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When *Howey* met Gary (Gensler): Ripple or tsunami?

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The SEC lost a game point in its case against Ripple Labs when a federal court ruled that several categories of XRP token sales were not securities transactions. If adopted by other courts, the decision would represent a significant setback for the SEC's regulatory and enforcement program—but could be a catalyst for needed congressional action.

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Ruling in the Securities and Exchange Commission's closely watched case against Ripple Labs, on July 13 Judge Analisa Torres of the Southern District of New York dealt a potentially significant blow to the SEC's digital asset regulatory and enforcement program.

Although Judge Torres ruled that Ripple's sales of XRP directly to sophisticated buyers amounted to investment contracts under the *Howey* test—and therefore were securities transactions under federal law—she found that the XRP token itself is *not* a security. Analyzing the facts and circumstances of each transaction category making up the SEC's case, the court found that sales to retail buyers through digital asset trading platforms were not investment contracts—and thus not within the scope of the federal securities laws.

The SEC's crypto regulatory and enforcement program relies on the proposition that crypto tokens themselves—the individual tokenized assets—should be categorized as securities regardless of the facts, circumstances and various ways in which they are purchased and sold. Senior SEC officials regularly express the view that "the vast majority of crypto tokens are securities," but the question has arisen in few matters where the federal judiciary has been primed to give its definitive view.

Judge Torres's opinion rejects the SEC's categorical approach—at least as far as XRP is concerned.

Judge Torres's analysis, if upheld on appeal and applied to other digital assets, could have major implications:

- Token sales over retail trading platforms would not be subject to SEC oversight, even if the token issuer or its senior executives are sellers.

- Operators of retail trading platforms would not be subject to the SEC's securities exchange, broker-dealer or ATS registration regimes.

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- Perhaps most significantly, policymakers may more clearly see a need to adapt 20th century legislation to match up with 21st century technology, and lift the regulatory cloud over the digital asset market.

Judge Torres's opinion—based implicitly on the distinction between an *asset* and a *transaction*—is drawing criticism in some quarters for providing the protections of the federal securities laws to sophisticated investors who purchase tokens directly from a project sponsor, but not to secondary-market purchasers on retail trading platforms. But this is a *policy* question, not a *legal* one. If the federal securities and commodities laws need to be updated to account for the emergence of a new asset class—as we have argued in other forums—this is a job for our representatives in Congress.

The ruling

In late December 2020, the SEC sued Ripple Labs and two of its executives, Brad Garlinghouse and Christian Larsen, alleging that they raised over $1.3 billion through unregistered digital asset security offerings involving Ripple's native digital asset, XRP. The SEC alleged four categories of illegal unregistered XRP offers and sales:

- **Institutional sales**—sales directly to institutional counterparties pursuant to written contracts.
- **Programmatic sales**—anonymous, "programmatic" sales on digital asset trading platforms in which buyers and sellers did not know the identity of their counterparty.
- **Other distributions**—distributions to employees as a form of payment for services and to third parties to fund new applications for XRP and the Ripple network.
- **Sales by individuals**—sales by Larsen and Garlinghouse, as Ripple affiliates, on digital asset trading platforms in a manner similar to Ripple's programmatic sales

According to the SEC, all of these XRP transactions involved unregistered "investment contracts"—one of a list of instruments included in the statutory definition of "security." Resolution of the case turned on the Supreme Court's 1946 decision in *SEC v. W.J. Howey Co.*

Howey involved speculative investments in a Florida citrus profit-generating venture. With what has come to be known as the "*Howey* test," the Supreme Court held that the investments amounted to "investment contracts" and thus "securities" because they involved each of the following "prongs"—

- an investment of money
- in a common enterprise
- with an expectation of profits derived from the efforts of others

Framing her analysis, Judge Torres found that—

> *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 examines the totality of circumstances surrounding Defendants' different transactions and schemes involving the sale and distribution of XRP.*

Judge Torres separately analyzed each category of transaction under the *Howey* test and held that only Ripple's institutional sales were securities offerings.

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Transaction	Ruling	*Howey* analysis
Institutional sales pursuant to contracts	? Securities transactions	Each prong satisfied
Programmatic sales into the market	? Not securities transactions	No reasonable expectation of profits derived from efforts of others
Distributions in exchange for services and similar benefits	? Not securities transactions	No investment of money
Sales by individuals into the market	? Not securities transactions	No reasonable expectation of profits derived from efforts of others

Institutional sales

Ripple sold XRP to a number of institutional or sophisticated purchasers in a series of contracted-for purchases. Judge Torres held that each prong of the *Howey* test was met for the institutional sales. Central to Judge Torres's holding was her finding that Ripple marketed directly to these purchasers the investment potential of XRP and the relationship to Ripple's efforts, thus giving rise, in *Howey* lingo, to a reasonable expectation of profits derived from the efforts of others.

