Crypto and the SEC v. Ripple Labs, Inc. Decision: What Did the Court Actually Say?

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Earlier this month, a federal trial court judge issued an opinion ruling on whether sales of a digital token, XRP, constituted a "security" for purposes of federal securities laws. Some headlines reporting the ruling have described it as a "blow" to the SEC or used similar framing. However, the actual ruling was nuanced, and understanding those nuances will be important to crypto firms and investors.

Over 2 ½ years ago, the SEC initiated an enforcement action against Ripple Labs, Inc. ("Ripple") and two of its senior executives (collectively, the "Ripple Defendants") alleging that they violated the Securities Act of 1933 (the "Securities Act") by offering and selling XRP, a digital token created by Ripple, without registering XRP or the offering with the SEC.[1] The Ripple Defendants disputed the SEC's arguments, arguing that XRP did not constitute a "security" under the Securities Act, and therefore there was no obligation to register XRP under the Securities Act.[2]

On July 13, 2023, on dueling motions for summary judgment, a federal district court in Manhattan finally weighed in on the merits of each side's arguments.[3] Some headlines reporting on the case have described the ruling as a win for Ripple and the crypto industry, and in some respects, that characterization is accurate.[4] However, the court also partially ruled in favor of the SEC, finding that some offers and sales of XRP constitutes a security and that Ripple violated the Securities Act[5] by engaging in the unlawful offer and sale of securities without a registration statement in effect.

Therefore, it'd be a mistake to view the case as an absolute rejection of the SEC's efforts to apply federal securities laws to the crypto industry. This article looks at the underlying law regarding the definition of a security and how the court applied that law to Ripple and XRP.

The Securities Act and the definition of a "Security"

Section 5 of the Securities Act makes it unlawful for any person to offer to sell, offer to buy, sell, or buy a security unless (a) a registration statement is in effect or has been filed with the SEC as to the offer and sale of such security to the public, or (b) the offer, sale, or purchase is exempt from registration under the Securities Act.[5] Many security offerings by startups or other privately held companies avoid registration by adhering to one of the exemptions stated in the Securities or rules adopted by the SEC under the Securities Act, such as an exemption for private offerings by the issuer that do not involve any public offering, public advertising, or general solicitations.

The Ripple Defendants do not appear to have argued in their summary judgment motion that the offerings of XRP were exempt from registration due to the lack of a public offering. Rather, the Ripple Defendants argued that XRP did not constitute a security, and therefore its offering and sales of XRP did not fall within the scope of the Securities Act.[6]

Section 2(a)(1) of the Securities Act defines a security by providing a long of list of assets and items that constitute a security.[7] The list contains a few assets that many would intuitively consider to be a security, such as any "stock" or "bond." However, the list also includes a few terms that are not as well-defined, such as the term "investment contract"

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that was at the heart of the Ripple decision.

The *Howey* Test

The U.S. Supreme Court defined the term "investment contract" as used in the Securities Act in its 1946 ruling *SEC v. W.J. Howey Co.*[8] In *Howey*, the Supreme Court analyzed whether sales of citrus grove land sale contracts and optional service contracts to investors who were to receive profits in the harvest constituted "investment contracts", and therefore "securities", under the Securities Act.[9]

The land sale contract provided for investors to buy strips of land that had been planted with citrus trees from the offering company.[10] The service contracts, offered by an affiliate of the entity selling the land sale contracts, were optional, but investors were told that an investment in a citrus grove was not feasible without having service arrangements in place.[11] Under the service contracts, the investor leased the land back to the offering company and authorized the offering company to manage the citrus crops in exchange for the cost of labor and materials plus a specified fee.[12]

The Supreme Court defined an "investment contract" as a "contract, transaction or scheme whereby a person invests his money in a common enterprise and is led to expect profits solely from the efforts of the promoter or a third party."[13] Subsequent cases have, among other things, (a) indicated that courts should look at the "totality of circumstances" of each case in determining whether a given arrangement constitutes an investment contract,[14] (b) appeared to ignore the word "solely" when applying the *Howey* test, and (c) at least in some Circuit Courts, arguably reinterpreted "solely" to mean "primarily."[16] In *Howey*, the Supreme Court applied this test to the citrus grove arrangement to find that the land sales contracts and service contracts did constitute an investment contract, and thus a security, that was subject to the prohibition in Section 5 of the Securities Act on unregistered offers and sales of securities.[17]

The *Howey* decision importantly establishes that the offering of an asset that many would not typically consider a security – such citrus groves – can constitute a security if it was the subject of an investment contract. The key factors are the presence of a contract, transaction, or other scheme involving (1) the investment of money (2) into a common enterprise with (3) the expectation of profits deriving solely (or primarily) from the efforts of others.

