Blockchain Law

Crypto, the SEC and a tale of two judges

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What if you had been waiting years to get judicial clarity on a legal issue, only to receive contradictory rulings from two different judges in the same court just weeks apart? This ironic outcome is what befell the crypto industry in two high-profile challenges to SEC enforcement actions regarding sales of crypto tokens.

In mid-July 2023, the crypto industry finally saw at least some judicial success in its long-running debate with SEC enforcement authorities over whether federal securities laws applied to sales of crypto tokens. In a mixed decision in *SEC v. Ripple Labs*, 2023 WL 4507900 (S.D.N.Y. July 13, 2023) (Torres, J.), the court held that the securities laws applied to some, but not all, sales of Ripple's XRP token.

Barely more than two weeks later, though, another judge in that same court sided with the SEC against the crypto industry on that same issue, explicitly "reject[ing] the approach recently adopted" in *Ripple*'s "similar case," and upholding the SEC's enforcement complaint in its entirety against various cryptocurrency sellers. *SEC v. Terraform Labs Pte.*, 2023 WL 4858299 (S.D.N.Y. July 31, 2023) (Rakoff, J.). Adding insult to injury, the SEC is now citing its *Terraform* victory in seeking leave to take an interlocutory appeal of the *Ripple* ruling to the U.S. Court of Appeals for the Second Circuit.

Yet for the most part, Judge Rakoff's decision in *Terraform* diverged from U.S. District Judge Analisa Torres' decision in *Ripple* in very limited respects. In other respects, both judges were strongly dismissive of most of the other challenges to the SEC's assertion of authority with respect to crypto token sales based on its position that they involved sales of "securities" under the governing "*Howey* test" set forth in *SEC v. W.J. Howey*, 328 U.S. 293 (1946), and its progeny.

SEC's claim in 'Ripple'

Ripple was an SEC enforcement action charging the defendant platform and two of its leaders with engaging in the unlawful offer and sale of unregistered securities in violation of Section 5 of the Securities Act of 1933, 15 U.S.C. §77e, specifically the XRP token that Ripple created.

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The company distributed, issued and sold its XRP tokens in several ways. One was through "institutional sales," where XRP was sold directly to counterparties such as institutional buyers, hedge funds, and others pursuant to written contracts. Another was to sell XRP on digital asset exchanges "programmatically," or through the use of trading algorithms, where the sales were "blind bid/ask transactions" in which "Ripple did not know who was buying the XRP, and the purchasers did not know who was selling it." Lastly, Ripple engaged in various "other distributions" where it "distributed XRP as a form of payment for services," such as "to its employees as a form of employee compensation," and "in conjunction with [initiatives] to fund third parties that would develop new applications for XRP and the XRP Ledger."

The SEC alleged that Ripple and the individual defendants engaged in "extensive, years-long marketing efforts representing they would search for purported 'use' and 'value' for XRP—and casting XRP as an opportunity to invest in those efforts," through "a wide range of statements, including informational brochures, internal talking points, public blog posts, statements on social media, videos, interviews with various Ripple employees, and more."

The key issue for the SEC's Section 5 claim was whether these sales of XRP amounted to sales of "securities" within the meaning of the Securities Act, specifically as an "investment contract," one of the types of securities defined by Section 2(a)(1) of the Securities Act, 15 U.S.C. § 77b(a)(1).

Basics of the 'Howey' Test

The court naturally focused its discussion on the familiar *Howey* test for identifying an investment contract. Under that test, an investment contract 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" (citing *Howey*, 328 U.S. at 298-99). The court also noted that "[i]n analyzing whether a contract, transaction, or scheme is an investment contract, 'form should be disregarded for substance and the emphasis should be on economic reality' and the 'totality of circumstances'" (citing, inter alia, *Tcherepnin v. Knight*, 389 U.S. 332, 336 (1967)).

