significance in that it comprehensively considers substantive matters to deliver a judgment on a case-by-case basis taking into account specific factual circumstances and economic reality. It is particularly noteworthy that it focused on the transaction structure of sales activities, rather than on the rights inherent in the digital asset itself, which provides tremendous implications for Korea's law enforcement and financial authorities.

In the event that a particular digital asset traded on a virtual asset exchange in Korea falls under the investment contract category, it does not automatically classify the exchange as an illegal broker-dealer or unauthorized exchange under the FSCMA. Therefore, the relevant financial and law enforcement authorities in Korea do not need to feel unduly pressured by how the declaration of certain digital assets as securities influences the market. In particular, there is no reason for the authorities to hesitate in examining the securities nature of digital assets involved in unfair trading under the FSCMA.

A large volume of transactions on virtual asset exchanges is conducted non-face-to-face and anonymously. Consequently, it is extremely challenging for law enforcement authorities to prove all the elements of fraud under the criminal law in cases involving unfair digital market trading. In digital asset fraud cases involving

* All opinions expressed in this paper represent the author's personal views and thus should not be interpreted as Korea Capital Market Institute's official position.

* SJD, Senior Research Fellow, Capital Markets Department, Tel: 82-2-3771-0656, E-mail: klkim@kcmi.re.kr

large-scale trading facilities, such as the Terra-LUNA case, it is crucial to rigorously assess whether the relevant sales activities qualify as securities offerings. Once the sales activities are securities offerings, the law enforcement authorities can apply the unfair trading provisions of the FSCMA to the related fraud cases. By using the provisions for unfair trading under the FSCMA, law enforcement authorities can more easily prove the crime of fraud in the digital asset market and impose stricter punishments, in comparison to applying the fraud provisions under the criminal law. In this context, Korea's law enforcement and financial authorities should develop securities nature evaluation criteria and practices referring to related U.S. cases.

Introduction

Recently, the domestic extradition of Do-hyung Kwon, the mastermind behind Terraform and LUNA, accused of orchestrating a notorious crypto asset fraud scheme, has attracted public attention. It has become an issue whether Kwon, the key suspect in the Terra-LUNA scandal, will be extradited from Montenegro to South Korea or to the United States. The Terra-LUNA scandal is one of the worst incidents in the virtual asset market that occurred in 2022, producing numerous victims. Market participants in Korea speculate that if the Montenegro government seeks to extradite Kwon to South Korea instead of the U.S., he might face less severe punishment. This speculation stems from the fact that proving Kwon's fraud in the digital asset market could be more challenging under the Korean jurisdiction than under the U.S. jurisdiction. Many Korean market participants anticipate that the unfair trade provisions of Korea's Financial Investment Services and Capital Markets Act (FSCMA) cannot be applied to Kwon's fraudulent activities because the law enforcement authorities in Korea are having difficulty proving that Terra and LUNA are investment contract securities under the FSCMA.[1)] Kwon may be subject to charges of fraud under the Korean criminal law, rather than being prosecuted under the unfair trading provisions of the FSCMA, for his fraudulent activities. These circumstances are expected to cause difficulties in proving the crimes against Mr. Kwon and in providing relief to the victims.

1) Furthermore, the Korean criminal law specifies less stringent sentencing guidelines for large-scale crimes with numerous victims, resulting in concurrent crimes, compared with the relevant U.S. laws.

The question of whether the sale of Terra or LUNA constitutes a securities offering under the FSCMA forms the basis for applying the FSCMA to the Terra-LUNA case. There exists a significant possibility that the sale of Terra or LUNA could be interpreted as an investment contract, thereby potentially qualifying as the sale of investment contract securities. Currently, the Terra-LUNA civil lawsuit filed by the U.S. Securities and Exchange Commission (SEC) focuses on securities fraud rather than a typical type of fraud. On December 28, 2023, the U.S. District Court for the Southern District of New York (the "Court") issued a summary judgment that the sale of LUNA constituted the unregistered offer and sale of securities.[2] Based on LUNA's securities status, the jury for the trial found Terraform Labs and its founder Kwon liable on civil fraud charges on April 5, 2024.[3] Given that this case involves not just unregistered securities offering but securities fraud that has resulted in numerous victims, it is unlikely that an appellate court could overturn this ruling.

The Court's ruling recognizing the sale of LUNA as a securities offering is deemed a critical reference for the Terra-LUNA case in Korea. This is because the definition of investment contract securities, serving as the comprehensive regulatory framework under the FSCMA, has been established based on the "U.S. Howey test".[4] As in the case of the U.S. where the Howey test sets a precedent for determining whether LUNA is a security, the provision of investment contract securities under the FSCMA is applied to determine whether LUNA is a security or not.

