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Making Waves Across the Crypto Industry: SEC v. Ripple

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The federal government's approach to regulating the nascent cryptocurrency industry has been one of the most closely watched – and high stakes – questions over the last few years. Are tokens a commodity? Are they a security? Are they simply a form of currency?

The Securities and Exchange Commission's ("SEC") case against Ripple Labs, Inc. ("Ripple") seemed poised to answer the questions. Although the recent decision in *SEC v. Ripple Labs, Inc.*[1]could be construed as a partial victory for Ripple, in many ways it created more questions (and pitfalls) for the crypto industry and has sent ripples throughout it.

Background

The SEC's case against Ripple, filed in December of 2020, focused on whether or not Ripple's sale of 14.6 billion tokens of "XRP" qualified as the unregistered sales of "securities" and, therefore, subjected Ripple to liability under the securities laws. Before delving into the case, it is useful to explain some of the crypto nomenclature.

What Are "Digital Tokens"

Digital assets are assets that are issued and/or transferred using distributed ledger or blockchain technology and are generally referred to as crypto "tokens." Blockchain is a peer-to-peer database that securely records all transactions in theoretically immutable, digitally recorded data packages. Digital tokens can be traded on digital asset trading platforms for other digital assets or fiat currency. Some digital assets may act as "native tokens" exclusively represented on their own blockchain.

Other digital assets may also coexist on the same blockchain. Native tokens typically serve various technical functions on a distributed ledger, such as bolstering ledger security against manipulation or attacks. Like other "digital tokens," native tokens can also be bought and sold for consideration.

What Qualifies As a "Security" Under the Howey Test

The Securities Exchange Act of 1934 (the "Securities Act") dates back to the Great Depression, long before distributed ledgers (or even computers) were anything other than science fiction. Because the legislature had no illusions about the ability of regulators to keep up with human innovation, there is no static definition for what constitutes a "security" subject to regulation under the Securities Act. Instead, the Securities Act includes a non-exhaustive list of various investment vehicles, including "investment contracts," that constitute a security under the federal securities laws.

Approximately a decade after the Securities Act was signed into law, the U.S. Supreme Court, in a decision titled *SEC v. W.J. Howey Co.*,[2] recognized this fact, holding that Congress defined "security" broadly to embody a "flexible rather than a static principle, one that is capable of adaptation to meet the countless and variable schemes devised by those who seek the use of the money of others on the promise of profits."[3] It therefore came up with a functional framework for determining whether something constitutes a security. The *Howey* Test considers the following factors:

First Prong: Investment of money. There must be an actual transfer of funds in exchange for an investment opportunity.

Second Prong: Common enterprise. The investment contract is made in a joint enterprise. This means that buyers pool their funds to profit from a shared enterprise.

Third Prong: Expectation of profits. The investor expects profits, meaning that they buy the security in the hope of earning a return on their investment.

In simple terms, if an asset involves a financial investment in a business which is linked to profits from other people's hard work, the asset is a security. An "investment contract" is usually shorthand for anything that is considered a security because it meets the *Howey* Test. Courts have found that novel or unique investment vehicles constitute investment contracts, including interests in orange groves, whisky warehouse receipts, animal breeding programs, railroads, mobile phones, and enterprises that exist only on the Internet.

The *Howey* Test framework, and its application to XRP, was at the heart of the SEC's case.

The SEC's Allegations Against Ripple

The SEC alleged that Ripple raised more than $1.3 billion "through an unregistered, ongoing digital asset securities offering" by selling over 14.6 billion XRP tokens.

According to the SEC, because Ripple never filed a registration statement, it never provided investors with the material information that issuers include in such statements when soliciting public investment. Instead, according to the SEC, Ripple created an "information vacuum" such that Ripple and its insiders could sell XRP into a market that possessed only the information that Ripple chose to share.

Ripple argued that XRP should be considered a "digital asset" (*i.e.*, a cash equivalent) and not a security, and thus not subject to the Securities Act's registration requirements. Ripple contended that XRP functioned as a medium of exchange and had utility within the Ripple network, primarily for facilitating fast and low-cost cross-border transactions.

The SEC countered that Ripple had actually received legal advice that XRP could be considered, under certain circumstances, an "investment contract" and therefore a security under the federal securities laws.

The Ripple Ruling: Sometimes a Security, Sometimes Not

On July 13, 2023, Judge Torres of the Southern District of New York ruled on the parties' cross-motions for summary judgment, granting and denying each in part.

The Court found that the XRP tokens are not themselves securities. Judge Torres ruled that while the so-called *Howey* Test defines an investment contract as a "contract, transaction, or scheme", the subject of a contract, transaction, or scheme is not necessarily a security.[4]But that was not the end of the analysis.

The Court went on to hold that, even if XRP exhibits characteristics of a currency, or of a commodity like gold, silver, or sugar, it may nonetheless be offered or *sold* as an investment contract depending on circumstances. The Court stressed that the *Howey* analysis focuses not on the underlying asset that is the subject of the investment contract, but on the economic reality and totality of circumstances surrounding the manner in which the underlying asset is offered and sold.[5] Therefore, even if the underlying asset was not a security, it does not mean that the sale of that asset cannot constitute a contract, transaction, or scheme (and therefore a security) under the Securities Act, depending on the circumstances.

