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SEC v. Ripple Labs, Inc., et al.: A Turning Point in Cryptocurrency Jurisprudence?

On July 13, 2023, in a highly anticipated decision for the cryptocurrency industry, a Southern District of New York court granted in part and denied in part the parties' cross motions for summary judgment in *SEC v. Ripple Labs, Inc., et al.*[1] Despite mixed rulings, the decision has been viewed by several in the cryptocurrency community as a victory for Ripple Labs, Inc. and the individual co-defendants (collectively, "Ripple"), and for cryptocurrency enterprises more broadly. In its summary judgment filings, the Securities and Exchange Commission alleged that Ripple engaged in three categories of unregistered XRP token offers and sales in violation of Section 5 of the Securities Act of 1933: (1) "Institutional Sales" under written contracts for which it received $728 million; (2) "Programmatic Sales" on digital asset exchanges for which it received $757 million; and (3) "Other Distributions" under written contracts for which it recorded $609 million in "consideration other than cash." While the Court agreed with the SEC that Ripple's Institutional Sales were unregistered securities transactions, Judge Analisa Torres found to the contrary regarding Ripple's Programmatic Sales and Other Distributions. The Court's decision regarding these two transaction categories—that they were not "investment contracts" and thus not securities—constitutes a notable departure from other recent SEC cryptocurrency cases (see our articles

[1] Unless otherwise indicated, all docket citations herein refer to the docket in *Securities and Exchange Commission v. Ripple Labs, Inc. et al.*, 20-cv-10832-AT-SN (S.D.N.Y. Dec. 22, 2020).

on *SEC v. LBRY, Inc.*, *SEC v. Kik Interactive Inc.*, and *SEC v. Telegram Group*)[2] in which the SEC secured victories in its ongoing cryptocurrency enforcement campaign.

Background

Ripple Labs, Inc. is a technology company founded in 2012 that has developed the Ripple payment protocol and exchange network. Ripple offers an open-source payment system and a digital currency token, XRP, that allows for currency exchange, payment, and money transfers on Ripple's blockchain, which is known as the XRP Ledger. A "blockchain" is a cryptographically secured ledger that tracks the current and historical state of accounts, transactions, and/or events occurring on a network of computers, and is maintained by multiple parties, often referred to as validators or miners—who validate transactions occurring among users on the network. Transactions are grouped together over some time interval and posted to the ledger in "blocks," and each block is cryptographically linked to the previous block, creating an unbroken chain of valid transactions. As alleged in the SEC's Amended Complaint (filed in February 2021), from at least 2013 through February 2021, Ripple engaged in securities transactions involving over 14.6 billion units of XRP worth over $1.38 billion but failed to register those sales with the SEC as would be required by the securities laws if the relevant offerings were, in fact, investment contracts.

The question before the court was whether Ripple's offers and sales of the XRP token were "investment contracts" and thus transactions in a security requiring registration with the SEC. While not defined by statute, the U.S. Supreme Court in *SEC v. W.J. Howey Co.*, 328 U.S. 293 (1946), provides the seminal analysis for what constitutes an "investment contract" and thus a security under Section 5. Specifically, the Supreme Court held that 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."[3]

The Parties' Arguments

In September 2022, following substantial discovery, the SEC and Ripple each filed motions for summary judgment. The SEC's filings urged that as a matter of economic reality, purchases of XRP are "investment contracts" satisfying all three prongs of the *Howey* test. The SEC claimed that XRP purchasers invested their money in a "common enterprise" under *Howey*, arguing that all of Ripple's offerings and sales exhibited both horizontal and strict vertical commonality. The SEC claimed horizontal commonality, which "ties the fortunes of each investor in a pool of investors to the success of the overall venture," was present because XRP tokens are all fungible, and because XRP's market price increases or decreases for all units of XRP "together and equally."[4] And notably, the SEC asked the Court to echo Judge Alvin K. Hellerstein's finding in *SEC v. Kik Interactive, Inc.* that "[t]he economic reality is that" the defendant "pooled proceeds from its sale" of its digital token "in an effort to boost the value of the investment," such that "[t]he stronger the ecosystem that" the defendant "built, the greater the demand for" the digital token "and thus the greater the value of each purchaser's investment."[5]

