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Insights

SEC V. RIPPLE LABS: A CRITICAL INDUSTRY WIN

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SUMMARY

- On July 13, 2023, Southern District of New York Judge Analisa Torres issued an Order in *SEC v. Ripple Labs, Inc.* The SEC alleged that Ripple Labs had issued unregistered securities to investors, but Ripple contended that its token, XRP, was not a security as it was not an investment contract under the *Howey* test.
- Judge Torres' Order provided three key holdings regarding the question of whether a transaction of XRP is an investment contract: first, when issued to institutional investors, XRP's sale was a security; second, when sold via exchanges "programmatically" to individual investors, XRP's sale was not a security; and third, when issued to executives or via grants, XRP's issuance was not a security.
- Judge Torres' Order deals a significant blow to many of the SEC's recent arguments that almost all cryptocurrencies are immutably securities—cryptocurrencies themselves are never securities.

SEC V. RIPPLE LABS: A CRITICAL INDUSTRY WIN

Ripple Labs ("Ripple") was one of the first companies to emerge in the crypto space and is now among the first to secure a win against the SEC. In 2020—nearly a decade after Ripple created its digital token, XRP—the SEC sued Ripple, alleging that XRP was an investment contract pursuant to the *Howey* test.[1] Under *Howey*, an investment contract (*i.e.,* a security) exists where there is an investment of money in a common enterprise with an expectation of profits from the efforts of others.[2]

This week, however, Judge Analisa Torres of the Southern District of New York ruled that, "having considered the economic reality and totality of circumstances, . . . Ripple's Programmatic Sales of XRP did not constitute the offer and sale of investment contracts."[3] Judge Torres' Order signals a landmark victory for the cryptocurrency industry, as it demonstrates that

cryptocurrencies themselves are not securities. Judge Torres also held that the sale of XRP by Ripple to institutional investors constituted a security, which further emphasizes the importance of considering the relevant context in each transaction.[4] The Order's holding with respect to Programmatic Sales undermines one of the SEC's main contentions; namely, that a digital asset—once deemed a security—is always a security. To understand the Order's true significance, some historical context is required.

LOOKING BACK: FROM "THE DAO REPORT" TO *TELEGRAM*

The debate regarding whether cryptocurrency is an investment contract is rooted in a number of events spanning from 2017 to 2019,[5] all of which culminated in the SEC's action against Ripple Labs in late 2020. Many crypto companies have taken the position that tokens are not securities.[6] The general idea posited is that network tokens are decentralized assets that do not rely on the efforts of others.[7] To the contrary, the SEC has taken the position that certain tokens are investment contracts, and therefore constitute unregistered securities.[8]

The SEC's first answer to questions of cryptocurrency regulation came in the form of its report on The DAO.[9] The DAO was a "decentralized autonomous organization" designed to operate through smart contracts, allowing for decentralized control of the organization.[10] However, following a hack, the SEC alleged in 2017 that DAO tokens—currency used to vote on DAO projects[11]—were investment contracts under the *Howey* test and therefore unregistered securities.[12] Despite these allegations, the SEC refused to take action at that point in time.[13]

The SEC's next steps came in 2018 in the form of three settlements and two lawsuits. On November 8, 2018, the SEC announced its settlement with EtherDelta's founder, who the SEC alleged was running an unregistered securities exchange.[14] Specifically, the SEC alleged that "[f]rom July 12, 2016 to December 15, 2017, more than 3.6 million buy and sell orders in ERC20 tokens that included securities as defined by Section 3(a)(10) of the Exchange Act were traded on EtherDelta."[15] The SEC was unclear, however, as to exactly which digital assets that were traded constituted securities. Just one week after the EtherDelta settlement, the SEC announced that it settled registration charges with two token providers: AirFox and Paragon,[16] in connection with allegations that Paragon and AirFox engaged in securities offerings and that their tokens were therefore securities under the *Howey* test.[17] Pursuant to the settlements, Paragon and AirFox both agreed to register their tokens as securities.[18] Finally, in 2019, the SEC brought successful actions against both Kik and Telegram for unregistered securities offerings of tokens.[19]

