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SDNY Rules Ripple's XRP Token Was – and Was Not – a Security

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On July 13, 2023, US District Judge Analisa Torres of the US District Court for the Southern District of New York ruled that Ripple Labs' token, XRP, was a security when sold to institutional investors and not a security when sold to retail investors using digital asset exchanges or when used for service providers.

Judge Torres's analysis in *Securities and Exchange Commission v. Ripple Labs, Inc.* relied on the Supreme Court's *Howey* test, which outlines the standard for an investment contract and, therefore, a security under federal securities laws. Judge Torres rejected many of the novel arguments made by Ripple but ultimately decided in its favor, except for one category of token sales. This alert looks solely at the court's analysis of XRP as an investment contract.

In *SEC v. W.J. Howey Co.*, the Supreme Court stated that "an investment contract for purposes of the Securities Act [of 1933] means a contract, transaction or scheme." In analyzing whether XRP, a digital asset, was an investment contract, Judge Torres looked at the economic reality and totality of circumstances surrounding each offer and sale of the underlying asset. The subject itself is not necessarily a security, but how it is used in the circumstances determines whether it meets the *Howey* requirements.

The *Howey* test consists of three criteria that must be met for an investment contract to be considered a security:

1. It must be an investment of money.
2. The investment must be in a common enterprise.
3. There must be an expectation of profits derived primarily from the efforts of others.

Background

The SEC commenced its action against Ripple on December 22, 2020, alleging that the company engaged in various sales and distributions of XRP in violation of Section 5 of the Securities Act. The sale and distribution of XRP by Ripple fit into three categories between 2013 and 2020:

1. "Institutional Sales," which were primarily to institutional buyers, hedge funds and on-demand liquidity customers, pursuant to written contracts for which Ripple received $728 million in proceeds.
2. "Programmatic Sales," which were blind bid/ask transactions on digital asset exchanges for which Ripple received $757 million in proceeds.
3. "Other Distributions," which were a form of payment for services under written contracts for which Ripple recorded $609 million in "consideration other than cash."

The offers and sales of XRP by two of Ripple's executives – Christian Larsen (former CEO and current executive chairman) and Bradley Garlinghouse (current CEO) – were categorized as "Programmatic Sales," which totaled $450 million and $150 million, respectively.

The decision

Before the court were the parties' cross-motions for summary judgment. We've outlined the court's conclusions below.

1. Ripple's 'Institutional Sales' of XRP constituted unregistered offer and sale of investment contracts in violation of Securities Act Section 5

First, the court rejected the defendant's argument that "all investment contracts must contain three 'essential

ingredients': (1) 'a contract between a promoter and an investor that establishe[s] the investor's rights as to an investment,' which contract (2) 'impose[s] post-sale obligations on the promoter to take specific actions for the investor's benefit' and (3) 'grant[s] the investor a right to share in profits from the promoter's efforts to generate a return on the use of investor funds.' "

The court looked at the economic reality and totality of circumstances surrounding the offers and sales of XRP to institutional buyers and concluded that they constituted investment contracts. The court found that the institutional buyers had made an investment of money. Applying the horizontal commonality test, the court found they had done so in a common enterprise because the institutional investors' assets were pooled, and their fortunes were tied to the fortunes of other investors and the success of the enterprise. Finally, the court found that the institutional investors had a reasonable expectation of profits to be derived from the efforts of Ripple.

2. Ripple's 'Programmatic Sales' of XRP didn't constitute offer and sale of investment contracts

The court found that the "Programmatic Sales" did not satisfy *Howey*'s third prong because such buyers could not reasonably have expected that Ripple would use the proceeds of the sales to improve the XRP ecosystem and thereby cause an increase in the price of XRP. Citing *SEC v. Telegram Group Inc.*, the court stated that this inquiry turns on the "promises and offers made to investors" and not each buyer's motivation, making the blind bid/ask aspect of the transactions a key consideration. Ripple did not make any promises or offers because it did not know who was buying the XRP, and the purchasers did not know who was selling it. Even if the motive was to turn a profit, these buyers "did not derive that expectation from Ripple's efforts (as opposed to other factors, such as general cryptocurrency market trends)" for that same reason. The court further differentiated the "Programmatic Sales" from "Institutional Sales" based on the sophistication of the buyers and other factors, such as the contractual provisions and promotional materials relating to the "Institutional Sales."

3. Ripple's 'Other Distributions' didn't constitute offer and sale of investment contracts

"Other Distributions" did not satisfy *Howey*'s first prong requiring an "investment of money" as part of the transaction or scheme. The court, citing *International Brotherhood of Teamsters v. Daniel*, stated that a buyer must give up some "tangible and definable consideration" in exchange for the security. Here, the record showed an inverse of this relationship, where Ripple paid out XRP to the service providers and never received payments from those XRP distributions.

Significance

Although this decision likely will be appealed, it provides stakeholders with a fresh perspective on the offer and sale of digital assets.

Companies with ongoing commercial projects now have support for the position that not all digital assets are securities. To avoid the characterization of a token as a security, a token issuer would nonetheless still have to ensure that the sale does not satisfy the *Howey* elements, similar to the analysis the court went through with the "Programmatic Sales" and "Other Distributions" of XRP. If the project is raising money in a manner similar to the "Institutional Sales," securities laws limitations would likely apply, at least until such time as there is rulemaking or legislation providing otherwise.

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