RIPPLE CASE: A PARTIAL WIN AGAINST SEC? KEY TAKEAWAYS FROM THE JUDGEMENT

The long anticipated summary judgement for Securities and Exchange Commission v Ripple Labs, Inc., Bradley Garlinghouse and Christian A. Larsen[1] (the "**Ripple Case**"), was granted on 13 July 2023 by the United States District Court Southern District of New York (the "**Court**") with respective to the Securities and Exchange Commission's (the "**SEC**") complaints against Ripple Lab Inc. ("**Ripple**"), Bradley Garlinghouse and Christian A. Larsen (together "**Garlinghouse and Larsen**"), who are the founders of Ripple, that their sales of XRP[2] amounts to sale of "security".

The Ripple Case has attracted high level of attention because XRP is one of the largest cryptocurrencies by market capitalisation of over US$37billion[3] and Gensler, the Chairman of SEC, has only recently expressed that many crypto financial assets have the characteristics of securities, implying inclusive of Ether.[4] It is then recently reported that SEC requested Coinbase to halt trading in every cryptocurrency except Bitcoin.[5] Thus, the decision in this case has significant regulatory implications for the United States, and subject to appeal, to provide greater certainty for investors, companies and projects which are considering issuing tokens in the future.

Background

In 2020, the SEC alleged that Ripple raised more than US$1.3 billion in 2013 by selling XRP in an unregistered security offering to investors. Ripple has denied the allegation and eventually proceeded the dispute to federal court.

Ripple owned between 50 and 80 billion XRP at all times before the end of 2020, and from 2013 through the end of 2020, engaged in various sales and distributions of XRP. These included (i) sales directly to institutional buyers, hedge funds, and "on demand liquidity" customers[6] ("**Institutional Sales**"), (ii) sales on digital asset exchanges through trading algorithms ("**Programmatic Sales**"), and (iii) distributions of XRP as payment for services and as employee compensations ("**Other Distributions**"). Ripple used the proceeds to fund its operations, and Garlinghouse and Larsen also sold XRP individually, making at least US$450 million and US$150 million in profit respectively.

The SEC alleges that since 2013, Ripple engaged in extensive marketing efforts to promote XRP as an investment opportunity, and that Ripple and its senior management made statements, including through brochures, social media, interviews, and public blog posts. Ripple also prepared and distributed documents that describe the Ripple's operations, the XRP trading market, and the XRP Ledger. Ripple's senior leaders used various social media platforms to communicate about

[1] 20 Civ. 10832 (AT), issued by the United States District Court Southern District of New York.
[2] XRP is a digital token created and managed by Ripple Labs to facilitate transactions on the Ripple network for cross-border payments and remittances.
[3] Figures as at 31 July 2023.
[4] Forbes, "SEC Chairman Gary Gensler Implies that Ether is a Security and Falls Under His Jurisdiction", found on https://www.forbes.com/sites/mariagraciasantillanalinares/2022/06/27/sec-chairman-gary-gensler-implies-that-ether-is-a-security-and-falls-under-his-jurisdiction/?sh=69aad6fe7775
[5] Financial Times, "SEC asked Coinbase to halt trading in everything except bitcoin, CEO says", found on https://www.ft.com/content/1f873dd5-df8f-4cfc-bb21-ef83ed11fb4d
[6] A feature of RippleNet which facilitates cross-border transactions by allowing customers to exchange fiat currency (for example, U.S. dollars) for XRP and then the XRP for another fiat currency (for example, Mexican pesos).

XRP and Ripple, and participated in interviews and conferences to discuss Ripple's operations and the XRP market (collectively, the "**Marketing Campaign**").

In a legal memorandum issued from an international law firm which analysed the legal risks associated with selling XRP which stated that, although the law firm considers that the XRP tokens did not constitute securities under federal securities laws, there was a small risk that the SEC might disagree with the analysis. Larsen testified that after receiving the memorandum, Ripple took specific steps to ensure compliance in accordance with the advice contained from the memorandum.

Certain Key Findings in the Summary Judgement

The SEC specifically claimed that the sales of XRP was an "investment contract" under Section 5 of the U.S. Securities Act of 1933 ("**US Securities Act**") which is determined by the *Howey* Test[7] that has three prongs[8]:-

1. there must be an investment of *money* ("**1st Prong**");
2. the investment must be in a *common enterprise* ("**2nd Prong**"); and
3. there must be an *expectation of profits* to be derived from the *entrepreneurial or managerial efforts of others* ("**3rd Prong**").

Institutional Sales do constitute sale of securities. For the Institutional Sales, the 1st Prong and 2nd Prong are satisfied without too much to dispute. The Court found that the 3rd Prong is satisfied due to (i) the Marketing Campaign was pitching and that buyers ("**Institutional Buyers**") would have understood a speculative value proposition for XRP with potential profits to be derived from Ripple's entrepreneurial and managerial efforts; and (ii). that Ripple sold XRP as an investment because the Institutional Buyers have agreed to lockup provisions or resale restrictions based on XRP's trading volume ("**Lockup Provisions**"), which they would not have so agreed if they intended for consumptive use of XRP.