Judge Torres also indicated that her holding related to Ripple's sales of XRP to institutional buyers, not to the public *through* institutional buyers. Judge Torres held that "[t]o the extent the SEC instead argues that Ripple actually sold investment contracts to the public and used the Institutional Buyers as underwriters, the Court rejects that argument."

Programmatic sales

Most significantly for the digital asset market, Judge Torres held that programmatic sales were not investment contracts, because *even if* purchasers expected profits, their expectations would not be from Ripple's use of their money—because purchasers could not have known whether they were buying directly from Ripple:

> *[T]he undisputed record does not establish the third* Howey *prong. Whereas the Institutional Buyers reasonably expected that Ripple would use the capital it received from its sales to improve the XRP ecosystem and thereby increase the price of XRP, … Programmatic Buyers could not reasonably expect the same. Indeed, Ripple's Programmatic Sales were blind bid/ask transactions, and Programmatic Buyers could not have known if their payments of money went to Ripple, or any other*

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> *seller of XRP. … [T]he economic reality is that a Programmatic Buyer stood in the same shoes as a secondary market purchaser who did not know to whom or what it was paying its money.*

Like Ripple's programmatic sales, Larsen and Garlinghouse sold XRP anonymously on secondary-market trading platforms. Judge Torres similarly said no investment contract was formed. Because "Larsen and Garlinghouse did not know to whom they sold XRP, and the buyers did not know the identity of the seller," these transactions were not investment contracts "as a matter of law."

While Judge Torres noted that the court was "not address[ing] whether secondary market sales of XRP constitute offers and sales of investment contracts," there is a logical implication to the holding.

Other distributions

An additional consequential aspect of the ruling is that other distributions of XRP—to employees and third-party developers—were not investment contracts because they did not satisfy *Howey*'s first prong, requiring an "investment of money." The SEC has articulated an expansive view on what satisfies this *Howey* prong. In its 2019 Framework for "Investment Contract" Analysis of Digital Assets, the SEC staff asserted that a free distribution of tokens via an airdrop could satisfy the prong, without money or other investment capital flowing from the recipient to the issuer.

Judge Torres implicitly rejected this argument. Consistent with case law requiring an investor to have "put up their money," the court found that no *Howey* "investment of money" had taken place because "recipients of the Other Distributions did not pay money or 'some tangible and definable consideration' to Ripple."

Judge Torres also rejected the SEC's argument that these other distributions amounted to an indirect public offering when employees and third parties offloaded XRP onto the public. The court noted that the SEC did not elsewhere allege that these recipients were Ripple's "underwriters," a category of buyer with regulatory obligations.

If endorsed by other courts, the holdings undermine the basis for much of the SEC's crypto regulatory and enforcement agenda

While Judge Torres's decision is not binding on other courts, the ruling marks the SEC's first significant loss in a digital asset case. And it comes from the Southern District of New York, an influential court that serves as venue for most SEC enforcement actions. The SEC has previously been successful in obtaining settlements or winning in litigation—such as in *Kik*, *Telegram* and *LBRY*—with cases primarily involving an issuer's initial distribution of digital assets. While the SEC has sought to categorize almost all digital assets intrinsically as securities, even after their initial sale, Judge Torres's decision would require an analysis of each particular transaction at issue. Under this approach, secondary-market transactions on trading platforms or otherwise not involving the issuer would not appear to involve securities, undermining the basis for any SEC jurisdiction over those activities or the intermediaries who facilitate them.

If read to limit the SEC's jurisdiction to the initial bilateral sale of a digital asset between an issuer and an investor, Judge Torres's decision would significantly curtail the scope of the SEC's authority over the digital asset market.

Implications for public policy and legislation

The paradox in Judge Torres's ruling is that the protections of the securities laws accrue to sophisticated investors who purchase digital assets directly from an issuer or affiliate—but not to retail investors who purchase in anonymous secondary markets.

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While backward from a policy perspective, this result flows from the SEC's need to rely on the proposition that digital assets are "investment contracts." There is logic in concluding that a purchaser who knows they're in privity with the issuer is entering an investment "contract," while a secondary-market trader is not.

As this implication of Judge Torres's decision becomes clearer, Congress and other policymakers may come to be persuaded that our 1930s-era securities and commodities laws are due for an update.

Resources
Crypto Regulation Hub

Visit our Crypto Regulation Hub for links to congressional proposals related to the regulation of crypto assets and other helpful materials.

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