

District Court Allows ‘Fair Notice’ Defense in SEC’s Cryptocurrency Case Against Ripple Labs, But Denies Motions To Dismiss

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In December 2020, the Securities and Exchange Commission (SEC) filed an action against Ripple Labs, Inc. and two of its executives, alleging they raised over \$1.3 billion through an unregistered ongoing securities offering of its XRP digital currency. The case, which has potentially wide-ranging implications for digital asset markets, centers predominantly on whether XRP constitutes a “security” under federal securities laws. Over the past year, the SEC and Ripple have largely battled over discovery and privilege matters.

On March 11, 2022, Judge Analisa Torres of the Southern District of New York issued two substantive rulings: (1) one denying the SEC’s motion to strike the defendants’ “fair notice” defense and (2) the other denying the individual defendants’ motions to dismiss.

“Fair notice” affirmative defense. First, the court addressed Ripple’s affirmative defense that it lacked “fair notice that its conduct was a violation of law, in contravention of Ripple’s due process rights.” Claiming that the SEC failed to provide clarity on whether to label XRP a security, Ripple argued that the SEC has now unfairly engaged in regulation by enforcement by targeting Ripple for unregistered sales of XRP. Ripple’s contention has important consequences for the industry at large.

Limiting itself to the facts set forth in Ripple’s pleading — including that the price of XRP had no relation to Ripple’s activities, that Ripple had not sold XRP as an investment and that Ripple had no relationship with the vast majority of XRP holders — the court denied the SEC’s motion to strike. In doing so, the court emphasized: “[a]t the very least, these facts, if true, would raise legal questions as to whether Ripple had fair notice that the term ‘investment contract’ covered its distribution of XRP, and the Court may need to consider these questions more deeply.”

While it is unclear whether Ripple will prevail on the merits of this affirmative defense or in the overall case, the denial of the SEC’s motion permits Ripple to assert the affirmative defense of “fair notice.”

Aiding-and-abetting claims. Second, the court denied the individual defendants’ motions to dismiss the claims that they had aided and abetted Ripple’s violation of Section 5 of the Securities Act of 1933 by assisting in Ripple’s unregistered sales of XRP. The court held that, to succeed on an aiding and abetting theory, the SEC must plead and ultimately prove “(1) the existence of a securities law violation by the primary (as opposed to the aiding and abetting) party; (2) knowledge of this violation on the part of the aider and abettor; and (3) substantial assistance by the aider and abettor in the achievement of the primary violation.”

In doing so, the court rejected the defendants’ argument that aiding and abetting liability requires a showing that defendants knew or recklessly disregarded that Ripple’s actions were somehow “improper.” The court discredited this line of argument because requiring “knowledge of ‘improper’ activity would result in the imposition of a ‘willfulness’ requirement that is absent” from the statute.

The court then determined that the SEC met its pleading burden as to both defendants, focusing on the SEC’s allegations that one or both of the individuals oversaw Ripple’s sale of XRP; were directly involved in Ripple’s strategy for supporting XRP’s price; were aware that XRP sales were funding Ripple’s operations; and understood that XRP was allegedly being sold to “investors.” The SEC’s decision to charge individuals with aiding and abetting an unregistered offering was notable because it typically does not pursue charges of this nature against individuals.

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Domestic versus foreign offers. Finally, the court also denied the individual defendants' motion to dismiss the SEC's Section 5 claim based on the U.S. Supreme Court's 2010 ruling in *Morrison v. National Australia Bank*. More specifically, the individuals argued that their alleged offers and sales of XRP were not "domestic," or alternatively were "predominately foreign," such that the SEC's claims should be dismissed under *Morrison*.

Judge Torres held that the defendants' sales of XRP occurred domestically because, among other things, they sold XRP on digital asset trading platforms incorporated and with principal places of business in the U.S. The court further held that, because the defendants made the offers while located in California, the offers were in fact domestic and within the purview of Section 5 liability.

The court went on to reject the argument that the offers and sales were "predominantly foreign" because the offers and sales were made by U.S. residents, involved alleged securities issued by a U.S. company, involved a U.S.-based platform and included offers and sales to U.S. purchasers.

The SEC-Ripple litigation has been closely watched because it presents crucial issues involving the application of securities laws to digital assets. Judge Torres' decisions address questions that may prove to be important in other digital asset litigation, including the viability of "fair notice" defenses, aiding and abetting liability and the application of *Morrison* in the Section 5 context.