Reuters Legal News

Two sides of the same coin: analyzing the recent *Ripple* and *Terraform* decisions

By Stuart D. Levi, Esq., Alex Drylewski, Esq., and Daniel Michael, Esq., Skadden, Arps, Slate, Meagher & Flom LLP

AUGUST 31, 2023

In July 2023, two federal district court judges in the Southern District of New York issued rulings that touched on a crucial question for the digital asset space — whether secondary market digital asset sales through trading platforms constitute securities transactions subject to the federal securities laws.

On July 13, 2023, Judge Analisa Torres issued a summary judgment decision in *SEC v. Ripple Labs, Inc.*, No. 20 Civ. 10832, ECF No. 874 (S.D.N.Y. July 13, 2023), holding in part that Ripple's sales of XRP through trading platforms did not constitute securities transactions while its direct sales to institutional investors did. In contrast, on July 31, 2023, Judge Jed Rakoff rejected Judge Torres' distinction based on how the digital assets were sold in *SEC v. Terraform Labs Pte. Ltd.*, No. 23 Civ. 01346, ECF No. 51 (S.D.N.Y. July 31, 2023), denying defendants' motion to dismiss the Securities and Exchange Commission's claims that they violated federal securities laws in part by selling various digital assets through trading platforms.

Although Judge Torres and Judge Rakoff disagreed on whether sales through trading platforms may constitute securities transactions, the facts and procedural postures of the two cases differ in meaningful ways that may explain the outcomes and shed light on how future courts may view this legal issue.

Background

Ripple develops and manages a digital asset exchange network that operates on the XRP Ledger blockchain. When the XRP Ledger launched, a fixed supply of 100 billion XRP tokens were generated to facilitate international currency transactions. Ripple received 80 billion XRP, some of which it sold and transferred in three ways: (i) directly to counterparties — primarily institutional buyers — pursuant to written contracts ("Institutional Sales"); (ii) on trading platforms through the use of trading algorithms ("Programmatic Sales"); and (iii) to employees and third parties as a form of payment for services ("Other Distributions").

Terraform develops and manages an ecosystem of digital assets and launched the Terra blockchain to record transactions in two of its digital assets, TerraUSD ("UST") and a companion cryptocurrency called "LUNA." UST was developed as an algorithmic stablecoin, which in this case meant its price was algorithmically pegged to another asset, the U.S. dollar.

For a while, one UST could be traded for $1 of LUNA, and $1 of LUNA could be traded for one UST. Owners of UST could also deposit their tokens into a smart contract associated with the "Anchor Protocol" to earn returns Terraform allegedly advertised as 19-20%, to be derived through lending UST deposits to borrowers. Terraform allegedly sold UST, LUNA and three other digital assets — "wLUNA," "mAssets," and "MIR" — directly to institutional investors and through trading platforms to U.S. retail investors.

In an order deciding competing summary judgment motions, Judge Torres analyzed the three categories of transactions in which Ripple engaged and found that only the Institutional Sales were offered and sold as investment contracts.

The SEC brought enforcement actions against Ripple and Terraform (and certain of their executives) in 2018 and 2023, respectively, alleging that the defendants' sales and distributions constituted unregistered sales of securities in violation of Section 5 of the Securities Act of 1933.

Decisions

Under the federal securities laws, investment contracts are a type of security and, therefore, their sale must comply with registration requirements. In *Ripple* and *Terraform*, the parties disputed whether the digital asset sales and distributions were investment contracts.

Both courts relied on the same body of law dealing with investment contracts stemming from and including *SEC v. W.J. Howey Co.*, 328 U.S. 293 (1946). To determine whether a transaction is an investment contract, courts assess whether a person (i) invests his money (ii) in a common enterprise and (iii) has a reasonable expectation of profit based on the entrepreneurial and managerial efforts of the promoter. *Howey*, 328 U.S. at 299.

Thomson Reuters is a commercial publisher of content that is general and educational in nature, may not reflect all recent legal developments and may not apply to the specific facts and circumstances of individual transactions and cases. Users should consult with qualified legal counsel before acting on any information published by Thomson Reuters online or in print. Thomson Reuters, its affiliates and their editorial staff are not a law firm, do not represent or advise clients in any matter and are not bound by the professional responsibilities and duties of a legal practitioner. Nothing in this publication should be construed as legal advice or creating an attorney-client relationship. The views expressed in this publication by any contributor are not necessarily those of the publisher.

