

## XRP, Ripple, and other Cryptocurrencies as Securities

Days before Christmas in 2020, the cryptocurrency market was thrown into a state of turmoil when the SEC filed a lawsuit against Ripple Labs alleging that the company's associated cryptocurrency token, XRP, was a security.<sup>1</sup> After two and a half years of litigation, a ruling was made in July of 2023 presenting Ripple with a partial victory, holding most sales of XRP to not be a security.<sup>2</sup> Despite this outcome, questions remain regarding the future of cryptocurrency due to unclarity in the court's decision, recent statements by other courts, and ambiguity on behalf of the SEC. However, by examining the reasoning and outcome of Ripple's lawsuit with the SEC, it is possible to gain further insight into the regulatory future of cryptocurrency and identify some of the most critical, unanswered questions facing the industry.

It is important to explain, for context, that XRP is a cryptocurrency token that Ripple helped create with the aim of bringing blockchain technology to a more mainstream audience.<sup>3</sup> Ripple, who received 80% of the original tokens, has been the central figure in encouraging XRP's adoption.<sup>4</sup> To spur adoption, Ripple has partnered with large banking institutions and created products for businesses that are based on XRP's blockchain.<sup>5</sup>

At issue in *SEC v. Ripple* was Ripple's selling of XRP tokens to institutional investors, its public sale on exchanges, and its distribution of XRP to employees and third parties in exchange for services and increasing XRP's applications. The SEC brought suit under Section 5 of the

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<sup>1</sup> Complaint, *SEC v. Ripple Labs Inc.*, 1:20-cv-10832 (S.D.N.Y. Dec. 22, 2020).

<sup>2</sup> *SEC v. Ripple Labs Inc.*, 2023 WL 4507900 (S.D.N.Y. July 13, 2023).

<sup>3</sup> Sam Kessler, *XRP Blockchain Still Faces Centralization Caveats as Ripple Regulatory Threat Recedes*, COINDESK (Jul. 24, 2023, 11:14 AM), <https://www.coindesk.com/tech/2023/07/19/xrp-blockchain-still-faces-centralization-caveats-as-ripple-regulatory-threat-recedes/>.

<sup>4</sup> *Id.*

<sup>5</sup> *Id.*

Securities Act, which makes it unlawful to sell a security across state lines without first registering the security with the SEC.<sup>6</sup> The SEC alleged that XRP was a type of security known as an investment contract.<sup>7</sup> To determine whether XRP was an investment contract, the court applied the *Howey* test.<sup>8</sup> The *Howey* test is important as it is a three-prong test used by courts to determine whether or not a specific sale or asset is an investment contract, and therefore a security, regardless of whether the sale looks like a conventional security sale.<sup>9</sup> The *Howey* test stipulates that something is an investment contract when it 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.”<sup>10</sup>

The court ruled that the first condition of *Howey* is not, despite the use of the word “invest,” limited to mere investments. Rather, it is met whenever someone pays currency for the asset.<sup>11</sup> Ripple’s selling of XRP to institutional investors, and on exchanges, was therefore deemed sufficient to constitute an investment in this context.<sup>12</sup> The distributions to employees and third parties, however, did not involve money. As a result, the XRP distributed to these groups did not satisfy the first condition of *Howey* and was summarily determined not to meet the necessary conditions to be a security.<sup>13</sup>

The second condition of *Howey*, that of the investment being in a common enterprise, was found by the court to be established simply by the fact that the value of XRP tokens all rose

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<sup>6</sup> SEC v. Ripple Labs Inc., 2023 WL 4507900 at \*1.

<sup>7</sup> *Id.* at 5.

<sup>8</sup> *Id.* at \*5-15.

<sup>9</sup> Framework for “Investment Contract” Analysis of Digital Assets, SEC (Mar. 8, 2023), <https://www.sec.gov/corpfm/framework-investment-contract-analysis-digital-assets>

<sup>10</sup> SEC v. Ripple Labs Inc., 2023 WL 4507900 at 5 (citing SEC v. W.J. Howey Co., 328 U.S. 293, 298 (1946)).

<sup>11</sup> SEC v. Ripple Labs Inc., 2023 WL 4507900 at 8.