In performing the *Howey* analysis, Judge Torres began by rejecting a "novel" argument proposed by the defendants that was dubbed the "essential ingredients" test. The defendants' contention was that in addition to satisfying the *Howey* test factors, "all investment contracts must contain three 'essential ingredients': (1) 'a contract between a promoter and an investor that establishe[s] 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 this proposed test, stating that it "would call for the court to read beyond the plain words of *Howey* and impose additional requirements not mandated by the Supreme Court." The court stated that no case was cited applying any such test, and that many post-*Howey* cases found the existence of an investment contract even in the absence of the defendants' supposedly "essential ingredients," including "recent digital asset cases in this District" such as *SEC v. Kik Interactive*, 492 F. Supp. 3d 169, 175-80 (S.D.N.Y. 2020), and *Balestra v. ATBCOIN*, 380 F. Supp. 3d 340, 354 (S.D.N.Y. 2019).

Judge Torres also held that XRP's nature as simply a token did not preclude its sales from qualifying as investment contracts. She noted that "*Howey* and its progeny have held that a variety of tangible and intangible assets can serve as the subject of an investment contract. . . . In each of these cases, the subject of the investment contract was a standalone commodity, which was not itself inherently an investment contract." Accordingly, she held, the defendants' argument "that XRP does not have the 'character in commerce' of a security . . . misses the point because ordinary assets . . . may be sold as investment contracts, depending on the circumstances of those sales."

Thus, "[e]ven if XRP exhibits certain characteristics of a commodity or a currency, it may nonetheless be offered or sold as an investment contract." In this regard, Judge Torres cited approvingly Judge Castel's explanation in *SEC v. Telegram Group*, 448 F. Supp. 3d 352, 379 (S.D.N.Y. 2020), that "[w]hile helpful as a shorthand reference, the security in this case is not simply the [digital token], which is little more than alphanumeric

cryptographic sequence," but rather the overall "scheme" that "consists of the full set of contracts, expectations, and understandings centered on the sales and distribution of the [token]."

Ripple's institutional sales meet the 'Howey' test

The court then separately analyzed each of the three categories of XRP distributions under the *Howey* test, starting with the institutional sales. The court rejected defendants' argument that *Howey*'s "investment of money" prong "requires not just payment of money but an intent to invest that money," stating that this "purported distinction is not supported by caselaw" and holding that since money indisputably had been paid in these sales, "this element has been established."

The court also held that *Howey*'s second prong, the "common enterprise" requirement, had been met through a showing of "horizontal commonality" among the institutional buyers of the XRP tokens. "Horizontal commonality exists where the investors' assets are pooled and the fortunes of each investor are tied to the fortunes of other investors, as well as to the success of the overall enterprise."

Here, "Ripple pooled the proceeds of its institutional sales into a network of bank accounts" and "used the funds raised from the Institutional Sales to finance its operations." "Further, each institutional buyer's ability to profit was tied to Ripple's fortunes and the fortunes of other institutional buyers because all institutional buyers received the same fungible XRP. . . . When the value of XRP rose, all institutional buyers profited in proportion to their XRP holdings." These facts, held the court, established "the existence of a common enterprise" for the institutional buyer under *Howey*'s second prong.

Finally, looking at whether under *Howey*'s third prong the institutional buyers were led to have a reasonable expectation of profits to be derived from the entrepreneurial or managerial efforts of others, the court held that they were:

> From Ripple's communications, marketing campaign, and the nature of the Institutional Sales, reasonable investors would understand that Ripple would use the capital received from its institutional sales to improve the market for XRP and develop uses for the XRP Ledger, thereby increasing the value of XRP. * * * Clearly, the institutional buyers would have understood that Ripple was pitching a speculative value proposition for XRP with potential profits to be derived from Ripple's entrepreneurial and managerial efforts.

Accordingly, given this "economic reality and totality of circumstances" surrounding Ripple's institutional sales of XRP tokens, the court held that such sales "constituted the unregistered offer and sale of investment contracts in violation of Section 5 of the Securities Act."

SEC falls short on the other categories of XRP sales

The SEC did not fare so well, however, when it came to the other categories of XRP sales and distributions by Ripple. The court held that the "programmatic sales" could not satisfy *Howey*'s third prong because, unlike the institutional buyers, "programmatic 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."

The court noted that the "programmatic sales were blind bid/ask transactions, and programmatic Buyers could not have known if their payments of money went to Ripple, or any other seller of XRP." Even if "some programmatic buyers may have purchased XRP with the expectation of profits to be derived from Ripple's efforts," she found it remained the case that "Ripple did not make any promises or offers because Ripple did not know who was buying the XRP, and the purchasers did not know who was selling it."

