Latest Ripple Development Highlights SEC's Crypto Approach

By **Katherine Stoller and John Nathanson** (October 5, 2022)

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The U.S. Securities and Exchange Commission has shown continued commitment to regulating digital assets through enforcement actions.

While the SEC's actions and public pronouncements consistently take the position that the application of securities law to digital assets is clear, the agency's "regulation by enforcement"[1] approach has led many to call for cooperation with the industry and for rulemaking, which would provide far greater certainty.

In this context, recent developments in the SEC v. Ripple Labs case demonstrate that the question of whether any particular digital asset should be considered a security remains consequential and contentious.

On Sept. 17, both the SEC and Ripple Labs Inc., with its executive chairman and CEO, filed motions for summary judgment in the SEC's U.S. District Court for the Southern District of New York suit alleging that Ripple Labs sold billions of units of a virtual currency, XRP, which the SEC believes should be considered a digital asset security.[2]

According to the SEC's complaint, the sale of XRP constituted an unregistered sale of securities in violation of the registration and disclosure requirements of federal securities laws.[3]

Ripple is a private financial technology company that was founded in 2012 with a particular focus on facilitating cross-border payments. Its products generally rely on the open-source blockchain created by Ripple, called the XRP Ledger, and the associated XRP native virtual currency.

When the XRP Ledger was created in 2012, a fixed supply of 100 billion units of XRP was created, 20% of which was retained by the founders and the remaining 80% was given to Ripple.[4] Over the years the defendants have sold and distributed some XRP currency, transactions which are being challenged by the SEC as unregistered securities sales.[5]

The SEC's Position

The question of whether XRP is a security and therefore subject to the requirements of the federal securities laws is a significant one for the digital asset industry, which has repeatedly asked for clear guidance from the SEC on the application of securities law to these novel assets and technologies.[6]

SEC Chairman Gary Gensler has been aggressive about claiming jurisdiction over digital assets,[7] while publicly questioning the digital asset industry's calls for greater guidance, claiming that the agency has "spoken with a pretty clear voice."[8]

In its case against Ripple, the SEC alleges that XRP should be considered a digital asset security because it qualifies as an investment contract under the traditional securities test laid out in the U.S. Supreme Court's 1946 decision in SEC v. Howey Co.: "an instrument through which a person invests money in a common enterprise and reasonably expects

profits or returns derived from the entrepreneurial or managerial efforts of others."[9]

In particular, the SEC argues that "economic reality" indicates that "a purchase of XRP is an investment in a common enterprise with other XRP holders and with Ripple."[10] The SEC also points to multiple public representations in which Ripple "publicly tied the potential for profit to its promised entrepreneurial and managerial efforts."[11]

The complaint's arguments are consistent with the position the SEC has taken in other recent enforcement actions involving cryptocurrency assets, including its July 21 insider trading charge against a former Coinbase Global Inc. exchange manager, SEC v. Wahi.[12]

Both in Ripple and Wahi, the SEC relied on its broad interpretation of the term "investment contract" under Howey to assert authority over transactions involving digital assets. Its Ripple arguments are also consistent with recent public pronouncements in which the SEC has stated that the securities laws, and which digital assets those laws govern, are sufficiently clear that additional guidance is unnecessary.[13]

In particular, Gensler's view is that "nothing about the crypto market is incompatible with securities laws," concluding that "most crypto tokens are investment contracts under the Howey Test," and thus subject to the securities laws and SEC jurisdiction.[14]

He warned companies acting as intermediaries in digital asset transactions that they should "come in, talk to us, and register."[15]

Ripple's Response

Ripple pushed back in its own summary judgment motion, arguing that distribution of XRP lacks the "essential ingredients" to be considered investment contracts under the Howey test.[16]

First, Ripple noted that in many of the transactions covered by the complaint, there was no actual contract between a promoter and an investor — for example, donations and giveaways.[17]

Second, Ripple argued that when contracts were present, they established no post-sale obligations for Ripple or rights for the purchaser of XRP to share in profits from the company's efforts.[18]

Third, Ripple pointed to the absence of a "'common enterprise' in which those who purchase XRP invest," arguing that the "XRP ecosystem," comprised by multiple third parties who interact with the XRP Ledger or own XRP currency, cannot be characterized as a common enterprise under Howey.[19]

In essence, Ripple asserts that sales of XRP merely represent sales of assets, not securities, and that the SEC's theory represents an "open-ended assertion of jurisdiction over any transfer of an asset (for consideration or not) that the SEC thinks may benefit from the registration and disclosure requirements of securities law."[20]

As such, Ripple contends that the SEC's position, at least if it were taken literally and applied consistently, would convert sales of ordinary assets — such as gold and soybeans — into securities transactions.[21]

Looking Forward

These concerns about potential consequences of the SEC's aggressive reading of the securities laws have been voiced by other regulators as well, most notably by one of the SEC's primary competing regulators in the digital asset space — the Commodity Futures Trading Commission.

