July 21, 2023

Client Memorandum: ***S.E.C. v. Ripple Labs*** – Judicial Endorsement of the "Ineluctable Modality" of the Federal Securities Laws

On July 13, 2023, Judge Analisa Torres of the Southern District of New York entered an order deciding key issues in *Securities and Exchange Commission v. Ripple Labs, Inc. et al.* [1], the longest running and highest-profile case brought to date by the U.S. Securities and Exchange Commission (the "**SEC**"), involving the application of federal securities law to transactions involving crypto assets (the "**Order**"). In the Order, Judge Torres granted Ripple Labs, Inc.'s ("**Ripple Labs**") motion for summary judgment with respect to two out of the three categories of XRP distributions by Ripple Labs and granted the SEC's motion for summary judgment with respect to the institutional sales of a token known as "XRP" by Ripple Labs. Judge Torres also granted summary judgment to the individual defendants on the question of their sales of XRP but scheduled a trial for further fact finding on the individual defendants' level of involvement in the institutional sales by Ripple Labs which the judge concluded did violate Section 5 of the Securities Act.

Although specifically addressing only certain transactions involving XRP, a crypto asset initially developed by Ripple Labs, the Order has far-reaching consequences for virtually all market participants engaging with a wide range of fungible crypto assets. Critically, Judge Torres rejected the SEC's theory that a crypto asset initially sold in an investment contract transaction thereafter *embodies* the elements of that investment contract. Instead, Judge Torres correctly recognized that *Howey* is a facts and circumstances specific test that applies to a transaction, contract or scheme and she applied that test to each category of XRP distribution at issue in the case. The Judge's reasoning is already being called the "Torres Doctrine".

The Ripple Labs case began in December 2020, when the SEC filed a complaint against the company and two of its senior executives, Brad Garlinghouse and Chris Larson. The SEC complaint alleged violations of Section 5 of the Securities Act of 1933, as amended (the "**Securities Act**"), resulting from Ripple Labs' failure to register long-running distributions of XRP, which the SEC referred to in the complaint as a "digital asset security". These distributions were conducted in a variety of ways, including:

- **Institutional sales**, which are sales directly to institutional buyers pursuant to written contracts;
- **Programmatic sales**, which are anonymous, "programmatic" sales on digital asset trading platforms;
- **Other distributions**, which include distributions to employees and to third parties to fund new applications for XRP and the XRP Ledger; and

[1] *S.E.C. v. Ripple Labs, Inc. et al.* No. 20-10832 (S.D.N.Y.).

- **Sales by individuals**, which are sales by Larsen and Garlinghouse, in their individual capacities, on digital asset trading platforms in a manner similar to Ripple's programmatic sales.

Key aspects of the Order with respect to each category of XRP distributions considered by Judge Torres are set out below.

- **Institutional sales** of XRP by Ripple Labs were found to constitute unregistered offer and sale of investment contracts (and, thus, securities) in violation of Section 5 of the Securities Act.
    - In deciding this, Judge Torres *rejected* Ripple Labs' defense that the "essential ingredients" of an investment contract (as that concept was styled by Ripple Labs) were not present in these transactions.
    - Also *rejected* were Ripple Labs' due process and "fair notice" defenses with respect to the institutional sales of XRP that the judge found were investment contract transactions.
    - On the other hand, the Court summarily *rejected* the SEC's argument that Ripple Labs sold investment contracts to the public and used the institutional buyers as "underwriters".

- **Programmatic Sales** of XRP by Ripple Labs on digital asset trading platforms were found by Judge Torres *not* to constitute investment contract transactions. Specifically:
    - Judge Torres concluded that a reasonable purchaser in programmatic sales would not expect to profit from the efforts of Ripple Labs. The Judge therefore did not assess the "investment of money" or "common enterprise" elements of the *Howey* test with respect to the programmatic sales.
    - Judge Torres focused on the fact that Ripple Labs' programmatic sales represented less than 1% of the global XRP trading volume. Because these transactions were "blind bid/ask" transactions into a very active trading market primarily consisting of third parties trading with each other, the Judge concluded that purchasers of XRP on digital asset trading platforms could not have known whether they were buying XRP from Ripple Labs or other third-party traders and thus, unlike the buyers in the institutional sales, had no intent to fund the business of Ripple.
    - The Judge was also swayed by the fact that there was no evidence presented of promises or offers made by Ripple Labs with respect to the purchasers in the programmatic sales that would lead a reasonable purchaser to expect their profits to be derived from Ripple's entrepreneurial or managerial efforts.
        - Although a variety of general statements by Ripple Labs or its officers and directors were entered into evidence, the Judge did not find evidence that Ripple made any specific promises or offers to the purchasers in the programmatic sales.
        - The Judge also did not find evidence that a reasonable buyer would have understood the statements by Ripple Labs' employees as *representations* of Ripple Labs itself.

- Ironically for the SEC, the Court focused on the "economic reality" of these programmatic sales concluding that the buyers, just like purchasers in secondary market transactions on marketplace platforms, did not know to whom their purchase funds were going.
  - That said, the Court specifically stated in a key footnote that it was not addressing whether actual secondary market sales of XRP constitute offers and sales of investment contracts, and suggested that whether such sales constitute 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*.

- **Other distributions** of XRP by Ripple Labs were found not to constitute investment contract transactions, because the Court concluded that these distributions did not involve an "investment of money" and failed the first prong of the *Howey* test.

