Securities Regulation Daily Wrap Up, TOP STORY—SEC complaint sufficiently alleged that company engaged in unlawful offer and sale of securities, (Mar. 14, 2022)

Securities Regulation Daily Wrap Up

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By Sara Cracau, J.D.

The SEC's complaint sufficiently alleged that a technology company and two of its leaders engaged in the unlawful offer and sale of securities in violation of Section 5 of the Securities Act and that the leaders aided and abetted these violations.

A federal district court in New York denied the motion to dismiss of a company and its senior leaders of an action charging them with engaging in the unlawful offer and sale of securities in violation of Section 5 of the Securities Act. The court found that the SEC had plausibly alleged that the company's leaders had knowledge of or recklessly disregarded the facts that allegedly made the company's sale of XRP amount to the unregistered sale of securities and that one of the leaders provided substantial assistance in such sale. Furthermore, the court concluded that the SEC had plausibly shown that the company's leaders made domestic offers and sales of XRP and found that they were not predominantly foreign. The court also denied the SEC's motion to strike the company's fair notice defense under Federal Rule of Civil Procedure 12(f), finding no authority for striking a fair notice affirmative defense at the pleadings stage (*SEC v. Ripple Labs, Inc.*, March 11, 2022, Torres, A.; *SEC v. Ripple Labs, Inc.*, March 11, 2022, Torres, A. (Fair notice defense opinion)).

The SEC alleged that, from 2013 until the filing of this action in 2020, the company violated Section 5 of the Securities Act by selling XRP, which the SEC alleged to be an "investment contract" and for which registration is required, without filing a registration statement. The SEC also contended that the company's executives promoted XRP as an investment into a common enterprise that would increase in value and price based on the company's efforts. The co-founder of the company began creating the XRP Ledger, a software code that operates as a peer-to-peer database, spread across a network of computers, that records data respecting transactions, among other things. The co-founder and others created a fixed supply of 100 billion XRP, a digital asset and the native token on the XRP Ledger. The founder served as the company's CEO and the company was intended to "continue the XRP Ledger and XRP projects." The COO of the company later took over as CEO and served as the executive chairman of the company's board of directors.

Company's CEO. Before the company began distributing XRP, the CEO and other company executives received two legal memoranda from a law firm which analyzed the risks associated with the company's distribution and monetization of XRP. The law firm warned that there was some risk that XRP would be considered an investment contract by the SEC and would, therefore, be subject to federal securities laws and that there would be an increased risk of XRP being deemed a security if individuals purchased XRP as a speculative investment, or if company employees promoted the idea that XRP could increase in price. From 2013 to 2014, the company and the CEO made efforts to create a market for XRP by having the company distribute approximately 12.5 billion XRP to programmers through "bounty programs" that paid them for reporting problems in the XRP Ledger's code.

In a public interview, the CEO explained that one of the company's "key roles is making sure that [the company] distribute [XRP] as broadly as in a way that adds as much utility and liquidity as [it] possibly can." Both the CEO and the COO played significant roles in negotiating and approving the company's institutional sales as well as other offers and sales of XRP to institutional investors. The COO negotiated an institutional investor's purchase of XRP in connection with the investor's formation of a private investment fund "whose sole purpose would have been to speculate on XRP as an investment."

Company's COO. The company's COO approved the timing and amounts of offers and sales of XRP. He also understood the concept of speculative investing and a company employee informed him that the company's goal was to "drive XRP speculative trading volume." He was actively involved in promoting XRP. During his tenure, he received warnings that XRP may be classified as a security. Both the CEO and COO offered and sold their XRP and they directed their XRP offers and sales within the United States.

Aiding and abetting liability. The SEC alleged that the company's leaders aided and abetted the company's violation of Section 5 by assisting in the company's unregistered sale of XRP and the court found that the SEC had adequately alleged the first requirement, i.e., the existence of a securities law violation by the primary party. The court found no basis for finding in the statute the company leaders' contention that there was a willfulness requirement for aiding and abetting liability. The court noted that when evaluating whether a defendant rendered substantial assistance, courts may consider the degree of knowledge that the defendant had of the primary violation and that when the SEC plausibly alleged a high degree of actual knowledge, this reduced the burden it must meet in alleging substantial assistance. The SEC asserted that the company's leaders had knowledge of or recklessly disregarded the facts that allegedly made the company's sales of XRP amount to the unregistered sale of securities and that the CEO provided substantial assistance.

Individual sales. After deciding which test applied in deciding whether sales occurred in the United States, the court, giving the term "offer" its most expansive meaning, ruled that the SEC sufficiently alleged that the leaders sold XRP in the United States. The company's leaders executed offers and sales on a digital trading platform through accounts based in the United States and, therefore, it can be inferred that the sales occurred in the United States and it rejected the argument that the sales were predominantly foreign as they were made by U.S. residents, involved alleged securities issued by a U.S. company, concerned at least some offers made on U.S.-based platforms, and included at least some offers and sales made to U.S. purchasers.

Motion to strike fair notice defense. The company pleaded that it lacked, and the SEC failed to provide, "fair notice that its conduct was in violation of law, in contravention of the [company's] rights." The SEC contended that it would be prejudiced by the company's defense because the defense would lead it to seek intrusive discovery.

At the pleading stage, the court's examination of the company's conduct is limited to facts pleaded in the company's answer, the undisputed facts in the amended complaint, and any fact of which the court may take proper judicial notice. The court must determine what the company did before assessing whether the statute fairly apprised the company that its conduct was prohibited.

The court concluded that the SEC did not meet its burden of showing that there are no questions of fact or law that might allow the defense to succeed. The SEC did not cite any caselaw where a court struck a fair notice affirmative defense at the pleadings stage and the court did not find that this was warranted in this case and the SEC did not show that it would suffer undue prejudice as a result of continuation of this defense or that it was timely filed.

The case is No. 20 Civ. 10832 (Fair notice defense opinion).

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Companies: Ripple Labs Inc.

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