THOMSON REUTERS®

SEC v. Ripple

In an order deciding competing summary judgment motions, Judge Torres analyzed the three categories of transactions in which Ripple engaged and found that only the Institutional Sales were offered and sold as investment contracts.

In assessing the third prong of the *Howey* test for the Institutional Sales, the court found that the institutional investors had a reasonable expectation of profits derived from Ripple's efforts, noting 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." *Ripple Labs*, ECF No. 874 at 19.

Importantly, the court determined the Programmatic Sales — Ripple's sales on digital asset trading platforms — did not constitute investment contracts because the "expectation of profits" prong of *Howey* was not met. The court noted these sales occurred on secondary trading platforms that match buyers and sellers without disclosing the identity of either.

> *The* Terraform *court stated that it "reject[ed] the approach recently adopted" by Judge Torres in* Ripple *and declined to distinguish between the assets sold directly to institutional investors and the assets sold through secondary market transactions to retail investors.*

Because the buyers in Programmatic Sales did not know they were buying XRP from Ripple, the court found they did not reasonably expect that Ripple would use their funds to increase the value of XRP. Contrasting these buyers to the purchasers in Institutional Sales, the court also concluded that, due to their lack of sophistication, there was no evidence the buyers in Programmatic Sales had their expectations informed by Ripple's public statements and, therefore, the court did not consider Ripple's statements in its analysis.

On Aug. 18, 2023, the SEC filed a motion to certify an interlocutory appeal of the court's ruling on Programmatic Sales and Other Distributions.

SEC v. Terraform

In deciding the motion to dismiss in *Terraform*, Judge Rakoff was required to accept as true the allegations in the SEC's complaint. At that juncture, the court held that the SEC adequately pled that Terraform's sales of its various digital assets were investment contracts.

When considering the SEC's allegations regarding secondary market sales to retail investors, the *Terraform* court stated that it "reject[ed] the approach recently adopted" by Judge Torres in *Ripple* and declined to distinguish between the assets sold directly to institutional investors and the assets sold through secondary market transactions to retail investors. *Terraform Labs*, ECF No. 51 at 40.

> *The question of whether digital asset sales on trading platforms constitute securities transactions is of central importance to the SEC's broader enforcement initiatives, as the SEC recognized in its Aug. 18, 2023, motion seeking an interlocutory appeal in* Ripple.

The court explained, "[t]hat a purchaser bought the tokens directly from the defendants or, instead, in a secondary re-sale 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."

In contrast to *Ripple*, the *Terraform* court considered defendants' public statements, accepted as true, including that Terraform and its founder promised all purchasers "rates of returns of 19-20%" and that "sales from purchases of *all* crypto-assets — no matter where the tokens were purchased — would be fed back into the Terraform blockchain and would generate additional profits for *all* crypto-asset holders." The court concluded that these alleged statements gave secondary-market purchasers good reason to believe that Terraform would use their capital contributions to generate profits on their behalf.

Analysis and implications

The question of whether digital asset sales on trading platforms constitute securities transactions is of central importance to the SEC's broader enforcement initiatives, as the SEC recognized in its Aug. 18, 2023, motion seeking an interlocutory appeal in *Ripple*. While we await further potential guidance from the 2d U.S. Circuit Court of Appeals, a closer look at the facts in *Ripple* and *Terraform* may provide insights into why the district courts reached seemingly different conclusions.

Although Judge Rakoff stated that he rejected Judge Torres's ruling on Programmatic Sales, that rejection does not appear to have been a total one. Both decisions sought to answer the same two questions. First, can an unsophisticated purchaser have an expectation of profit informed by the promoter's marketing campaign and public statements? And, second, could secondary-market purchasers who buy from unknown sellers reasonably expect profits based on the promoters' use of the money paid by the buyer?