The Court's determination of LUNA's securities nature holds significance in that it comprehensively considers substantive matters to deliver a judgment on a case-by-case basis by taking into account specific factual circumstances and economic reality. This approach is consistent with the stance taken by Korean financial authorities, who have issued guidelines on fractional investment and security tokens. A comparative legal interpretation is crucial to derive insights from the U.S. ruling on whether LUNA is categorized as a security. In this regard, it is essential to identify similarities and distinctions in the securities regulation systems of both Korea and the U.S., while also understanding their respective market environments and social contexts. By doing so, it is possible to conduct an accurate analysis and present relevant insights

2) In the summary judgment, besides LUNA, UST (US Terra), sLUNA, and MIR were also recognized as securities meeting the Howey test. SEC v Terraform Labs, 23-cv-1346, Opinion and Order (December 28, 2023), p. 37. However, this article only focuses on the application of the Howey test to the sale of Luna, due to space constraints.

3) SEC v Terraform Labs, 23-cv-1346, Verdict (April 5, 2024).

4) Ministry of Finance and Economy, June 30, 2006, Explanation for the 'proposed Financial Investment Services and Capital Markets Act', p.11.

for Korea. Against this backdrop, this article aims to analyze the Court's ruling on LUNA's securities nature, address any relevant misconceptions, and offer implications for the Terra-LUNA judgment in Korea.

Applying the Howey test to the sale of LUNA

The summary judgment issued by the U.S. Court on December 28, 2023, confirming LUNA's securities status should not be interpreted as considering LUNA itself as a digital asset, a security. Instead, it signifies that the sale of LUNA constitutes an investment contract. According to the long-standing precedents under the U.S. Securities Act, an investment target does not necessarily have to be a security for the determination of investment contracts. This position was evident in the Ripple XRP case, where the federal court issued a summary judgment stating that "XRP, as a digital token, is not in and of itself a *contract, transaction[,] or scheme* that embodies the Howey requirements of an investment contract."[5] This position was recognized as correct by the SEC.[6] In that ruling, the federal court made it clear that XRP sold directly to institutional investors was considered a security, while XRP sold through digital asset exchanges to unspecified investors was not. Whether a digital asset is classified as a security subject to securities regulations can be determined by analyzing the economic reality and totality of circumstances regarding the offers and sales of the asset.[7] The Howey test focuses on sales activities rather than the underlying asset itself. In other words, the Howey test serves as criteria for determining whether a contract, transaction, or scheme[8] related to sales activities of an underlying asset constitutes an investment contract, rather than deciding whether the intrinsic contractual structure of a given asset qualifies as an investment contract. In the same vein, although the U.S. government categorizes Bitcoin as a commodity, not a security, if a contractual structure that includes Bitcoin as its underlying asset qualifies as an investment contract, the sale of Bitcoin would be deemed the sale of investment contract securities and might be regulated by the U.S. Securities Act.[9] Whether the elements of an investment

5) SEC v. Ripple Labs Inc., 20 Civ. 10832 (AT) (S.D.N.Y. July 13, 2023), p. 15.

6) "The SEC did not argue [in Ripple] or in Terraform that the asset underlying those investment contracts were necessarily a security." SEC v. Ripple Labs Inc., 20 Civ. 10832 (AT) (S.D.N.Y. Aug. 18, 2023), p. 16.

7) "[I]n searching for the meaning and scope of the word *security* in the Act, form should be disregarded for substance and the emphasis should be on economic reality." Tcherepnin v. Knight, 389 U.S. 332, 336 (1967).

8) SEC v. W.J. Howey Co., 328 U.S. 293, 298-299 (1946).

9) SEC v. Shavers, Case No. 4:13-CV-416 (E.D. Tex. Aug. 6, 2013).

contract are met is judged based on the totality of specific circumstances to assess economic reality.[10)]

Similarly, the Court did not conclude that the contractual structure of LUNA itself, as a digital asset, inherently constituted an investment contract. The ruling issued on December 28th of last year recognized LUNA as a security, on the ground that the structure of its offer or sale satisfied the criteria outlined by the Howey test. The four elements of Howey include: i) the investment of money; ii) a common enterprise; iii) the efforts of others; and iv) a reasonable expectation of profits. Initially, the SEC demonstrated that LUNA investors put money into a common enterprise established for the benefit of LUNA holders. Additionally, the SEC presented statements and promises made by Terraform Labs (including Terraform Labs, Kwon, and their related persons) during the sale of LUNA as evidence, proving that LUNA investors had reasonable expectations of profits arising from the managerial efforts of third parties. As evidence, the SEC presented public remarks made by Terraform Labs, such as "[o]wning LUNA is essentially owning a stake in the network and a bet that value will continue to accrue over time" and "$Luna value is actionable — it grows as the [Terraform] ecosystem grows."[11)] The Court found that such repeated statements led LUNA investors to reasonably expect future profits from the issuer's profit-seeking efforts. This ruling on LUNA's securities status illustrates that the key factor in determining a digital asset as a security lies in whether the asset's sale structure constitutes an investment contract, rather than whether the asset itself qualifies as an investment contract security.