<sup>12</sup> *Id.*

<sup>13</sup> *Id.* at 13.

and fell in unison, with additional support being granted by Ripple’s practice of pooling XRP sale proceeds.<sup>14</sup> More consequential was the third condition of *Howey*. The court understood the third condition to be met when the buyers have “a reasonable expectation of profits to be derived from the entrepreneurial or managerial efforts of others.”<sup>15</sup> The court ruled that the XRP sold to public buyers on exchanges did not meet this condition for multiple reasons. First, because the purchasing individuals did not know if they were buying XRP from Ripple, the court felt that the condition was not met. Furthermore, the consumers did not reasonably derive their belief that XRP would gain in value because of promises from the management of Ripple.<sup>16</sup> In contrast to this, the court ruled that the XRP sold directly to institutional investors were purchased on the belief that Ripple would use its capital to fund projects that would increase XRP’s value.<sup>17</sup> As a result, the XRP sales to institutional investors were ruled to be an unauthorized selling of investment contract securities.<sup>18</sup>

It is important to note that the decision regarding Ripple is not a binding authority on future cases. Even so, in the absence of some other change, the cryptocurrency landscape is likely to be shaped and guided by the court’s ruling in the days to come. An important takeaway is that the centralization of XRP in the hands of Ripple seems to have put it at a particular risk for inducing investors into relying on its ability to raise XRP’s value.<sup>19</sup> In the case on hand in

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<sup>14</sup> *Id.* at 8-9.

<sup>15</sup> *Id.* at 9.

<sup>16</sup> *Id.* at 11-12.

<sup>17</sup> *Id.* at 10-11.

<sup>18</sup> *Id.* at 11.

<sup>19</sup> See generally Sam Kessler, *XRP Blockchain Still Faces Centralization Caveats as Ripple Regulatory Threat Recedes*, COINDESK (Jul. 24, 2023, 11:14 AM), <https://www.coindesk.com/tech/2023/07/19/xrp-blockchain-still-faces-centralization-caveats-as-ripple-regulatory-threat-recedes/>.

particular, the fact that the success of the token is linked with the success of the company was always going to make separating the two very difficult.

A close review of the decision, and the *Howey* test more generally, suggests that sales of largely decentralized currencies appear to be safe, at least for the time being, from being declared a security. The clearest example of this is Bitcoin. Bitcoin, while potentially bought for use in speculation, does not fit the third prong of *Howey* of having an expectation of profit based on the efforts of any particular other entity.<sup>20</sup> This is particularly true given how courts have read efforts of others to have the meaning of managerial or entrepreneurial efforts.<sup>21</sup> Being that Bitcoin's creator is unknown and inactive, it would be nearly impossible to make the claim that they induced reasonable people to buy on the expectation that they intend to do anything to change Bitcoin's price.<sup>22</sup> Perhaps as a result of this logic, the head of the SEC Gary Gensler has openly stated that the SEC views Bitcoin as a commodity instead of a security.<sup>23</sup>

Ripple's partial victory, and the court's stringent application of the *Howey* test, is also likely to be a positive sign for the many other cryptocurrencies that have some decentralized aspects. An example of this would be with the cryptocurrency Ethereum. While the SEC has refused to say whether it believes Ethereum, the second largest cryptocurrency by market cap, has been sold as a security, it seems unlikely that the SEC could press a case against it successfully.<sup>24</sup> Though it is true that the non-profit Ethereum Foundation has publicly worked to

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<sup>20</sup> SEC v. W.J. Howey Co., 328 U.S. 293, 298 (1946)

<sup>21</sup> SEC v. Ripple Labs Inc., 2023 WL 4507900 at \*9 (S.D.N.Y. July 13, 2023).

<sup>22</sup> See Adam Hayes, *Who is Satoshi Nakamoto?*, INVESTOPEDIA (May 21, 2023), <https://www.investopedia.com/terms/s/satoshi-nakamoto.asp>.

<sup>23</sup> Landon Manning, *SEC's Gensler Warns Crypto Investors but Differentiates Bitcoin*, NASDAQ (Mar. 6, 2023, 12:16 PM), <https://www.nasdaq.com/articles/secs-gensler-warns-crypto-investors-but-differentiates-bitcoin>.