The programmatic buyers were not given Ripple's promotional materials and there was no evidence they "would have been aware of Ripple's marketing campaign and public statements connecting XRP's price to its own efforts." Judge Torres commented 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."

Given these circumstances, the court concluded that "Ripple's programmatic sales of XRP did not constitute the offer and sale of investment contracts," and thus could not fall within Section 5's registration requirements.

The court cautioned in a footnote, however, that despite its earlier comment it was not addressing "whether secondary market sales of XRP constitute offers and sales of investment contracts" because that question was not presented in this case. "Whether a secondary market sale constitutes an offer or sale of an investment contract would depend on the totality of circumstances and the economic reality of that specific contract, transaction, or scheme."

The court next held that Ripple's "other distributions" failed the *Howey* test under the first prong of that test which requires an "investment of money." Because "the record shows that recipients of the other distributions did not pay money or 'some tangible and definable consideration' to Ripple," and that "[t]o the contrary, Ripple paid XRP to these employees and companies," the court held that these distributions did not constitute the offer and sale of investment contracts.

In a final note, the court rejected the defendants' arguments that there was a lack of fair notice and vagueness with respect to the conduct that the SEC in its enforcement action claimed was prohibited. *Howey*, the court said, "sets forth a clear test" with an abundance of supporting caselaw.

While defendants argued that the SEC failed "to issue guidance on digital assets and [was guilty of] inconsistent statements and approaches to regulating the sale of digital assets as investment contracts," the court held that the SEC's approach to enforcement was "consistent" with its prior enforcement actions regarding digital asset sales in other cases, noting that "the law does not require the SEC to warn all potential violators on an individual or industry level."

Ripple thus yielded a mixed result, perhaps unsatisfying to all involved. It held that certain but not all sales and distributions of XRP tokens amounted to the sale of unregistered securities in violation of Section 5.

'Terraform' agrees with 'Ripple' on many basic premises

Barely more than two weeks later, similar questions were presented in *Terraform*, which likewise focused on the SEC's claims that sales of various tokens amounted to "investment contracts" under *Howey*. The SEC claimed in *Terraform* that the defendants had engaged in fraud in the sale of securities under Section 17(a) of the Securities Act, 15 U.S.C. §77q(a), and Section 10(b) of the Exchange Act, 15 U.S.C. § 78j(b), as well as the sale of unregistered securities in violation of Section 5 of the Securities Act.

As in *Ripple*, the core focus in the *Terraform* case was whether sales of the tokens in question—UST stablecoins, LUNA cryptocurrency and MIR tokens—involved "investment contracts" so as to qualify as sales of "securities" under the three requirements of the *Howey* test. In ruling forcefully in favor of the SEC on this issue and rejecting the defendants' motion to dismiss in all respects, U.S. District Judge Jed Rakoff began by noting several governing principles that largely echoed points made by Judge Torres in *Ripple*.

First, similar to Judge Torres's rejection in *Ripple* of the proposed "essential ingredients" test for *Howey* "investment contracts," Judge Rakoff held that "there need not be – contrary to defendants' assertions – a formal common-law contract between transacting parties for an 'investment contract' to exist." He pointed out that *Howey* itself had defined "investment contracts" as extending not just to "contracts" but also more broadly to "transaction[s]" and "scheme[s]," so long as they involved one party "mak[ing] an investment of money in the [other's] profit-seeking endeavor."

Second, similar to Judge Torres' focus in *Ripple* not merely on the token itself in isolation but rather "the economic reality and totality of circumstances surrounding the offers and sales of the [token]," Judge Rakoff held that the court need not "restrict its *Howey* analysis to whether the tokens themselves – apart from any of the related various investment 'protocols' – constitute investment contracts." The reason for this, he said, is that under Supreme Court precedent the *Howey* investment contract analysis must look to "the 'substance' – and not merely the 'form' – of the parties' economic arrangement

and decide if, under the 'totality of the circumstances,' that transaction or scheme meets the three requirements of *Howey*."

This analysis looks at "'. . . the content of the instruments in question, the purposes intended to be served, and the factual setting as a whole.'" Thus, "the court declines to erect an artificial barrier between the tokens and the investment protocols with which they are closely related for the purposes of its analysis."