In a public statement published on the same day that the Wahi indictment and complaint were filed, CFTC Commissioner Caroline Pham noted that the SEC's decision to pursue the former Coinbase manager's actions as securities fraud "could have broad implications beyond this single case, underscoring how critical and urgent it is that regulators work together" and
"[engage] the public to develop appropriate policy with expert input."[22]

These calls for cooperation were joined by SEC Commissioner Hester Peirce,[23] who has suggested that the SEC "need[s] to commit to working with ... companies to craft sensible, timely, and achievable regulatory paths."[24]

Gensler has at least implicitly determined to take a different path, given that these calls for greater cooperation and regulatory certainty have to date not resulted in a more nuanced regulatory approach.

We may also get some insight into the SEC's internal deliberations regarding this topic, given that the SEC was recently ordered to disclose emails written by a former SEC director of the Division of Corporation Finance as part of an ongoing dispute about the scope of discovery in the Ripple case.[25]

Despite the SEC's continued aggressive positioning as it asserts its authority over digital assets, the Ripple defendants raise significant questions about the wisdom of applying an orange grove case from 1946 to a class of assets developed only in the last 10 years, particularly as the term "digital assets" encompasses a broad spectrum of assets with varying properties and characteristics.

While the SEC has at least in some contexts historically favored flexibility in the application of the securities laws — for example, in the insider trading context — the regulation of digital assets would seem to be a place in which certainty would assist all parties in making informed decisions and moving an innovative industry forward in a more orderly fashion.[26]

While it will not substitute for a robust regulatory framework, perhaps a ruling on Ripple's summary judgment motion will shed some light on how digital assets will be treated moving forward. It will not, however, end the debate as to whether the SEC's approach to digital asset regulation is an appropriate one.

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should not be taken as legal advice.

[1] Statement of Commissioner Caroline D. Pham on SEC v. Wahi, CFTC (Jul. 21, 2022).

[2] Complaint at 1-2, SEC v. Ripple Labs, 20-cv-10832 (S.D.N.Y. Dec. 22, 2020).

[3] Id.

[4] Defendants' Memorandum of Law in Support of Their Motion for Summary Judgment at 1, SEC v. Ripple Labs, 20-cv-10832 (S.D.N.Y. Dec. 22, 2020).

[5] Complaint at 1-2, SEC v. Ripple Labs, 20-cv-10832 (S.D.N.Y. Dec 22, 2020).

[6] Coinbase, Petition for Rule-making—Digital Asset Securities Regulation, (Jul. 21, 2022).

[7] Chair Gary Gensler, Kennedy and Crypto, SEC (Sept. 8, 2022).

[8] Id.

[9] Complaint at 6-7, SEC v. Ripple Labs, 20-cv-10832 (S.D.N.Y. Dec. 22, 2020).

[10] Plaintiff's Memorandum of Law in Support of Its Motion for Summary Judgment at 2, SEC v. Ripple Labs, 20-cv-10832 (S.D.N.Y. Dec. 22, 2020).

[11] Id.

[12] SEC Charges Former Coinbase Manager, Two Others in Crypto Asset Insider Trading Action, SEC (Jul. 21, 2022).

[13] Chair Gary Gensler, Kennedy and Crypto, SEC (Sept. 8, 2022).

[14] Id.

[15] Id.

[16] Defendants' Memorandum of Law in Support of Their Motion for Summary Judgment at 1-2, SEC v. Ripple Labs, 20-cv-10832 (S.D.N.Y. Dec. 22, 2020).

[17] Id. at 2.

[18] Id.

[19] Id. at 3.

[20] Id.

[21] Id.

[22] Statement of Commissioner Caroline D. Pham on SEC v. Wahi, CFTC (Jul. 21, 2022).

[23] Caroline D. Pham and Hester M. Peirce, Making Progress on Decentralized Regulation — It's Time to Talk About Crypto Together, The Hill (May 26, 2022).

[24] Commissioner Hester M. Peirce, Statement on Settlement with BlockFi Lending LLC, SEC (Feb. 14, 2022).

[25] Order Overruling SEC's Objections, Sept. 29, 2022, SEC v. Ripple Labs, 20-cv-10832 (S.D.N.Y. Dec. 22, 2020).

[26] Coinbase, Petition for Rule-making—Digital Asset Securities Regulation, (Jul. 21, 2022).