Ripple Labs and XRP

According to the court in the *Ripple Labs* decision, XRP was originally created in 2011-12 by three individuals.[18] In 2012, two of those individuals, together with one of the defendant senior executives, founded Ripple as a company seeking to "modernize international payments by developing a global payments network for international currency transfers."[19] The three founders transferred 80 billion XRP tokens to Ripple, and Ripple in turn used XRP, among other purposes, as part of a product to allow customers to exchange one fiat currency for another.[20]

The court noted that from 2013 to the end of 2020, Ripple engaged in various sales and transactions involving XRP.[21] The court separated those transactions into three categories:

1. "Institutional Sales", whereby Ripple sold XRP to purchasers such as institutional buyers, hedge funds, and Ripple customers pursuant to written contracts. These contracts often contained lockup and resale restrictions, which the court noted were indicative of investment intent.

2. "Programmatic Sales", whereby Ripple sold XRP on digital asset exchanges through trading algorithms. The court noted that "Ripple's XRP sales on these digital asset exchanges were blind bid/ask transactions: Ripple did not know who was buying the XRP, and the purchasers did not know who was selling it." The two defendant senior executives of Ripple also sold XRP on digital asset exchanges on a similar programmatic basis. Buyers of XRP in Programmatic Sales did not enter into contracts with lockup or resale restrictions as part of the transaction.

3. Finally, what Judge Torres called "Other Distributions", which primarily involved Ripple issuing XRP to employees or other third parties as compensation.

As a backdrop to the above categories of transactions, the court found that since 2013, Ripple had engaged in public marketing efforts describing Ripple's operations and the XRP market and token. These efforts consisted of both (1) the preparation and public distribution of brochures and other documents directed to existing and prospective XRP investors that discussed the ties between XRP and Ripple's business model, and (2) communications about XRP and Ripple through social media and interviews with media outlets such as CNBC, Bloomberg, and the Financial Times.[22]

Application of the *Howey* Test

The Ripple Defendants attempted to argue that the XRP token did not have the "character" of a security and instead was more akin to "'ordinary assets' like gold, silver, and sugar."[23] However, Judge Torres noted that this argument failed because even "ordinary assets" can be part of a security if sold as part of an investment contract, as established in *Howey.*

Judge Torres then applied the *Howey* test to each of the three transaction categories described above.

1. Institutional Sales.[24] Judge Torres found that Ripple's Institutional Sales of XRP constituted an investment contract under the *Howey* test, and thus Ripple had engaged in the offer and sale of securities through these transactions. The buyers of XRP in the Institutional Sales invested money in exchange for XRP, and Ripple pooled these sales proceeds into accounts to support Ripple's businesses, which established a common enterprise.

   Judge Torres noted that in determining whether the third *Howey* prong – the expectation of profits deriving solely from the efforts of others – was present, the court must look at the economic reality of the transaction and make an "objective" inquiry to determine whether a "reasonable" investor would have made the investment expecting to derive profits from the efforts of others.[25] Applying that test to the Institutional Sales, Judge Torres determined that reasonable investors would have purchased XRP in Institutional Sales expecting to profit from increases in the value of XRP based on Ripple's efforts, based on the following:

   a. The ability of the institutional buyers to profit from XRP was tied to Ripple's efforts, as "Ripple used the funds it received from its Institutional Sales to promote and increase the value of XRP by developing uses for XRP and protecting the XRP trading market."[26]

   b. Ripple's marketing efforts, both in the brochures distributed to prospective investors and in social media and media interview communications, touted "XRP as an investment tied to the company's success."[27]

   c. The resale and lockup restrictions in contracts between Ripple and the institutional buyers relating to the XRP sales as evidencing an investment intent. [28]

2. Programmatic Sales.[29] However, Judge Torres found that the Programmatic Sales did not constitute investment contracts, and thus were not securities. Judge Torres concluded that, with respect to the third *Howey* prong, programmatic buyers could not reasonably expect that Ripple would use the capital received from Programmatic Sales to increase the value of XRP. Judge Torres cited the following factors that led her to this decision:

   a. Programmatic buyers (i.e., via blind bid/ask transactions on exchanges) did not know whether their funds were being paid to Ripple as part of a common enterprise or any other seller of XRP, and most purchasers on exchanges bought XRP from a party other than Ripple. To Judge Torres, this meant that programmatic buyers on exchanges did not have an objective, reasonable expectation to profit from the efforts of Ripple, as Ripple did not make any promises or offers to programmatic buyers (because it didn't know who was buying XRP), and the buyers did not know who was selling XRP.

   b. Programmatic Sales were not made pursuant to contracts with lockup provisions,

resale restrictions, or similar terms, unlike Institutional Sales.