For this reason, even if the tokens at issue in *Terraform* "as originally created and when considered in isolation, might not then have been, by themselves, investment contracts," said Judge Rakoff, "this conclusion is only marginally of interest, because, to begin with the coins were never, according to the amended complaint, standalone tokens." Rather, the SEC alleged the coins "were, from the outset, pitched to investors, not as stablecoins, but primarily as yield-bearing investments whose value would grow in line with the Terraform blockchain ecosystem." The same applied to other tokens that were pitched as being convertible into those coins.

In another point of agreement with Judge Torres, Judge Rakoff rejected defendants' argument that the SEC violated due process by bringing an enforcement action "without first providing them 'fair notice' that their crypto-assets would be treated as securities." He noted that the SEC had taken a nuanced, case-by-case view on that issue, rather than the blanket all-or-none position that defendants sought to ascribe to SEC. He noted that the SEC had "asserted the exact same position it has taken in this case in several enforcement actions brought against other crypto-currency companies" that he characterized as "relatively high-profile lawsuits." These prior actions, he said:

> would have apprised a reasonable person working in the crypto-currency industry that the SEC considered *some* crypto-currencies to be securities and that the agency would enforce perceived violations of the securities laws through the development, marketing, and sale of these crypto-currencies. (Emphasis in original.)

Judge Rakoff thus rejected defendants' due process argument as "asserting the SEC's position in this litigation is inconsistent with a position that the SEC never adopted." He held that this enforcement action was not "a 'radical departure' from the SEC's stated views on the law," but "simply a 'fact-intensive application of a statutory standard'" which did not require notice-and-comment rulemaking. He also concluded that the SEC's actions did not implicate "[t]he so-called 'Major Questions Doctrine'" that the Supreme Court has applied in a handful of recent "extraordinary" cases that presented "transformative expansion" of regulatory authority over "industries of 'vast economic and political significance.'"

Agreement that the first two 'Howey' requirements were met

Focusing next on the three core *Howey* elements, Judge Rakoff held they were satisfied with regard to the tokens at issue. Noting that it was undisputed that the first *Howey* requirement—that the purchasers made an "investment of money" in exchange for the tokens—was met in this case, the court focused on the second and third factors: that the purchasers were "investing in a common enterprise" and were "led to expect profits solely from the efforts of the promotor or a third party."

The court held that a "common enterprise" had been pled because the SEC's complaint alleged "horizontal commonality" between purchasers and the defendants. Horizontal commonality exists when "each investor's fortunes are 'ti[ed] … to the fortunes of the other investors by the pooling of assets,' and there is a 'pro-rata distribution of profits' earned from these combined assets." The court found these tests satisfied by the SEC's allegations.

As to one of the defendants' coins, UST, "defendants marketed the UST coins as an asset that, when deposited into [their] Anchor Protocol [and thus pooled], could generate returns of up to 20%." As to LUNA tokens, the SEC alleged that "the defendants' used proceeds from LUNA coin sales to develop the Terraform blockchain and represented that these improvements would increase the value of the LUNA tokens themselves," *i.e.*, "alleging that the defendants 'pooled' the proceeds of LUNA purchases together and promised that further investment through these purchases would benefit all LUNA holders."

Similarly, the SEC alleged that "the proceeds from sales of [defendants'] MIR tokens were 'pooled together' to improve [defendants'] Mirror Protocol," with the resulting profits then being "fed back to investors based on the size of their investment," i.e., distributed to purchasers "on a pro-rata basis."

The point of departure—what did purchasers reasonably believe?

Judge Rakoff then next held that the SEC had sufficiently alleged *Howey*'s final element—that investors reasonably "were led to believe that it was the efforts of the defendants or other third parties that could earn them a return on their investment."

The court began its discussion by explaining the importance of the "reasonableness" requirement—a point that would prove significant in later departing from the holdings in *Ripple*:

> The qualification that the investors' expectations be reasonable is an important one. The SEC need not prove that each and every investor was personally led to think that profits would follow from their investment in the defendants' products. If an objective investor would have perceived the defendants' statements and actions as promising the possibility of such returns, the SEC has satisfied *Howey*'s requirement.

