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Landmark Decision in *SEC v. Ripple Labs*: Digital Assets Are Not Inherently Securities

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On July 13, 2023, the United States District Court for the Southern District of New York granted in part and denied in part the parties' cross motions for summary judgment in a highly anticipated *Ripple Labs* decision.

Overall, the decision is widely regarded as a victory for the digital asset community. Most significantly, the Court determined that XRP was not inherently a security and that two of the three categories of "offerings" of XRP by Ripple at issue were not "investment contacts" and therefore not securities offerings. While the Court noted that it was not expressly opining on "secondary market sales" of XRP, the impact of the Court's reasoning on secondary market transactions is manifest—and leaves many to question whether, under the logic of the decision, any secondary market trading of digital assets would qualify as securities trading activity.

The timing of the Court's decision is vital given that the SEC and private litigants are advancing many lawsuits and enforcement actions premised on a theory that is now being called into question by one of the nation's most significant courts.

On December 20, 2020, the SEC sued Ripple and certain of its officers alleging that by issuing and distributing XRP, the defendants engaged in the unlawful issuance and sale of unregistered securities in violation of Sections 5(a) and 5(c) of the Securities Act of 1933. The SEC also alleged that Ripple's current and former CEO "aided and abetted" Ripple's alleged Section 5 violations. The parties filed cross-motions for summary judgment.

The Court 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." This holding is significant because the SEC appears to have taken the view—somewhat inconsistently over time—that if a digital asset is initially offered in a security transaction, the digital asset itself is a security. In rejecting this position, the Court suggests that asking whether a digital asset is a security is the wrong question. Instead, the question is whether the digital asset was offered in an investment contract based on "economic reality" and the "totality of circumstances."

Accordingly, the Court examined "the totality of circumstances surrounding Defendants' different transactions and schemes involving the sale and distribution of XRP," which included the following categories:

- Institutional sales of XRP to sophisticated individuals and entities (the "Institutional Buyers") pursuant to written contracts;

- Programmatic sales to public buyers (“Programmatic Buyers”) through trading algorithms on digital asset exchanges; and
- Other distributions as payments for services, such as distributions to employees as compensation and to third parties as part of Ripple’s initiative to develop new applications.

The Court analyzed these categories of sales separately under the Supreme Court’s Howey test, which provides that 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.” SEC v. W.J. Howey Co., 328 U.S. 293, 289-99 (1946).

In doing so, the Court rejected Defendants’ argument that, in addition to the Howey test, all investment contracts must contain “three essential ingredients” that center around post-sale obligations. Defendants relied primarily on the theory that courts should look to pre-1933 state “blue sky” laws cases on which the Howey Court relied. The Court held that Defendants’ theory goes beyond the “plain words of Howey.” However, the Court explicitly stated that it **did not reach the question** of whether “a contract must exist for an investment contract to exist.”

Addressing each category of XRP sales, the Court first held that the institutional sales of XRP to Institutional Buyers constituted the unregistered offer and sale of investment contracts because all three of the Howey elements were established. Of particular note, in determining whether there existed horizontal commonality in institutional sales of XRP, the Court focused on the fact that Ripple did not “segregate[] and separately manage[]” investor funds or “allow[] for profits to remain independent” and that Ripple’s accountants recorded all of its XRP-related proceeds together.

Second, the Court found that Ripple’s programmatic sales **did not** constitute the offer and sale of investment contracts because they did not meet the third prong of the Howey test. In distinguishing between institutional and programmatic sales, the Court stated that “[w]hereas 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 would not reasonably expect the same.” The Court emphasized that 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 seller of XRP. The Court also noted that the Programmatic Sales constituted only 1% of the global XRP trading volume, and therefore, the majority of individuals who purchased XRP from digital assets exchanges did not invest their money in Ripple. In what is certainly viewed as one of the most consequential holdings of the decision, the Court concluded that “the 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.” However, the Court noted in a footnote that its holding does not address the broader question of whether secondary sales of XRP constitute offer and sales of investment contracts because that question was not properly before the Court.

Third, the Court held that other distributions under written contracts, including distributions to employees as compensation and to third parties as part of Ripple’s initiative to develop new applications did not constitute the offer and sale of investment contracts. The Court reasoned that these distributions did not satisfy the first prong of the Howey test because the recipients did not pay money or “some tangible and definable consideration” to Ripple. The Court also highlighted that, as a factual matter, there is no evidence that Ripple funded its projects by transferring XRP to third parties and then having them sell the XRP because Ripple never received the payments from these XRP distributions.

Although the decision is generally viewed as a victory for the digital asset community, there remains a strong possibility of appeal. It is noteworthy that some exchanges have resumed the sale of XRP and other digital assets based on the Court’s decision. The decision has also brought renewed calls for Congress to pass legislation clarifying the status of digital assets.

Winston & Strawn’s Digital Assets & Blockchain Technology Group is closely monitoring these developments. We will provide our clients and friends of the firm with more information on this topic as it becomes available.

Summer Associate Hamza Rashid also contributed to this briefing.

Watch the webinar on the decision here.

Read the team's insights on the decision in *The National Law Journal*, *Bloomberg*, and PYMTS.

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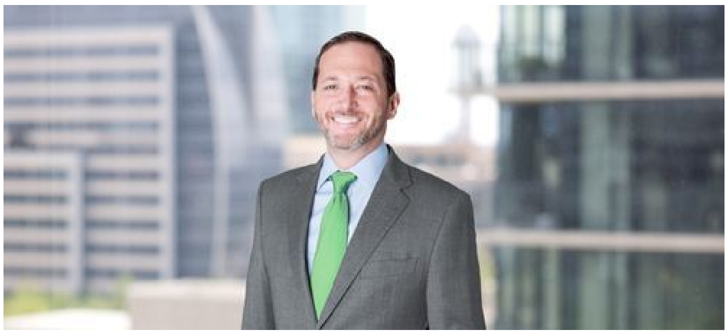

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