SEC V. RIPPLE LABS

Following *Kik* and *Telegram*, the SEC brought an action against Ripple alleging the unregistered offer and sale of securities in December of 2020.[20] In so doing, the SEC argued that the XRP token was a security because it met the *Howey* test's elements.[21] In response, Ripple denied that XRP was an investment contract: it had never "offered or contracted to sell future tokens as a way to

raise money to build an ecosystem [and] never explicitly or implicitly promised profits to any XRP holder."[22] Over the course of the next several years, a number of high-profile *amici curiae* also filed briefs in support of Ripple.[23]

Finally, in September of 2022, both sides filed Motions for Summary Judgment.[24] In its later filings, Ripple contended that "[t]he SEC has not shown – and has not even tried to show – that *any* specific transactions (much less *all* of them) meet the requirements of the *Howey* test."[25] Shortly after the parties' initial submissions, however, the SEC prevailed in the District of New Hampshire case *SEC v. LBRY*.[26] There, the court held that LBRY's token, LBC, was a security because it met the "efforts of others" prong of *Howey* due to LBRY's officers making statements that were "representative of LBRY's overall messaging about the growth potential for LBC."[27] Nevertheless, Ripple maintained that "[a]t most, the SEC has shown that Ripple was acting to build its own innovative financial products, with no commitments to XRP holders."[28] Ripple's arguments, taken together, paved the way for this week's Order.

LOOKING AHEAD: TAKEAWAYS FROM THE *RIPPLE* DECISION

The judiciary's rebuke of the SEC's allegations that XRP is a security is a welcome victory for many in the digital asset space. As such, there are three key lessons from Judge Torres' Order: (1) the SEC's views are not the final word on digital asset regulation; (2) token sales on exchanges are unlikely to be securities; and (3) the SEC's regulation by enforcement approach is unsustainable.

Rebuking the SEC:

Judge Torres' Order shows that the SEC's one-size-fits-all arguments with respect to cryptocurrency are inherently flawed. Over the past six years, the SEC has repeatedly brought actions against token creators and DAOs alleging unregistered securities offerings.[29] The SEC's position that numerous digital assets are securities and remain so indefinitely is being challenged in the judicial and political spheres, as evidenced by CFTC Chair Rostin Behnam's statement that he "believe[s] [Ethereum is] a commodity."[30] Members of Congress also disagree with the SEC, as House Republicans recently proposed legislation to allow cryptocurrencies to be regulated as commodities.[31] Moreover, this Order underscores the importance of considering the context for each transaction, as it demonstrates that a token can exist as an investment contract in one transaction and not in another. These developments, coupled with yesterday's Order from Judge Torres, signify the growing consensus that digital assets are not all securities. To that end, alternative regulatory approaches, rather than the SEC's unuanced approach, are not just possible but indeed probable.

Sales on Exchanges are Permissible:

Further, this Order bolsters the argument that Programmatic Sales of a token by its creators on exchanges do not constitute investment contracts. In the Order, Judge Torres concluded that "Ripple

did not make any promises or offers because Ripple did not know who was buying the XRP, and the purchasers did not know who was selling it."[32] Thus, if a token is sold by a developer on an exchange, it is unlikely to meet *Howey*'s "efforts of others" prong. With regard to secondary market sales, the Order noted that this issue was not before the court.[33] Judge Torres' reasoning, however, suggests that the exchange investors in Programmatic Sales "stood in the same shoes as a secondary market purchaser who did not know to whom or what it was paying its money."[34] As such, this Order forms a solid basis for others to argue that secondary market token sales do not meet the "efforts of others" prong of *Howey* either.

