SECURITIES – CRYPTOCURRENCY

The United States District Court for the Southern District of New York held that institutional sales of unregistered cryptocurrency, but not programmatic sales and other distributions of unregistered cryptocurrency, constitute investment contracts under § 5 of the Securities Act. *SEC v. Ripple Labs, Inc.,* No. 20 CIV. 10832 (AT), 2023 U.S. Dist. LEXIS 120486, 2023 WL 4507900 (S.D.N.Y. July 13, 2023), *motion to certify appeal denied,* No. 20 CIV. 10832 (AT), 2023 U.S. Dist. LEXIS 178300, 2023 WL 6445969 (S.D.N.Y. Oct. 3, 2023).

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In *Securities and Exchange Commission v. Ripple Labs, Inc.*, the United States District Court for the Southern District of New York addressed the definition of a security, specifically whether institutional sales, programmatic sales, and other distributions of unregistered cryptocurrency constitute an investment contract—a type of security—under the Securities Act. According to Section 5 of the Securities Act of 1933 ("Securities Act"),[1] "it is 'unlawful for any person, directly or indirectly, … to offer to sell, offer to buy or purchase[,] or sell' a 'security' unless a registration statement is in effect or has been filed with the SEC as to the offer and sale of such security to the

[1] 15 U.S.C. § 77e.

public."[2] After applying the three-part *Howey*[3] test to each distribution type, the Court held that institutional sales of unregistered cryptocurrency, but not programmatic sales and other distributions of cryptocurrency, constitute investment contracts, and may violate Section 5 of the Securities Act.

I. FACTUAL BACKGROUND

During 2011 and the beginning of 2012, Arthur Britto, Jed McCaleb, and David Schwartz created the XRP Ledger, which is a source code for a blockchain, as an alternative to the bitcoin blockchain. The source code they created generated 100 billion XRP, which is the native digital token of the ledger.[4] In 2012, Britto, McCaleb, and Defendant Larsen founded Ripple,

[2] SEC v. Ripple Labs, Inc., No. 20 CIV. 10832 (AT), 2023 WL 4507900, at *5 (S.D.N.Y. July 13, 2023), *motion to certify appeal denied*, No. 20 CIV. 10832 (AT), 2023 WL 6445969 (S.D.N.Y. Oct. 3, 2023) (quoting 15 U.S.C. §§ 77e(a), (c), (e)).
[3] SEC v. W.J. Howey Co., 328 U.S. 293 (1946) (outlining the standards of an investment contract).
[4] *Ripple Labs, Inc.,* 2023 WL 4507900, at *1.

and Larsen became the CEO. Collectively, they retained 20 billion XRP for themselves and provided Ripple with 80 billion XRP.[5]

Ripple sought to "realize an 'Internet of Value'" by transferring value through the internet via technology, specifically by the creation of a global payment network for international currency transfers.[6] One way to do this is through the exchange of currency for XRP and then XRP for a different currency, which is known as "on demand liquidity" ("ODL").[7] Other features of Ripple, outside of ODL, also rely on XRP and the ledger. Anyone can use the open-source XRP Ledger in a variety of ways, with other developers having built products that use the ledger.[8] Ripple has also attempted to incentivize the development of other uses on the ledger, in part, through the funding of other companies.[9]

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[5] *Id.* at *2.
[6] *Id.*
[7] *Id.*
[8] *Id.* (referencing the construction of payment processing applications).
[9] *Id.*

From 2013 to the end of 2020, Ripple sold and distributed XRP through various methods. Ripple sold the token directly to counterparties such as institutional buyers and hedge funds. These sales were done through wholly owned subsidiaries and according to written contracts.[10] Ripple also sold XRP "programmatically" on digital asset exchanges, which occurred blindly through trading algorithms, so Ripple was unaware of the purchaser's identity and the purchasers did not know the seller's identity.[11] Lastly, Ripple distributed XRP to employees and third parties as payment for services. Defendants Larsen and Garlinghouse also engaged in the sale and distribution of XRP in their individual capacities.[12]

[10] *Ripple Labs, Inc.*, 2023 WL 4507900, at *2.
[11] *Id.; see* Defendant's 56.1 Response at 269, SEC v. Ripple Labs, Inc., 2023 WL 4507900 (S.D.N.Y. July 13, 2023) (No. 838).
[12] *Id.* at *3.

