

Ripple and Howey

The questions revolving around crypto assets typically begin with examining if a security is involved. The answer to that question is determined by applying the *Howey* test and frequently concluding that the asset is in fact a security. In *SEC v. Ripple Labs, Inc.*, Civil Action No. 1:20-cv-10832 (S.D.N.Y. Ruling July 13, 2023) the Court concluded that in some instances the crypto assets were securities, but not in others. The ruling is thoughtful and raises significant questions about the future of crypto assets, as well as the pending similar actions which are working their way toward decision in similar cases now.

The case

XRP Ledger traces its roots to 2011 and early 2012 when the source code or blockchain was developed. Since that time Ripple has sought to realize an “Internet of Value by using technology to facilitate the transfer of value across the internet . . . Specifically, Ripple looked to modernize international payments by developing a global payments network . . .” (citations and internal quotations omitted). Some, but not all, of Ripple’s products and services depended on XRP Ledger and XRP.

Eventually Ripple began selling XRP in three ways. In some instances sales were made directly to certain counterparties who were largely institutional or professional investors. These were called institutional sales. In others, the firm sold XRP on digital asset exchanges “programmatically” or through the use of trading algorithms. There were “blind bid/ask transactions” since the company did not know who was buying or selling XRP. In yet other situations there were distributions of XRP for things like wages at Ripple to its employees. There was no registration statement covering any of these transactions.

The question presented for resolution by the Court on cross-motions for summary judgment by the SEC and Ripple hinged on if the transactions involved the offer or sale of an investment contract or security within the meaning of the Supreme Court’s seminal

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decision in *SEC v. W.J. Howey Co.*, 328 U.S. 293 (1946). The answer from the Court was “sometimes.”

The ruling

The focus under *Howey*, the Court began, ties to an investor’s expectation of profits from the efforts of others. In addressing this question the “Supreme Court was guided by the ‘fundamental purpose undergirding the Securities Acts,’ in which Congress ‘painted with a broad brush’ in recognition of the ‘virtually limitless scope of human ingenuity.’” The Supreme Court crafted the decision to ensure that “the protections Congress sought to afford investors” would not be thwarted “by unrealistic and irrelevant formulae” the Court concluded.

Viewed in this context the issue is not if a digital token is a contract, transaction or scheme that somehow embodies the *Howey* test. To the contrary, to apply *Howey* the court must examine the “totality of circumstances surrounding Defendants’ different transactions and schemes involving the sale and distribution of XRP,” the Court concluded. Here there are three variations of those transactions which must be considered: 1) Institutional sales; 2) Programmatic sales; and 3) Other distributions.

Institutional Sales. Here each prong of the *Howey* test is met, the Court concluded. The transactions involve an “investment of money” by the purchasers at the outset, that is the buyers “put up their money.” The point was for an investment in a common enterprise as that phrase is used by *Howey*. Stated differently there was “Horizontal commonality . . . where the investors’ assets are pooled and the fortunes of each investor are tied to the fortunes of other investors, as well as to the success of the overall enterprise.” All are at risk, and all will share in the profits or losses from the common enterprise.

The economic reality of the sales made to institutional investors, the Court concluded, was that all were part of a common enterprise. Viewed through this lens, the reasonable expectation of profits need not be the sole reason a purchaser buys an investment. Rather, it is sufficient the Court found, that “reasonable investors, situated in the position of the Institutional Buyers, would have purchased XRP with the expectation that they would derive profits from Ripple’s communications, marketing campaign . . .” and other efforts.

Programmatic Sales. For this category, the Court reached the opposite conclusion. While it was clear that those involved with the Institutional sales could reasonably expect that future profits could come from the efforts of Ripple, there are no facts supporting that point as to this group. This is because “Ripple’s Programmatic Sales were blind bid/ask transactions, and Programmatic Buyers could not have known if their payments of money went to Ripple, or any other seller of XRP.” This point was bolstered by the fact that since 2017 less than 1% of the global XRP trading volume involved such transactions. While Ripple may have targeted speculators as the SEC argued, that is not a sufficient basis on which to conclude that an investment contract is involved here. To the contrary, in this case Ripple did not know who was buying the XRP and the purchaser did not know who was selling it. There is no investment contract the Court

concluded.

Other Distributions. This category failed the first prong of the *Howey* test, the Court found. That prong of the test requires that there be an investment of money as part of the transaction or scheme. Stated differently, the investor must “put up their money” in the words of the Court (citation omitted). Here, they did not. Therefore, the transaction does not involve a security.

Comment

The Court’s opinion clearly constitutes a careful, thoughtful, and rigorous application of the *Howey* test. The application of that test to the Institutional Investors is fully consistent with, not just the basic principles of the decision, but its underlying tenants which are key to assessing the economic reality of the situation.

Those same comments clearly apply to the Court’s ruling as to the third group. If those in the third group are typified by Ripple employees, for example, who apparently receiving a distribution of the assets not as a substitute for compensation but perhaps as some type of “employee appreciation,” then there is little reason to view the transactions through the lens of making an investment of money to join with others in a hoped for future profit, the *Howey* test.

The same cannot necessarily be said of those in the second group, the Programmatic sales. There the Court’s statement that this group represents a very small percentage of overall distributions or sales fails to actually address the *Howey* test. Likewise, statements, such as those noting that Ripple has no real contact with those in this group or that the distributions were only 1% of the total, also fail to address the questions being posed and thoughtfully debated as to other groups. This is particularly true given the impact of the decision. In the end, the question deserved better consideration.