Securities Regulation Daily Wrap Up, BLOCKCHAIN—SEC plans to seek interlocutory appeal of Ripple opinion, (Aug 10, 2023)

By Mark S. Nelson, J.D.

The SEC said the two issues it lost in the district court involve controlling questions of law and that an immediate appeal would resolve substantial differences of opinion about the law that could advance the resolution of the SEC's case against Ripple.

The SEC has formally announced via letter filed with a judge in the U.S. District Court for the Southern District of New York that it plans to seek an interlocutory appeal of the two unregistered securities claims that it lost in the case it brought against Ripple Labs, Inc. The agency also cited an emerging intra-district split of authority and the use of the *Ripple* opinion against it in other cases as reasons for the court to grant the SEC's request to file an interlocutory appeal (*SEC v. Ripple Labs, Inc.*, August 9, 2023).

Relying on 28 U.S.C. §1292(b), the SEC told U.S. District Judge Torres that her opinion in the *Ripple* case should be subjected to an interlocutory appeal and that the remainder of the district court case against Ripple should be stayed while that appeal happens. The U.S. Code provision allows for an interlocutory appeal where the appeal would involve a controlling question of law, there is substantial ground for difference of opinion on that question of law, and the immediate appeal from the lower court's order would materially advance the ultimate determination of the litigation.

In July, the district court in Manhattan concluded, for purposes of cross motions for summary judgement brought by the SEC and Ripple, that institutional sales of Ripple's XRP were investment contracts under the *Howey* framework and, thus, securities, but that programmatic sales of XRP via blind bid-ask transactions and other distributions of XRP (e.g., to employees) were not investment contracts and, thus, not securities. Under *Howey*, the SEC must show that there was an investment of money in a common enterprise with an expectation that others (e.g., a promoter or other third party) will use their skills to generate profits. In the case of institutional sales of XRP, the court reasoned that there were in fact contractually-driven expectations that Ripple would generate profits in XRP.

With respect to programmatic sales of XRP to retail investors, the court reasoned that the buyers of XRP could not have formed a reliance on Ripple's managerial and entrepreneurial skills to generate profits from XRP because they could not have known from whom they bought the XRP. In the case of other distributions of XRP, the court reasoned that there was no investment of money. Here, however, the SEC suggested in its letter that interlocutory appeal could help with the other distributions of XRP issue because in a similar case, *SEC v. LBRY, Inc.*, a judge in the U.S. District Court for the District of New Hampshire concluded that, for purposes of cross motions for summary judgment by the SEC and LBRY, LBC tokens issued to incentivize users, developers, and employees were sales of investment contracts and, thus, securities.

The SEC's letter to Judge Torres also argued that an interlocutory appeal is appropriate, in part, because of the emerging intra-district split of authority over whether certain types of sales of crypto assets are sales of investment contracts and, thus, securities. For example, in the *Terraform* case, Judge Rakoff declined to dismiss the charges brought by the SEC that, among other things, multiple tokens issued by *Terraform* were securities under *Howey*. In reference to the *Ripple* opinion's distinctions between direct and secondary market purchasers, Judge Rakoff said: "But *Howey* makes no such distinction between purchasers. And it makes good sense that it did not. That a purchaser bought the coins directly from the defendants or, instead, in a secondary resale transaction has no impact on whether a reasonable individual would objectively view the defendants' actions and statements as evincing a promise of profits based on their efforts."

The SEC's letter to Judge Torres also expressed concern about the use of the *Ripple* opinion in still other cases that could present a situation "of particular consequence to an issue of programmatic concern to the SEC's enforcement of the securities laws and potentially to a large number of pending litigations." Chief among these cases is the SEC's recent case charging that Coinbase, Inc. allowed the trading of crypto asset securities on its allegedly unregistered national securities exchange and that Coinbase also acted as an unregistered broker and unregistered clearing agency. Coinbase has filed a motion for judgment on the pleadings largely on the basis of the *Ripple* opinion's treatment of programmatic sales of XRP.

According to Coinbase: "Decades of precedent confirm that for an investment to constitute an investment contract, the buyer must have a contractually-grounded expectation of delivery of future value. The investment, moreover, must be directed in the business itself rather than a purchase of the business's products or output." In Coinbase's view, the SEC is attempting to disregard the "contract" part of *Howey*'s "contract, transaction, or scheme" phraseology.

In *Terraform* by comparison, Judge Rakoff suggested that "contract," as used in *Howey*, does not necessarily mean a formal contractual arrangement. Said the court: "By stating that 'transaction[s]' and 'scheme[s]'—and not just 'contract[s]'—qualify as investment contracts, the Supreme Court made clear in *Howey* that Congress did not intend the term to apply only where transacting parties had drawn up a technically valid written or oral contract under state law" (citations omitted).

One can see a progression in crypto companies' arguments in response to SEC enforcement actions. Early cases tended to emphasize questions about whether horizontal and/or vertical commonality existed between investors and those alleged to have sold investment contracts. More recent cases have tended to emphasize questions about whether *Howey* requires a formal contractual arrangement as well as other issues focused on whether the defendant company had fair notice of the securities laws regarding crypto assets and whether the SEC can even regulate crypto assets under the Supreme Court's major questions doctrine.

According to Judge Torres's Individual Practices in Civil Cases (See III.A.i. and III.A.ii.), most motions require a pre-motion letter to be field with the court, to which the opposing party must respond by filing an opposition letter within five business days of receiving the movant's letter. The SEC filed its pre-motion letter on August 9, 2023, so Ripple can be expected to file its response to the agency's letter anticipating an SEC motion for leave to file an interlocutory appeal by August 16, 2023.

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

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Companies: Ripple Labs, Inc.

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