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SEC v. Ripple

March 11, 2021

On December 22, 2020, the Securities and Exchange Commission filed a complaint in the Southern District of New York (*SDNY*) against Ripple Labs, Inc., and Ripple executives Bradley Garlinghouse and Christian A. Larsen in their individual capacities.[1]

The complaint alleges that (i) the defendants engaged in unregistered sales of securities in violation of Sections 5(a) and 5(c) of the Securities Act of 1933 through repeated sales of the XRP token dating back as far as 2013, and (ii) Larsen and Garlinghouse aided and abetted Ripple's unregistered sales of securities, dating as far back as 2013 and 2015 respectively, by taking actions such as deciding when and how much XRP Ripple would sell, establishing an escrow account holding most of Ripple's XRP to assuage investor concerns about sales,[2] making promotional statements about XRP and taking other actions intended to increase demand from XRP. The SEC did not allege that any fraud on investors occurred, but detailed how the defendants timed their sales of XRP leveraging asymmetric information.[3] The SEC asked the SDNY (the same federal district that recently heard the cases against both Telegram[4] and Kik[5]) to permanently enjoin the defendants from violating Sections 5(a) and 5(c), to disgorge ill-gotten gains and impose civil monetary penalties, as well as to ban the defendants from participating in any future offering of digital asset securities.

On January 29, 2021, Ripple – represented by a former chair of the SEC – filed its answer with the SDNY.[6] Ripple denied the SEC's allegations stating it had "never offered or sold XRP as an investment." Ripple noted how "XRP holders do not acquire any claim to the assets of Ripple, hold any ownership interest in Ripple, or have any entitlement to share in Ripple's future profits." Further, Ripple argued that "What limited contracts Ripple did enter into with sophisticated, institutional counterparties were not investment contracts, but standard purchase and sale agreements with no promise of efforts by Ripple or future profits." According to the answer, Ripple therefore "has no relationship at all with the vast majority of XRP holders today, nearly all of whom purchased XRP from third parties on the open market."

Ripple concluded that "the SEC's theory in the Complaint would read the word 'contract' out of 'investment contract,' and stretch beyond all sensible recognition the Supreme Court's test for determining investment contracts in *SEC v. W.J. Howey Co.*, 328 U.S. 293 (1946). Ripple never held an ICO, never offered future tokens to raise money, and has no contracts with the vast majority of XRP holders."

Background on Ripple's alleged unregistered securities offerings

Ripple was founded in San Francisco in 2012 and describes itself as a "privately-held payments technology company that uses blockchain innovation (including XRP) to allow money to be sent around the world instantly, reliably, and more cheaply than traditional avenues of money transmission."[7] In December 2012, the total supply of 100 billion XRP on the Ripple protocol was created, and 80 billion XRP was transferred to Ripple, with the remaining 20 billion XRP transferred to three early employees.[8]

The complaint details how as far back as February 8, 2012, and October 19, 2012, Ripple received two legal memos from an international law firm which warned "there was some risk that XRP would be considered" an "investment contract."[9] Ripple contends this assertion arguing in part "that any reasonable reader of the true and accurate contents of the memorandum dated October 19, 2012 would understand that counsel's ultimate conclusion was that Ripple Credits (as described) did not constitute 'securities' under

the federal securities laws."[10]

According to the complaint, the unregistered securities offerings began in August 2013 with the sales of XRP in exchange for fiat currencies or digital assets. The SEC further alleged that these unregistered sales continued until 2017 when they accelerated as Ripple faced increasing operational costs and limited alternative sources of revenue.

According to the SEC's complaint, from 2014 through the end of 2019, Ripple sold at an aggregate of 3.9 billion XRP to purchasers in the open market for a total of approximately $763 million. Ripple conducted the market sales by first transferring the XRP to investors and later using traders to offer and sell XRP to investors. The complaint alleges that Garlinghouse and Larsen personally participated in these market sales and profited by approximately $600 million.

According to the SEC's complaint, from 2013 through the end of the third quarter of 2020, Ripple sold at least 4.9 billion XRP to investments funds, wealthy individuals or other sophisticated investors for approximately $624 million. The complaint notes that XRP II, LLC, a NY limited liability company and wholly owned subsidiary of Ripple was the entity through which Ripple sold most of the XRP in institutional sales at discounts ranging from 4% to 30% off market price. XRP II is registered as an MSB with FinCEN and has a BitLicense from NYDFS.

