CLIFFORD CHANCE

A RIPPLE IN STILL WATER OR A TIDAL WAVE? INITIAL REFLECTIONS ON THE *SEC* v. *RIPPLE* DECISION

In a long-awaited decision in the case between the Securities and Exchange Commission (SEC) and Ripple Labs, Inc. (Ripple), a federal court has ruled that certain transactions involving the XRP token were not securities transactions. The decision has already created "ripple effects" in the global crypto industry, with XRP being relisted by exchanges, and it could impact the direction of ongoing US legislative and regulatory efforts, including SEC enforcement.

Key issues

- An SDNY judge has ruled that the XRP token itself is not a security and that certain transactions involving the XRP token were not securities transactions.
- The court distinguished marketing efforts and off-exchange sales to institutions of XRP tokens (which it found constituted "investment contracts" under *Howey*) from initial on-exchange sales and other distributions.
- The decision provides useful guidance to market participants and could impact current litigation between market intermediaries and the SEC, particularly spot digital assets exchanges.

On July 13, 2023, Judge Analisa Torres of the Southern District of New York ruled on the parties' cross-motions for summary judgement in *Securities and Exchange Commission* v. *Ripple Labs, Inc.*, Bradley Garlinghouse (CEO of Ripple) and Christian A. Larsen (co-founder and former CEO of Ripple), granting and denying each in part.[1] Crucially, Judge Torres ruled that, based on the manner in which they were offered and sold, certain transactions involving the XRP token (representing close to two thirds of the total consideration received by Ripple from sales of XRP) were not securities transactions, in a decision that could broadly impact the development of digital asset markets in the United States and beyond.

BACKGROUND

The XRP distributed ledger (XRP Ledger) is permissionless and based on open-source software. Ripple's mission is to realize an "Internet of Value" by using technology to facilitate the transfer of value across the Internet, including by funding companies to incentivize the development of "use cases" on the XRP Ledger. The SEC alleged that Ripple conducted extensive, years-long marketing efforts through public materials, interviews, and other media related to the XRP Ledger and XRP, touting its use cases and the investment opportunity.

100 billion XRP tokens were issued. Of these, 80 billion were allocated to Ripple. Ripple sold most of these XRP tokens while retaining some. The other 20 billion XRP tokens went to Ripple's founders, who eventually sold some of these tokens. XRP Tokens were sold in the following manner by Ripple: (1) "Institutional Sales," where Ripple sold XRP directly to institutional buyers

[1] Order, *Securities and Exchange Commission* v. *Ripple Labs Inc. et al.*, Case No. 1:20-cv-10832, Dkt. No. 874 (S.D.N.Y. Jul. 13, 2023).

such as hedge funds (Institutional Buyers), pursuant to written contracts; (2) "Programmatic Sales," where Ripple sold XRP on digital asset exchanges in blind bid/ask transactions; and (3) "Other Distributions," where Ripple distributed XRP as a form of payment for services (employee compensation, funding third parties that would develop new applications for the XRP Ledger, etc). Separately, Ripple executives offered and sold XRP in their individual capacities (Personal Sales).

None of the foregoing XRP sales were the subject of a filed registration statement with the SEC pursuant to the Securities Act of 1933. Ripple sought legal advice from its counsel about the status of XRP and related activities under the securities laws prior to the issuance of XRP.

"THERE IS A ROAD, NO SIMPLE HIGHWAY; BETWEEN THE DAWN AND THE DARK OF NIGHT" – KEY ASPECTS OF THE COURT'S HOLDING

The XRP tokens are not themselves securities: The court explained that while the so-called "*Howey* test" defines an investment contract as a "contract, transaction, or scheme", the *subject* of a contract, transaction, or scheme is not necessarily a security. The court noted that even if XRP exhibits certain characteristics of a currency, or of a commodity like gold, silver, or sugar, it may nonetheless be offered or sold as an investment contract. The court stressed that the *Howey* analysis focuses not on the underlying asset that is the subject of the investment contract, but on the economic reality and totality of circumstances surrounding the manner in which the underlying asset is offered and sold. The court noted that in past cases, including in *SEC* v. *Howey* itself, the subject of an investment contract standing alone was a tangible or intangible asset that was not itself inherently an investment contract (in *Howey's* case, groves of citrus trees). The court observed that if the citrus groves in *Howey* were later resold, those resales may or may not constitute investment contracts, depending on the totality of circumstances surrounding the resale. The court then held 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." As a result, the court shifted its analysis to the totality of circumstances surrounding the sale and distribution of the XRP tokens, as opposed to the tokens themselves.