c. Although the SEC pointed to Ripple's marketing brochures and documents as evidence that Ripple pitched XRP to the general public as a means to invest in an asset tied to Ripple's success, Judge Torres "found no evidence that these documents were distributed more broadly to the general public."[30] With respect to Ripple's marketing communications on social media and in media interviews, Judge Torres found no evidence that buyers of XRP on exchanges understood public statements made by Ripple executives to be representations of Ripple and its efforts,[31] although the manner in which Judge Torres framed this question appears to indicate that she was looking for subjective intent on the part of the investors, rather than making an "objective" inquiry of what a "reasonable investor" would believe based on the marketing efforts in line with Judge Torres' earlier description of the third *Howey* prong.

d. Somewhat controversially, Judge Torres noted that programmatic buyers were "generally less sophisticated" than institutional buyers, and she found no evidence that "a reasonable Programmatic Buyer, who was generally less sophisticated as an investor, … could parse through the multiple documents and statements that the SEC highlights" as evidence of Ripple's marketing of XRP as a means to invest in Ripple's potential success.[32] Therefore, Judge Torres held that there was not sufficient evidence to find that buyers in the Programmatic Sales had "'a reasonable expectation of profits to be derived from the entrepreneurial or managerial efforts of others'" when purchasing XRP on the exchanges.[33]

Judge Torres applied this reasoning to the sales of XRP by the two defendant senior executives of Ripple to find that they also did not engage in the offer or sale of securities.

3. Other Distributions.[34] Judge Torres found that the Other Distributions also did not constitute investment contracts, and thus were not securities. Judge Torres stated that the Other Distributions did "not satisfy Howey's first prong that there be an 'investment of money' as part of the transaction or scheme." [35] Judge Torres found that the recipients of XRP in Other Distributions did not pay money or provide other "tangible and definable consideration" to Ripple, but rather, "Ripple paid XRP to these employees and companies" as compensation.[36]

All parties to the litigation agreed that Ripple had never filed any registration statements in respect of its offering and sales of XRP.[37] As a result, Judge Torres found that Ripple had violated Section 5 of the Securities Act by offering and selling unregistered securities through the Institutional Sales. However, Judge Torres found that the Programmatic Sales and Other Distributions did not violate Section 5 of the Securities Act on the grounds that such transactions did not constitute offers or sales of securities.

Takeaways

1. Context matters. Judge Torres' decision differentiated whether sales of XRP constituted a security based on the context in which XRP was sold, such as the terms of the sale, the marketing efforts, and the identity of the buyers. It's not enough to simply look at the asset underlying a transaction, whether it be a citrus grove or a crypto token, to determine whether an offering could be subject to Section 5 of the Securities Act. Rather, parties must consider the totality of the circumstances surrounding the offering to determine whether the offeror should pursue either registration or an exemption from registration under the Securities Act.

2. Certain factors could strongly influence the determination of whether a crypto transaction is a security transaction. For Judge Torres, Ripple's marketing materials and the existence of resale and lockup provisions in contracts with buyers of XRP pointed strongly in the direction of the existence of an investment intent on the part of the buyers. On the other hand, selling XRP in blind transactions where neither party knew the identity of the other, and issuing XRP solely as compensation for services and without money changing hands, were each factors leaning away from a security characterization in Judge Torres' view.

3. The Ripple Decision is likely not the final word. As a district court decision, the decision is not binding on courts in other districts or even on other judges in the Southern District of New York. Some commentators believe that Judge Torres' decision on Programmatic Sales may be vulnerable to being overturned.[38] In similar instances, legislators, regulators and courts have ruled that more sophisticated investors may not require as many disclosures and protections than less sophisticated investors, because more sophisticated investors are more likely to pick up on the nuances and risks inherent in a securities transaction.[39]

However, Judge Torres' ruling on Programmatic Buyers seems to lean in the opposite direction – finding that because those buyers were less sophisticated, they were less likely to understand Ripple's marketing materials as indicating that an investment in XRP was an investment in the potential success of Ripple. Because those programmatic investors did not expect to profit from Ripple's success by virtue of buying XRP, their purchases of XRP did not constitute a security, which then frees Ripple from having to produce all of the disclosure materials for those buyers that are required as part of a securities registration statement. It's possible that another court could find that although some programmatic buyers did not have a subjective expectation to profit from Ripple's success from buying XRP, a "reasonable" investor would have generated that expectation after viewing Ripple's marketing materials, and therefore another court may find that element of the *Howey* test satisfied. Already, the SEC has indicated in another case that it intends to appeal the Ripple decision, which may allow the Second Circuit an opportunity to assess Judge Torres' rulings.[40]

Judge Torres also made clear that her decision did not extend to resales of XRP on the secondary market.[41] A subsequent decision by another court could specifically address secondary resales, which may impact the outcome, particularly with respect to sales of crypto tokens on exchanges.

