Ripple effects: developments following groundbreaking decision in *SEC v. Ripple Labs*

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On July 13, 2023, Judge Analisa Torres issued a summary judgment decision in *SEC v. Ripple Labs, Inc.*, 2023 WL 4507900 (S.D.N.Y. July 13, 2023), holding that Ripple's sales of XRP through secondary trading platforms did not constitute securities transactions while its direct sales to institutional investors did. The court denied summary judgment with respect to claims against two senior Ripple executives, Bradley Garlinghouse and Christian Larsen, who the SEC alleged had aided and abetted Ripple's alleged violations, requiring that claims against these individuals proceed to trial.

Since that decision, there have been two notable developments that may impact other pending digital asset secondary trading cases:

- First, Judge Torres denied the SEC's request for an interlocutory appeal to challenge her holding regarding sales on secondary trading platforms. In the near term, the summary judgment decision will therefore remain non-binding precedent that counsels against a finding that digital asset purchases or sales on secondary trading platforms are "securities" transactions.
- Second, the SEC voluntarily dismissed charges against the individual defendants. Although questions remain regarding the remedies for claims involving institutional sales of XRP tokens, this voluntary dismissal could accelerate an appeal of the summary judgment decision.

The uncertainty around *Ripple* lingers large in light of the dearth of existing case law applying *SEC v. W.J. Howey Co.*, 328 U.S. 293 (1946) to secondary market transactions as well as the subsequent decision in *SEC v. Terraform Labs Pte. Ltd.*, 2023 WL 4858299 (S.D.N.Y. July 31, 2023), in which Judge Jed S. Rakoff held that the SEC had plausibly alleged that secondary trading platform transactions of various crypto-assets qualified as investment contracts.

Although *Ripple* and *Terraform* can be reconciled based on important procedural and factual differences, as we suggested in our last column (https://reut.rs/49XBkQV0), the divergent outcomes nonetheless inject further uncertainty into an already murky landscape of decisions applying *Howey* in the digital asset context.

Recent developments in *SEC v. Ripple*

Following Judge Torres' summary judgment decision, on Aug. 18, the SEC moved for an interlocutory appeal to challenge the court's holding that Ripple's programmatic sales of XRP on secondary trading platforms were not securities transactions. Judge Torres denied the SEC's motion on Oct. 3, ruling that its holding did not (i) pose a controlling question of law (ii) for which there was a substantial ground for difference of opinion.

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Under the first prong, the court reasoned that the SEC disputed not the relevant legal standard, but its application to the facts of the case. Second, the court rejected the SEC's claim that the summary judgment decision had precedential value in a number of pending digital asset cases because every case the SEC cited presented different conduct and involved different assets.

Importantly, the court emphasized that it did not hold that offers or sales of digital assets on secondary trading platforms could never constitute securities transactions. Rather, it focused only on the specific facts presented by Ripple's programmatic sales.

In doing so, the court harmonized its decision with the *Terraform* decision, which the SEC invoked to argue that there was a substantial ground for difference of opinion. As Judge Torres explained, and as we noted in our previous article, the two cases differed both factually and procedurally, allowing for the results to be reconciled. For example, the SEC alleged that secondary market buyers reasonably believed Terraform Labs would use their investments to generate profits, a crucial allegation — which a court must accept as true on a motion to dismiss — not present in *Ripple*.

On Oct. 19, following Judge Torres' denial of interlocutory appeal, the SEC voluntarily dismissed its claims against the individual defendants, eliminating the need for a trial and leaving damages and remedies determinations before a final judgment is entered.

The voluntary dismissal suggests that the SEC may have strategically decided to avoid a prolonged trial in order to reach a final, *appealable* decision more quickly, thus allowing the agency to challenge aspects of Judge Torres' summary judgment decision through appeal. In the meantime, this decision does not have binding authority over any other case, unless and until the 2nd U.S. Circuit Court of Appeals adopts the holding itself. Indeed, in other digital asset litigation, the SEC has characterized the *Ripple* decision as an outlier that should not be followed.

A brief survey of relevant cases

It is not surprising that both Judges Torres and Rakoff addressed the question of secondary market trading by relying on cases involving direct sales between issuers and buyers. Despite a large progeny of cases applying *Howey*, those that address whether a product traded on a secondary market is an investment contract could be counted on one hand.

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This stands to reason because the *Howey* test did not expressly account for, nor does it appear designed to address, secondary trades between anonymous buyers and sellers without the issuer's involvement. While the *Howey* test is — as the SEC frequently points out — flexible, it is not limitless. By seeking to apply it to circumstances it was not designed to address, the SEC appears to test those limits.

