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SEC vs. Ripple: Reading the NFTea Leaves

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Judge Analisa Torres has now told the world that whether a cryptocurrency token is involved in an investment contract and therefore a security depends on how it is sold - *i.e.,* is the nature and specifics of that sale transaction within the meaning of an investment contract? Many fungible tokens are largely analogous to the XRP token in the ways that matter to Judge Torres' decision. But what about non-fungible tokens (NFT)? What does this decision mean for the NFT vertical in the Web3 ecosystem?

The Southern District of New York decision in *SEC v. Ripple Labs, et al.* is a watershed opinion for the cryptocurrency industry, finding that token XRP is not, in and of itself, a security under the "investment contract" analysis of the Supreme Court's *Howey* test. If XRP is not a security, the logic goes, then neither is any other cryptocurrency token.

The *Ripple* decision is more nuanced than that because it did, in fact, find that Ripple violated the registration requirements of Section 5 of the Securities Act of 1933 in sales of XRP directly from Ripple to institutional investors. That finding is a technical "win" for the SEC, but overall the decision is a loss for the SEC's broader, and ongoing, efforts to "regulate by enforcement" in the cryptocurrency arena, because Judge Torres also found that "programmatic" (*i.e.,* " blind" bid/ask sales) of XRP were not investment contracts and therefore not securities. Judge Torres similarly found that Ripple's use of XRP as compensation for services by employees and third parties did not amount to investment contracts or securities transactions.

What Does This Mean for NFT Projects?

The SEC has not yet announced any enforcement actions or settlements relating to the registration of NFTs as securities, but all signs point to the agency working on it.

Note: The recent Rally Rd. settlement doesn't count here. Rally qualified its offerings under the Reg. A exemption from registration, thereby conceding that it was offering securities, but the settlement for a relatively inconsequential US$350,000 was for failing to register as a securities exchange.

Here's the upside for secondary trading: the *Ripple* decision essentially establishes, without actually deciding, that secondary market trades of XRP are not investments. Judge Torres did not formally make that conclusion because the question was "not properly before this Court," meaning it was

technically not part of the SEC's claims in this case. That being said, Judge Torres held that the reasonable expectation of profits/efforts of others prong of the *Howey* test was not met because "the economic reality is that a Programmatic Buyer stood in the same shoes *as a secondary market purchaser who did not know to whom or what it was paying its money*." (Emphasis added).

XRP secondary trading did not involve resale royalties going back to Ripple, like most NFT projects, but the recent Southern District of New York decision in *Friel v. Dapper Labs* found that the existence of resale royalties in NFT secondary trading alone does not establish the "common enterprise" prong of the *Howey* test. Put these two cases together and it starts to form what lawyers call a "string cite" for purposes of legal briefing to support the argument that the existence of a secondary market, even with resale royalties, does not in and of itself make a token (fungible or non-fungible) a security.

Of course, it will all come down to the facts and circumstances of the contract or "scheme" (a la *Howey*) pursuant to which sales are made. The SEC might argue, for example, that resale royalties known to be flowing to an issuer is suggestive of a common enterprise and/or a rise in sales prices based on expected efforts of the promoter, but judicial precedent on these points is starting to pile up against them. In all events, the good news for NFT projects is that a body of law is beginning to evolve where the SEC has refused to issue guidance or regulations.

Primary sales of NFTs may be analogous to Ripple's "institutional sales," which Judge Torres found were investment contracts and, therefore, subject to registration as securities. Even so, there are lessons in Judge Torres' decision about how to structure those sales, based on the Court's discussion of the actual contracts governing the institutional sales.

Finally, the *Ripple* decision mentions and relies on *United Hous. Found. v. Forman*, the Supreme Court decision that, among other things, underscores the proposition that purchases made primarily for consumption or use do not meet the expectation of profits prong of the *Howey* test.
The *Ripple* decision does not discuss this utility/consumption argument, which will almost certainly be the main battlefield where the applicability of *Howey* to NFTs will be decided. It's still the case that NFT projects will be on safer ground if they are primarily about utility and consumption and zealously avoid any promotion or marketing that suggests or appeals to profit motives.

Takeaways

While the *Ripple* decision is certainly a win for the cryptocurrency industry and an overall loss for the SEC, its application in the NFT space will be fact specific and largely dependent on the terms and structure, *i.e.,* the economic reality, of NFT sales. Perhaps the *Ripple* decision will spark a chilling effect on the SEC's current "regulation by enforcement" approach, including in the NFT sector. Maybe they will begin to provide actual guidance and/or regulation in the manner that federal agencies are supposed to act. Maybe not. The SEC will likely appeal the decision to the Second Circuit Court of Appeals, so we may end up with more case law from higher courts to add to the discussion in the future. In the meantime, keep an eye out for motions and decisions citing the *Ripple* decision in the SEC's recently-filed enforcement actions against Coinbase (also in the Southern District of New York) and Binance (in the D.C. District).

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