Securities Regulation Daily Wrap Up, BLOCKCHAIN—S.D.N.Y.: Ripple opinion's two holdings encourage crypto fans, potentially curb enforcement, (Jul. 14, 2023)

Securities Regulation Daily Wrap Up

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By Mark S. Nelson, J.D.

The opinion appeared to be protective of sophisticated investors but interpreted existing law in a way that withheld such protections from others, thus suggesting a somewhat complicated path forward that may weaken some SEC crypto enforcement efforts.

A judge on the U.S. District Court in Manhattan issued a long-awaited opinion in the Ripple Labs, Inc. XRP token case, but that opinion reached a split result that at least partially raises many questions about the likely efficacy of the SEC's future crypto enforcement efforts and the resulting sate of the law on crypto tokens. The opinion held that Ripple violated federal securities laws because institutional buyers of XRP were entitled to the protections that registration under Securities Act Section 5 would afford, while those who bought XRP on digital asset exchanges, certain Ripple employees and third-party developers who received XRP were not entitled to the protections afforded by registration because they did not acquire XRP via investment contracts as had the institutional buyers. If that seems like an unusual way to describe an enforcement case outcome, it is because of how the court elected to evaluate the role of sophistication under federal securities laws. Court watchers focused on crypto have tended to hail each major SEC enforcement case as the one that will finally resolve the legal status of crypto (e.g., the *Telegram* case) but, with few exceptions, the SEC has prevailed, until now. Expect a deluge of legal commentary on the Ripple opinion and its potential consequences for SEC crypto enforcement going forward (*SEC v. Ripple Labs, Inc.*, July 13, 2023, Torres, A.).

The SEC's case against Ripple and two of its executives, Bradley Garlinghouse (CEO since 2017) and Christian A. Larsen (CEO before 2017 and currently executive chair), claimed that Ripple allegedly made unregistered sales of the XRP token, which the SEC said is an investment contract and, thus, a security. The court's opinion focused on three distinct types of sales of XRP, one set of sales to institutional investors that raised $728 million, a second set of sales to non-institutional buyers via digital asset exchanges that raised $757 million, and a third set of distributions to Ripple employees and other third parties that prompted Ripple to record $609 million in noncash consideration on its books. The court noted that Ripple used funds raised from institutional and programmatic sales of XRP to fund its operations.

Institutional investors. The court applied the familiar *Howey* test in the Ripple case to the three separate allegedly unregistered issuances of XRP detailed in the SEC's complaint. *Howey* requires an investment of money in a common enterprise with the reasonable expectation that others will use their management skills to generate profits. The first of several issuances challenged by the SEC involved institutional buyers of XRP.

According to the SEC, Ripple and institutional buyers of XRP had written investment contracts through which XRP was distributed to public markets via certain "conduits," including through institutional investors acting as brokers. In its defense, Ripple asserted that it was not enough to make a payment of money (this indisputably occurred regarding XRP) to meet *Howey*'s investment of money prong; rather, Ripple said there also must be an intent to invest that money. The court rejected Ripple's gloss and concluded that the monies paid by institutional buyers for XRP satisfied *Howey*'s investment of money prong.

The court next concluded that a common enterprise existed through the horizontal commonality that resulted from Ripple pooling money received in various accounts that it controlled. Some courts will also examine

whether there was vertical commonality, but the district court here declined the SEC's invitation to rule on vertical commonality because horizontal commonality had already been established.

Finally, with respect to institutional investors, the court concluded that a reasonable investor in the position of the institutional buyers of XRP would have reasonably expected Ripple to use its skills to make XRP profitable by building out the XRP ledger and marketing XRP to an expanding universe of buyers and users. For example, among many things, the court noted a "Deep Dive' brochure" that pitched XRP as the future backbone of global transactions. As a result, the court determined that Ripple's sales of XRP to institutional buyers via investment contracts were unregistered sales of securities and, thus, violated Securities Act Section 5.

Programmatic sales of XRP. Some sales of XRP were executed on digital asset exchanges by noninstitutional buyers whom the court said did not received the same marketing materials as the institutional buyers and who generally lacked the sophistication of the institutional buyers. These and other factors, explained the court, led to the conclusion that programmatic sales of XRP involved buyers who could not reasonably have relied on Ripple's entrepreneurial and managerial efforts, thus, negating the existence of the third *Howey* prong.

The court further explained its conclusion by noting that programmatic sales of XRP to noninstitutional buyers occurred via blind bid-ask transactions, so the buyers could not have known whether they traded with Ripple or another XRP seller. The court added that Ripple did not make offers or promises of the type it made to institutional buyers and could not have known who was buying XRP in the programmatic sales context. The court also emphasized that, in the case of programmatic sales, the buyers did not have contracts that contained lockups or other limiting terms.

