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Ripple Labs Case Will Address Key Cryptocurrency Question

By **Christian Everdell** (June 11, 2018, 1:18 PM EDT)


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It is time to start talking about the elephant in the room. A critical question about the regulation of cryptocurrencies that has long been apparent, but until recently has been lying dormant, has now vaulted to the forefront of the conversation: Do cryptocurrencies that function primarily as a medium of exchange and otherwise operate like traditional currencies (e.g., ether, ripple and bitcoin) qualify as securities under the U.S. securities laws?

The question is a tricky one as a legal matter, but even more so as a practical matter. According to CoinMarketCap, a website which tracks cryptocurrencies, bitcoin, ether and ripple are currently the top three cryptocurrencies by market capitalization and comprise more than 60 percent of the total market cap of all cryptocurrencies, which is now roughly $340 billion.[1] Their market dominance reflects the crucial role that these coins play in the cryptocurrency/initial coin offering marketplace, serving as the primary medium of exchange to purchase ICO tokens and other, less ubiquitous cryptocurrencies. If they were deemed to be securities, it would have a profound and potentially destructive effect on the U.S. cryptocurrency market, as everyone who bought these coins would be holding unregistered securities that could not be transferred without violating the law.

The discussion around this issue has become increasingly urgent in the last few weeks. On April 23, Gary Gensler, the former chairman of the U.S. Commodity Futures Trading Commission, caused a stir when he made the case in a speech at the Massachusetts Institute of Technology that both ether and Ripple Labs' XRP coin could be classified as securities.[2] Around the same time, it was first reported that representatives of the venture capital firms Andreessen Horowitz and Union Square Ventures, which back ether, had met with U.S. Securities and Exchange Commission officials in March to plead their case that ether should not be treated as a security.[3] Then on May 1, The Wall Street Journal reported that the SEC and the CFTC were investigating whether ether and other widely traded cryptocurrencies should be regulated as securities.[4] In contrast to the frenzied doomsday predictions that followed, Gensler speculated that it would take several years for the SEC to implement a rule that would answer this burning question.[5]

Now it seems that an answer may be coming sooner than expected — not from the SEC, but from a federal judge in California. The issue has been squarely teed up in a private securities lawsuit filed by Ryan Coffey, who sued Ripple Labs and its CEO, Bradley Garlinghouse, on May 3, 2018, claiming that XRP is a security and that Ripple's sale of XRP coins constituted an unregistered securities offering in

violation of Sections 5 and 12(a)(1) of the Securities Act.[6] The case raises interesting legal questions of first impression about whether XRP coins can be regulated as securities. It also raises the larger policy question of whether cryptocurrencies that function as true currencies should be regulated as securities even if they meet the elements of an "investment contract" under the test articulated in SEC v. W. J. Howey Co., namely, (1) an investment of money, (2) in a common enterprise, (3) with a reasonable expectation of profits, (4) to be derived from the entrepreneurial or managerial efforts of others.[7]

The Test Case: Coffey v. Ripple Labs Inc.

The timing of Coffey's lawsuit, filed just over a week after Gensler's speech at MIT and only two days after reports surfaced that the SEC and CFTC were considering the regulatory fate of coins like ether and XRP, could not have been more on cue. With the attention of the crypto community and the regulators now focused on this issue, it will be up to a federal judge to decide whether Ripple's ongoing sale of XRP is, in Coffey's words, a "neverending ICO" that violates the securities laws.[8]

In the complaint, Coffey outlined his argument for why XRP passes the Howey test and qualifies as a security, echoing many of the same points that Gensler made in his speech at MIT:

1. ***An investment of money.*** XRP purchasers invested both traditional fiat currency (i.e., dollars, etc.) and other digital currencies, such as bitcoin and ether, to purchase XRP.

2. ***In a common enterprise.*** Unlike bitcoin, which is continuously created through the computational efforts of a decentralized network of "miners" who validate the transactions on the bitcoin network, Ripple Labs created the total volume of 100 billion XRP "out of thin air" in 2013 and gradually sells XRP to the general public through exchanges whenever, and in whatever amounts, it chooses. Ripple Labs pools the profits from these sales and uses them to fund its operations and promote the Ripple network for the benefit of all XRP investors, which include the owners of Ripple Labs.

3. ***With a reasonable expectation of profits.*** Ripple Labs publicly touts the price increases of XRP to encourage investors to buy, and has taken steps to limit the supply of XRP to control the inflation rate and drive prices higher. Hence, XRP purchasers had a reasonable expectation that the value of their XRP would appreciate.

4. ***To be derived from the entrepreneurial or managerial efforts of others.*** The future profitability of XRP is dependent on (i) the success of the XRP Ledger — the blockchain ledger that records all XRP transactions — and (ii) the efforts of Ripple Labs to market and drive greater adoption of XRP. Unlike the bitcoin blockchain, which is decentralized and not controlled by any one entity or individual, the XRP Ledger is controlled entirely by Ripple Labs. Ripple Labs invests considerable time and money to maintain and develop the XRP Ledger, and to promote more widespread acceptance of the XRP network. The success of XRP is therefore dependent on the technical, entrepreneurial and managerial efforts of Ripple Labs and its employees.[9]

Although the SEC has not offered any guidance on whether it considers XRP a security, Coffey's argument falls within the bounds of the SEC's general position on cryptocurrencies. The most complete formulation of the SEC's current position was given by SEC Chairman Jay Clayton to a subcommittee of the House Appropriations Committee on April 26, 2018. Clayton divided cryptocurrencies into "two areas." The first group includes coins that function as "a pure medium of exchange" and "a replacement for currency." This group includes bitcoin, which he said "has been determined by most people to not be a security." The second group includes "tokens which are used to finance projects" — i.e., ICO tokens. As

to those, Clayton reiterated his comment from several months before: “there’s none that I’ve seen … that aren’t securities.”[10]