Larsen stepped down as CEO in December 2016 and became the Executive Chairman of Ripple's Board of Directors. Garlinghouse became the COO of Ripple in April 2015, and became the CEO on January 1, 2017, after Larsen stepped down.[13] None of the defendants filed a registration statement regarding the sales of XRP, and Ripple never filed financial statements or periodic reports publicly; Ripple also never made EDGAR filings with the SEC.[14]

Since 2013, Ripple engaged in distributions of documents which describe the XRP ledger, the XRP trading market, along with information about the company. The documents were publicly distributed on Ripple's website, and some were sent to over one hundred people. In 2016, Ripple began posting market reports on their website regarding the XRP market.[15]

[13] *Id.* Both sold XRP during their tenures and Garlinghouse additionally received XRP as compensation. *Id.*
[14] *Id.*
[15] *Id.*

Ripple also used various social media platforms to distribute information about the company and XRP, and Ripple's leaders also participated in interviews on many large platforms discussing XRP and Ripple.[16]

Before the public launching of the XRP Ledger, however, in February 2012, the founders engaged the Perkins Coie LLP law firm and received a memorandum which analyzed the legal risks of the product and business structure, ultimately to assist in mitigating any risks present. The memorandum specifically stated that XRP, if sold to investors, would likely constitute a security, and XRP would not likely constitute an investment contract if there was no investment of money with the distribution of XRP. Ripple and Larsen, among others, received another memo from Perkins Coie in October 2012, and the memorandum articulated that the firm believed

[16] *Id.* at *4.

there may be some risk that XRP tokens constituted securities.[17] It further articulated that the tokens would be more likely to be considered investment contracts if Ripple promoted XRP as an investment opportunity.[18]

The SEC commenced action on December 22, 2020, and an amended complaint was filed on February 18, 2021.[19] Cross-motions for summary judgment were filed on September 13, 2022, and are considered here before the Court.[20]

II. ISSUE

Section 5 of the Securities Act states "it is 'unlawful for any person, directly or indirectly, … to offer to sell, offer to buy or purchase[,] or sell' a 'security' unless a registration statement is in effect or has been filed with the SEC as to the offer and sale of such security to the public."[21] The SEC must

[17] *Ripple Labs, Inc.*, 2023 WL 4507900, at *4.
[18] *Id.*
[19] *Id.* at *4.
[20] *Id.*
[21] *Id.* at *5 (quoting 15 U.S.C. §§ 77e(a), (c), (e)).

satisfy three requirements to prove a violation of Section 5: "(1) that no registration statement was filed or in effect as to the transaction, and (2) that the defendant directly or indirectly offered to sell or sold the securities (3) through interstate commerce."[22] Both the SEC and Defendant's brought forth summary judgment motions, filed on September 13, 2022. The only disputed element was "whether Defendants offered to sell or sold XRP as a security."[23]

III. LAW AND REASONING

Pursuant to the *Howey* test, an investment contract is defined as "'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.'"[24] The Court analyzed each sale

[22] *Ripple Labs, Inc.*, 2023 WL 4507900, at *5.
[23] *Id.* (questioning if the sale of XRP was an "investing contract" under 15 U.S.C. §§77b(a)(1)).
[24] *Id.* (quoting W.J. Howey Co., 328 U.S. at 298–99).

or distribution category according to the *Howey* requirements.[25] The Court first clarified that XRP may be offered or sold as an investment contract, despite Defendant's arguments that it is more like an "ordinary asset" than a security.[26] The Court clarified, however, that ordinary assets may still be considered investment contracts based on the circumstances of the sale.[27]

A. INSTITUTIONAL SALES

The Court first looked at the Institutional Sales and analyzed the three factors of the *Howey* test. Under the test, the Court must first determine whether there was an investment of money in completing the transaction. The Institutional Buyers provided fiat or other currency in exchange for XRP, which the Court held is an investment of money because there was a