Judge Torres' decision has been welcomed by the crypto community, and at the same time, has caused much confusion, especially in contrast with a decision on motion for summary judgment in *S.E.C. v. LBRY, Inc.*[2] by Judge Paul Barbadoro of the District Court for the District of New Hampshire. The decision on remedies in the LBRY case was issued only two days prior.

In March of 2021, the SEC filed a complaint against LBRY, Inc., a company that developed a decentralized digital content marketplace, claiming that LBRY had offered and sold unregistered securities in the form of crypto asset known as "LBC". According to the statement of facts filed in the motion for summary judgment stage, LBRY sold LBC in a variety of ways, including:

- Sales on digital asset trading platforms;
- Direct sales through LBRY's website and apps, in partnership with MoonPay;
- Sales via market makers;
- Sales to institutional investors and equity investors;
- Sales to investment clubs run by FlipSide Crypto;
- Sales to digital asset trading platforms; and
- Distributions to contractors and employees as compensation.

Instead of evaluating each of the above categories of LBC sales separately, the Court in LBRY ruled in November 2022 that LBRY offered and sold LBC as securities (apparently, *all* offers and sales, regardless of the specific circumstances of the transaction) in violation of Section 5 of the Securities Act and granted the SEC's motion for summary judgment. The November 2022 LBRY order framed the dispute as whether the economic realities surrounding LBRY's offers and sales of LBC led investors to have "a reasonable expectation of profits to be derived from the entrepreneurial or managerial efforts of others" without attempting to assess the facts and circumstances surrounding each specific category of LBC distributions by LBRY and considering their economic realities separately. Instead, the court considered all LBC distributions by LBRY, Inc. together and concluded that they *all* should be treated as investment contract transactions.

[2] *S.E.C. v. LBRY, Inc.* No. 21-cv-00260 (D.N.H.).

The DLx Law team has previously released a discussion draft of a paper entitled "The Ineluctable Modality of Securities Law: Why Fungible Crypto Assets are Not Securities," which was attached to an *amicus* brief we filed with the Court in *S.E.C. v. Ripple Labs* together with other attorneys. In our paper, which was based on a thorough review of 266 relevant federal appellate and Supreme Court decisions which considered whether a particular contract, transaction, or scheme should be deemed to constitute an investment contract transaction, we argued that the *Howey* test must be applied a transaction-by-transaction basis, and non-financial "objects" of an investment contract transaction (whether physical, like whiskey or beavers, or intangible, like digital tokens) are not themselves securities solely as a result of being sold as part of such a transaction.[3]

Judge Torres' decision in *Ripple Labs* adopted this view and evaluated each category of XRP distributions separately under *Howey*. In doing so, the *Ripple Labs* decision explicitly rejects what we refer to as the SEC's "embodiment theory" – *i.e.,* that the XRP token somehow "embodies" the investment contract elements of *Howey* when initially sold in an investment contract transaction. As we argued in the paper, this embodiment theory has no basis in legal precedent, and is also unworkable in practice.

In contrast, the *LBRY* court did not delve as deeply into whether transactions in every category of LBC sales should properly be considered investment contract transactions such that the purchasers were looking to profit through price increases reasonably expected to come from LBRY's efforts. Instead, the court simply grouped all stated that LBRY offered LBC *as a security*.

More recently, the SEC brought enforcement actions against several crypto asset trading platforms for acting as unregistered national securities exchanges, brokers, and clearing agencies in violation of the federal securities laws. These cases require the SEC to prove that the crypto assets themselves are securities or that the transactions in these crypto assets are securities transactions.

In a pretrial/pre-motion conference in the SEC's lawsuit against Coinbase,[4] which was held on the same day that the Order in the Ripple Labs case was entered, Judge Katherine Polk Failla of the Southern District of New York pointed out that the SEC has taken the position with respect to certain crypto assets that they are not securities, and there are certain other crypto assets, which the SEC has taken the position that they are securities. The SEC attorney acknowledged that whether a crypto asset is a security is a fact-intensive analysis, and the SEC attorney was not able to take a position on all of the crypto assets listed on Coinbase. The Judge questioned how such decisions have been communicated to the investing public, and how a market participant could know whether a particular crypto asset is or is not going to be found to be a security by the SEC at some point.

As we presented in our paper, the SEC's approach that all crypto assets are themselves securities, whether due to the embodiment theory or any other theory, is fundamentally inconsistent with *Howey* jurisprudence that the *Howey* test is a transaction-based, not asset-based, analysis. In light of recent developments, including the Order, we are optimistic that federal courts will apply the *Howey* test to crypto asset transactions, as we argue *Howey* requires, and reject the SEC's unfounded approach.

[3] It is important to bear in mind that a digital asset could be considered to represent an interest in an ongoing business, like a "decentralized autonomous organization" or "DAO" in certain circumstances.
[4] *S.E.C. v. Coinbase, Inc.*, No. 1:23-cv-04738 (S.D.N.Y.).

In the wake of this decision, the need for a legislative solution to the uncertainty around the appropriate regulatory regime for crypto assets has become even more pronounced. Recently introduced legislation in Congress, if passed, would potentially provide a more tailored regulatory framework for crypto assets and crypto asset transactions.

Our team will be monitoring the developments in crypto asset cases as they unfold, as well as pending legislation. Please contact the DLx Law team should you have any questions.

DLx Law