Clayton echoed this same position in an interview with CNBC on June 6, 2018, in which he unambiguously stated that bitcoin fell in the first group and was “not a security.” However, Clayton specifically declined to comment on whether XRP and ether were securities.[11]

Hence, in the SEC’s view, there is a very select group of cryptocurrencies that function like traditional currencies and therefore do not qualify as securities. Bitcoin is undoubtedly in this group. It follows, as Gensler pointed out in his MIT speech, that other coins that forked off of bitcoin and are therefore structured similarly — like bitcoin cash and litecoin — probably fall in this group as well. However, the SEC has thus far declined to give clear direction as to whether ether, XRP or any other cryptocurrencies that are structured differently than bitcoin, but still function primarily as a medium of exchange, fall into this safe harbor.

The Potential Outcome/Questions for the Future

Whether or not Coffey’s argument prevails will ultimately be up to the judge. It is very likely that Ripple Labs will move to dismiss the complaint on a number of different grounds (the deadline for their motion is June 22). But given the intentionally flexible and expansive nature of the Howey test, it is very possible that the judge will decide that XRP is a security and that all of the roughly 39 billion XRP coins currently in circulation were illegally issued. The fallout of such a ruling would be profound. Among other remedies, the judge could enjoin all further sales of XRP and/or grant a right of rescission to all current holders of XRP, allowing them to seek a return of their original investment.

Setting aside the practical effect that such a ruling might have on the U.S. cryptocurrency market, it is worth asking the question: For digital coins that function as currencies, does it make sense to regulate them as securities even if they pass the Howey test?

The securities laws specifically exempt “currency” from the definition of “security.”[12] Traditional currencies like bank notes are included in this exemption, but to date no court has opined on whether cryptocurrencies are included as well. Indeed, Ripple Labs may argue that XRP should be covered by this exemption because it functions primarily as a medium of exchange. Other defendants have made this same argument in similar cases that are currently before the federal courts.[13] However, unless the court agrees that XRP is a “currency” as that term is used in the securities laws — which would be an entirely novel interpretation that term — it will not be treated as a currency and instead be analyzed under the Howey test.

Overcoming the Howey test may be an uphill battle for XRP, or any cryptocurrency other than bitcoin and its descendants. The critical point is that cryptocurrencies cannot function or even exist without an underlying blockchain ledger that records transactions. Cryptocurrency ledgers do not generate themselves. They must be developed and maintained through the efforts of developers and engineers. If the work that it takes to create, maintain and promote the digital ledger will always be enough to satisfy the last prong of the Howey test, then almost all cryptocurrencies will be swept into the definition of a security and will be regulated as such, even if they function exclusively as a currency. That is not a particularly attractive outcome, but it is a realistic one.

The better solution is for Congress to act to clarify the rules that apply to different types of cryptocurrencies. The SEC and the CFTC already seem to recognize this need. On Feb. 6, 2018, SEC

Chairman Clayton and CFTC Chairman Christopher Giancarlo told the Senate Banking Committee, "We may be back with our friends from Treasury and the [Federal Reserve] and ask for additional legislation."[14] Until then, we eagerly wait to see what the courts will say.

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[1] CoinMarketCap, https://coinmarketcap.com (last visited June 6, 2018).

[2] Annaliese Milano, "Everything Ex-CFTC Chair Gary Gensler Said About Cryptos Being Securities," Coindesk (Apr. 24, 2018), https://www.coindesk.com/ex-cftc-chair-gary-gensler-on-tokens-securities-and-the-sec/.

[3] Gabriel T. Rubin and Dave Michaels, "Silicon Valley Is Into Bitcoin. It Wants to Keep Washington Out," The Wall Street Journal (Apr. 19, 2018).

[4] Dave Michaels and Paul Vigna, "World's Second Most Valuable Cryptocurrency Under Regulatory Scrutiny," The Wall Street Journal (May 1, 2018).

[5] See supra note 2.

[6] Coffey v. Ripple Labs Inc. et al., No. 3:18-cv-03286 (N.D.C.A.), complaint dated May 3, 2018.

[7] SEC v. W. J. Howey Co., 328 U.S. 293, 298-99, 301 (1946); see also SEC v. Edwards, 540 U.S. 389, 393 (2004).

[8] See supra note 6.

[9] See supra note 6.

[10] Neeraj Agrawal, "SEC Chairman Clayton: Bitcoin is not a security," Coincenter (Apr. 27, 2018), https://coincenter.org/link/sec-chairman-clayton-bitcoin-is-not-a-security.

[11] Interview by Bob Pisani with Jay Clayton, SEC Chairman, CNBC (June 6, 2018), https://www.cnbc.com/video/2018/06/06/sec-chairman-cryptocurrencies-like-bitcoin--not-securities.html

[12] See 15 U.S.C. § 78c(a)(10).

[13] See United States v. Maksim Zaslavskiy, No. 1:17-cr-00647-RJD-RER (E.D.N.Y.), Defendant's Motion to Dismiss Indictment for Subject Matter Jurisdiction and Vagueness, at 6-10; Balestra v. ATBCOIN LLC, No. 1:17-cv-10001-VSB (S.D.N.Y.), Memorandum of Law in Support of Defendants' Motion to Dismiss Pursuant to Federal Rules of Civil Procedure 12(b)(2) and 12(b)(6), at 15-17.

[14] Michelle Price and Pete Schroeder, "U.S. regulators may ask Congress for virtual currency legislation," Reuters (Feb. 6, 2018), https://www.reuters.com/article/us-global-bitcoin-congress/u-s-regulators-may-ask-congress-for-virtual-currency-legislation-idUSKBN1FQ0KU.