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Will There Be a Ripple Effect? Federal Judge Rules Some Sales of XRP Were Not Securities Transactions.

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The long battle between the U.S. Securities and Exchange Commission ("SEC") and Ripple reached a partial resolution with the Court ruling the digital asset at issue ("XRP") is not itself a security and certain sales of the asset are not securities transactions. This is one of the most significant rulings in digital asset cases thus far and the first final disposition by a court that was in favor of a digital asset issuer and against the SEC.

Introduction

A federal judge ruled on July 13, 2023, that sales of XRP by Ripple and its affiliates (i) to the general public through anonymous exchanges did not constitute sales of securities but (ii) to institutional investors through contractual arrangements did constitute securities transactions.[1]

As will be discussed in more detail below, Ripple is a network for the global transmission of payments, primarily between financial institutions with XRP being the "in network" token used for processing transfers between different currencies. During the period from 2013 to 2020, more than $1.3 billion of XRP was sold by Ripple primarily through two different methods: (i) sales to institutional investors through some sort of subscription documents and (ii) sales to the public anonymously via digital asset exchanges.

U.S. District Court Judge for the Southern District of New York (S.D.N.Y.) Analisa Torres ruled in SEC v. Ripple Labs, Inc. that Ripple's sales of XRP to sophisticated buyers and hedge funds ("Institutional Buyers") pursuant to written contracts ("Institutional Sales") were securities because, considering the totality of the circumstances, these buyers would have purchased XRP expecting to profit from Ripple's efforts.[2] In contrast, sales to the general public anonymously through digital asset exchanges ("Programmatic Sales") were not securities because there was no evidence demonstrating these buyers ("Programmatic Buyers") had the same expectation.[3] The Court also

found that distributions of XRP as employee compensation or to third parties as a way to develop new applications for Ripple's platform ("Other Distributions") were not securities because there was no investment of money.[4]

It remains to be seen whether this decision will have a significant "ripple" effect for the crypto industry because other jurisdictions are not bound by the court's decision and the SEC may appeal the decision once it is able to do so. For now, it marks the first significant judicial headwind to what is perceived by many as the SEC's attempt to impose rules on crypto entities through enforcement. This ruling also provides some hope that courts will provide material clarity on the regulatory status of digital assets and shape future regulations.

Ripple Background

Ripple was founded to create a less expensive means of transferring between currencies by creating a more efficient alternative to the Bitcoin blockchain, which it launched in 2012 and was labeled the XRP Ledger (the "Ledger").[5] The Ledger requires XRP, the native token, to operate and XRP is intended to be used to build software products on top of the Ledger.[6] Unlike Bitcoin where additional Bitcoin is consistently created through "mining," all XRP was created at the time the Ledger was launched, with 80% of the token supply given to Ripple and 20% given to its founders.

Ripple's stated mission is to revolutionize international financial transactions by reducing both transaction fees and the time to complete a transaction. For instance, Ripple's network, RippleNet, employs the blockchain to create a payment network designed to provide faster and cost-effective international transactions by enabling financial institutions to transact directly with one another.[7] Likewise, XRP acts as a bridge currency to other currencies to facilitate fast and inexpensive international transfers.[8]

Between 2013 and 2020, Ripple allegedly raised more than $1.3 billion from selling or distributing XRP through Institutional Sales, Programmatic Sales, and Other Distributions.[9] During this time, Ripple allegedly marketed XRP as an opportunity for people to invest and grow XRP's value and use cases. Some of these marketing efforts included informational brochures, public blog posts, or Ripple leaders publicly commenting on XRP's value.[10]

Specifically, Ripple raised approximately $730 million by selling XRP to Institutional Buyers pursuant to written contracts in Institutional Sales.[11] These written contracts often contained resale restrictions and required the Institutional Buyers to indemnify Ripple for claims resulting from selling or distributing XRP. Ripple raised approximately $758 million from Programmatic Sales through blind bid/ask transactions—XRP was sold on digital asset exchanges and neither party knew who was selling or buying the XRP.[12] Further, Ripple allegedly raised approximately $609 million in value from Other Distributions which were distributions of XRP in the forms of grants, charitable giving, and employee rewards.[13] Ripple's co-founder, Chris Larsen, and Ripple's CEO, Brad Garlinghouse, each allegedly sold XRP via Programmatic Sales and earned a combined $600 million. Throughout this time, Ripple did not file any registration or financial statements or periodic reports with the SEC.[14]

Case Background

In 2020, the SEC filed a lawsuit against Ripple, Larsen, and Garlinghouse alleging that the sale of XRP was an unregistered security offering in violation of Sections 5(a) and 5(c) of the Securities Act (15 U.S.C. §§ 77e(a) and 77e(c)).[15]