The SEC also argued that even absent horizontal commonality, the Court could find strict vertical commonality (which requires that "the fortunes of investors be tied to the fortunes of the promoter") because, as a matter of economic reality, Ripple's ownership of and dependence on selling XRP to fund its operations proved that the success or failure of the token would affect the fortunes of Ripple, its

[2] *SEC v. Ripple* is notably distinct from *Telegram* and *Kik* in that those cases arose in the context of Initial Coin Offerings (ICOs) or Simple Agreements for Future Tokens (SAFT). No such offerings are alleged here.
[3] *Howey*, 328 U.S. at 298-99.
[4] *See* ECF No. 837, SEC Motion for Summary Judgment ("SEC MSJ") at 50-51.
[5] *See id.* at 51.

executives, and XRP investors.[6] Rounding out its *Howey* analysis, the SEC contended that XRP's purchasers reasonably expected to profit from their XRP purchases because Ripple marketed and promoted XRP as an investment. In support, the SEC cited a wide range of Ripple's statements, including informational brochures, internal talking points, public blog posts, statements on social media, videos, interviews with various Ripple employees, and more.[7] Lastly, the SEC alleged that the individual defendants—Ripple executives Bradley Garlinghouse and Christian Larsen—aided and abetted Ripple's purported violations of the securities laws, and urged the Court to reject the defendants' due process defenses.[8]

In contrast, Ripple's summary judgment motion (and its opposition to the SEC's motion) argued that Ripple's offers and sales of XRP lacked the "essential ingredients" of an investment contract.[9] The defense urged the Court to look to the so-called "blue sky" law cases on which *Howey* relied to find that all investment contracts must contain the following "essential ingredients": (1) a contract between a promoter and an investor that establishes the investor's rights as to an investment; (2) the contract imposes post-sale obligations on the promoter to take specific actions for the investor's benefit; and (3) the contract grants the investor a right to share in profits from the promoter's efforts to generate a return on the use of investor funds.[10] Ripple claimed that the "essential ingredients" test "give[s] meaning and structure to the *Howey* test," and argued that the SEC's inability to show the presence of these "ingredients" was fatal to its claims.[11]

Turning to the elements of the *Howey* test itself, Ripple stated that in many of the transactions at issue, those who received XRP from Ripple did not provide any consideration and, accordingly, no "investment of money" occurred.[12] Moreover, Ripple maintained that even for sales of XRP in which a buyer did pay money to Ripple (rather than receiving XRP as a form of compensation), the SEC still could not satisfy the first *Howey* element because *Howey* requires an *investment* of money, as opposed to a mere *payment* of money: "If mere payment were sufficient to satisfy the first *Howey* element, then that element would have no meaningful effect; it would be satisfied not just for people buying investment contracts in orange groves, but for people who bought oranges at the supermarket."[13]

Ripple further argued that, contrary to the SEC's contention, no "common enterprise" existed among holders of the XRP token. Ripple urged that XRP's fungible nature does not suggest the existence of a "common enterprise" and instead argued that XRP should be compared to gold or other fungible assets that are not traditionally considered securities: "That XRP is fungible does not mean that XRP holders depend upon one another to earn profits; it means that those who own XRP as an investment have a common interest in XRP's price when they decide to sell … it could just as well be said that all owners of gold share a common interest in the price of gold; or that all owners of soybeans or of pigs share a common interest in the price of soy or pork. Those owners are still not engaged in a common enterprise because they do not depend upon one another to earn profits on sales."[14] Ripple went on to argue that the SEC could show neither horizontal nor strict vertical commonality, explaining that XRP holders have no participatory interest in any common "pool" of assets and that the fortunes of Ripple and XRP holders were not inextricably linked.[15] In other words, Ripple claimed, XRP holders might experience losses while

[6] *See id.* at 52.
[7] *See id.* at 53-58.
[8] *See id.* at 66-75.
[9] *See* ECF No. 825, Defendants' Motion for Summary Judgment ("Def. MSJ") at 13.
[10] *See id.* at 18-21.
[11] *Id.* at 25.
[12] *See id.* at 36-37.
[13] ECF No. 828, Defendants' Opposition to SEC's Summary Judgment Motion at 19.
[14] Def. MSJ at 43.
[15] *See id.* at 45.