In one of the few cases interpreting *Howey* involving secondary market trading, the 9th U.S. Circuit Court of Appeals in *Hocking v. Dubois*, 885 F.2d 1449 (9th Cir. 1989), rejected the view that the features of an asset alone can make that asset an investment contract. Instead, the court held that the promotion of an asset, and representations made at the time of the sale, were relevant to determining the existence of a security in secondary market transactions.

This emphasis on the circumstances at the time of sale highlights two challenges to the SEC's theories: (1) buyers on secondary markets may not see the seller's promotional efforts, and (2) the seller may not make any representations specifically to buyers on secondary markets.

Two other cases addressing secondary market trading offer little guidance on these challenges. In *Gary Plastic v. Merrill Lynch*, 756 F.2d 230 (2d Cir. 1985), and *SEC v. Life Partners Inc.*, 87 F.3d 536 (D.C. Cir. 1996), the existence of a secondary market was relevant only in determining whether the issuer's efforts relating to that market satisfied the "efforts of others" prong of *Howey*. In both, the courts analyzed direct sales from the issuer to the buyer. Therefore, neither speaks to whether a product bought on a secondary market from an anonymous seller can constitute an investment contract.

These cases reinforce the notion that the SEC appears to be taking the *Howey* test into unchartered waters. The fate of this voyage may ultimately depend on parts of the standard rarely focused on. While (a) an investment of money, (b) a common enterprise, (c) an expectation of profits and (d) efforts of others all may be afoot in some crypto secondary market trading, that is not the relevant inquiry because prepositions matter.

The *Howey* test is only satisfied if there is an investment of money *in* a common enterprise with a reasonable expectation of profits *from* the efforts of others. In *Ripple*, as with many other digital assets, money from secondary market sales is not invested in the enterprise, and it is unclear whether any expectation of profits is based on the efforts of the issuer as opposed to market forces or the statements and activities of third parties.

What comes next?

While the *Ripple* case continues to proceed through the damages phase and potential appeals, other SEC litigations have directly raised the same or similar issues to those decided by Judge Torres. In *SEC v. Coinbase*, the SEC alleged that the defendants facilitated the sale of crypto assets through an unregistered exchange. Coinbase moved for judgment on the pleadings, arguing that (i) secondary sales on their exchange do not confer any rights against the sellers, a necessary feature of an investment contract under *Howey* and (ii) the SEC overstepped its regulatory power, noting SEC Chair Gary Gensler's comment that "only Congress could confer authority to regulate crypto exchanges."

Similarly, in *SEC v. Binance* and *SEC v. Payward, Inc.*, the SEC alleged that defendants functioned as an unregistered exchange for crypto assets.

Even though the SEC alleges that some of the same digital tokens are "securities" in all actions, the cases are pending before different judges in different courts, opening up the possibility of different results. Notably, the judge presiding over the *Coinbase* action recently dismissed a class action lawsuit against Uniswap Labs, a decentralized finance system that facilitates the sale or offer of digital tokens through its smart contracts.

In dismissing claims that the defendants sold unregistered securities or acted as unregistered securities exchanges and/or broker-dealers, the court in the Uniswap action "decline[d] to stretch the federal securities laws to cover the conduct alleged

... conclud[ing] that Plaintiffs' concerns are better addressed to Congress than to this Court." *Risley v. Universal Navigation Inc.*, 2023 WL 5609200, at *11 (S.D.N.Y. Aug. 29, 2023). (The authors' firm represents one of the defendants in the Uniswap action.) Whether this same perspective influences the court's view of the issues in *Coinbase* remains to be seen.

A multitude of other digital asset litigations, brought by the SEC or private plaintiffs, allege that secondary sales of digital assets constitute unregistered securities transactions. The success or failure of such actions may hinge on whether Judge Torres' programmatic sales ruling is upheld on appeal and/or adopted by other courts.

The *Ripple* decision demonstrates that the *Howey* test is ill-fitted to secondary market transactions between anonymous buyers and sellers. This fact complicates any assessment of whether a "common enterprise" exists and whether secondary purchasers could reasonably expect to profit based on the efforts of the initial seller with whom they have no relationship, formal or otherwise.

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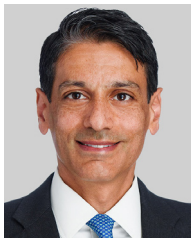
About the authors



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