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The SEC Sues Ripple, Alleging Sales of $2 Billion of XRP Tokens Violated Securities Laws

The U.S. Securities and Exchange Commission ("SEC") filed a lawsuit December 22, 2020 against Ripple Labs, Inc., its CEO and co-founder for violating the federal securities laws by selling nearly $2 billion in XRP tokens (a digital asset) since 2013 without registration under the Securities Act of 1933 ("Securities Act"). XRP was the third-largest crypto-currency by market capitalization (after bitcoin and ether) but has now been delisted from trading by leading crypto-currency "exchanges" including Binance.US, Coinbase and others, and has been removed from Grayscale Investments' large-cap crypto fund.

Other Enforcement Actions

The Ripple lawsuit follows high-profile enforcement actions against Kik Interactive Inc. ("Kik") and Telegram Group Inc. ("Telegram") in 2019. The SEC alleged that the Kik and Telegram tokens were in fact securities within the meaning of the U.S. securities laws and that Kik and Telegram should have registered the tokens under the Securities Act. Telegram settled with the SEC in June 2020 (returning $1.2 billion to investors), and a federal judge granted summary judgment in the Kik case in September 2020, ruling that Kik's tokens, called "Kins," were securities and that the sale of nearly $100 million in tokens should have been registered under the Securities Act. Kik was enjoined from further violations of the Securities Act and paid a $5 million fine.

The terms "digital asset" or "token" generally refer to assets created using distributed ledger or blockchain technology, including "cryptocurrencies" and "tokens." A blockchain or distributed ledger is a peer-to-peer database spread across a network of computers that records all transactions in theoretically unchangeable data packages. The system relies on cryptographic techniques for secure recording of transactions. Blockchains typically employ a consensus mechanism to "validate" transactions, which, among other things, aims to achieve agreement on the state of the ledger. Digital tokens may be traded for other digital assets or fiat currency (legal tender issued by a country) on digital asset trading platforms (known as "exchanges").

The *Howey* Test

In determining whether a token or other digital asset is a "security" within the meaning of the Securities Act, the SEC applies the "*Howey* test" from the 1946 Supreme Court case *SEC v. W.J. Howey Co.* ("*Howey*"). An "investment contract" is included in the Securities Act's definition of a security. In *Howey*, the Supreme Court defined an "investment contract" as an investment of money in a common enterprise with a reasonable expectation of profits, derived from the entrepreneurial and managerial efforts of others.

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The SEC's 71-page complaint details a years-long offering of XRP tokens to fund Ripple's operations and "enrich" the other defendants. Over 14.6 billion XRP tokens were sold, starting in 2013, by both Ripple and the individual defendants, for a total of nearly $2 billion, including $600 million in sales by the individual defendants. Ripple and the other defendants failed to take any steps to register the XRP tokens under the Securities Act, or to find an exemption from registration, even though Ripple had received legal advice as early as 2012 that the tokens might be "investment contracts" and, as such, securities, under federal law.

The failure to register the XRP tokens under the Securities Act deprived investors of "material information about the issuer [Ripple] and the offering, including financial and managerial information, how the issuer will use offering proceeds, and the risks and trends that affect the enterprise and an investment in its securities."

According to the SEC, the XRP tokens are "investment contracts" under the *Howey* test. The SEC alleges that investors in XRP had a reasonable expectation of profits because of the entrepreneurial and management efforts of Ripple. The SEC alleges that from the start the defendants marketed XRP as an investment and promised investors that Ripple would develop and maintain a public market for XRP investors to resell XRP. Ripple's efforts to create and maintain a liquid market included, among other things, listing XRP on crypto "exchanges," selling XRP to institutional investors, and managing the price of XRP through sales, buy-backs and an "escrow" arrangement for the XRP retained by Ripple.

In late 2018, five years after Ripple started selling XRP, it developed a non-speculative, non-investment "use" for XRP as an element of a cross-border payments system called ODL. However, the SEC maintains that ODL is merely a *post hoc* attempt to buttress Ripple's position that XRP is not a security. The complaint states that ODL is not an economically viable product and that Ripple paid the principal ODL customer a total of over $50 million through 2020 to subsidize the use of ODL.

Rulemaking

Time will tell whether the SEC will prevail in its action, but the *Kik* precedent and the Ripple fact pattern do not inspire confidence in Ripple's position. The case does, however, highlight the need for SEC rulemaking in this area that would give the digital asset industry a clearer road map for compliance. An SEC rulemaking on when a digital asset constitutes a security would represent a step in the direction of less "regulation by enforcement" and would update *Howey's* 1946 test for the crypto age. Offering a greater degree of regulatory certainty for the crypto industry would lead to more innovation and would benefit crypto investors and the U.S. economy as a whole.

Additional Information

If you have any questions regarding this client alert, please contact your Kutak Rock attorney or one of the authors listed on the left. For more information regarding our practices, please visit us at www.kutakrock.com.