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After Ripple, SEC Faces An Uphill Battle Exerting Comprehensive Regulatory Control Of Cryptoassets As Securities

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We have reached an inflection point in the United States' current "regulation by enforcement" paradigm of blockchain. The recent summary judgment opinion in SEC v. Ripple Labs, Inc., No. 1:20-cv-10832 (S.D.N.Y.), undertakes a valuable discussion on the circumstances under which token sales form investment contracts subject to securities laws. The opinion strikes the correct balance: at bottom, Judge Torres held that direct sales by an issuer to institutional and sophisticated investors are investment contracts, but sales through exchanges—even by Ripple itself—are not. The holding has significant implications for crypto market participants.

XRP is a classic centralized cryptocurrency: Ripple remains intimately involved in the promotion and administration of the network and the token itself, and Judge Torres cited evidence to that effect in her decision. Ripple works from a baseline, though, that even centralized cryptoassets are not inherently securities. Rather, the particular facts and circumstances of a transaction may make such a sale an "investment contract," a type of security. That theory is nothing new: in 1946, the Supreme Court held in SEC v. W.J. Howey Co., that sales of tracts of a Florida citrus grove could be regulated as securities because they were designed to raise capital to reinvest in the operation of the citrus grove, thus creating a return for buyers of the individual tracts. Put differently, if the sale of anything operates like a security—to raise funds to reinvest back into an enterprise to create a return—it is subject to the securities laws.

Howey led Judge Torres to opposite outcomes for Ripple's "programmatic" sales of XRP through exchanges, which the court held were not investment contracts, and direct sales of XRP to institutions and sophisticated investors, which were.

As to the programmatic sales, the purpose of exchanges is to anonymously match buy and sell orders to facilitate liquidity. The court found that even if Ripple intended to reinvest the proceeds of the programmatic sales into the coin and network, XRP buyers could not have known Ripple was the seller. Therefore, the buyers could not have known Ripple intended to reinvest the proceeds of the sale, and so no investment contract was formed. The court also found it was irrelevant that Ripple made the programmatic sales to take advantage of speculator activity in XRP because the appropriate inquiry is "not a search for the precise motivation of each individual participant" buying XRP on an exchange.

On the other hand, buyers in institutional sales know exactly who the seller is, and they frequently (as in Ripple) review investor materials that make clear why the seller is selling the asset. Judge Torres found that Ripple, through promotional materials, made XRP's institutional buyers aware that Ripple planned to use the proceeds of the sale to promote XRP, which would have the effect of increasing the value of the investor's own XRP holdings.

So, what are the takeaways?

First, should issuers seek to sell centralized tokens, direct sales to investors for investment purposes likely implicate the securities laws. Sales to the public through an anonymous exchange, however, will probably avoid obligations under the securities laws. Though no court has yet considered these facts, a court could come out differently under the logic of Ripple if the issuer of a token explicitly marketed the token to the general public for speculation or investment, and the public was aware that coins purchased on an exchange were highly likely to be sold by the issuer itself (for example, because of an explicit announcement by the issuer that it would be making a large number of sales at a particular time).

Second, the institutional sale holding in Ripple may be distinguishable where the underlying token is decentralized, or where the sale is being made to facilitate specific transactions where the token will be used as currency, rather than for speculative investment. Those facts were not before the court in Ripple, so they are necessarily outside the holding.

Third, Ripple poses real problems for SEC enforcement actions against crypto brokers and exchanges, which rely on many of the same legal theories. If the assets being sold on crypto exchanges are not inherently securities and are not investment contracts due to the anonymity of exchange transactions, then it will be difficult for the SEC to argue that the exchange operators are running securities exchanges, or that crypto brokers are securities brokers. Coinbase, for example, has to be feeling better today than they were a week ago about their likelihood of a successful defense.

Fourth, although Judge Torres explicitly did not opine on whether direct sales of cryptoassets between non-issuer market participants are investment contracts (see footnote 16 of the Opinion), non-issuers should be feeling relatively safe that most secondary market crypto transactions are not subject to securities laws after Ripple. Although it is conceivable that a non-issuer of a coin could use the proceeds of a direct sale to promote the coin or improve the administration of the coin's network, which under the logic of Ripple could be an investment contract, the vast majority of crypto sales will not involve those facts.

Finally, it is important to remember one district judge's view—however logically and legally sound—is not a panacea. Until higher courts have a chance to pass on these issues, all market participants should continue to assign some risk (though less than before) to the possibility that their cryptoasset transactions could be considered securities. For example, some recent cases involving more problematic allegations could incline another judge to rule differently. However, Ripple could be a catalyst for the SEC, CFTC, and/or Congress to work together to create a coherent framework for crypto regulation, given the difficulties the SEC is facing in attempting to shoehorn cryptoassets into the existing securities laws.

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