Clarifying misconceptions

The U.S. Court's decision to recognize LUNA as a security is significant as it highlights the need for related issues to be adjudicated by Korean judicial authorities. To understand its implications in the Korean context, it is crucial to analyze the similarities and differences between the securities regulatory frameworks of both the U.S. and Korea. Due to the lack of such a comparative interpretation approach, there are the following misunderstandings about the security nature of LUNA in the South Korean markets.

First, there is a misconception that if virtual assets with securities attributes, like LUNA, are

10) United Housing Foundation v. Forman, 421 U.S. 837 (1975).

11) SEC v Terraform Labs, 23-cv-1346, Opinion and Order (December 28, 2023), p. 40-41.

recognized as securities, virtual asset exchanges in Korea would be accused of illegal broker-dealer or exchange, as in the U.S. Coinbase case. As a result, "domestic virtual asset exchanges are bound to take a big hit."[12] In the Coinbase case, the SEC filed a civil suit against Coinbase last June, alleging that Coinbase engaged in unregistered securities business (broker-dealer, security exchange, and clearing agency).[13] The SEC claimed that 13 digital assets traded on the Coinbase platform were offered and sold as investment contracts. The U.S. Securities Act generally treats investment contracts the same as other securities. In contrast, under the FSCMA in Korea, investment contracts are considered securities only with respect to issuance disclosure (securities registration statements), prohibition of unfair trading, liability of compensation, and crowdfunding exemptions.[14] Therefore, the relevant provisions pertaining to unlicensed investment broker-dealers or unauthorized exchanges under the FSCMA do not apply to virtual asset exchanges involved in the distribution of investment contract securities. In 2022, the Securities Futures Commission in Korea recognized Musicow's music royalty participation claims as investment contracts; however, Musicow, which offered and sold these investment contract securities, did not face punishment as an unauthorized investment broker-dealer or unauthorized exchange under the FSCMA.[15]

The second misconception lies in believing that digital asset trading by retail investors on virtual asset exchanges does not constitute the issuance and distribution of securities. In the Terra-LUNA case, Terraform Labs cited the Ripple XRP summary judgment,[16] arguing that trading on the secondary market by retail investors should not be seen as securities offerings. They filed a motion to dismiss the SEC litigation, on the ground that LUNA investors did not expect Terraform Labs and others to improve the Terra-LUNA ecosystem and increase the value of LUNA by using the proceeds from digital asset sales. However, if a digital asset issuer promises to open and develop a secondary market through its efforts for the benefit of unspecified investors, thus boosting the digital asset's value for profit realization, it likely meets

12) Chosun Biz, March 28, 2024, [Financial Focus] Why did the CEO of Dunamu attend the Financial Research Forum.

13) SEC v. Coinbase, Complaint, 23 Civ. 4738 (June 6, 2023).

14) Proviso clause of Article 4(1) of the FSCMA.

15) Musicow faced sanctions for failing to submit a securities registration statement regarding the solicitation and sales of relevant investment contract securities. However, Korea's Securities and Futures Commission deferred the sanction procedure, taking into account the relevant circumstances. Financial Services Commission, November 29, 2022, Decision on Musicow's exemption for sanctions and assessment of the securities nature of fractional investment in Korean beef and artwork, press release, p.1-2.

16) SEC v. Ripple Labs Inc., 20 Civ. 10832 (AT) (S.D.N.Y. July 13, 2023).

the requirements of third-party efforts and reasonable profit expectations, as specified in the Howey test. The Court denied the motion filed by Terraform Labs based on the accepted evidence,[17] finding that LUNA investors could reasonably expect future profits resulting from the issuer's efforts in the secondary market. This denial of the motion demonstrates that whether an asset qualifies as a security under the Howey test should not be uniformly determined by categorization. Whether the requirements of an investment contract are met should be judged case by case based on specific facts.

