5 Considerations To Give Crypto Sellers Pause Post-Ripple

By **Mark Hiraide** (August 1, 2023)

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In a long-awaited decision on cross-motions for summary judgment in the U.S. Securities and Exchange Commission v. Ripple Labs Inc. case, U.S. District Judge Analisa Torres granted the respective motions in part and denied them in part.

With the July 13 decision, the U.S. District Court for the Southern District of New York became the first to reject the SEC's position that cryptocurrencies are securities. Judge Torres' view of Ripple's programmatic sales of its XRP token has been heralded by many in the crypto community as groundbreaking.

Ripple created a public market for its XRP tokens by selling them "over the counter" without registration under Section 5 of the Securities Act or exemption therefrom.

Ripple did so by selling $728 million XRP to institutional investors and hedge funds, or institutional sales, and selling $757 million XRP directly to the public through market makers on crypto-trading platforms, or programmatic sales — market makers used trading algorithms to sell on crypto-trading platforms amounts programmatically set not to exceed a percentage of XRP's daily trading volume.

Ripple also distributed $609 million XRP as a form of payment for services to employees and others, or other distributions, and to third-party developers as part of Ripple's Xpring initiative to fund those parties' efforts to develop new applications for XRP and the XRP Ledger.

Finally, affiliates of Ripple — its then-CEO, Christian Larsen, and its current executive chairman of the board, Bradley Garlinghouse — offered and sold XRP in their individual capacities. Larsen alone sold at least $450 million.

At issue was whether the XRP tokens were investment contracts under the U.S. Supreme Court's seminal 1946 decision in SEC v. W.J. Howey Co. Judge Torres held that XRP institutional sales were sales of securities in violation of the registration provisions of the Securities Act.

However, in a ruling that surprised many securities lawyers, the court held that Ripple's programmatic sales to the public were not investment contracts, as they did not satisfy Howey's third prong — whether the economic reality surrounding Ripple's XRP sales to the public led purchasers to have "a reasonable expectation of profits to be derived from the entrepreneurial or managerial efforts of others."[1]

In this regard, the court concluded that the open market buyers in Ripple's programmatic sales — as well as the buyers in open market affiliate sales, which were blind bid/ask transactions — could not have known if their payment of money went to Ripple or any other seller of XRP.[2]

The court found that whereas institutional buyers reasonably expected that Ripple would use the capital it received from its sales to improve the XRP ecosystem and thereby increase the price of XRP, programmatic buyers could not reasonably expect the same.[3] In so

deciding, the court flipped on its head the investor-protection policy of the federal securities laws, affording institutional investors the statutory protections of the Securities Act while leaving retail purchasers unprotected.

As for the other distributions — which the SEC alleged were part of Ripple's scheme to fund its projects by transferring XRP to third parties in exchange for services, and then having these third parties sell the XRP into public markets — the court held that those sales were not investment contracts, as they did not satisfy Howey's first prong that there be an "investment of money" as part of the transaction or scheme.

Judge Torres' order is unprecedented, as it holds that a token sold as part of an investment contract is not always a security. Hence, as here, a token may be at once both a security and a nonsecurity.

However, before taking too much comfort in Judge Torres' decision and embarking on a public distribution of crypto tokens through programmatic sales and dispensing tokens to employees and vendors, you should consider the following:

1. Ripple's programmatic sales represented less than 1% of the global XRP trading volume.

The court noted that since 2017, Ripple's programmatic sales represented less than 1% of the global XRP trading volume and, therefore, most who purchased XRP from digital asset exchanges did not invest their money in Ripple, as they instead purchased crypto tokens via secondary transactions in an active market.[4]

Query, at what point does a greater proportion of programmatic sales, as compared to total trading volume, distinguish the facts in Ripple?

2. The court did not address whether secondary market sales of XRP constitute offers and sales of investment contracts because that question was not properly before the court.

To generate a sufficient supply of XRP to support an active secondary market, Ripple conducted institutional sales that the court found constituted sales of securities. For that supply of securities to reach trading markets, the institutional purchasers necessarily resold some or all their XRP.

Query, under what circumstances are the secondary transactions — i.e., resales — exempt from registration?

The court expressly declined to answer this question.

In a footnote, the court stated that it rejected the SEC's argument that Ripple sold investment contracts to the public and used the institutional buyers as underwriters, which would have vitiated the registration exemption for the institutional buyers' secondary sales.

However, in the very next footnote, the court said, concerning programmatic buyers, that it did not address whether secondary market sales of XRP constituted offers and sales of investment contracts, noting that whether a secondary market sale constitutes an offer or sale of an investment contract would depend on the totality of circumstances and the economic reality of that specific contract, transaction or scheme.

3. The SEC did not consider that recipients of other distributions, like Ripple employees and Xpring third-party companies, acted as statutory underwriters.

As to the other distributions, the court noted that the SEC did not allege, other than in its opposition papers, that recipients of the other distributions — like Ripple employees and Xpring third-party companies — were Ripple's underwriters, nor did the SEC develop the argument that these secondary market sales were offers or sales of investment contracts.[5]

Query, can employees, affiliates and others who receive tokens resell them in programmatic sales without registration?

4. The SEC may appeal.

The SEC may decide to appeal Judge Torres' ruling to the U.S. Court of Appeals for the Second Circuit. If it does so, the appellate court's decision will set a binding precedent in the Second Circuit and may serve as a persuasive authority in other federal circuits.

5. SEC v. Ripple is not the law of the land.

Even if the SEC does not appeal Judge Torres' order, it is not binding on other federal district courts and is limited to the facts of the Ripple case. That one federal district court disagrees with the SEC's interpretation of the law may not prevent the commission from advancing its interpretation in subsequent cases.[6]

Conclusion

So, what are the takeaways?

First, Judge Torres' order clearly rejected the SEC's position that tokens distributed as part of an investment contract are always themselves securities under Howey. However, the Howey analysis is fact-specific, and whether another court will be persuaded by Judge Torres' analysis or if others will regard her decision as an outlier limiting it to the facts of the Ripple case is difficult to predict.

Second, Judge Torres' analysis is difficult to square with 90 years of federal securities law jurisprudence.

Although at first glance the order appears to provide a mechanism to distribute tokens to the public through programmatic sales to market makers without complying with the federal securities laws, the order raises a number of difficult unanswered questions.

Unfortunately, Judge Torres' Ripple decision does not make carving a pathway to a compliant token distribution any easier. No doubt, token issuers will try.

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[1] See United Hous. Found., Inc. v Forman, 421 U.S. 837, 852 (1975).

[2] U.S. Securities and Exchange Commission v. Ripple Labs, Inc. Order, pp. 23, 27

[3] Id.

[4] Order, p. 23.

[5] Order, p. 27.

[6] See, e.g., In re Ranieri Partners LLC, SEC Release No. 34-69091 (Mar. 2013) (private fund adviser's receipt of transaction-based compensation constituted acting as a broker) and SEC v. Kramer, 778 F. Supp. 2d 1320 (M.D. Fla. 2011)(rejecting SEC's interpretation that a person's receipt of transaction-based compensation, without engaging in certain other activities, constituted acting as a broker).