As the court's ruling in the Ripple Labs decision indicates, the regulatory issues involved in crypto sales are complex and nuanced, and many courts are making determinations in the absence of much case law directly on point. Therefore, it's important for crypto industry participants and investors to perform their due diligence and potentially consult legal counsel when operating in this space.

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Endnotes

1. *SEC Charges Ripple and Two Executives with Conducting $1.3 Billion Unregistered Securities Offering*, U.S. SECURITIES & EXCHANGE COMMISSION, https://www.sec.gov/news/press-release/2020-338.
2. Dave Michaels, *Ripple's Legal Brawl With SEC Could Help Settle When Cryptocurrencies Are Securities*, THE WALL STREET JOURNAL, Feb. 2, 2022, https://www.wsj.com/articles/crypto-industry-hopes-looming-legal-brawl-will-thwart-secs-regulation-push-11643724002?mod=article_inline.
3. *SEC v. Ripple Labs, Inc.*, 1:20-cv-10832, ECF No. 874 (S.D.N.Y. July 13, 2023) (hereinafter Ripple Labs).
4. See, e.g., Dave Michaels, Ripple Ruling Deals a Blow to SEC's Effort to Regulate Crypto, THE WALL STREET JOURNAL, July 13, 2023, https://www.wsj.com/articles/ripple-wins-early-dismissal-of-some-claims-in-sec-lawsuit-over-xrp-sales-f88f968f.
5. 15 U.S.C. 77e(a).
6. *Ripple Labs*, at 11.
7. 15 U.S.C. 77b(a)(1).
8. 328 U.S. 293 (1946).
9. *Id.* at 294-95.
10. *Id.* at 295.
11. Id. at 295.
12. Id. at 296.
13. Id. at 298-99.
14. See, e.g., Glen-Arden Commodities, Inc. v. Constantino, 493 F.2d 1027, 1034 (2d Cir. 1974).
15. See e.g., United Hous. Found., Inc. v. Forman, 421 U.S. 837, 852 (1975).
16. See e.g., SEC v. Glenn W. Turner Enterprises, Inc., 474 F.2d 476 (9th Cir.), cert. denied, 414 U.S. 821 (1973); US v. Leonard, 529 F.3d 83, 88 (2nd Cir. 2008).
17. *SEC v. W.J. Howey Co.,* 328 U.S. 293, 299-301 (1946).
18. Ripple Labs, at 2.
19. *Id.* at 2-3.
20. *Id.*
21. *Id.* at 4-5.
22. *Id.* at 6-7.
23. *Id.* at 14.
24. *Id.* at 16-22.
25. *Id.* at 18-19.
26. *Id.* at 18.
27. *Id.* at 19.
28. *Id.*
29. *Id.* at 22-25.
30. *Id.* at 25.
31. *Id.* at 25.
32. *Id.*
33. *Id.* (quoting *United Hous. Found., Inc. v. Forman*, 421 U.S. 837, 852 (1975)).
34. *Id.* at 26-27.
35. *Id.* at 26 (quoting *SEC v. W.J. Howey Co.*, 328 U.S. 293, 301 (1946)).
36. *Id.* (quoting *Int'l Bhd. of Teamsters v. Daniel*, 439 U.S. 551, 560 (1979)).
37. *Id.*
38. *See* Monika Ghosh, *Ripple ruling is likely to be appealed and overturned, ex-SEC official says*, CRYPTOSLATE, July 16, 2023, https://cryptoslate.com/ripple-ruling-is-likely-to-be-appealed-and-overturned-ex-sec-official-says/
39. *See, e.g.,* 15 U.S.C. 80a-3(c)(7) (exempting from the definition of an investment company that is required to register with the SEC an issuer whose outstanding securities are owned exclusively by individuals or entities that constitute a "qualified purchaser"); *Pharos Capital Partners L.P. v. Deloitte & Touche*, No. 12-4381 (6th Cir. Oct. 23, 2013) (finding that an investor unjustifiably relied on a placement agent's representations regarding equity securities in light of a "big boy" letter signed by the investor acknowledging that it was not relying on any representations from such agent); 17 C.F.R. 230.501 et seq (stating that offerings in which issuers sell securities only to individuals or entities that constitute an "accredited investor" are exempt from registration and are not required to produce certain disclosure requirements, provided the offering meets other requirements set forth in Regulation D promulgated by the SEC).
40. *See* Dave Michaels, *SEC Says XRP Ruling Was Wrong, Signals It Will Appeal*, THE WALL STREET JOURNAL, July 22, 2023, https://www.wsj.com/livecoverage/stock-market-today-dow-jones-07-21-2023/card/sec-says-xrp-ruling-was-wrong-signals-it-will-appeal-oCqi2N05kHNT-7MqOkDev.
41. *Ripple Labs*, at 23.