Programmatic Sales do not constitute sale of securities. Buyers of Programmatic Sales ("**Programmatic Buyers**") were blind bid/ask transactions ("**Blind Bid/Ask Transactions**"), therefore could not have known if their payments of money went to Ripple, or any other seller of XRP, and that these buyers purchased XRP from digital asset exchanges did not invest their money in Ripple. Programmatic Sales were not made pursuant to contracts that contained Lockup Provisions, indemnification clauses, or statements of purpose, i.e. more inclined to be consumptive use; and the Programmatic Buyers generally are less sophisticated compared to Institutional Buyers and may not appreciate or with the same level of understanding from Ripple's statements, marketing campaign and public statements connecting XRP's price to its own efforts as highlighted by the SEC (which the judgement did not make further examples).

Other Distributions to Ripple employees do not constitute sale of securities. This is because as the recipients (mainly being Ripple's employees) did not pay money or "some tangible and

[7] SEC v. W.J. Howey Co., 328 U.S. 293 (1946).
[8] Certain judges will breakdown the *Howey* Test into four prongs by having "the profits must come primarily from the efforts of others" as the 4th prong.

definable consideration" to Ripple. To the contrary, Ripple paid XRP to these employees and companies. Hence, the 1st Prong is not satisfied, and the Court did not further examine this issue with the rest of the *Howey* Test.

There was factual dispute as to whether the Ripple Founders were aiding and abetting Ripple's violation. It was found that because Garlinghouse and Larsen reviewed and acted upon the legal memorandum that a compelling argument can be made that XRP does not constitute 'security' and XPR is also not regarded as security in other jurisdictions such as Japan[9], Singapore[10], the United Kingdom[11], Switzerland, and UAE. Hence, Garlinghouse and Laren might not have known or recklessly disregarded Ripple's violations. Their respective individual sales were made via means of Programmatic Sales, which are Blind Bid/Ask Transactions. Thus, the Court cannot establish the 3rd Prong as to these transactions.

OUR OBSERVATIONS

Generally, the Ripple Case is not directly applicable to Hong Kong laws as the definition of "collective investment scheme" ("**CIS**") under the Securities and Futures Ordinance, is not the same, though similar, as *Howey* Test, which is normally considered to be more flexible for the US courts to consider the "economic reality and totality of circumstances". Nevertheless, the Ripple Case still provides valuable insights that potential token issues, particularly those to be launched in Hong Kong should take reference from:

(i) Ripple received "money" (instead of cryptocurrencies such as Ether) for the sales of XRP to institutional investors, and therefore fell squarely within the 1st Prong of *Howey* Test. Having said that, the payment type made by the participants in a token offering (in fiat currency or in crypto-currency) may not make a difference under the CIS definition as it catches all types of "contribution".

(ii) Ripple pre-sold the XRP to "institutional investors" who had agreed in the sale contracts to lockup provisions and resale restrictions. This became evidence that the institutional investors did not buy the XRP for utility purposes. This is a strong argument and the Issuer should avoid those lockup provisions and resale restrictions (though commercially it could be understood why this may cause problems).

(iii) The wording used in the Ripple marketing materials and the interviews was too aggressive. They emphasised too much on the investment potential of XRP as a result of Ripple team effort. The wording should have been more neutral providing updates on the new utility features of XRP.

(iv) Ripple continued to connect XRP's price and trading to its own subsequent XRP Market Reports. Ripple should not have traded XRP itself nor mentioned that in the Reports. This is something to be avoided in future token offerings.

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[9] The Block, "Japan's top securities regulator says XRP is not a security", found on https://www.theblock.co/post/90922/japan-fsa-xrp-comments-cryptocurrency

[10] CNBC, "Crypto firm Ripple gets in-principle payments license in Singapore", found on https://www.cnbc.com/2023/06/21/crypto-firm-ripple-gets-in-principle-payments-license-in-singapore.html

[11] Financial Conduct Authority of the United Kingdom, "Consultation Paper CP19/22" released in July 2019, in particular paragraph 2.7 compared XRP with Ether stating "XRP has similar features".

(v) Ripple used the sale proceeds to promote and increase the value of XRP by developing uses of XRP and also protecting the XRP trading market. There were clear records to show that the fortune of these institutional investors were tied to success of Ripple.

(vi) On the other hand, the US Court found that Ripple's Programmatic Sales (which were Blind Bid/Ask Transactions) to the retail investors would not clear enough for a Summary Judgment, mainly because the retail buyers could not have known if their money went to Ripple, and there was no written contract between Ripple and such retail investors. Such retail investors might have expected a profit, but such expectation did not derive from the effort of Ripple team. In the contrary, under HK law, there is no such requirement that the profit exception must derive from the issuer's effort.

It is also interesting to note that the Court did not grant a summary judgment against Ripple founders, Garlinghouse and Larsen, because Ripple obtained a legal memorandum stating that XRP was unlikely to be a security. This serves as an example of how a legal opinion or memorandum and a good lawyer can help an issuer and its founders when facing allegations from regulators at a later stage. Also that Garlinghouse and Larsen have genuine believe that XRP is non-security as this is the case for other major jurisdictions worldwide, including two major common law jurisdictions like the UK and Singapore's financial regulators.

We should also be mindful that the current Ripple Case is **only a summary judgement** that patience is required to avoid pre-mature conclusion(s) being drawn, especially when the SEC has already signaled to appeal[12].

Please do get in touch with our team members at hyu@lylawoffice.com or at (+852) 2115-9525 if you have any views on the above or would like to further discuss any of the issues raised in this Client Alert more generally.

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[12] Bloomberg, "SEC Signals Appeal to Crypto Ripple Ruling in Response to Terra Case", found on https://www.bloomberg.com/news/articles/2023-07-21/sec-signals-appeal-to-crypto-ripple-ruling-in-terra-response?in_source=embedded-checkout-banner