Judge Torres ruled that, based on the manner in which they were offered and sold, certain transactions involving the XRP token are securities transactions and certain transactions are not. Specifically, the Court distinguished institutional marketing efforts and off exchange sales of XRP tokens (which it found constituted "investment contracts" under *Howey*) from on-exchange sales and other distributions.

Institutional sales:

The Court found that all three prongs of the *Howey* Test were met in the context of institutional sales. The Court framed the critical third *Howey* prong as whether the economic reality would have led institutional investors to have a reasonable expectation of profits to be derived from the entrepreneurial or managerial efforts of others. It held that this test was met primarily because Ripple's marketing to institutional investors linked increases in XRP's price to Ripple's success as a company.[6]

The Court explained that a reasonable institutional investor would have understood that Ripple would use the capital received from the sales to improve the market for XRP tokens and develop uses for the XRP Ledger, thereby increasing the value of XRP tokens. The Court further stressed that Ripple's overall messaging to institutional investors focused on XRP's investment potential and its relationship to Ripple's efforts and that the nature of the sales supported the conclusion that the tokens were sold as an investment rather than for consumptive use.[7]

Retail sales:

However, the Court held that Ripple's sales of XRP tokens on crypto exchanges, *i.e.*, to retail investors and others, did not meet the test for a security. Judge Torres concluded that, while an institutional investor could reasonably expect that Ripple would use the capital it received from its sales to improve the XRP ecosystem and thereby increase the price of XRP tokens, retail investors would not reasonably expect the same.[8]

Those sales were blind bid/ask transactions, and those retail investors could not have known if their payments of money went to Ripple, or any other seller of XRP tokens. Since 2017, Ripple's so-called "programmatic sales" represented less than 1% of the global XRP token trading volume. Therefore, the vast majority of individuals who purchased XRP tokens from digital asset exchanges did not invest their money in Ripple at all. While an institutional investor knowingly purchased XRP directly from Ripple pursuant to a contract, the economic reality is that a retail investors stood in the same shoes as a secondary market purchaser who did not know to whom or what it was paying its money.

Possible Regulatory Implications

Under the logic of the *Ripple* decision, at a minimum, distributions of tokens like XRP by the issuer or promoter should not be considered transactions in investment contract securities if: (i) they occur through blind bid/ask transactions on digital asset exchanges; (ii) the issuer's/promoter's distribution transactions represent only a small portion of global market trading volume at the time; (iii) public marketing materials would not lead a reasonable purchaser to expect that the issuer/promoter will deploy such assets to promote the business or tie an increase in value to the efforts of the promoter; and (iv) they lack other indicia such that a reasonable purchaser would harbor an expectation of profits derived from the issuer's/promoter's efforts rather than general market trends.

Perceived Victory for Cryptocurrency Exchanges

The ruling is being viewed as a victory for cryptocurrency exchanges because the tokens they list are similar to the XRP tokens in that they are not in and of themselves a "contract, transaction, or scheme." Therefore, the conventional wisdom goes, if they are not listing investment contracts, they cannot be accused of operating an unregistered securities exchange.

Whether a secondary market sale constitutes an offer or sale of an investment contract would depend on the totality of circumstances and the economic reality of that specific transaction. However, most secondary trading on crypto exchanges does not involve the token issuer, thus, under the *Ripple* reasoning, such secondary trading on crypto exchanges should not be deemed to be trading in securities.

Conclusions

In the famous thought experiment, the hypothetical Schrödinger's cat may be considered simultaneously both alive and dead until it is observed. Like Schrödinger's cat, following the Court ruling, a token can be simultaneously a security and not a security until it is sold.

There is a certain irony to the distinction between institutional investors and retail investors. If you are an institutional investor (deemed to be a sophisticated investor) that purchases a crypto token directly from an issuer or promoter, then that transaction is a security offering. However, if you are a retail (unsophisticated) customer purchasing a crypto token on an exchange, that transaction is different from an investment contract and falls outside the scope of (and protection from) the securities laws.

This is likely just the beginning of litigation on these issues, and the case has intensified scrutiny and criticism of the SEC. On the heels of the decision, members of Congress sent a letter to SEC Chair Gary Gensler criticizing the SEC for regulating by enforcement and calling for legislation that would provide clarity and allow for firms to come into regulatory compliance. Some members of Congress are trying to build bipartisan support for a crypto bill that would grant new powers to the Commodity Futures Trading Commission, the industry's preferred regulator, and limit the SEC.[9]

So, in many ways, this decision might just be the first major ripple in what is likely to involve significant developments in the regulatory landscape.

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[1] No. 20 Civ. 10832 (AT), 2023 U.S. Dist. LEXIS 120486 (S.D.N.Y. July 13, 2023).

[2] 328 U.S. 293 (1946)

[3] *Id.* at 299-300.

[4] *Ripple*, 2023 U.S. Dist. LEXIS 120486, at *22-24.

[5] *Id.*

[6] *Id.* at *26-36.

[7] *Id.*

[8] *Id.* at *35-39.

[9] https://agriculture.house.gov/uploadedfiles/fit_for_the_21st_century_act_of_2023.pdf

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