[25] *Id.*
[26] *Id.* at *7.
[27] *Id.* The *Howey* test is really a consideration of the totality of the circumstances. *Id.* at *8. "Each transaction must be analyzed and evaluated on the basis of the content of the instruments in question, the purposes intended to be served, and the factual setting as a whole." Marine Bank v. Weaver, 455 U.S. 551, 560 n.11 (1982).

payment.[28] The Court's next inquiry was whether there was a "common enterprise,"[29] which exists by a showing of horizontal commonality, i.e., when the assets of each individual investor are related to other investor's fortunes as well as the success of the overall company.[30] The Court established that there was a demonstration of horizontal commonality because the assets received from the Institutional Sales were pooled together into bank accounts controlled by Ripple and used to fund Ripple's operations.[31] The profitability of each Institutional Buyer was also tied to Ripple and other buyers since they all received XRP in the exchange.[32] Lastly, the Court examined whether the Institutional Buyers had a reasonable

[28] *Ripple Labs, Inc.*, 2023 WL 4507900, at *8 (providing the Court looks for provision of "capital[,]" "money[,]" or "cash").
[29] *Id.* (quoting W.J. Howey Co., 328 U.S. at 301).
[30] *Id.* (referencing Revak v. SEC Realty Corp., 18 F.3d 81,87 (2d Cir. 1994)).
[31] *Id.* at *9.
[32] *Id.*

expectation of return, or profits, from the efforts of a third party.[33] The Court found that reasonably buyers would assume that Ripple would use the assets received to increase the overall value of XRP because of the marketing communications available to the public and sent out the people, along with the nature of Institutional Sales.[34] Ultimately, the Court concluded that Institutional Sales of XRP constitutes the sales of investment contracts in violation of Section 5 of the Securities Act.[35]

B. PROGRAMMATIC SALES

The Court then turned to the Programmatic Sales, using the same analysis as above. The Court, however, differentiated Programmatic Sales from Institutional Sales according to the third prong of the *Howey* test, concluding that Institutional Buyers would not reasonably expect their assets

[33] *Id.*
[34] *Ripple Labs, Inc.*, 2023 WL 4507900, at *10–11.
[35] *Id.* at 11.

to be used to increase the value of XRP.[36] The reasoning for this was the blind bid/ask nature of the transactions, so Programmatic Buyers did not know their assets were going to Ripple or any XRP seller.[37] The Programmatic Sales also did not involve any contracts, and the buyers were not considered sophisticated buyers like the Institutional Buyers.[38] Considering these factors, the Court held that Programmatic Sales could not constitute the offer and sale of investment contracts.[39]

C. OTHER DISTRIBUTIONS

Finally, the Court looked at the Other Distributions category, such as the distribution of XRP to employees and third parties as compensation.[40] The Court held that this category did not satisfy the first prong of the *Howey*

[36] *Id.*
[37] *Id.*
[38] *Id.* at *12.
[39] *Id.* at *13.
[40] *Ripple Labs, Inc.*, 2023 WL 4507900, at *13.

test, that there be an "investment of money," since the recipients did not offer money or other assets to Ripple in exchange for XRP.[41] Further, there was no evidence that Ripple distributed XRP for the recipients to turn around and sell to other parties.[42] Therefore, the Other Distributions cannot constitute the offer and sale of investment contracts.[43]

D. LARSEN AND GARLINGHOUSE

Focusing on Larsen's and Garlinghouse's actions, the Court held that Larsen's and Garlinghouse's individual sales, like the Programmatic Sales, were not offers and sales of investment contracts because the exchange was done through blind bid/ask transactions, so the third prong of the *Howey* test could not be established.[44]

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[41] *Id.* (referencing Int'l Bhd. of Teamsters v. Daniel, 439 U.S. 551, 560 (1979)) ("In every case [finding an investment contract] the purchaser gave up some tangible and definable consideration in return for an interest that had substantially the characteristics of a security.").

[42] *Id.* (declining to find a sale of an investment contract where the SEC failed to develop their argument that secondary sales could be an indirect public offering).

