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The Ripple Effect: Implications of the SEC's Partial Loss in SEC v. Ripple Labs Inc.

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The SEC suffered a significant loss last week in its ongoing legal battle with Ripple over the XRP digital token. While the District Court held that Ripple's initial sales of XRP to institutional investors constituted the sale of unregistered securities, it was a Pyrrhic victory as the court held that all other ways in which Ripple sold or distributed XRP did not involve the sale of unregistered securities. In particular, the court held that Ripple's program to sell XRP to public buyers on digital asset exchanges, as well as its distribution of XRP as compensation to employees and third parties, did not constitute the offer or sale of securities. The court also rejected the SEC's arguments that Ripple used the institutional buyers as underwriters to sell XRP to the public. The opinion, if followed by other courts in pending litigation with the SEC, could have a far-reaching impact on the cryptocurrency markets, especially with respect to secondary market crypto trades on digital asset exchanges.

The Facts

The SEC sued Ripple Labs Inc. and two of its senior leaders for the unlawful offer and sale of securities in violation of Section 5 of the Securities Act of 1933 ("Securities Act"). The alleged security – the XRP token, which runs on the XRP blockchain – was developed by Ripple in 2012. The SEC alleged that from 2013 through the end of 2020, Ripple engaged in three categories of unregistered XRP offers and sales.

- First, Ripple sold XRP to institutional investors, such as hedge funds and institutional buyers, pursuant to written contracts (the "Institutional Sales") in order to raise money to finance its operations and help build a global payments network. Ripple raised approximately $728.9 million through Institutional Sales.
- Second, Ripple sold XRP "programmatically" on digital asset exchanges or through the use of trading algorithms (the "Programmatic Sales"). Ripple's XRP sales on these digital asset exchanges were blind bid/ask transactions – neither party knew who was buying or selling the XRP. The SEC alleged Ripple sold approximately

$757.6 million of XRP in Programmatic Sales and used the proceeds to fund its operations.

- Third, Ripple distributed XRP as a form of payment for services valued at approximately $600 million (the "Other Distributions"), which included employee compensation and payments to fund third parties to develop new applications for XRP and the XRP ledger.

While the context in which SEC is seeking enforcement is relatively novel (crypto tokens), the theory the SEC employed was not. Applying the precedent of *SEC v. W.J. Howey Co.*, the SEC argued that the crypto tokens met the definition of a security: that is, the tokens were an investment contract in which people (1) invest their money (2) in a common enterprise and (3) are led to expect profits solely from the efforts of the promoter or a third party.

The Ruling

Faced with deciding whether the XRP token was a security, Judge Analisa Torres issued a ruling that essentially says, "it depends." Judge Torres noted that the Institutional Sales to sophisticated investors – who were engaged in open, bilateral sales with Ripple pursuant to a written contract, and who understood that the value of the token would be directly tied to the performance and success of the seller (Ripple), constituted an investment contract (and involved sales of a security). In such transactions, the court found that all three prongs of the *Howey* test were satisfied. The court rejected defendants' attempt to supplement the *Howey* test with "a novel 'essential ingredients' test," which would have required "(1) 'a contract between a promoter and an investor that establishe[s] the investor's rights as to an investment,' which contract (2) 'impose[s] post-sale obligations on the promoter to take specific actions for the investor's benefit' and (3) 'grant[s] the investor a right to share in profits from the promoter's efforts to generate a return on the use of investor funds.'"

On the other hand, Judge Torres ruled that Ripple's Programmatic Sales of XRP to buyers on digital asset exchanges – in which Ripple was anonymously selling the tokens to unknown buyers – did *not* constitute an investment contract, because the buyers there had no expectation that the performance of the seller would impact the value of the token. The court further observed 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 (and therefore the record did not establish the third *Howey* prong). Thus, the court ruled, the knowledge of the *buyer* is key to understanding whether the sale of a crypto token is a securities offering, even if in actuality the seller's performance (in this case, Ripple's) could directly impact the value of the buyer's purchase in the future.

With regard to the Other Distributions, the court held that such distributions did not satisfy *Howey*'s first prong that there be an investment of money as part of the transaction or scheme. The court held that the recipients of the Other Distributions had not paid money or some tangible and definable consideration to Ripple.

Takeaways

If the ruling stands – and to be clear, the SEC may consider seeking an interlocutory appeal– the legal conclusions would severely limit the SEC's jurisdiction over crypto. The regulators are surely not happy about a two-tier classification of crypto offerings where (a) the same instrument sold at the same time can be a security or not one, depending on the buyer's expectations, (b) sales to (presumably) retail exchange customers would be subject to fewer protections than sales to institutional investors, and (c) at some point early in the process, secondary market crypto trades may cease being securities trades.

The impact in future offerings of the court's ruling that the Institutional Sales of the XRP token was a securities offering remains uncertain. Sales to institutional investors can be structured as exempt from registration under various exemptions under the Securities Act, subject to additional conditions applicable to the sale of restricted stock. While an exempt private offering would typically acknowledge that the digital asset in question was a security, the offering itself would not result in a Section 5 violation. It is unclear how Judge Torres would have ruled had the Institutional Sales of XRP been structured as an exempt offering. Indeed, two other district court judges in the Southern District of New York previously held that the sales of digital tokens in exempt private offerings were part of a larger scheme to distribute securities in a secondary public market in violation of Section 5.

The ruling could also affect securities class actions and plaintiffs' efforts to obtain class certification. If the determination whether a particular type of crypto is a security turns on each purchaser's expectations, individual questions about class members' expectations in buying crypto could overwhelm allegedly common questions and thereby preclude class certification – just as individual questions about reliance would inevitably defeat class certification without a presumption of reliance under an efficient-market theory.

The *Ripple Labs* ruling is a dramatic one, and its waves could be felt for a long time. Judge Torres' ruling is just the latest in a continuing series in which courts have wrestled with both the distinct similarities and differences that crypto tokens share with traditional securities investments, such as stocks. And although this ruling is a win for crypto companies, *Ripple Labs* will hardly be the last word on the narrower question of SEC jurisdiction over crypto tokens and the wider issue of oversight of the nascent cryptocurrency market.

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