 ©2023 Thomson Reuters

As to the first question, Judge Rakoff, in deciding a motion to dismiss, answered "yes." Judge Torres, in deciding competing motions for summary judgment, ruled that the record demonstrated that Ripple's statements were made across various platforms and were sometimes inconsistent, and thus there was no evidence that an unsophisticated purchaser would have had a reasonable expectation of profit based on this varied collection of statements.

On the second question, both judges appear to have aligned on the answer. Given this consistency, the differing results of the two decisions appear to be more driven by important factual distinctions and procedural posture than differing legal analysis.

In answering the second question, Judge Torres ruled that the evidentiary record failed to show that secondary-market purchasers had a reason to believe their sales proceeds would be used by the promoters to generate profits for purchasers because sales on secondary markets are not typically made by the issuer or promoter but rather by unknown third parties. Unlike in *Ripple*, the SEC in *Terraform* alleged that the defendants told all purchasers that funds from *all* digital asset sales — including those on secondary markets — would be fed back into the Terraform ecosystem to generate profits for purchasers.

Given this allegation (assumed as true at the pleading stage), Judge Rakoff ruled that "secondary-market purchasers had every bit as good a reason to believe that the defendants would take their capital contributions and use it to generate profits on their behalf." *Terraform Labs*, ECF No. 51 at 42.

In *Ripple*, however, even if Judge Torres agreed with Judge Rakoff on the answer to the first question, there was no evidence of a comparable statement being made by the defendants. And, conversely, given Judge Rakoff's heavy reliance on this uncommon allegation, it is not clear he would have reached the same result if that allegation was not made.

Although it was not directly addressed by either decision, it is possible that these factual distinctions would also impact how a court might analyze the "common enterprise" prong of *Howey* when evaluating secondary market sales not made by the issuer. In those circumstances, purchasers' funds would not be pooled and used by the promoters to generate profits, but would go to myriad unknown third parties who would not use the funds to generate profits for the purchasers.

Notably, *Ripple* and *Terraform* are both SEC enforcement actions against digital asset issuers rather than secondary trading platforms. Because those who act as a broker-dealer or an exchange for securities may be required to register with the SEC, the treatment of secondary market sales under the *Howey* test will likely have profound implications for many digital asset trading platforms. Because many (if not most) digital asset issuers do not claim, as was alleged in *Terraform*, that secondary market sales proceeds will be used to generate profits, it is possible that the *Terraform* decision may be limited in future decisions to its unique alleged facts.

Alex Drylewski is a regular contributing columnist on cryptocurrency and digital assets for Reuters Legal News and Westlaw Today.

About the authors

Stuart D. Levi (L) serves as co-head of **Skadden, Arps, Slate, Meagher & Flom**'s Web3 and digital assets group, in addition to coordinating the firm's outsourcing and privacy practices. His diverse practice includes advising on matters involving Web3 and digital assets (including NFTs), artificial intelligence, fintech, technology transactions, outsourcing transactions, intellectual property licensing, privacy and cybersecurity, and branding and distribution agreements. He can be reached at stuart.levi@skadden.com. **Alex Drylewski** (C) is co-head of the firm's Web3 and digital assets group. His practice focuses on high-stakes complex commercial litigation around the world, and he has represented companies and individuals across nearly every type of industry and dispute, including high-profile commercial litigation involving emerging technologies, government investigations, securities class actions, trials and appeals. He can be reached at alexander.drylewski@skadden.com. **Daniel Michael** (R) is co-head of the firm's Web3 and digital assets group. He advises corporations, boards, committees, officers, directors and employees on their most complex criminal and civil enforcement matters. He previously served as the chief of the SEC Enforcement Division's Complex Financial Instruments Unit (CFI). He can be reached at daniel.michael@skadden.com. The authors are based in New York. Travis Bragg and Brittany Libson, associates of the firm, contributed to this article.

This article was first published on Reuters Legal News and Westlaw Today on August 31, 2023.

© 2023 Thomson Reuters. This publication was created to provide you with accurate and authoritative information concerning the subject matter covered, however it may not necessarily have been prepared by persons licensed to practice law in a particular jurisdiction. The publisher is not engaged in rendering legal or other professional advice, and this publication is not a substitute for the advice of an attorney. If you require legal or other expert advice, you should seek the services of a competent attorney or other professional. For subscription information, please visit legalsolutions.thomsonreuters.com.