[43] *Id.*

[44] *Id.* at *14. Additionally, the SEC also brought claims of aiding and abetting against Larsen and Garlinghouse for their involvement with the unregistered offer and sale of investment contracts under Section 5 of the Securities Act. *Id.* at *15. The SEC had to show "(1) a

IV. CONCLUSION

The Court ultimately determined that the SEC's motion for summary judgment was granted as to the Institutional Sales but denied as to all other motions, and the Defendants' motion for summary judgment was granted as to Programmatic Sales, Other Distributions, and Larsen's and Garlinghouse's sales but denied as to all other motions.

V. INTERLOCUTORY APPEAL OF PROGRAMMATIC SALES AND OTHER DISTRIBUTIONS

In 2023, the SEC moved for interlocutory appeal regarding the holdings as to the Programmatic Sales and the Other Distributions.[45] In certifying an order for interlocutory appeal, the moving party must establish that "(1) '[the] order involves a controlling question of law,' (2) 'as to which there is a substantial ground for difference of opinion,' and (3) 'an immediate

securities violation; (2) knowledge of the violation; and (3) substantial assistance in the achievement of the primary violation." SEC v. Apuzzo, 689 F.3d 204, 206 (2d Cir. 2012).

[45] SEC v. Ripple Labs, Inc., 2023 WL 6445969 (S.D.N.Y. Oct. 3, 2023).

appeal from the order may materially advance the ultimate termination of the litigation.'"[46]

The Court first analyzed whether the SEC had presented a controlling question of law, which can be decided without the Court needing to study the details of the record.[47] The Court determined that the SEC did not present such a question. First, the previous conclusions of the Court as to whether the sales and distributions of XRP were investment contracts required extensive review of reports and facts, so a further review would require even greater studying of the record.[48] Also, the Court stated that the questions is not controlling because it does not have precedential value over many cases because the facts are highly case-specific.[49]

[46] *Id.* at *2 (quoting 28 U.S.C. § 1292(b)).
[47] *Id.* at *3 (citing Youngers v. Virtus Inv. Partners Inc., 228 F. Supp. 3d 295, 298 (S.D.N.Y. 2017)).
[48] *Id.*
[49] *Id.* at *3–4. The Court also noted that the SEC did not identify what specific labor of the employees could meet the first prong of the *Howey* test, i.e., investing of money. *Id.* at *5.

The Court next looked at whether there was a substantial ground for a difference of opinion, concluding that there was not because there was no conflicting authority on the issue cited by the SEC.[50] Rather, the SEC misstated the holding of cases cited, and those cited also used the *Howey* test applied to the specific facts of each case, and the SEC did not argue that courts differ as to the proper legal standard.[51]

Finally, the Court looks at whether the certification of interlocutory appeal would materially advance the ultimate termination of the litigation.[52] The Court held, however, that the SEC did not meet its burden to establish this because remanding the case would require another extensive review of both the legal and factual issues, and likely add to the time it would take to

[50] *Ripple Labs, Inc.*, 2023 WL 6445969, at *5.
[51] *Id.* (explaining that the SEC's citation to SEC v. Terraform Labs Pte. Ltd., 2023 WL 4858299 (S.D.N.Y. July 31, 2023) was inappropriate as the facts included representation to the public, as well as institutional investors, about the use of capital to generate profits).
[52] *Ripple Labs, Inc.*, 2023 WL 6445969, at *6.

terminate the case. Ultimately, the Court denied the SEC's motion for certification of interlocutory appeal.[53]

VI. APPLICATION

In light of these decisions, transactional attorneys should be aware that sales to more sophisticated parties of various cryptocurrencies could be considered investment contracts, and therefore securities; however, sales to less sophisticated parties or those made in blind transactions are not likely to constitute investment contracts. With this in mind, transactional attorneys should advise their clients to comply with Section 5 of the Securities Act when making direct sales of cryptocurrency to sophisticated parties by filing registration statements when making sales of anything that may be considered a security. Interestingly, perhaps less sophisticated investors should also be wary that their cryptocurrency investments may not be found

[53] *Id.* at *6–7.

to have the same protections as the same vehicle sold to their institutional contemporaries.[54]

[54] *See* Ann Lipton, *So, Ripple*, BUSINESS LAW PROF BLOG (July 13, 2023), https://lawprofessors.typepad.com/business_law/2023/07/so-ripple.html.