Because the court concluded that programmatic buyers of XRP could not have relied on Ripple to generate profits, there was no need to address other *Howey*-related questions, such as whether programmatic sales involved an investment of money or a common enterprise. As a result, programmatic sales of XRP did not involve the offer or sale of investment contracts.

Employees and third parties. The third route by which persons acquired XRP was through Ripple providing XRP to its employees and to other third parties, who in turn could sell XRP into public markets. Here, the court emphasized that the employees and third parties merely received XRP from Ripple and did not make any payments to Ripple in exchange for the XRP. As a result, the court concluded that there was no investment of money and, thus, no investment contract under *Howey*. The court likewise declined to address whether there was a common enterprise or a reasonable expectation that Ripple would generate profits under the remaining two *Howey* prongs.

In reaching these conclusions, the court also rejected the SEC's assertion that the distributions of XRP to Ripple employees as compensation and to other third parties were indirect public offerings. The court explained that the SEC never alleged that Ripple employees or third parties were underwriters for Ripple, nor did the SEC show that secondary sales of XRP were offers or sales of investment contracts. The court noted that payments of money related to such transactions could not be traced back to Ripple.

Larsen and Garlinghouse. The court also addressed purported sales of XRP by Ripple's Larsen and Garlinghouse. Here, the court likened the sales to those involving programmatic buyers of XRP; Larsen and Garlinghouse merely sold XRP through blind bid-ask transactions on digital asset exchanges and could not have known the identity of the buyers nor could the buyers have known it was Larsen and Garlinghouse selling the XRP. Thus, the third *Howey* prong was absent because there could not be an expectation that Ripple would use its special skills to generate XRP profits.

The court declined to address the SEC's argument about the inapplicability to Larsen and Garlinghouse of the exemption contained in Securities Act Section 4(a)(1) for transactions by any person other than an issuer, underwriter, or dealer.

Due process concerns. The court briefly addressed Ripple's due process concerns regarding the SEC's enforcement case. Ripple had asserted a fair notice defense while Larsen and Garlinghouse additionally asserted an as-applied vagueness defense. The court said that well-developed caselaw defined what constitutes

an investment contract and that *Howey* provided a "clear test" for applying that definition. The court added that that same caselaw amounted to "sufficiently clear standards" so as to avoid arbitrariness. As a result, the court rejected Ripple's, Larsen's, and Garlinghouse's due process claims with respect to the institutional sales of XRP.

The court declined to address the same due process concerns asserted by Ripple in the context of the programmatic sales of XRP and the distributions of XRP to Ripple employees and other third parties.

Aiding and abetting. Lastly, the court addressed the question of whether the SEC was entitled to summary judgment on the issue of Larsen's and Garlinghouse's alleged aiding and abetting of Ripple's primary violation of federal securities law. The SEC's motion was denied because the court found triable issues of genuinely disputed material facts.

The court easily concluded that, at the least, there was a primary violation of federal securities laws to the extent of the sales of XRP to institutional investors. But the court found the other two elements of aiding and abetting liability were missing.

First, there were triable issues about whether Larsen and Garlinghouse had knowledge of the primary violation. Larsen and Garlinghouse claimed that internationally XRP was not considered to be a security, the U.S.'s FinCEN had identified XRP as a virtual currency, the former Director of the SEC's Division of Corporation Finance, Bill Hinman, gave a speech in which he broadly said Bitcoin and Ether and possibly other tokens likely were not securities in their current forms (although not mentioned by the court, Hinman never expressly mentioned Ripple or XRP; current SEC Chair Gary Gensler questioned whether Ether and XRP are non-compliant securities while teaching at MIT before he joined the SEC), and Ripple considered a 2012 memo from the law firm Perkins Coie suggesting that there was a low probability that XRP was a security (that memo would have pre-dated the SEC's DAO Report and subsequent CorpFin framework on tokens). The court also said there were triable issues about whether Larsen and Garlinghouse recklessly disregarded each *Howey* prong.

Second, and finally, the court noted triable issues about whether Larsen and Garlinghouse provided substantial assistance to the one primary violation found by the court. Both Larsen and Garlinghouse did not dispute providing substantial assistance during their respective tenures as Ripple's CEO. However, Larsen disputed that he provided substantial assistance while serving in his post-CEO capacity as Ripple's executive chair.

As a result, the court denied the SEC's motion for summary judgment on the agency's aiding and abetting claim against Larsen and Garlinghouse.

The case is No. 1:20-cv-10832.

Attorneys: Jorge Gerardo Tenreiro for the SEC. Andrew J. Ceresney (Debevoise & Plimpton LLP) for Ripple Labs Inc.

Companies: Ripple Labs, Inc.

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