Ripple maintained positive income, and vice versa.[16] Ripple also contended that XRP holders' profits were not due to the "efforts of the promoter" as required by *Howey*, but instead were primarily a result of market forces.[17] Additionally, Ripple argued that it never made any promises or statements to purchasers sufficient to create a reasonable "expectation of profits" as required by *Howey*.[18] Finally, Ripple propounded fair notice and due process arguments for why the SEC was not entitled to summary judgment. The Court addressed the parties' arguments in a comprehensive 34-page opinion.

The Court's Decision

Relevant Background and Legal Standards

The Court began its opinion by outlining the critical facts underpinning its analysis. First, the Court walked through the SEC's allegation that Ripple conducted three categories of improper XRP offerings without filing any registration statements, financial statements, or other periodic reports with the SEC: (1) "Institutional Sales" through which Ripple sold XRP directly to institutional buyers, hedge funds, and other sophisticated customers pursuant to written contracts; (2) "Programmatic Sales" or blind transactions through the use of trading algorithms made on digital asset exchanges; and (3) "Other Distributions" through which Ripple distributed XRP as a form of payment for services (e.g., XRP distributions made to Ripple employees as a form of compensation).[19] The Court also noted that in addition to Ripple's sales and offers, co-defendants Garlinghouse and Larsen offered and sold XRP in their individual capacities during the relevant period.[20] In embarking on its analysis, the Court observed that Ripple represented to the public that it would search for "use" and "value" for XRP, and that Ripple received legal advice to the effect that "[t]he more that [the founders and Ripple] promote [XRP] as an investment opportunity, the more likely it is that the SEC will take action and argue that [XRP tokens] are 'investment contracts.'"[21]

Next, Judge Torres briefly laid out the relevant legal standards concerning Section 5 and the *Howey* test.[22] The Court then discussed—but swiftly rejected—Ripple's proposed "essential ingredients" test, concluding that two of the "essential ingredients" advocated by Ripple fall outside the scope of *Howey's* requirements.[23] The Court ruled that *Howey's* focus is on a purchaser's expectation of "profits … from the efforts of others," emphasizing that the test is intended to "embod[y] a flexible rather than a static principle," thus rejecting the "essential ingredients" test's more rigid requirements that investment contracts impose formal post-sale obligations on a promoter and/or provide a formal grant to an investor of a right to share in profits.[24] Critically, though, the Court declined to evaluate the merits of the first "essential ingredient," i.e., whether an "investment contract" under *Howey* presumes the existence of an *underlying contract* between the parties. According to the Court, such an analysis was not necessary here, as "in each instance where Defendants offered or sold XRP as an investment contract, a contract existed."[25]

Consistent with *Telegram*, *Kik*, and *LBRY*, the Court clarified that whether Ripple's XRP offerings constitute investment contracts must turn on the totality of the circumstances surrounding each

[16] *See id.* at 48-49.
[17] *See id.* at 49-54.
[18] *See id.* at 50-58.
[19] *See* ECF No. 874, Summary Judgment Decision ("MSJ Decision") at 4-5.
[20] *See id.* at 5.
[21] *See id.* at 8.
[22] *See id.* at 10-11.
[23] *See id.* at 11-13.
[24] *See id.* at 12-13.
[25] *Id.* at 13.

transaction, rather than just on the inherent character or nature of an underlying asset. The Court explained, "if the original citrus groves in *Howey* were later resold, those resales may or may not constitute investment contracts, depending on the totality of circumstances surrounding the later transaction."[26] Thus, the Court reasoned, Ripple's suggestion that XRP itself, like gold or other "ordinary assets," cannot be a security, "misses the point because ordinary assets—like gold, silver, and sugar—may be sold as investment contracts, depending on the circumstances of those sales."[27]