In its motion for summary judgment, the SEC alleged that selling XRP qualified as an "investment contract" under securities law.[16] The SEC advanced an "embodiment" theory in which the token itself embodied the securities transaction it was allegedly being sold under.[17] The SEC supported their assertions, among other things, by citing Ripple's marketing promises to increase the value of XRP for the benefit of XRP owners and for Ripple, and by pointing to the economic expectations XRP purchasers had for Ripple to increase XRP's value.[18]

In response, Defendants countered in their own motion for summary judgment that XRP transactions did not constitute investment contracts, claiming that the transactions did not have the "essential ingredients" of an investment contract.[19] Defendants also focused on the Blue-Sky laws from which the term "investment contract" originated to support their defense that there are certain essential elements of every investment contract such as privity of contract between the promotor/investor, and contractual post-sale obligations on the promotor/its affiliates.[20] Defendants focused on the transactions where there was no consideration, aiming to demonstrate that not all distributions of XRP fulfilled the necessary elements.[21] Additionally, for all XRP transactions, Defendants underscored the fact that XRP sales lacked a written contract explicitly designating the purchase of XRP as an investment and imposing obligations on Ripple to enhance the value of XRP.[22]

Defendants also raised the affirmative defense that Defendants did not have fair notice of the violations by the SEC, alleging the SEC failed to offer clear guidance regarding the sale of cryptocurrencies like XRP, making it unreasonable for individuals to know that XRP qualifies as a security.[23]

The Order

Under the pinnacle Howey test, the Court laid out the relevant analytical framework: "under the Securities Act, an investment contract is "a contract, transaction[,] or scheme whereby a person [(1)] invests his
money [(2)] in a common enterprise and [(3)] is led to expect profits solely from the efforts of the promoter or a third party."[24] Further, the Court highlighted the requirement for a transaction-by-transaction analysis according to the substance, economic reality, and the totality of the circumstances.[25]

The Court's ruling focused on three key issues. First, determining the applicable test to ascertain whether the sale of XRP constituted an investment contract. Second, establishing a clear distinction between the various transactions Ripple conducted for distributing XRP and determining which transactions were in violation of the Securities Act, if any. Lastly, addressing whether the Defendants had a valid fair notice defense.

Is XRP a "Security"?

Rejection of Defendants' "Essential Ingredients" Test and SEC Embodiment Theory

The Court declined to accept the Defendants' "essential ingredients" test, where the Defendants claimed, in addition to the Howey elements, investment contracts must be "'(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.'"[26]

The Court rejected this idea and found the relevant inquiry must focus on whether it was objectively reasonable for XRP purchasers to expect a financial return or profit based on Ripple's efforts.[27] Additionally, the Court found the current test effectuates the Securities Act's fundamental policy of giving broad protection to investors regardless of whatever scheme human ingenuity produces.[28]

The Court also rejected the SEC's embodiment theory, that the token itself embodies an investment contract scheme. In a previous digital asset case ruling, the Court in SEC v. Telegram held that the "security" was neither the token nor the sales contracts for those tokens, but rather the entire scheme.[29] The Ripple decision seems to take it a step further holding that the digital asset itself is not a security, but rather the scheme under which the digital asset is sold is the important consideration and is something which needs to be done on a transaction-by-transaction basis.

Institutional Sales

The Court ultimately found the Institutional Sales were investment contract sales subject to the Securities Act.[30] Under Howey's first element, the Court found the Institutional Buyers invested money because they provided fiat currency in exchange for XRP thereby providing Ripple with capital.[31] The Court also found the "common enterprise" element was satisfied because Ripple pooled all the proceeds from the Institutional Sales and the Institutional Buyers' fortune benefitted from XRP's success.[32] Lastly, the Court concluded there was a reasonable expectation to profits from Ripple's entrepreneurial and managerial efforts.

Utilizing an objective approach, the Court reasoned Ripple's communications, marketing efforts, and the substance of the written contracts between Ripple and the Institutional Buyers would cause investors to believe Ripple would invest the money received from the Institutional Sales to enhance XRP's value, which in turn would generate profits for the Institutional Buyers.[33] For instance, Ripple's marketing brochures conveyed XRP's value would increase as more people adopted XRP or as XRP's popularity grew.

Notably, the Court rejected the Defendants' claim that XRP was akin to buying or selling a commodity, like gold or silver.[34] The Court explained that even selling gold or silver could be sold as an investment contract, under certain circumstances.[35]

Programmatic Sales

On the other hand, the Court determined that the Programmatic Sales of XRP did not constitute the offer and sale of investment contracts.[36] Without evaluating the other two prongs, the Court ruled that the Programmatic Sales did not establish the third Howey prong because Programmatic Buyers could not reasonably expect that Ripple would use the capital from the Programmatic Sales to increase the value of XRP.[37] These buyers were not aware they were buying XRP from Ripple in the first place. In fact, the majority (about 99%) of Programmatic Buyers purchased XRP from secondary owners, meaning Ripple did not directly receive the proceeds from these transactions.[38]

The decision is similar to Hocking v. Debois, in which a 9th Circuit Court of Appeals found that the sales of condos with rental service contracts would be a securities transaction if sold by the original developer, but which required a facts and circumstances analysis when sold on the secondary market.[39] Unlike stocks and bonds which are de facto securities,[40] the existence of an investment contract is determined on a transaction-by-transaction basis taking into account the asset purchaser's objectively reasonable understanding at the time of purchase: it could be an asset (which they could subjectively believe will increase in value, like a car or horse) or an investment

contract (in which they are objectively relying on the efforts of others to make the value increase).

