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Three Critical Questions That Will (Hopefully) be Answered by the SEC's Lawsuit against Ripple

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Late last year, the SEC filed a litigated action in the U.S. District Court for the Southern District of New York against Ripple Labs Inc. and two of its executive officers (collectively, "Ripple"), alleging that Ripple raised over $1.3 billion in unregistered offerings of the digital asset known as XRP. Ripple opted not to file a motion to dismiss the complaint, and based on recent filings it appears that the parties do not believe a pre-trial settlement is likely. The SEC's complaint alleges that, beginning in 2013, Ripple raised funds through the sales of XRP in unregistered securities offerings to investors in the U.S. and abroad. Ripple also allegedly exchanged billions of XRP units for non-cash consideration, including labor and market-making services. The SEC's complaint also named as defendants two executives of Ripple who allegedly effected personal, unregistered sales of XRP totaling approximately $600 million. According to the SEC, during all of this, Ripple failed to register its offers and sales of XRP, or satisfy any exemption from registration, in violation of Section 5 of the Securities Act of 1933.

The SEC's case rests on the proposition that XRP is a security – if it is not, the SEC lacks jurisdiction. In *SEC v. Howey*, the Supreme Court provided a framework for determining whether certain assets are "investment contracts," and therefore, are securities (Section 3(a)(10) of the Securities Act defines the term "security" to include an "investment contract"). In what is now known as the "Howey Test," the Court explained that an asset is a security if it represents an investment in a common enterprise *with the expectation of profits derived solely from the efforts of others*. In its complaint, the SEC argues that XRP is a security because investors who purchased XRP anticipated that profits would be dependent upon Ripple's efforts to manage and develop the market for XRP. Ripple has disputed the SEC's allegations, arguing that XRP is a "fully functioning currency that offers a better alternative to Bitcoin."

The Ripple case raises three very important questions regarding digital assets, and may provide a vehicle for the SEC or the court to offer answers to those questions:

1. When does a digital asset transition from a security to a currency (or something else)? At one end of the spectrum, the SEC has made it clear that it views almost any initial coin offering (ICO) to involve the offer of securities. At the other end, there is Ether, which today relies on a distributed ledger without a centralized administrator. In 2018, then Director of the SEC's Division of Corporation Finance, William Hinman, stated publicly that "putting aside the fundraising that accompanied the creation of Ether, based on my understanding of the present state of Ether, the Ethereum network and its decentralized structure, current offers and sales of Ether are not securities transactions." XRP probably falls somewhere in between those two extremes. Because of that, this case may present a unique opportunity for the SEC or the court to shed further light on how and where to draw the line between a security and a currency.
2. How will President Biden's administration approach digital assets? Under Chairman Clayton's leadership, the SEC took a deliberate approach towards digital assets and, as reflected by the Ripple case, was not hesitant to bring enforcement actions in this space. President Biden has nominated Gary Gensler to the be the next SEC Chair. For the past few years, Mr. Gensler has been a Professor at MIT, teaching courses on blockchain and crypto assets. He will almost certainly have strong views on how the SEC should approach digital assets. As this litigation progresses, we may gain some insight into those views.
3. How should disgorgement be calculated for a violation of Section 5 (and only Section 5) after the Supreme Court's decision last year in *Liu*? In the Ripple case, the SEC has alleged that the company raised over $1.3 billion from sales of XRP, and the two individual defendants sold approximately $600 million of XRP. In the past, the SEC has often argued that all proceeds of an offering made in violation of Section 5 were subject to disgorgement as ill-gotten gains. In *Liu*, however, the Supreme Court explained that courts should deduct "legitimate expenses" when calculating disgorgement. The Ripple case could provide the SEC or the court the opportunity to explain how to calculate legitimate expenses, particularly in this case, where there are no allegations that the company or executives engaged in fraud, and it looks like the company will be able show substantial expenses from operating its business and the executives will be able to show that they provided legitimate employment services to Ripple.

Hopefully, the Ripple case will provide answers to one or more of these questions. Stay tuned.

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