Institutional Sales: The court found that all three prongs of the *Howey* Test were met in the context of Institutional Sales. In *Howey*, the Supreme Court held that under the Securities Act, an investment contract is "a contract, transaction[,] or scheme whereby a person [(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."[2] In analyzing whether a contract, transaction, or scheme is an investment contract, "form should be disregarded for substance and the emphasis should be on economic reality" and the "totality of circumstances."[3]

In the case of Institutional Sales, the *Ripple* court found that the first *Howey* prong of "investment of money" was met because Institutional Buyers invested money by providing fiat or other currency in exchange for XRP. The second *Howey* prong, "existence of a common enterprise", was not contested by Ripple - it admitted that it pooled the proceeds of the Institutional Sales, satisfying horizontal commonality.[4] Moreover, an Institutional Buyer's ability to profit was

[2] *SEC v. W.J. Howey Co.*, 328 U.S. 293, 29899 (1946).
[3] *Tcherepnin v. Knight*, 389 U.S. 332, 336 (1967).
[4] The second prong of *Howey*, the existence of a common enterprise, may be demonstrated through either horizontal commonality or vertical commonality. Horizontal commonality is established when investors' assets are pooled and the fortunes of each investor are tied to the fortunes of

tied both to Ripple's fortunes and those of other institutional buyers because they received the same fungible XRP tokens.

The court framed the critical third *Howey* prong as whether the economic reality would have led institutional buyers to have a reasonable expectation of profits to be derived from the entrepreneurial or managerial efforts of others. It held that this test was met primarily because Ripple's marketing to Institutional Buyers connected increases in XRP's price to Ripple's success as a company. The court explained that a reasonable Institutional Buyer would have understood 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. The court further stressed that Ripple's overall messaging to Institutional Buyers focused on XRP's investment potential and its relationship to Ripple's efforts and that the nature of the Institutional Sales supported the conclusion that the tokens were sold as an investment rather than for consumptive use. For example, Institutional Buyers had agreed to lockup provisions or resale restrictions based on XRP's trading volume in their contracts, provisions consistent with an investment as opposed to a consumptive use. Accordingly, the court found that the Institutional Sales constituted the unregistered offer and sale of securities in violation of Section 5 of the Securities Act of 1933.

Programmatic Sales: In contrast, the court found that the Programmatic Sales materially differed from Institutional Sales, and that an "investment contract" did not exist under the *Howey* test for Programmatic Sales. The court found that Programmatic Sales did not satisfy the "expectation of profits from the efforts of others" prong of the *Howey* test. The court considered the economic reality of the Programmatic Sales, which involved anonymous purchases on digital assets exchanges and held that Programmatic Sales buyers could not reasonably expect their purchases to fund Ripple's efforts to improve the XRP ecosystem, because they did not know that the proceeds of their purchases were going to Ripple.

In support of its holding, the court noted that over 99% of global XRP trading volume since 2017 took place outside of Ripple's Programmatic Sales, and that the SEC's own evidence showed that many buyers in the Programmatic Sales did not even know Ripple existed. No statements or marketing materials were cited in which Ripple stated that it would use the proceeds of the Programmatic Sales to develop the XRP ecosystem and increase XRP's value (unlike the marketing materials used for Institutional Sales which included such statements). The court rejected the SEC's argument that Ripple "explicitly targeted speculators" with the Programmatic Sales or that "Ripple understood that people were speculating on XRP as an investment." The court explained that a speculative motive or profit expectation by the purchaser or seller does not evidence the existence of an investment contract unless the basis for the expectation derives from the entrepreneurial or managerial efforts of another (in this case, Ripple) as opposed to other factors such as general market trends.[5]

In reaching a different conclusion under the *Howey* test with respect to Programmatic Sales compared to Institutional Sales, the court stressed that a reasonable buyer in a Programmatic Sale had a different basis for its profit

---

other investors as well as to the success of the overall enterprise. In contrast, strict vertical commonality, which is the form of vertical commonality recognized in the Second Circuit, requires that the fortunes of investors be tied to the fortunes of the promoter. *Revak* v. *SEC Realty Corp.*, 18 F.3d 81, 88 (2d Cir. 1994).

