JENNER & BLOCK

FinTech Focus: Ripple, and Terra, and Coinbase, Oh My!

Publications

August 10, 2023
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Three federal judges in the Southern District of New York sit at the center of the long-running battle between the SEC and the crypto industry, overseeing cases that may eventually bring clarity to the industry. After two recent decisions, that clarity remains elusive, but as Dorothy said, "if we walk far enough, I am sure we shall sometime come to someplace."[1] Until then, the industry and regulators continue to dance to their own tunes.

The TL;DR (the Bottom Line)

- Recent decisions appear to agree that:
  - tokens, themselves, are not securities;
  - some token sales are securities offerings, particularly those made directly from the issuer to a purchaser.
- Recent decisions appear to disagree on whether or in what circumstances token sales are securities transactions in a secondary market;
- The SEC sought leave to appeal the *Ripple* case, which may provide more substantial guidance next year.

Key Takeaways

- The law remains unclear;
- Issuers selling directly to a secondary market is not a panacea to avoid securities laws;
- Stay tuned. The resolution of a Coinbase motion to dismiss, and the *Ripple* case on appeal, could be defining moments for the industry;
- True clarity may need to wait for action by Congress, so don't hold your breath.

SEC v. Ripple

The cryptocurrency industry was abuzz last month, when Judge Analisa Torres issued the long-awaited summary judgment ruling in *SEC v. Ripple Labs, Inc.*, holding (among other things) that XRP was not itself a security and that the SEC had failed to establish that Ripple's transactions in the secondary market were securities transactions.

The SEC's complaint had alleged that the XRP token itself was a security, and that multiple categories of sales of the XRP token by Ripple Labs constituted unregistered sales of securities in violation of the Securities Act.[2] The SEC relied on the now-familiar *Howey* test for evaluating whether a "contract, transaction, or scheme" is an investment contract, which inquires whether the circumstances involve: (i) an investment of money; (ii) in a common enterprise; (iii) with an expectation of profits derived from the promoter or third party.[3]

On summary judgment, the court held that the XRP token was "not in and of itself" an investment contract, and that the *Howey* analysis must be conducted based on the circumstances of each set of transactions.[4] The court then applied the *Howey* test to three different types of transactions: (i) Institutional Sales; (ii) Programmatic Sales; and (iii) Other Distributions (such as distributions to Ripple employees as a form of compensation).[5]

The court held that "Institutional Sales," which were sold directly to sophisticated investment entities through written contracts, were a security. The court held that the buyers paid for the tokens, that there was "horizontal commonality" among the investors because their money was pooled and their fortunes tied to the success of each other (and of Ripple itself), and Ripple's marketing communications and the nature of the Institutional Sales were such that reasonable investors would understand the investment was intended to result in a profitable return.[6]

The case received attention mostly for its discussion of "Programmatic Sales," through which Ripple Labs sold XRP through secondary-market platforms in "blind bid/ask" transactions where the purchaser and seller did not know who the other party was.[7] The court held that in these transactions, the buyers "could not reasonably expect" that "Ripple would use the capital it received from its sales to improve the XRP ecosystem and thereby increase the price of XRP."[8] Indeed, the court said, "many Programmatic Buyers were entirely unaware of Ripple's existence."[9]

The court held 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."[10] The court also noted that whereas the parties who engaged in Institutional Sales were sophisticated entities, where the context of the sales supported a conclusion that the Institutional Buyers "would have been aware of Ripple's marketing campaign and public statements connecting XRP's price to its own efforts," there was no evidence that the less sophisticated Programmatic Buyer "shared similar 'understandings and expectations' and could parse through the multiple documents and

statements" the SEC pointed toward, which occurred across social media sites and news articles over an eight-year period.[11] Thus, the court held there was no reasonable expectation of profits for Programmatic Sales, failing the third *Howey* prong. Notably, the court held that because "the record does not establish the third *Howey* prong as to the Programmatic Sales," the court "does not reach whether the first [investment of money] or second [common enterprise] *Howey* prongs have been satisfied."[12]

SEC v. Terraform Labs

While many in the crypto industry heralded the *Ripple* decision, that enthusiasm was quickly chilled by Judge Jed Rakoff just three weeks later when he denied Terraform Labs' motion to dismiss the SEC's claims concerning the Terra (UST) and LUNA tokens.

Judge Rakoff declined "to draw a distinction between" sales of tokens to institutional investors and sales in secondary market transactions, and expressly stated that "in doing so, the Court rejects the approach recently adopted by another judge of this District in a similar case, *SEC v. Ripple Labs Inc.*, 2023 WL 4507900 (S.D.N.Y. July 13, 2023)."[13]

While Judge Rakoff acknowledged that the UST and LUNA tokens in and of themselves may not have qualified as "investment contracts" on a standalone basis, he found "this conclusion is only marginally of interest, because, to begin with the coins were never, according to the amended complaint, standalone tokens." Instead, the SEC had alleged the LUNA coins were marketed as "yield-bearing investments whose value would grow in line with the Terraform blockchain ecosystem," and the UST coins "could be converted to LUNA coins."[14]

Specifically, the *Terraform* court held there was a plausible "common enterprise" because the defendants had broadly marketed the coins as profit-generating based on defendants "pooling" purchasers' investments, including by investing proceeds from the sale of coins "to develop the Terraform blockchain" which defendants allegedly held out publicly would "increase the value of the LUNA tokens themselves."[15] In so holding, Judge Rakoff did not appear to find necessary that the secondary purchasers' money go to the promoter of the tokens in order to establish a common enterprise.