Lastly, it is also a misconception that digital assets that can realize profits solely through capital gains, without the right to dividend, cannot satisfy the right-related requirement for investment contract securities under the FSCMA. However, this argument is difficult to accept based on the literal interpretation of the investment contract securities provision under the FSCMA. Since the requirements of investment contract securities under the FSCMA primarily originate from the U.S. Howey test, they closely mirror the three elements of the Howey test: i) the investment of money; ii) a common enterprise; and iii) the efforts of others. As for the fourth requirement, the Howey test requires "a reasonable expectation of profits" from the efforts of others, while the investment contract provision under the FSCMA requires "a contractual right to profits and losses" from the efforts of others.[18] Compared to the fourth requirement of the Howey test, which requires a reasonable expectation, the fourth requirement under the FSCMA, which demands an investor's contractual right beyond mere expectation, is more stringent. Therefore, the definition of investment contract securities under the FSCMA seems narrower compared to that of the U.S. Howey test. Some argue that a contractual right of investment contract securities should only be construed as a right to claim profit distribution. However, this hardly aligns with the literal interpretation of the relevant provision. When textually interpreted, the right stipulated in the requirement is interpreted as a contractual right to receive profits and losses from the efforts of others, and should not be narrowly construed as merely the right to claim profit distribution. In terms of the requirement, Korean financial authorities provide examples where the requirement is met, including "equity interest in the business operation" and "claims for the distribution of residual assets", as well

17) The evidence includes "readouts of investor meetings, excerpts of investor materials, and screenshots of social media posts made by Mr. Kwon and other Terraform executives." SEC v Terraform Labs, 23-cv-1346, Opinion and Order (July 31, 2023), p. 40.

18) Article 4(6) of the FSCMA.

as the "right to receive dividends based on business performance".[19] In transactions involving digital assets with smart contract functionality, contracts can be entered into solely through program codes without any written documentation, if the counterparty explicitly or implicitly agrees. In such cases, the relevant contractual obligations may be automatically performed. It is not desirable to rely solely on the concept of claims against the counterparty to define the scope of the right-related requirement for investment contract securities. From a financial policy perspective, it is not advisable to exclude all digital assets that do not have the right to dividend from being considered as investment contract securities. This is because it is not difficult to facilitate a secondary market that allows investors to enjoy capital gains equivalent to dividend income, without distributing profits from the common enterprise. If the securities nature of digital assets is determined based on the right to claim profits, many may attempt to seek less strict virtual asset regulations rather than rigorous securities regulations, potentially expanding regulatory gaps in the digital asset market.

Implications

The Court's ruling recognizing LUNA as a security is significant in that its assessment of securities nature focused on the transaction structure of sales activities, rather than on the rights inherent in the digital asset itself. This underscores that whether the sale of a specific digital asset falls under the jurisdiction of the Securities Act depends on the totality of circumstances such as specific facts and overall aspects, based on the economic reality of each case.[20] When interpreting the FSCMA provision regarding investment contract securities, akin to the U.S. Howey test, viewing the requirement for investment contract rights solely based on the intrinsic rights of the investment target is overly restrictive. A comprehensive assessment of the contract, transaction structure, and related sales activities context is necessary.

As mentioned above, in the event that a particular digital asset traded on a virtual asset exchange in Korea falls under the investment contract category, the virtual asset exchange would not be automatically deemed an illegal broker-dealer or unauthorized exchange under the FSCMA. Therefore, Korean financial and law enforcement authorities should not feel undue

19) Financial Services Commission, February 6, 2023, Regulatory framework for issuance and distribution of security tokens, press release, p.7.

20) Tcherepnin v. Knight, 389 U.S. 332, 336 (1967); Glen-Arden Commodities, Inc. v. Constantino, 493 F.2d 1027, 1034 (2d Cir. 1974).

pressure from how declaring certain digital assets as securities might influence the market. In particular, there is no reason for the authorities to hesitate in examining the securities nature of digital assets involved in unfair trading under the FSCMA.

The FSCMA should be strictly applied to unfair trading of digital assets involved in alleged securities fraud and significant investor damages, such as the Terra-LUNA case. Until the implementation of the Virtual Asset User Protection Act on July 19, 2024, there inevitably exists a regulatory gap in the unfair trading regulatory scheme of virtual assets in Korea. A large volume of transactions on virtual asset exchanges is conducted non-face-to-face and anonymously. Consequently, it is extremely challenging for law enforcement authorities to prove all the elements of fraud under criminal law in cases involving unfair digital market trading. In digital asset fraud cases utilizing large-scale trading facilities, it is imperative to rigorously assess whether the relevant sales activities qualify as securities offerings. Additionally, it is necessary to apply the stringent unfair trading provisions of the FSCMA, which facilitate the easier proof of fraud in the digital asset market and allow for stricter punishments. Considering the legislative intent of the FSCMA, which adopts the comprehensive regulatory framework for financial investment instruments, it is crucial to avoid narrowly interpreting the provisions of investment contract securities and leaving regulatory gaps unaddressed. In this context, Korea's law enforcement and financial authorities should develop securities nature evaluation criteria and practices using related U.S. cases as references.