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Ripple Labs: District Court Holds That Direct Digital Token Sales Constituted Investment Contracts Under *Howey*, but Other Transactions Did Not

On July 13, 2023, Judge Torres of the U.S. District Court for the Southern District of New York issued a much-awaited summary judgment decision in *SEC v. Ripple Labs, Inc.*, No. 1:20-cv-10832-AT-SN (S.D.N.Y. July 13, 2023), that speaks to crucial issues concerning the digital asset marketplace and is, therefore, an important step toward further clarity on legal issues concerning digital asset sales.

The case presented the question whether Ripple Labs, Inc.'s offers and sales of XRP tokens constituted securities transactions subject to registration requirements under the Securities Act of 1933 (Securities Act). At the outset, the court emphasized, "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 "examine[d] the totality of circumstances surrounding Defendants' different transactions and schemes involving the sale and distribution of XRP." Specifically, Judge Torres separately evaluated three forms of transactions in XRP undertaken by Ripple:

i. Sales directly to institutional buyers.

ii. "Programmatic sales" made on secondary digital asset trading platforms.

iii. Transfers to individuals and entities as compensation for services.

The court held that Ripple's sales to institutional buyers constituted "investment contracts" subject to registration requirements under the Securities Act. On the other hand, the court held that neither programmatic sales on digital asset trading platforms nor the distribution of XRP tokens to employees or third parties for services constituted investment contracts subject to registration requirements.

Within hours of the decision, several digital asset trading platforms relisted XRP.

Background

Ripple develops and manages a digital asset exchange network that operates on the XRP Ledger blockchain. When the XRP Ledger launched, its source code generated a fixed supply of 100 billion XRP. As alleged, Ripple's three founders retained 20 billion XRP and provided 80 billion to Ripple.

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To determine whether an investment contract existed at the time of sale, the court analyzed three ways in which Ripple has sold and transferred XRP. First, Ripple, through wholly owned subsidiaries, has sold XRP directly to counterparties — primarily institutional buyers, hedge funds and "on demand liquidity" customers — pursuant to written contracts (the Institutional Sales). Second, Ripple has sold XRP on digital asset trading platforms "programmatically," or through trading algorithms (the Programmatic Sales). Lastly, Ripple has distributed XRP to individuals and entities, including employees and third parties, as a form of payment for services (the Other Distributions). Ripple did not file a registration statements for any sales or distributions. Nor did Ripple file any financial statements or other periodic reports with the SEC for Ripple or XRP.

In 2018, the Securities and Exchange Commission (SEC) sued Ripple alleging that its XRP sales and distribution activities constituted unregistered sales of securities in violation of Section 5 of the Securities Act.

Legal Standard

Section 5 of the Securities Act prohibits the purchase or sale of a "security" unless a registration statement is in effect or has been filed with the SEC for the sale of the security to the public. To prove a violation of Section 5, the SEC must show: (i) that no registration statement was filed or in effect as to the transaction, and (ii) that the defendant directly or indirectly offered to sell or sold the securities (iii) through interstate commerce.

An "investment contract" is a type of security as defined by the Securities Act and therefore subject to Section 5's requirements. Because neither side disputed the fact that no registration statement was filed for any transaction at issue, or that offers and sales took place through interstate commerce, the sole question was whether the transactions were investment contracts.

Courts evaluate whether a transaction constitutes an investment contract under the *Howey* test set forth by the U.S. Supreme Court more than 75 years ago: An investment contract exists where a person (i) "invests his money" (ii) "in a common enterprise" and (iii) "is led to expect profits solely from the efforts of the promoter or a third party."[1]

Decision

Judge Torres analyzed three categories of transactions in which Ripple engaged:

1. **Institutional Sales were investment contracts.** The court held that the Institutional Sales constituted the unregistered offer and sale of investment contracts in violation of Section 5 of the Securities Act. First, the court found that the investment prong of *Howey* was met because the institutional investors paid money to Ripple. Second, the court found that the "common enterprise" prong of *Howey* was met based on "horizontal commonality" — *i.e.*, the investors' assets were pooled and their fortunes were tied to the success of the enterprise and each other. Third, the court found, "[b]ased on the totality of circumstances," that the institutional investors had a reasonable expectation of profits derived from Ripple's efforts.

   The court explained that, "[f]rom Ripple's communications, marketing campaign, and the nature of the Institutional Sales, reasonable investors would understand that Ripple would use the capital received from its Institutional Sales to improve the market for XRP and develop uses for the XRP Ledger, thereby increasing the value of XRP."

2. **Programmatic Sales were *not* investment contracts.** Critically, the court held that the Programmatic Sales — Ripple's sales on digital asset trading platforms — were *not* required to be registered and did not constitute unregistered offerings. The court identified a key distinction between Programmatic Sales and Institutional Sales: Because these sales occurred on secondary trading platforms that match buyers and sellers without disclosing the identity of either, the XRP buyers could not have known if their payments went to Ripple or another seller. As such, the "expectation of profits" prong of *Howey* was not met because programmatic buyers could not reasonably expect that Ripple would use the capital it received from its sales to improve the XRP ecosystem and thereby increase the price of XRP.

3. **Other Distributions were *not* investment contracts.** The court also held that the Other Distributions did not constitute unregistered offerings. It found that these transfers did not satisfy the "investment of money" prong of the *Howey* test because there was no evidence that the recipients of these distributions paid money or other consideration for the distributions.

Implications

This opinion is the first judicial decision directly addressing whether digital asset transactions on secondary trading platforms constitute securities transactions, and for that reason may have broader implications in other digital asset related litigation — including, for example, in recent enforcement actions brought by the SEC against large digital asset trading platforms themselves, which allege that the platforms constitute unregistered securities exchanges and/or broker-dealers. And, while the court highlighted that its decision does not apply to all secondary sales, it carries implications for other types of market intermediaries. For those that fill customer orders from inventory and act as the counterparty, the buyers in these transactions have no reason

[1] *SEC v. W.J. Howey Co.*, 328 U.S. 293 (1946).

to believe that the funds they invest will be used by the issuer in connection with efforts that would increase the price of the digital assets purchased.

Additionally, the court's reasoning with respect to the Other Distributions could have implications for digital asset transactions that do not involve the direct tender of money by the buyers — for example, in air drops, protocol emissions and other transactions.

It is important to note that this decision, while significant, is by only one district court judge and how other judges, districts, and circuits view these legal issues is currently unknown. For that reason, these questions may not be considered settled until there are further judicial developments. At the same time, this is the first decision on a number of novel issues and may be seen as persuasive authority in other cases.

For two reasons, we can expect more rulings on these questions. First, due in part to the significant number of enforcement actions recently filed by the SEC against digital asset trading platforms, there will be opportunities in multiple districts for litigants to present these arguments and gauge courts' receptivity to them. Second, because the *Ripple* decision is fundamentally at odds with the reasoning underlying a major aspect of the SEC's enforcement efforts in the digital asset space, the SEC will likely appeal the decision.

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