The court then rejected *Ripple's* conclusion that there was no expectation of profits for purchasers on a digital asset exchange. Rather, the court held that defendants' statements at investor meetings and on social media were plausibly sufficient to make a reasonable purchaser – even retail purchasers – believe the defendants were promising a profit based on their efforts.[16] The court held that "secondary-market purchasers had every bit as good a reason to believe that the defendants would take their capital contributions and use it to generate profits on their behalf."[17] The court did not address the fact that Terraform Labs would not receive those purchasers' funds as capital contributions, because the purchase money went to a secondary-market seller and not the

issuer, rendering it unclear how "defendants would take their capital contributions" at all, much less use them to generate profits.[18]

It is important to note that *Terraform* considered only whether the SEC's allegations were sufficient to state a claim under a standard that requires the allegations to "nudge the [SEC's] claims across the line from conceivable to plausible," as opposed to the *Ripple* decision which evaluated the actual evidence the SEC brought in support of its claims to determine whether there was a dispute of material fact that would merit going to trial.

SEC v. Coinbase

The SEC's case against Coinbase places the secondary market questions squarely before Judge Katherine Failla. In Coinbase's recently filed motion for judgment on the pleadings, Coinbase argues that the SEC's attempt to regulate Coinbase on the basis that secondary market transactions are securities fails because the transactions are ordinary asset sales, with no obligations for the buyer, seller, or issuer of the tokens after the transaction is complete. Coinbase argued that the *Terraform* decision is unduly expansive in suggesting a blind bid/ask transaction, where neither party is the token promoter, constitutes an investment contract, because the SEC had not (and could not) claim that such transactions involve an agreement or scheme that the buyer's payments would be invested in the seller's "profit-seeking endeavor."[19] Coinbase further argued that *Terraform's* suggestion that an issuer's public representations about the possibility of a return on investment was sufficient to constitute "a contract that promised a future return" (as at issue in *Howey*) was "insupportable" under the law.[20]

The SEC's Coinbase case is the first case in the Southern District to place secondary market transactions directly at issue, and the court will be faced with seeking to reconcile, choose between, or distinguish both *Ripple* and *Terraform*.

What's Next

The outcome of all three cases remains an open question. In addition to the forthcoming ruling in the Coinbase motion and the ongoing *Terraform* litigation, last Wednesday, the *Ripple* court issued a scheduling order for the remaining claims with an anticipated trial in spring of 2024.[21] That same day, the SEC filed a notice of its intent to seek an interlocutory appeal on the court's adverse summary judgment findings, including with respect to whether Programmatic Sales are securities, noting the "intra-district split" created by the *Ripple* and *Terraform* decisions.[22] Interlocutory appeals for such non-final judgments require a showing of "exceptional circumstances,"[23] but the court may conclude that standard is satisfied here.[24] We will know this fall whether an appeal will be granted, but will not see any decision on an appeal until well into 2024, if not 2025.

Footnotes

[1] The Wizard of Oz

[2] Amended Compl., *SEC v. Ripple Labs*, No. 20-CV-10832 (Feb. 18, 2021) Dkt. 46.

[3] *SEC v. W.J. Howey Co.*, 328 U.S. 293, at 298–99 (1946).

[4] Order, *SEC v. Ripple Labs*, No. 20-CV-10832 at 15 (S.D.N.Y. July 13, 2023) Dkt. 874 ("Ripple Order").

[5] The court held that the Other Distributions failed the first *Howey* prong because the recipients did not pay money or provide other consideration to Ripple in exchange for these distributions. Ripple Order at 26.

[6] Ripple Order at 16-22.

[7] *Id.* at 23.

[8] *Id.* at 23.

[9] *Id.* at 24.

[10] *Id.* at 23.

[11] *Id.* at 25.

[12] *Id.* at 25 n.17,

[13] Opinion & Order, *SEC v. Terraform Labs Pte. Ltd.*, No. 1:23-cv-01346 at 40 (S.D.N.Y. July 31, 2023) Dkt. 51. ("Terraform Order")

[14] *Id.* at 34.

[15] *Id.* at 36-37.

[16] *Id.* at 40–42.

[17] *Id.* at 42.

[18] *Id.*

[19] Mem. of L. in Supp. of Coinbase's Motion for Judgment on the Pleadings, No. 23-civ-4738 at 14 (S.D.N.Y. Aug. 4, 2023).

[20] *Id.* at 14 n. 10.

[21] Pretrial Scheduling Order, *SEC v. Ripple Labs*, No. 20-CV-10832 at 1 (S.D.N.Y. Aug. 9, 2023) Dkt. 884.

[22] Letter, *SEC v. Ripple Labs*, No. 20-CV-10832 at 1 (S.D.N.Y. Aug. 9, 2023) Dkt. 887.

[23] *Klinghoffer v. S.N.C. Achille Lauro Ed Altri-Gestione Motonave Achille Lauro in Amministrazione Straordinaria*, 921 F.2d 21, 25 (2d Cir. 1990).

[24] Letter, *SEC v. Ripple Labs*, No. 20-CV-10832 at 4 (S.D.N.Y. Aug. 9, 2023) Dkt. 887.

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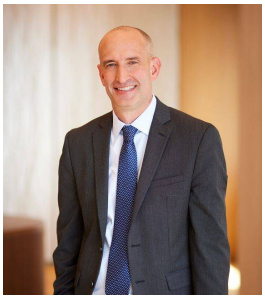

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