

Client Alert:

SDNY Court Holds That Ripple Labs' Sale of XRP on Public Crypto Exchanges Are Not Securities Transactions

July 17, 2023

On July 13, 2023, U.S. District Court Judge Analisa Torres issued a decision in the U.S. Securities and Exchange Commission's (SEC) lawsuit against Ripple Labs Inc. ("Ripple"), dealing a blow to the SEC's position that sales of cryptocurrency tokens on public exchanges constitute sales of unregistered securities.

The decision in *SEC v. Ripple Labs, Inc.*, No. 20-cv-10832-AT-SN (S.D.N.Y.), on the parties' cross motions for summary judgment held that Ripple did not sell unregistered securities when it sold approximately \$758 million of its cryptocurrency token, XRP, on cryptocurrency exchanges via algorithmic trading. Nor did Ripple violate securities laws when it provided employees and third parties with XRP in exchange for services. If upheld, the decision paves the way for future public token sales without the need for registration, provided the tokens are sold on cryptocurrency exchanges through algorithmic trading via "blind bid/ask transactions." It may be the case—assuming the opinion holds on appeal—that even tokens initially created as part of a securities transaction could be traded on exchanges and treated as non-securities.

In its motion for summary judgment, the SEC argued that various categories of Ripple's XRP sales constituted investment contracts under the test set forth by the Supreme Court in *SEC v. W.J. Howey Co.*, 328 U.S. 293 (1946). Under *Howey*, a product is an investment contract—and therefore a security subject to registration requirements—if a purchaser "[1] invests his money [2] in a common enterprise and [3] is led to expect profits solely from the efforts of the promoter or a third party." The Court recognized that under *Howey*, the question is not whether the token itself is a security, but whether the transaction as a whole constitutes an investment contract. "[O]rdinary assets—like gold, silver, and sugar—may be sold as investment contracts, depending on the circumstances of those sales."

The Court held that Ripple's public, exchange-based transactions failed to meet *Howey*'s third prong. The Court focused mainly on whether Ripple promised public purchasers to use its "entrepreneurial or managerial efforts" to increase the value of the customers' alleged investment. But XRP purchasers had no way of knowing whether they purchased XRP directly from Ripple or instead from some other, secondary XRP seller. Because public XRP purchasers did not know whether they purchased from Ripple, Ripple could not have made any promises or offers to these purchasers. Thus, those who purchased XRP on an exchange via blind bid/ask transactions did not purchase with a reasonable expectation that their profits would be derived from Ripple's "entrepreneurial or managerial efforts."

The Court also rejected the SEC's argument that Ripple's alleged targeting of speculators was enough to turn Ripple's exchange-based sales into securities transactions. It held that the relevant inquiry is whether Ripple made promises and offers to individuals who purchased XRP on public markets. "Ripple did not make any promises or offers [to public purchasers] because Ripple did not know who was buying the XRP, and the purchasers did not know who was selling it." Indeed, many public market XRP purchasers were unaware of Ripple's existence.

Judge Torres also rejected the SEC's position on Ripple's distributions of XRP to its employees and other third parties, holding that these transactions did not constitute the sale of investment contracts. According to the Court, these transactions failed *Howey*'s first prong, which requires an "investment of money." The opinion says that employees and third parties who received XRP from Ripple did not pay "some tangible and definable consideration" to Ripple.

However, the ruling was not a complete victory for Ripple, as the Court held that Ripple's direct sale of approximately \$729 million of XRP to institutional buyers were unregistered securities transactions. Unlike Ripple's public sale of XRP on exchanges, institutional buyers, including hedge funds and institutional investors, extracted specific promises from Ripple. Ripple promised that its "amazing team of dedicated professionals" would work hard to increase the value of XRP.

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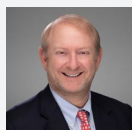
In exchange, the institutional buyers agreed to lockup provisions and resale restrictions, supporting the Court's conclusion that these purchasers "did not view the XRP sale as a sale of a commodity or a currency," but as "an investment in Ripple's efforts."

Notwithstanding Ripple's potential liability, Judge Torres's decision may be significant. If Judge Torres' holding is accepted by other courts, established companies could publicly sell their tokens to the public on exchanges with significantly more comfort. These exchange-based sales will almost certainly be algorithmic, blind bid/ask transactions, making it impossible for buyers to know whether they are buying from the token's creator or some secondary participant. Companies in such transactions are unlikely to make promises and offers to purchasers, as neither the company nor the purchaser are aware of the other party's identity. However, companies should avoid advertising these public, exchange-based sales and should not broadly distribute promotional materials, as that may well change the analysis of whether the public relied on the company's promises.

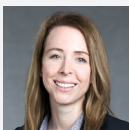
Nevertheless the decision must be viewed in context. The Court cautioned that its ruling was limited to these particular factual circumstances and expressly left open the possibility that secondary sales of a cryptocurrency token could constitute the sale of securities in the right set of circumstances. Only time will tell if other district courts follow Judge Torres's lead, and the SEC may well appeal this decision.

For more information about the *Ripple Labs* decision or on cryptocurrency issues more generally, please get in touch with your regular Brown Rudnick contact or with this article's authors.

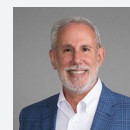
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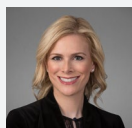
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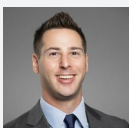
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