Here, the Court found there wasn't an objectively reasonable understanding that some of the purchase price for XRP bought on secondary markets would go to Ripple to increase XRP's value. "Whereas the Institutional Buyers reasonably expected Ripple would use the capital it received from its sales to improve the XRP ecosystem and thereby increase the price of XRP…Programmatic Buyers could not reasonably expect the same."[41]

The Court used that and other factors, such as lack of contractual lockup provisions for those XRP purchases and lack of evidence that Programmatic Buyers saw or understood the marketing materials of Ripple prior to purchasing XRP on secondary marketplaces, to find the Programmatic Sales were not investment contract transactions.[42]

Notably, the Court explicitly rejected the SEC's arguments that managerial efforts of others could be inferred because Ripple targeted speculative investors or because Ripple "understood that people were speculating on XRP as an investment."[43] Instead, the Court applied the objectively reasonable understanding standard from Howey, rejecting the arguments by both sides regarding subjective intent to use or subjective belief that the value of XRP would increase after purchase.

Other Distributions

The Court also ruled that Ripple's grants of XRP to charities, Ledger developers, and as employee compensation did not constitute an "investment of money" under Howey.[44] While the Court cited to caselaw which establishes that "investment of money" does not need to be fiat currency but can be other forms of tangible and definable consideration, the Court found there was no such investment of money in the Other Distributions.[45] This section of the Court's ruling is the most cursory, and it is unclear if this is based on the Court's belief that these particular Other Distributions didn't meet the "investment of money" standard or if the SEC simply failed to produce a record showing the consideration provided by employees and XRP Ledger developers were tangible and definable.

Did Defendants Have Fair Notice?

The Court did not accept Defendants' defense under the Due Process Clause of the Fifth Amendment that they lacked fair notice of what conduct was forbidden or required, asserting that the caselaw provides a clear test for determining what constitutes an investment contract.[46] In alleging their defense, the Defendants focused on the SEC's lack of clear guidance on digital assets, but the law does not require the SEC to warn all potential violators.[47] The Court found there was sufficient due process because caselaw that defines an investment contract provides a person of ordinary intelligence a reasonable opportunity to understand what conduct it covers, and cases subsequent to Howey show how that test would be applied in various situations.[48] However, in footnote 20, the Court stated its holding was "limited to the Institutional Sales because the SEC's theories as to the other sales in this case are potentially inconsistent with its enforcement in prior digital asset cases."[49]

What This Means for the Industry

Similar to the ruling in LBRY, this is a single decision from a single court with limited precedential value.[50] It is likely to be appealed by the SEC, Ripple, or both, although the courts would need to exercise a fair amount of discretion for the decision to be appealed before the remaining portions of the case – pertaining to aiding and abetting violations – are finally decided or otherwise disposed of.

However, unlike LBRY, the Ripple ruling handed the SEC its first true loss against the digital asset industry. It provides both a potential framework on how to structure certain distributions of digital assets and a cogent argument against the “embodiment theory” pushed by the agency that once a token is sold in a securities transaction then it and all other tokens like it are securities. It also provides some additional guidance on how to conduct an offering and sale of digital assets in compliance with applicable laws.

While not explicitly stated, the decision provides some vindication to the view that tokens without equity-like characteristics are not themselves securities, but an investment contract could be formed when that token is paired with a transaction. This is similar to Howey itself, which related to the sale of plots of orange groves combined with a service agreement to pick and sell the fruit. That combination created an investment contract, but the oranges weren’t securities. This puts tokens in a category with a myriad of other asset classes – beavers, construction equipment, gold, condominiums, and cattle among them – which, if paired with a contract, the sale could become a securities transaction.[51]

By finding that digital assets are not securities in certain circumstances, this case also underscores the need for legislative and regulatory clarity. It shows that a reasonable court could find that there are regulatory gaps in the sale of these instruments – a position that the SEC itself acknowledged as recently as 2021,[52] until changing its tune and stating that the entire crypto industry outside of Bitcoin can be regulated by the SEC.[53]

There was already a rising push for some form of digital asset regulation, even amongst detractors, as the industry’s longevity has become less and less deniable. We hope this ruling spurs Congress to work diligently to pass digital asset framework legislation. Currently, both the House and Senate are discussing comprehensive digital asset bills along with other digital asset bills like the stablecoin legislation in the House.[54] It is possible this Ripple decision spurs forward motions on some of these legislative efforts.

