LAW360

Portfolio Media. Inc. | 111 West 19th Street, 5th Floor | New York, NY 10011 | www.law360.com
Phone: +1 646 783 7100 | Fax: +1 646 783 7161 | customerservice@law360.com

SEC V. Ripple Labs Decision Could Change Crypto Regulation

By **Joseph Hall** (July 24, 2023, 4:17 PM EDT)

Joseph Hall

One of the more confounding concepts for a lawyer to explain to a client is the different dimensions of what "registration" means under the federal securities laws. A company going public in the U.S. registers in two different ways.

Under the Securities Act of 1933, registration means that the company has described a transaction — the proposed sale of securities to the public — to the U.S. Securities and Exchange Commission, and the SEC has declared the company's registration statement effective for that transaction, and only that specific, time-bound transaction.

On the other hand, registration under the Securities Exchange Act of 1934 means that the company has registered a particular class of security with the SEC, which allows that asset to gain a nonexpiring, perpetual listing on a stock exchange.

After spending months of effort and millions of dollars to successfully register its initial public offering — the transaction — a company will sometimes puzzle over why it can't simply sell as much stock — the asset — as it likes, when it wants. After all, it registered with the SEC!

The answer, annoyingly, is that under the Securities Act, each sale transaction must be registered, if there is no exemption — even if the asset being sold is, and remains, registered under the Exchange Act.

The registration dichotomy is rooted in a distinction that is fundamental to how the federal securities laws work. And this distinction — between a transaction and an asset — is at the heart of the remarkable opinion issued this month by U.S. District Judge Analisa Torres of the U.S. District Court for the Southern District of New York, in SEC v. Ripple Labs.

In Ripple, the SEC posited that an investment contract is an asset, but Judge Torres quickly dismissed this idea and held, in effect, that an investment contract is instead a transaction.

Of course it is. A contract is formed when two parties come together and strike a deal. The subject of their bargain could be anything — a citrus orchard, a Manhattan co-op apartment, a payphone. But anyone can intuitively grasp the distinction between a contract or transaction, and the subject of the contract, which is an asset.

Judge Torres immediately recognized that XRP — the native token of the Ripple protocol, and nothing

but a string of ones and zeroes — is an asset and not a transaction. And since it wasn't a transaction, it could not be an investment contract as alleged by the SEC.

Instead, the judge analyzed each of the various transactions making up the SEC's case, and determined that some satisfied the U.S. Supreme Court's Howey test for investment contracts — stemming from its 1946 ruling in SEC v. Howey — but others did not.

This should not have been a surprise, because that's how the Howey test works — as the SEC itself seemed to say as recently as 2019, when it released its first, and only, detailed explanation of how entrepreneurs should apply Howey to a wide variety of hypothetical fact patterns.

But since publishing that framework, the SEC has beaten a path away from the proposition that an investment contract is a transaction, and instead has tried to establish that an investment contract is an asset — the living, breathing embodiment of a transaction.

Why has the SEC sought to reify the investment contract? For a couple of reasons: First, because that's the hand Congress dealt the agency, and second, because the agency's broader regulatory program depends on it.

When the Securities Act became law in 1933, it did not define "security" in conceptual terms. Instead, it set forth a long list of things that were thenceforth to be regulated as securities: notes, stocks, bonds, debentures and the like — as well as investment contracts, a thing that states had begun to recognize as securities in the "blue sky" laws adopted in the earliest years of the 20th century.

When, a few years later, W.J. Howey launched a venture selling individual tracts in a Florida citrus grove to investors in the Northeast, coupled with an agreement to cultivate and tend the crop, harvest it and bring it to market, the SEC sued him, alleging he'd sold investment contracts to the public without registering under the Securities Act.

The SEC did not argue that Howey had sold "stock" to the public, even though the agency might have taken that route. In other words, the SEC could have argued that what Howey sold looked like common stock in a citrus production and marketing company, albeit without the specific label.

But the SEC did not make this argument in its case against Howey in 1946. And that choice, fatefully, has had consequences to this day: There is no broad "looks like" test under the federal definition of security.

The SEC announced in 2017 that the proper way to determine whether most digital assets are securities is the Howey investment contract test. It had no other choice. Digital assets were novel, and covered by none of the enumerated items in the list of things that count as securities.

So the agency relied on the term "investment contract," which over the decades had become a catchall for transactions in which promoters obtain capital from passive investors in order to launch and build a business.

The promoters and investors may not even intend to enter securities transactions. But the transactions are close enough to the activity Congress intended to regulate that courts have repeatedly agreed with the SEC's contention that they're investment contracts, and therefore securities.

But here's the catch. Often the only foot-fault in these transactions is the initial sale. The promoter takes

the capital, and — hopefully — returns a profit, and that's how the investor is rewarded.

There is usually no secondary market or after-market for investors to resell their investments to third parties. The investment contract construct works well in these situations, as it worked in all of the SEC's settlements and litigated cases — right up to Ripple.

What was different in Ripple? Some of the transactions at issue modeled the classic investment contract paradigm: bilateral sales of XRP directly from Ripple Labs to investors. But other sales didn't exactly fit this mold.

They were, instead, sales by Ripple Labs and others intermediated through crypto trading platforms, wherein the sellers did not know to whom they were selling, and the purchasers did not know from whom they were buying. Judge Torres found that these anonymous sales were not investment contracts.

Which brings us to the second reason the SEC has tried to push the idea that digital asset investment contracts are assets regulated under the Exchange Act, rather than transactions regulated only under the Securities Act: If digital assets must be approached as transactions under the Howey investment contract test, and are not inherently securities in and of themselves, then some transactions in digital assets won't be securities transactions.

And the SEC has no jurisdiction where there's no securities transaction. This is the direct implication of Judge Torres's ruling: The SEC holds no sway over anonymous transactions in XRP carried out in secondary trading venues.

This would mean, among other things, that the SEC has no claim to jurisdiction over market intermediaries like the crypto trading firms currently in its crosshairs.

This explains why, shortly after the Ripple decision was released, news surfaced of trading platforms relisting XRP, having delisted it in the frantic days following the SEC's surprise 2020 lawsuit filed against Ripple Labs in the twilight hours of former Chairman Jay Clayton's tenure.

Judge Torres presides over a trial court and her opinion addresses but a single digital asset, and so the specific findings in the opinion may not be that important.

But her approach to the case — a careful transaction-by-transaction analysis as required by Howey — may well set the tone for future rulings, and thereby mark a turning point in the nation's fraught regulatory relationship with crypto.

Joseph A. Hall is a partner at Davis Polk & Wardwell LLP.

The opinions expressed are those of the author(s) and do not necessarily reflect the views of their employer, its clients, or Portfolio Media Inc., or any of its or their respective affiliates. This article is for general information purposes and is not intended to be and should not be taken as legal advice.