Further, the complaint alleges that Ripple exchanged XRP for non-cash consideration, such as labor or market-making services, which had the goal of achieving widespread distribution of XRP. Starting in 2013, Ripple began to distribute XRP through "bounty programs" that paid programmer for reporting problems with the Ripple protocol's code.[11]

Observations

Looking backward, one of the notable aspects of the complaint is its timing. According to the SEC, Ripple violated the Securities Act through repeated unregistered offerings of securities dating back to 2013, yet the SEC's complaint was filed more than seven years after. In its answer, Ripple noted that "The SEC filed this Complaint 8 years after XRP was created, 5 years after the DOJ and FinCEN characterized XRP as a virtual currency, and after more than 2½ years of investigation during which the SEC allowed Defendants to continue to distribute XRP, allowed the XRP open market to grow, and allowed millions of market participants to rely on the free and efficient functioning of that market."

Notwithstanding any potential final outcome for the litigation, the impacts of the SEC's complaint have been immediate. As Ripple noted in its answer, "the Complaint's mere filing has caused immense harm to XRP holders, cutting the value of their holdings substantially and causing numerous exchanges, market makers, and other market participants to cease activities in XRP." As of the publication of this alert, XRP continues to be delisted by many crypto exchanges, leaving the people the SEC purportedly protects without an avenue to liquidate their positions.

Looking forward, the SEC's case against Ripple, Garlinghouse and Larsen has the potential to establish additional meaningful precedent for the application of securities laws to the sale of digital assets. One important aspect of the dispute that the SEC under Gary Gensler's possible new leadership and the SDNY will need to grapple with is the potential remedy for the defendants' alleged violations. The SEC has previously pointed to settlements that required the issuers of unregistered securities to offer rescission to the purchasers of the digital assets as frameworks to follow for remediation.[12] However, requiring Ripple to offer rescission for all of its sales of XRP could have catastrophic consequences for Ripple the company and XRP, as well as present an administrative nightmare. Demanding that Ripple register XRP as a security could offer a path forward, but would present immediate frictions that could be insurmountable. In its answer, Ripple acknowledges the wide-ranging implications that would flow from XRP being denominated a "security," arguing "that utility depends on XRP's near-instantaneous and seamless settlement in low-cost transactions. Treating XRP as a security, by contrast, would subject thousands of exchanges, market-makers, and other actors in the gigantic virtual currency market to lengthy, complex and costly regulatory requirements"[13]

Notes

1. The complaint is **available here**.
2. In **its answer**, Ripple "admits that on May 16, 2017, Ripple announced that it would place 55 billion XRP into an escrow on the XRP Ledger, and thereafter implemented the escrow of that XRP."
3. In its answer, Ripple argued that "The Complaint alleges information asymmetries as between Ripple and XRP holders in vague, non-specific terms, but it fails to identify any material information asymmetries and omits Ripple's detailed quarterly reports about Ripple's activities in the XRP market. Nor could any such purported information asymmetries, even if present, transform the sale of a digital asset into a securities offering."
4. *SEC v. Telegram Group Inc.*, No. 1:19-cv-09439-PKC (S.D.N.Y. March 24, 2020) (opinion and order granting preliminary injunction).
5. *SEC v. Kik Interactive Inc., 19-cv-05244-AKH* (S.D.N.Y. June 4, 2019) (opinion and order granting motion for summary judgment in favor of the SEC).
6. Answer
7. Answer
8. In its answer, Ripple "admits, upon information and belief, that 20 billion XRP in total was retained by Mr. Larsen, Co-Founder, and Ripple Agent-1 and never transferred to Ripple."
9. Complaint
10. Answer
11. In its answer, Ripple "admits that Ripple made certain payments in XRP as a virtual currency substituting for fiat currency through a bug bounty program in 2013 and 2014."
12. In the matter of CarrierEQ, Inc., d/b/a AirFox, **Order Instituting Cease-and-Desist Proceedings Pursuant to Section 8A of the Securities Act of 1933** (Nov. 16, 2018); In the matter of Paragon Coin, Inc., **Order Instituting Cease-and-Desist Proceedings Pursuant to Section 8A of the Securities Act of 1933** (Nov. 16, 2018).
13. Answer

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