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SEC v. Ripple Labs: The SEC Suffers a Partial Reverse in its Ongoing War on Crypto

by Ken Witt and Colson Franse

A federal judge in the Southern District of New York recently handed the SEC a significant setback in its closely watched lawsuit against Ripple Labs Inc. The SEC had alleged that Ripple's crypto asset, XRP, was a security, and that sales of XRP by Ripple and two of its senior executives were made in violation of the federal securities laws.

U.S. District Judge Analisa Torres issued her landmark ruling on July 13, 2023, holding that programmatic (open market) sales of XRP tokens did not require registration under the securities laws but that sales of XRP by Ripple to institutional investors *were* sales of securities that required registration under the securities laws. In other words, in this novel decision, whether XRP is a security subject to the federal securities laws depends on how XRP is sold and who buys it.

The SEC had sued Ripple and two of its executives back in December 2020, claiming that they raised over $1.3 billion through the sale of XRP tokens in unregistered securities offerings, in violation of Section 5 of the Securities Act of 1933. The SEC argued that XRP is a security within the meaning of the Securities Act because it is an "investment contract" under the Supreme Court's *Howey*[1] test: (1) an investment of money (2) in a common enterprise (3) with an expectation of profits solely from the efforts of others.

Applying the *Howey* test, the Court held that "XRP, as a digital token, is not in and of itself, a 'contract, transaction or scheme' that embodies the *Howey* requirements of an investment contract. Rather the Court examines the totality of circumstances surrounding [d]efendants' different transactions and schemes involving the sale and distribution of XRP."[2]

Following this protocol, the Court found first that sales of XRP by Ripple to institutional investors, such as hedge funds, pursuant to written contracts were sales of securities that, absent an exemption, should have been registered under the securities laws. Judge Torres reasoned that such sophisticated investors understood that Ripple would use the proceeds to develop the functionality of XRP and increase its value, thereby meeting the third "prong" of the *Howey* test, expectation of profits from the efforts of others.

[1] *SEC v. W. J. Howey Co.*, 328 U.S. 293 (U.S. May 27, 1946).
[2] Order at 15, *SEC v. Ripple Labs, Inc.*, No. 20-10832 (S.D.N.Y. July 13, 2023), ECF 874.

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By contrast, "programmatic sales" of XRP on digital asset exchanges and through trading algorithms did not meet the "third prong" of *Howey*. Unlike institutional buyers who purchased XRP directly from Ripple, buyers of XRP through an exchange had no expectation that the performance of the seller, whoever that might have been, would enhance the value of the token.

Finally, the Court held that issuances of XRP to employees and developers as payment for services did not meet the "first prong" of the Howey test, the investment of money, in spite of the fact that value was clearly exchanged.

The SEC may consider an appeal of this decision, especially because applying this precedent would mean the same token could be a security or not depending on the buyer's expectations and the manner of sale. Note as well that, if upheld, the ruling would mean that, unlike institutional investors, retail investors with less money and sophistication would not be protected by the federal securities laws.

An order just handed down by a colleague of Judge Torres in the Southern District of New York does not augur well for her Ripple decision. In a July 31, 2023 order[3], Judge Jed Rakoff refused to dismiss the SEC's case against Terraform Labs Pte Ltd. and its founder, alleging a multi-billion dollar fraud involving various cryptocurrencies. Judge Rakoff expressly rejected Judge Torres' *Ripple* reasoning, stating that *Howey* makes no such distinction between retail and institutional purchasers: "That a purchaser bought the coins directly from the defendants or, instead, in a secondary resale transaction has no impact on whether a reasonable individual would objectively view the defendants' actions and statements as evincing a promise of profits based on their efforts."[4]

Time will tell, but Judge Torres' split decision will most likely only cause a "Ripple" in the SEC's ongoing anti-crypto campaign.

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[3] Securities and Exchange Commission v. Terraform Labs Pte Ltd., 1:23-cv-01346, (S.D.N.Y. Jul 31, 2023) ECF No. 51.
[4] *Id.* at 41.