Ripple's XRP Offerings and Sales

The Court then turned its attention to the first relevant category of XRP offerings, namely Ripple's Institutional Sales of XRP (made pursuant to written contracts). In deeming Ripple's Institutional Sales "investment contracts," the Court was unpersuaded by the defense's argument that *Howey's* first element—requiring an investment of money—was not satisfied. Specifically, the Court rejected Ripple's view that an "investment of money" is different from "merely payment of money," and instead held that simply "provid[ing] [] capital" is sufficient to establish *Howey's* first element.[28]

The Court also found horizontal commonality with regard to the Institutional Sales, noting that "each Institutional Buyer's ability to profit was tied to Ripple's fortunes and the fortunes of other Institutional Buyers because all Institutional Buyers received the same fungible XRP. 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. When the value of XRP rose, all Institutional Buyers profited in proportion to their XRP holdings."[29] Accordingly, the Court determined that as to the Institutional Sales, *Howey's* "common enterprise" element was satisfied.[30]

As for *Howey's* third element—whether Ripple's institutional purchasers had "a reasonable expectation of profits to be derived from the entrepreneurial or managerial efforts of others"—the Court again sided with the SEC, citing numerous examples of Ripple's statements and marketing materials linking Ripple's efforts with XRP's value.[31] The Court added that Ripple's transactions with the institutional purchasers—which were typically highly sophisticated entities such as hedge funds—included sales contracts with limitations such as lockup provisions and resale restrictions, supporting the conclusion that the Institutional Sales were sold as investments rather than for consumptive use.[32] And in so ruling, Judge Torres echoed the Court's language in *SEC v. LBRY, Inc.*, finding that an expectation of profits "need not be the sole reason a purchaser buys an investment; an asset may be sold for both consumptive and speculative uses."[33] Having found that all three *Howey* elements were satisfied, the Court held that Ripple's Institutional Sales were "investment contracts" that ran afoul of the U.S. securities laws.

Though the Court sided with the SEC as to the Institutional Sales, importantly, it found in favor of Ripple regarding its Programmatic Sales of the XRP token. The Court began this portion of its analysis by jumping immediately into *Howey's* third element, noting that purchasers of Ripple's Programmatic Sales participated in blind transactions, unable to know whether their payments were being sent to Ripple or elsewhere. The Court contrasted the Programmatic Sales with Ripple's Institutional Sales: "[w]hereas the Institutional Buyers reasonably expected that Ripple would use the capital it received from its sales to

[26] *Id.* at 14.
[27] *Id.*
[28] *Id.* at 16.
[29] *Id.* at 17-18 (internal citations omitted).
[30] After finding that horizontal commonality established the existence of a common enterprise, the Court declined to address the issue of strict vertical commonality. *Id.* at 17 n. 12.
[31] *See id.* at 19-22.
[32] *See id.* at 21.
[33] *Id.* at 18-19.

improve the XRP ecosystem and thereby increase the price of XRP, Programmatic Buyers could not reasonably expect the same. Indeed, Ripple's Programmatic Sales were blind bid/ask transactions, and Programmatic Buyers could not have known if their payments of money went to Ripple, or any other seller of XRP."[34] The Court added, "[i]t may certainly be the case that many Programmatic Buyers purchased XRP with an expectation of profit, but they did not derive that expectation from Ripple's efforts (as opposed to other factors, such as general cryptocurrency market trends)—particularly because none of the Programmatic Buyers were aware that they were buying XRP from Ripple."[35] The Court's holding in this regard appears to support similar arguments defense counsel recently advanced in *SEC v. Wahi*, contending that token transactions executed on a digital asset exchange do not satisfy Howey because in addition to there being no contract between the issuer/promoter and the purchaser, the purchaser's expectation of profits is derived primarily from market forces rather than from managerial efforts emanating from a contract.[36] Critically, however, the Court in *Ripple* declined to address directly whether secondary market sales of XRP constitute an offer or sale of an investment contract.[37]

Next, the Court turned to Ripple's "Other Distributions" of XRP. Here, the Court again ruled in favor of Ripple because the "Other Distributions" did not satisfy *Howey's* first requirement that there be an "investment of money" as part of a transaction. Simply, the Court observed that the record was clear: "recipients of the Other Distributions did not pay money or 'some tangible and definable consideration' to Ripple."[38]

