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NY Decision Sparks a Ripple Effect Across the Digital Assets Investment Industry

Key Notes:

- Tokens are not securities, per se.
- Marketing practices bolster finding of unregistered securities sales.
- Court rejects amending *Howey's* 'expectation of profit' prong.

The United States District Court for the Southern District of New York last week granted the Securities and Exchange Commission (SEC) partial summary judgment on the central question of whether the offer and sale of Ripple Lab's native digital token, XRP, could be considered an investment contract, and therefore, the unregistered sale of securities.

While the court, importantly, found that XRP "is not in and of itself" an investment contract, "the totality of the circumstances surrounding [Ripple's] transactions and schemes" supported a finding that unregistered sales of securities did occur. However, the court's decision also included silver linings for the crypto industry by granting Ripple summary judgment on certain practices that did not constitute unregistered securities sales and providing a glimpse into crypto sales approaches that may survive future SEC attacks.

The SEC argued that Ripple engaged in three practices constituting unregistered sales of securities: Institutional Sales, Programmatic Sales and Other Distributions, including XRP sales by Ripple executives. The court's consideration of the parties' cross-motions for summary judgment, however, found that only Ripple's Institutional Sales practices constituted unregistered sales of securities.

Institutional Sales

The court applied the *Howey* test to find that Ripple's Institutional Sales were investment contracts. The Supreme Court in SEC v. W.J. Howey Co., 328 U.S. 293 (1946) held that to determine whether a transaction is an investment contract, a person must: (1) invest his money (2) in a common enterprise and (3) be led to expect profits (4) solely from the efforts of others.

Ripple advanced a "novel" theory, arguing that in addition to the *Howey* test, all investment contacts must *also* contain three "essential ingredients" to be considered an investment contract, that there must also be:

1. "a contract between a promoter and an investor that establish[es] the investor's rights as to an investment," which contract
2. "impose[s] post-sale obligations on the promoter to take specific actions for the investor's benefit" and
3. "grant[s] the investor a right to share in profits from the promoter's efforts to generate a return on the use of investor funds."

The court rejected the "essential ingredients" test, observing that Ripple provided no authority for this test beyond the plain words of *Howey*. Instead, the court found that analyzing the totality of Ripple's marketing and sales conduct, an investment contract existed. Specifically, the court rejected the third prong of Ripple's "essential ingredients" test, which argued that proving the existence of an investment contract required more than Howey's *expectation* of profit element, also requiring proving an investor's contractual *right* to receive a profit.

Programmatic Trading

By contrast, the court declined to find that Ripple's Programmatic Trading constituted an investment contract in violation of Section 5 of the Securities Act because its algorithmic trading platform executed blind transactions which did not create a reasonable expectation of profit, as "Ripple did not know who was buying the XRP, and the purchasers did not know who was selling it."

Other Distributions

The court also declined to find that other distributions constituted investment contracts. Other distributions included those to employees and third parties as compensation as part of Ripple's Xpring initiative designed to develop new applications for XRP and the XRP Ledger and sales by principals.

The court found that Howey requires a showing that the investors "provide[d] the capital" or "gave up some tangible and definable consideration in return for an interest." Since Ripple employees and third parties did not "put up money," the court found that such XRP distributions could not meet the Howey requirement of an "investment of money."

As for the conduct of Ripple principals, the court also found that because their sales took place on Programmatic platforms, it need not look beyond its determination that Programmatic Sales did not constitute investment contracts.

Of course, the devil is in the details, and summary judgment is just a first step in clarifying rules for what practices will be the subject of future SEC actions.

Thompson Hine will closely follow these proceedings and update its guidance and alerts. Readers are encouraged to follow our Blockchain & Cryptocurrencies site as we continue to publish the latest updates and guidance regarding these and other crypto issues.

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