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Not Today, Gary: Court Says XRP is Not a Security

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What You Need To Know:

- **XRP is not a security.**
- **Multiple cryptocurrency exchanges, including Coinbase and Kraken, immediately relist XRP.**
- **The Order affords venture capital investors and various blockchain projects an opening to continue developing innovative financial solutions and token offerings within the U.S.**

On July 13, Judge Analisa Torres, district judge for the United States District Court for the Southern District of New York, issued a substantial order (the Order) on cross motions for summary judgment in the *U.S. Securities and Exchange Commission v. Ripple Labs* case (*SEC v. Ripple*), which breathed new life into the cryptocurrency ecosystem.

Buried within the legal and procedural language of the Order, Torres declared 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." Translation–XRP is not a security.

While the Order addressed a number of issues, the key takeaway is that a digital asset like XRP may be a commodity on its own, especially when traded on centralized or decentralized exchanges. However, the same digital asset may be deemed a security depending on how and to whom it is sold or distributed.

In its motion for summary judgment, the SEC alleged three categories of unregistered sales of XRP:

- Sales to institutional investors using purchase agreements that included lockup periods, resale restrictions, and indemnification clauses;
- Programmatic sales (i.e., digital asset exchange sales) that involved blind bid/ask transactions where neither the buyer nor the seller knew of the other's identity; and
- Other distributions–distributions to employees and third parties as compensation for services rendered

The court's Order addressed each of the SEC's categorical allegations in turn, and it ruled whether each method of distribution or sale constituted the unregistered offer or sale of investment contracts in violation of Section 5 of the Securities Act of 1933. In ruling on the allegations, the Order applied the facts and circumstances of each method of distribution or sale to the *Howey* test factors, the long-standing test defining what constitutes an investment contract. In *Howey*, an investment contract is a contract, transaction, or scheme whereby a person (1) invests their money (2) in a common enterprise and (3) is led to reasonably expect profits solely from the efforts of a promoter or a third party.

Institutional Sales:

Ripple's institutional sales were sales of XRP to "sophisticated individuals and entities." The Order found that the institutional sales constituted the unregistered offer and sale of investment contracts in violation of Section 5 of the Securities Act. The Order found that the first two prongs of the *Howey* test were rather easily met. However, the Order focused heavily on the third prong, i.e., whether the institutional buyers of XRP were led to expect profits solely from the efforts of a third party, in

this case, Ripple. In finding the third prong met, the Order cited various marketing materials and other advertisements from Ripple to institutional investors, which created the expectation that an investment in XRP was an investment in Ripple.[1] Therefore, the court found that institutional buyers "would have purchased XRP with the expectation that they would derive profits from Ripple's efforts."[2] Based on the economic reality of the sales and the totality of circumstances surrounding the sales, the court found that the institutional sales of XRP constituted the unregistered sale of investment contracts.

Programmatic Sales:

The programmatic sales of XRP differed from the institutional sales in that the programmatic sales occurred on digital asset exchanges with public buyers. The court focused almost exclusively on the third prong of *Howey* and found that the programmatic sales *did not* constitute unregistered offers and sales of investment contracts. In reaching its conclusion, the court reasoned that the public, exchange purchasers of XRP, did not expect profits based on the efforts of Ripple, particularly because they did not know they were buying XRP *from* Ripple. Instead, because the programmatic sales of XRP were facilitated using a blind bid/ask order book, the programmatic purchasers were not aware whether they were "investing" in Ripple. Importantly though, the court noted that the programmatic purchasers could have and may have expected profits from their purchase of XRP; however, "they did not derive the expectation of profits from Ripple's efforts" because they were not aware they were purchasing XRP from Ripple, and thus, they were not investing in Ripple with an expectation of profits from Ripple's efforts. Thus, the court was able to conclude that the programmatic sales, or blind bid/ask sales of XRP on exchanges, did not constitute the offer and sale of investment contracts.

Other Distributions:

The other distributions alleged by the SEC included distributions to employees as compensation and to third parties as part of Ripple's initiative to develop new applications for XRP and the XRP Ledger. The court concluded that the other distributions did not constitute unregistered offers and sales of investment contracts. The court noted that the other distributions failed to satisfy *Howey*'s first prong–the investment of money. Under *Howey*, courts have held that in order for there to be an "investment of money," investors must "provide the capital, put up their money," or "provide cash." The employees and companies that received XRP did not "pay money," and Ripple did not receive payment from these XRP distributions.[3]

Takeaway:

While acknowledging the Order will likely be appealed to the Second Circuit by both parties, it is nonetheless a win for the entire crypto economy, injecting a powerful and much-needed element of rationality and restraint into the crypto regulatory landscape.

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[1] The Order noted that certain marketing materials explicitly linked the success of XRP to the success or Ripple.
[2] Further supporting the court's position was the nature of the sales and the use of purchase agreements (which included typical private placement language, including lockup periods, indemnification clauses, and representations that the purchaser was not buying XRP for purposes of reselling or distribution).
[3] Note: this is a deviation from the SEC's "Framework for 'Investment Contract' Analysis of Digital Assets" which states that "the lack of monetary consideration . . . does not mean that the investment of money prong is not satisfied." The court here did not consider whether other consideration (e.g., services) can satisfy the "investment of money" prong of the *Howey* test.

Contacts

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