Finally, the Court opined on Ripple's due process arguments. The Court rejected the fair notice and vagueness defenses as to the Institutional Sales, holding that *Howey* sets forth a clear test for determining what constitutes an investment contract, and finding that *Howey's* progeny provides guidance as to how to apply that test to a variety of factual scenarios.[39] The Court also declined to award summary judgment on the SEC's claim that the individual defendants aided and abetted a securities violation in violation of 15 U.S.C. § 77o(b), concluding that the defendants "raised a genuine dispute of material fact as to whether Larsen and Garlinghouse knew or recklessly disregarded the facts that made Ripple's scheme illegal."[40]

Implications

Although Judge Torres's ruling granted relief to both sides, the Court's decision has been viewed as a victory for Ripple by several members of the cryptocurrency community, especially when compared to the victories secured by the SEC in other recent cases. There are several key takeaways from the Court's decision:

1. Judge Torres made clear that the relevant inquiry under *Howey* is not whether a particular asset is, in and of itself, determined to be a security, but instead whether the circumstances of the asset's offer or sale render it an investment contract and thus a security. To conduct this analysis,

[34] *Id*. at 23.
[35] *Id*. at 24. The Court dispensed with the issue of Garlinghouse and Larsen's personal sales of XRP in similar fashion. As with Ripple's Programmatic Sales, the Court held that individual defendants' XRP sales were programmatic sales on various digital asset exchanges made through blind bid/ask transactions. Thus, as a matter of law, the record did not establish the third *Howey* prong as to these transactions. *See id*. at 27-28.
[36] *See SEC v. Wahi*, 22-cv-1009-TL (W.D.Wa Feb. 6, 2023), ECF No. 33 at 52-54. The defendant was represented by Greenberg Traurig LLP and Jones Day LLP.
[37] Because the Court found that the record did not establish the third *Howey* element as to the Programmatic Sales, the Court did not reach whether the first or second *Howey* elements were satisfied. *See* MSJ Decision at 25 n. 17.
[38] *Id*. at 26. Because the Court determined that the record did not establish the first *Howey* element as to the Other Distributions, the Court did not reach whether the second or third *Howey* prongs were satisfied. *See id*. at 27 n. 18.
[39] *See id*. at 29.
[40] *Id*. at 31.

Courts must examine the totality of the circumstances surrounding each relevant asset transaction in a case rather than simply analyzing the character of the asset itself.

2. As we have seen in prior cases like *Telegram*, *Kik*, and *LBRY*, the Court in *Ripple* continued to support a pragmatic approach to Howey analyses, favoring an observance of the "economic realities" behind cryptocurrency offerings in lieu of "unrealistic and irrelevant formulae."[41]

3. The Court declined to adopt the "essential ingredients" test as promulgated by the defendants. But significantly, the Court declined to opine as to the merit of the first element of that test; namely, whether the existence of an "investment contract" requires the presence of an underlying contract between two parties (be it written, oral, or implied)—because a written contract existed for the Institutional Sales.

4. The critical distinction drawn by the Court between Ripple's Institutional Sales and its Programmatic Sales was that institutional purchasers, which were generally highly sophisticated professional entities in a written contractual relationship with Ripple, reasonably expected the funds they provided to Ripple would be used to increase XRP's value. Going forward, cryptocurrency issuers should be mindful of this distinction and carefully consider how their token sales and/or offerings are structured and presented to potential purchasers.

In sum, the *Ripple* decision is important precedent in an uncertain and developing cryptocurrency enforcement space. If not modified on appeal, *Ripple* may have significant utility for—and be used in litigation against the SEC by—cryptocurrency exchanges and secondary market purchasers who have no agreement, knowledge, or expectation that an issuer or promoter will undertake efforts to enhance token profits. Indeed, certain cryptocurrency businesses currently in litigation with the SEC over whether they are operating as unregistered securities exchanges may point to the *Ripple* decision to substantiate their belief that tokens trading in the secondary markets are not securities (even if that question was unresolved by *Ripple*). Regardless, the *Ripple* opinion appears to draw a critical distinction between direct contractual efforts between issuers/promoters and purchasers and market purchasing in the token space, and thus this decision could be the first major chink in the SEC's armor in its cryptocurrency enforcement efforts.

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[41] *Id*. at 13.