This decision alone, however, does not substantially change the regulatory and legal environment applicable to digital asset businesses. All it means is that certain anonymous sales of XRP when sold on secondary marketplaces do not constitute securities transactions (for now). It does not necessarily mean any other token is not a security when sold on a secondary marketplace, or that selling through a secondary marketplace is an endorsed end-around to securities laws for other token issuers. Each investment contract case still requires a transaction-by-transaction analysis and not every case will have identical facts to Ripple.

That said, when combined with other developments, such as large financial services, companies openly embracing digital assets, and movement amongst members of Congress on digital asset policy, it is hard not to be optimistic for the industry’s growth in the U.S. where previously such optimism was hard to come by.

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FOOTNOTES

[1] Order 22, ECF No. 874.

[2] Order 16, ECF No. 874.

[3] Order 25, ECF No. 874.

[4] Order 27, ECF No. 874.

[5] Order 2, ECF No. 874.

[6] Order 2, ECF No. 874.

[7] Order 3, ECF No. 874.

[8] See Order 3, ECF No. 874.

[9] See Order 4-5, ECF No. 874.

[10] Order 4-5, ECF No. 874.

[11] Order 4, ECF No. 874.

[12] Order 4, ECF No. 874.

[13] Order 5, ECF No. 874.

[14] Order 5, ECF No. 874.

[15] Pl's Memo in Supp. Summ. J. 63, ECF No. 640.

[16] Pl's Memo in Supp. Summ. J. 49, ECF No. 640.

[17] See Pl's Memo in Supp. Summ. J. 49-52, ECF No. 640.

[18] Pl's Memo in Supp. Summ. J. 53-56, ECF No. 640.

[19] Def. Memo in Supp. Summ. J. 2, ECF No. 643.

[20] Def. Memo in Supp. Summ. J. 2, ECF No. 643.

[21] Def. Memo in Supp. Summ. J. 26-28, ECF No. 643.

[22] Def. Memo in Supp. Summ. J. 29-30, ECF No. 643.

[23] Pl's Memo in Supp. Summ. J. 69, ECF. No. 640.

[24] SEC v. W.J. Howey Co., 328 U.S. 293, at 298–99 (alterations in original).

[25] Order 16, ECF No. 874.

[26] Order 11-12, ECF No. 874.

[27] Order 13, ECF No. 874.

[28] Order 12-13, ECF No. 874.

[29] SEC v. Telegram, 448 F. Supp. 3d 352, 366 (S.D.N.Y. 2020).

[30] Order 16-17, ECF No. 874.

[31] Order 16, ECF No. 874.

[32] Order 17-18, ECF No. 874.

[33] Order 18-22, ECF No. 874.

[34] Order 22, ECF No. 874.

[35] Order 22, ECF No. 874.

[36] Order 22, ECF No. 874.

[37] Order 23, ECF No. 874.

[38] Order 23, ECF No. 874.

[39] Hocking v. Debois, 885 F.2d 1449 (9th Cir. 1989).

[40] 15 U.S.C.A § 77B; 15 U.S.C.A. § 78c; & 15 U.S.C.A. § 80a-2.

[41] Order 23, ECF No. 874.

[42] Order 24, ECF No. 874.

[43] Order 22, ECF No. 874.

[44] Order 26, ECF No. 874.

[45] Order 26-27, ECF No. 874.

[46] Order 29-30, ECF No. 874.

[47] Order 30, ECF No. 874.

[48] Order 29-30, ECF No. 874.

[49] Order 29, ECF No. 874.

[50] SEC v. LBRY, Inc, No. 21-cv-260-PB, 2022 U.S. Dist. 2022 WL 16744741 (D.N.H. Nov. 7, 2022).

[51] Lewis Cohen et al., The Ineluctable Modality of Securities Law: Why Fungible Crypto Assets are Not Securities, DLxLaw. Nov. 2022, at 56-58.

[52] Chair Gary Gensler, Testimony at Hearing before the Subcommittee on Financial Services and General Government U.S. Appropriations Committee, U.S. Securities and Exchange Commission (May 17, 2022), https://www.sec.gov/news/testimony/gensler-testimony-fsgg-subcommittee.

[53] Chair Gary Gensler, Testimony of Chair Gary Gensler before the United States House of Representatives Committee on Financial Services, U.S. Securities and Exchange Commission (Apr. 18, 2023),.

[54] H.R. 4662 118th Cong. (2023); Responsible Financial Innovation Act S. 4356 118th Cong. (2023); Stablecoin Transparency Act S. 3970 117th Cong. (2022).

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