[5] *Sinva, Inc.* v. *Merrill, Lynch, Pierce, Fenner & Smith, Inc.*, 253 F. Supp. 359, 367 (S.D.N.Y. 1966) (citing *SEC* v. *C.M. Joiner Leasing Corp.*, 320 U.S. 344, 348 (1943)).

expectation than an Institutional Buyer. Unlike an Institutional Buyer, a buyer in a Programmatic Sale would not necessarily have been aware of the "multiple documents and statements . . . across many social media platforms and news sites from a variety of Ripple speakers . . . over an extended eight-year period," which the SEC said connected XRP's price to Ripple's own efforts.

Other Distributions/Personal Sales: The court held that the *Howey* "investment of money" prong was not satisfied for Other Distributions because employees and other recipients who received XRP as compensation for services did not pay money or "some tangible and definable consideration" to Ripple, noting that "[t]o the contrary, Ripple paid XRP to these employees and companies."

The court also held that the personal XRP sales by the individual defendants were like Programmatic Sales because they were effectuated through digital asset exchanges through blind bid/ask transactions and therefore were not "investment contracts" for the same reasons.[6]

"WOULD YOU HEAR MY VOICE COME THROUGH THE MUSIC?" – KEY TAKEAWAYS

Although the *Ripple* decision is the decision of a single district court (and therefore not binding precedent on other courts), the decision is from the Southern District of New York, a court long influential in financial matters given its location in the heart of the US financial sector i.e., Wall Street. Moreover, the court delivered a thorough opinion following extensive briefing by the parties and by multiple *amici curiae*.

Howey applies to the way digital tokens like XRP are offered and distributed and not to the token itself: The court confirmed that *Howey* is the applicable test for an offering and sale of a digital token, or at least, a digital token that, like XRP, exhibits certain characteristics of an "ordinary asset," such as a currency or a commodity like gold, silver, or sugar. In doing so, the court rejected the defendants' so-called "essential ingredients" test, stating that it would call for the court to "read beyond the plain words of *Howey* and imposed additional requirements not mandated by the Supreme Court." Under the *Howey* test, as applied to digital tokens like XRP, the digital token is not in and of itself the "contract, transaction[,] or scheme" that the *Howey* test requires. Rather, the focus is on the manner surrounding how the digital token is offered and distributed.

Regulatory clarity: Has a pathway emerged?: Under the logic of the *Ripple* decision, at a minimum, distributions of tokens like XRP by the issuer or promoter should not be considered transactions in investment contract securities if: (i) they occur through blind bid/ask transactions on digital asset exchanges; (ii) the issuer's/promoter's distribution transactions represent only a small portion of global market trading volume at the time; (iii) public marketing materials would not lead a reasonable purchaser to expect that the issuer/promoter will deploy such assets to promote the business or tie an increase in value to the efforts of the promoter; and (iv) they lack other indicia that a reasonable purchaser would harbor an expectation of profits derived from the issuer's/promoter's efforts rather than general market trends.

Digital Asset Exchange Secondary Market Trading: XRP tokens were and are traded in secondary-market transactions by parties other than Ripple and its

[6] The court also denied the SEC's motion for summary judgment against the individual defendants on claims of aiding and abetting violations of the securities laws. The court found that the individual defendants raised a genuine dispute of material fact as to whether they knew or recklessly disregarded the facts that made Ripple's scheme surrounding the Institutional Sales illegal under the securities laws.

founders on various digital assets exchanges. The court noted that secondary market sales were not briefed and that the question of secondary market sales was not before the court. Nevertheless, the *Ripple* decision should put significant pressure on the SEC's argument (which has been advanced in ongoing cases against digital assets exchanges) that secondary sales in blind bid/ask transactions on digital asset exchanges occurring under similar circumstances constitute securities transactions.