The Limits of Regulation by Enforcement:

Finally, this Order displays the limits of the SEC's regulation by enforcement approach. Those in the digital asset space have repeatedly expressed frustration over the SEC's regulatory approach to crypto for some time, as there are no clear guidelines, only enforcement actions.[35] Some have even petitioned the agency for regulatory clarity,[36] including Senator John Hickenlooper, who requested SEC rulemaking for digital assets.[37] Now that a federal judge has ruled against the SEC on the linchpin of its enforcement strategy, the SEC will face additional legal and political challenges unless it modifies its approach. The landscape is ripe for either rulemaking by the SEC to define a reasonable approach to digital asset regulation, or a legislative approach such as what was recently proposed in Congress.[38] Either way, yesterday's Order makes one point clear: the SEC's current approach to cryptocurrency regulation is unfit to meet the current needs of the digital asset space.

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[1] Answer at 3, 8, *SEC v. Ripple Labs, Inc.*, No. 20-CV-10832 (S.D.N.Y. Jan. 29, 2021) (ECF No. 43).

[2] *S.E.C. v. W.J. Howey Co.*, 328 U.S. 293, 301 (1946).

[3] Order at 26, *SEC v. Ripple Labs, Inc.*, No. 20-CV-10832 (S.D.N.Y. July 13, 2023) (ECF No. 874).

[4] *Id.* at 22.

[5] *See generally* Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934: The DAO, Exchange Act Release No. 81207, 117 S.E.C. Docket 745, (July 25, 2017); *S.E.C. v. Telegram Group*, No. 19-CV-9439, 2020 WL 61528 (S.D.N.Y. Jan. 3, 2020); *S.E.C. v. Kik Interactive Inc.*, 492 F. Supp. 3d 169 (S.D.N.Y. 2020); In the Matter of CarrierEQ, Inc., Securities Act Release No. 10575, 2018 WL 6017664 (Nov. 16, 2018) (hereinafter "AirFox"); In the Matter of Paragon Coin, Inc., Securities Act Release No. 10574, 2018 WL 6017663 (Nov. 16, 2018) (hereinafter "Paragon"); In the Matter of Zachary Coburn, Securities Act Release No. 84553 (Nov. 8, 2018) (hereinafter "EtherDelta").

[6] *See, e.g.*, Tracy Wang, *Solana Foundation: SOL Is 'Not a Security'*, CoinDesk, https://www.coindesk.com/policy/2023/06/08/solana-foundation-sol-is-not-a-security (June 9, 2023, 10:58 A.M.).

[7] *See* Glenn Williams & David Lawant, *Bitcoin, Ether Fall Outside* Howey *Test Criteria*, CoinDesk, https://www.coindesk.com/markets/2023/06/21/bitcoin-ether-fall-outside-howey-test-criteria/ (June 21, 2023, 2:15 P.M.).

[8] Olga Kharif, *Gary Gensler's SEC Crypto Enforcement Actions Are Crystal Clear*, Bloomberg (Apr. 18, 2023, 5:00 PM), https://www.bloomberg.com/news/newsletters/2023-04-18/gary-gensler-s-opinions-on-sec-crypto-regulation-are-crystal-clear.

[9] *See* Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934: The DAO, *supra* note 5, at 1.

[10] *Id.*

[11] *Id.* at 6.

[12] *Id.* at 11.

[13] *Id.* at 1. ("The Commission has determined not to pursue an enforcement action in this matter based on the conduct and activities known to the Commission at this time.").

[14] *See* EtherDelta, *supra* note 5, at 1.

[15] *Id.* at 2.

[16] *See* AirFox, *supra* note 5, at 1; Paragon, *supra* note 5, at 1.

[17] *Id.*

[18] *Id.*

[19] *See Kik Interactive*, 492 F. Supp. 3d at 173; *Telegram Group*, 2020 WL 61528, at *1; Jeff Benson, *SEC Wins Historic Lawsuit Against Kik Over $100 Million ICO*, Decrypt (Sept. 30, 2020), https://decrypt.co/43473/sec-wins-historic-lawsuit-against-kik-over-100-million-ico; Anna Baydakova, *Telegram Agrees to Pay $18.5M Penalty in SEC Settlement Over Failed TON Offering*, CoinDesk, https://www.coindesk.com/policy/2020/06/25/telegram-agrees-to-pay-185m-penalty-in-sec-settlement-over-failed-ton-offering/ (Dec. 10, 2022, 3:16 PM).