<sup>24</sup> See Turner Wright, *Gary Gensler Refuses to Answer if ETH is a Security: SEC Hearing*, COINTELEGRAPH (Apr. 18, 2023), <https://cointelegraph.com/news/us-house-committee-chair-repeatedly-presses-sec-chair-is-ether-a-commodity-or-a-security>

help increase Ethereum’s adoption, guide new projects, and support the blockchain, it has also made clear that it does not exercise particular control or lead over Ethereum.<sup>25</sup> Even more poignantly, while the Ethereum Foundation does sell coins to fund Ethereum projects, it does not have the same record of contracting to sell to investors. This is different from the situation with Ripple, as the Ethereum Foundation is not selling the coins to specific institutions to hold as something that will increase in value. So long as the Ethereum Foundation maintains that it is not the center or manager of Ethereum, the Ethereum Foundation most likely cannot be said to be making any of the prerequisite promises or offers necessary to lead to the expectations of profits.

Despite the ruling in the case of *Ripple*, the possibility has reemerged that courts could find companies culpable for selling cryptocurrencies on an exchange. This year, another court in the Southern District of New York refused to dismiss claims against the company Terraform Labs after finding that the SEC met the requirements to probably prove that Terraform violated the third condition of *Howey*.<sup>26</sup> The case in regard to Terraform is somewhat unique in that the company continued to tout that their UST coins could be entered into an “Anchor protocol” that would accrue interest at a high rate because of the management experience of the founders.<sup>27</sup> The court said that, in this case, the Anchor protocol and Terraform’s explicit pushing for people to buy and invest more of their UST, makes it potentially irrelevant that the coins are being sold to the public without buyers necessarily being aware they are transacting with the company instead of third party sellers.<sup>28</sup>

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<sup>25</sup> *About the Ethereum Foundation*, ETHEREUM FOUNDATION, <https://ethereum.org/en/foundation/> (last visited Oct. 6, 2023).

<sup>26</sup> SEC v. Terraform Labs PTE., 2023 WL 4858299, at \*14-15 (S.D.N.Y. July 31, 2023).

<sup>27</sup> *Id.* at 2, 14.

<sup>28</sup> *Id.* at 14-15.

Comparing the ruling in *Ripple* to that in *Terraform* brings to the forefront that there remains significant ambiguity as to several key issues. The judge in the case with *Terraform* explicitly rejected arguments regarding a difference in applying *Howey* to direct transactions with the company versus potential third market transactions with a variety of sellers.<sup>29</sup> While it may seem then that the ruling in *Ripple* is under threat, that is not necessarily the case. After *Terraform*'s move to dismiss was rejected, the judge in the *Ripple* case rejected a contention that the rulings were in conflict and instead said that the motion to dismiss in the *Terraform* case was denied because in that motion the judge, "was required to accept all reasonable inferences in the regulators favor."<sup>30</sup>

While the ruling and statement by the judge in the case of *Ripple* seem to point to public sales on exchanges being safe, for the time being, from being labeled a securities sale, whether or not this understanding will be upheld and adopted in the future is still uncertain. Further rulings on if specific circumstances can cause a public exchange sale to violate the third leg of *Howey* is something that will have market defining impact for the entire cryptocurrency community. In addition to this, what words or actions constitute enough for, "a reasonable expectation of profits to be derived from the entrepreneurial or managerial efforts of others" is still unclear.<sup>31</sup> While a final decision in the *Terraform* case may help to add clarity to the situation, the lack of a binding precedent on the issue leaves many questions still to be answered.

The decision regarding *Ripple* is undoubtedly positive for many entities in the cryptocurrency space. The ruling is especially likely to be positive for those organizations

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<sup>29</sup> *Id.* at 15.

<sup>30</sup> Jonathan Stempel, *US SEC Cannot Appeal Ripple Labs decision, Judge Rules*, REUTERS (Oct. 4, 2023), <https://www.reuters.com/legal/us-sec-cannot-appeal-ripple-labs-decision-judge-rules-2023-10-04>.

<sup>31</sup> SEC v. Ripple Labs Inc., 2023 WL 4507900 at \*9 (S.D.N.Y. July 13, 2023).

associated with decentralized currencies as well as for the cryptocurrency exchanges that the SEC has filed suit against. However, until more rulings and guidance are released, large actors in the cryptocurrency space seem destined to find themselves in uncertain new territory.