Fair notice and due process: The court rejected Ripple's fair notice and due process defenses, finding that the *Howey* test gives fair notice of conduct that is forbidden or required. The court found that "[t]he SEC's approach to enforcement, at least as to the Institutional Sales, is consistent with enforcement actions that the agency has brought relating to the sale of other digital assets to buyers pursuant to written contracts and for the purpose of fundraising." However, the court went on to observe in a footnote that while it did not address the fair notice and due process defenses in the case of the Programmatic Sales and Other Distributions, "[t]he Court's holding [as to the fair notice and due process defenses] is limited to the Institutional Sales because the SEC's theories as to the other sales in this case are potentially inconsistent with its enforcement in prior digital asset cases." Again, the court left open the door to further fights between the industry and the SEC over how to interpret the past ten years of regulatory statements, guidance, actions and legal counsel.

Impact on market participants: Until and unless an appeal is heard and decided, the decision could prove influential in shaping market participants' and regulators' understanding of how to apply the *Howey* test to issuances and sales of digital tokens. In particular, the holding that the XRP token as the subject of an investment contract "is not in and of itself a 'contract, transaction[,] or scheme' that embodies the *Howey* requirements of an investment contract," should provide some comfort to market intermediaries providing order matching, trading, custody, and similar services for similar tokens, such as spot digital asset exchanges. These market intermediaries should also benefit from the court's holding that the Programmatic Sales and Personal Sales are not investment contracts because they are conducted as blind bid/ask sale on digital asset exchanges. Already, XRP Tokens are being re-listed on exchanges that dropped the token due to the ongoing litigation.

From an investor perspective, holders of digital assets purchased on exchanges, such as investment funds (as opposed to privately negotiated arrangements with the issuer/promoter) may also benefit from greater clarity following the decision as they consider issues such as, for example, potential inadvertent investment company status issues under the Investment Company Act of 1940. Finally, the court's holding that the *Howey* "investment of money" prong was not satisfied in connection with payments to employees or to incentivize third parties may present intriguing possibilities with respect to the crypto markets.

Further litigation is likely: The *Ripple* court granted summary judgment in favor of the SEC on some claims and in favor of Ripple on other claims, while still other claims survived and could now proceed to trial. Each side could ultimately also seek to appeal the portions of the decision that went against them. Thus, the show is likely far from over, but *What a Long Strange Trip It's Been* so far.

CONTACTS

Cliff Cone
Partner

T +1 212 878 3180
E Clifford.Cone@cliffordchance.com

Steve Gatti
Partner

T +1 202 912 5095
E Steven.Gatti@cliffordchance.com

Jesse Overall
Associate

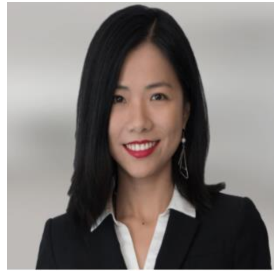
T +1 212 878 8289
E Jesse.Overall@cliffordchance.com

Robert Houck
Partner

T +1 212 878 3224
E Robert.Houck@cliffordchance.com

Benjamin Peacock
Counsel

T +1 212 878 8051
E Benjamin.Peacock@cliffordchance.com



Weisiyu Jiang
Associate

T + 1 202 912 5303
E Weisiyu.Jiang@cliffordchance.com

This publication does not necessarily deal with every important topic or cover every aspect of the topics with which it deals. It is not designed to provide legal or other advice.

www.cliffordchance.com

Clifford Chance, 31 West 52nd Street, New York, NY 10019-6131, USA

© Clifford Chance 2023

Clifford Chance US LLP

If you do not wish to receive further information from Clifford Chance about events or legal developments which we believe may be of interest to you, please either send an email to nomorecontact@cliffordchance.com or by post at Clifford Chance, 31 West 52nd Street, New York, NY 10019-6131, USA.

Abu Dhabi • Amsterdam • Barcelona • Beijing • Brussels • Bucharest • Casablanca • Delhi • Dubai • Düsseldorf • Frankfurt • Hong Kong • Houston • Istanbul • London • Luxembourg • Madrid • Milan • Munich • Newcastle • New York • Paris • Perth • Prague • Riyadh • Rome • São Paulo • Shanghai • Singapore • Sydney • Tokyo • Warsaw • Washington, D.C.

AS&H Clifford Chance, a joint venture entered into by Clifford Chance LLP.

Clifford Chance has a best friends relationship with Redcliffe Partners in Ukraine.