[20] Complaint at 1-2, *S.E.C. v. Ripple*, No. 1:20-CV-10832 (S.D.N.Y. Dec. 22, 2020) (ECF No. 4).

[21] *Id.* at 36-56 (alleging that XRP meets the following *Howey* test prongs: (1) investment of money; (2) common enterprise; and (3) with expectation of profit from efforts of others).

[22] Answer, *supra* note 1, at 4-5.

[23] *See, e.g.*, Brief of *Amicus Curiae* The Blockchain Association, *S.E.C. v. Ripple Labs, Inc.*, No. 20-CV-10832 (S.D.N.Y. Nov. 15, 2022) (ECF No. 706).

[24] *See generally* Notice of Plaintiff Securities and Exchange Commission's Motion for Summary Judgment on Liability Against All Defendants, *S.E.C. v. Ripple Labs, Inc.*, No. 20-CV-10832 (S.D.N.Y. Sept. 17, 2022) (ECF No. 639); Notice of Defendants' Motion for Summary Judgment, *S.E.C. v. Ripple Labs, Inc.*, No. 20-CV-10832 (S.D.N.Y. Sept. 17, 2022) (ECF No. 642).

[25] Defendants' Reply in Support of Motion for Summary Judgment at 13, *S.E.C. v. Ripple Labs, Inc.*, No. 20-CV-10832 (S.D.N.Y. June 13, 2023) (ECF No. 832).

[26] *See S.E.C. v. LBRY*, No. 21-CV-260-PB, 2022 WL 16744741, at *7 (D.N.H. Nov. 7, 2022).

[27] *Id.* at *5.

[28] Defendants' Reply in Support of Motion for Summary Judgment, *supra* note 25, at 36.

[29] *See supra* notes 5-19.

[30] Jesse Hamilton, *U.S. CFTC Chief Behnam Reinforces View of Ether as Commodity*, CoinDesk, https://www.coindesk.com/policy/2023/03/28/us-cftc-chief-behnam-reinforces-view-of-ether-as-commodity/ (Mar. 29, 2023, 10:22 AM).

[31] Jesse Hamilton, *U.S. House Republicans Push for Crypto Oversight With Bill to Make SEC Play Ball*, CoinDesk, https://www.coindesk.com/policy/2023/06/02/us-house-republicans-push-for-crypto-oversight-with-bill-to-make-sec-play-ball/ (June 5, 2023, 10:12 AM).

[32] Order, *supra* note 3, at 24.

[33] *Id.* at 23.

[34] *Id.*

[35] Michael J. Casey, *Regulating Crypto by Enforcement and Stealth Will Set the US Back*, CoinDesk, https://www.coindesk.com/consensus-magazine/2023/02/10/regulating-crypto-by-enforcement-and-stealth-will-set-the-us-back/ (Feb. 10, 2023, 1:22 PM).

[36] Nikhilesh De, *Coinbase Asks U.S. Court to Force SEC Response to 2022 Rulemaking Petition*, CoinDesk, https://www.coindesk.com/policy/2023/04/25/coinbase-asks-for-court-to-force-sec-response-to-2022-rulemaking-petition/ (Apr. 25, 2023, 9:40 AM).

[37] Turner Wright, *US lawmaker says crypto regulation from SEC is 'needed now'* (Oct. 13, 2022), https://cointelegraph.com/news/us-lawmaker-says-crypto-regulation-from-sec-is-needed-now/.

[38] Allyson Versprille, *Key House Republicans Unveil Crypto Market Structure Draft Bill*, Bloomberg (June 2, 2023), https://www.bloomberg.com/news/articles/2023-06-02/key-house-republicans-unveil-crypto-market-structure-draft-bill/.

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