The court cited the SEC's allegations to conclude that this final *Howey* factor had been sufficiently alleged. The SEC had alleged that the defendants—"through social media posts, at investor conferences, in monthly investor reports, and at one-on-one meetings with investors"—had urged purchases of their coins by "tout[ing] the profitability" of their protocols that would come from "the defendants' unique combination of investing and engineering experience." The SEC alleged that defendants "point[ed] out the possibility of future investment returns" by asserting that "profits from the continued sale of LUNA coins would be fed back into further development of the Terraform ecosystem, which would, in turn, increase the value of the LUNA coins," and made similar claims as to their MIR tokens.

The SEC's "particularized allegations" were "supported by . . . readouts of investor meetings, excerpts of investor materials, and screenshots of social media posts made by [defendant] Kwon and other Terraform executives" so as to withstand a motion to dismiss.

Judge Rakoff then staked out a notable point of departure from Judge Torres' *Ripple* holding, stating:

> [T]he Court declines to draw a distinction between these coins based on their manner of sale, such that coins sold directly to institutional investors are considered securities and those sold through secondary market transactions to retail investors are not. In doing so, the Court rejects the approach recently adopted by another judge of this District in a similar case" (citing *Ripple*).

Specifically, Judge Rakoff took issue with *Ripple*'s position that "because the re-sale purchasers could not have known if their payments went to the defendant, as opposed to the third-party entity who sold them the coin," such as "through secondary transactions," as a result "[w]hatever expectation of profit [the purchasers] had could not . . . be ascribed to defendants' efforts."

Noting that "*Howey* makes no such distinction between purchasers," he reasoned that whether "a purchaser bought the coins directly from the defendants or, instead, in a secondary resale transaction has no impact on whether a reasonable individual would objectively view the defendants' actions and statements as evincing a promise of profits based on their efforts."

In this regard, Judge Rakoff cited the SEC's allegation that "the defendants said that sales from purchases of *all* crypto-assets – no matter where the coins were purchased – would be fed back into the Terraform blockchain and would generate additional profits for *all* crypto-asset holders." He observed that "[t]hese representations would presumably have reached individuals who purchased their crypto-assets on secondary markets – and, indeed, motivated those purchases – as much as it did institutional investors." As a result, "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," thus satisfying *Howey*'s third requirement.

Thus, finding sufficient allegations to satisfy all of *Howey*'s elements as to the defendants' various tokens, Judge Rakoff denied the motions to dismiss the SEC's claims for fraud in the sale of securities and for sales of unregistered securities.

Putting Dueling Rulings Into Context

While perhaps frustrating to practitioners, there is nothing especially shocking or unusual in two federal district judges in the U.S. District Court for the Southern District of New York taking opposing positions on an unsettled legal issue, whether concerning securities, cryptocurrency or anything else.

Just recently, for example, opposing opinions were issued less than two weeks apart by U.S. District Judges Denise Cote and Lewis Liman regarding whether the owner of a hacked cryptocurrency account could seek remedies against the platform for inadequate security under the Electronic Funds Transfer Act (EFTA), 15 U.S.C. §1693 et seq. Judge Liman held that this depended on whether the account was "established primarily" for "profit-making" as opposed to personal purposes, *Yuille v. Uphold HQ*, 2023 WL 5206888, *8 (S.D.N.Y. Aug. 11, 2023), while Judge Cote 12 days later held that it did not, *Nero v. Uphold HQ*, 2023 WL 5426203, *6-8 (S.D.N.Y. Aug. 23, 2023).

Similar to how Judge Rakoff in *Terraform* addressed Judge Torres' prior ruling in *Ripple*, Judge Cote noted and cited the prior ruling of her fellow judge on her court but stated that she "decline[d]" to follow it for the reasons she explained in her decision. These cases, like *Terraform* and *Ripple*, illustrate the commonplace reality of how the dialogue of the judiciary is conducted en route to the eventual development of judicial consensus.

Conclusion

Many in the crypto industry watched the *Ripple* litigation intently, awaiting what they hoped would be a final reckoning on the SEC's authority over the crypto space. The back-to-back dueling rulings in *Ripple* and *Terraform*, however, dashed those hopes for the immediate future. Indeed, the many points on which those rulings agreed supported SEC authority in this area, and their points of difference at most affected just some but not all of the SEC's efforts. It appears those who were hoping the district court ruling in *Ripple* would clear the air once and for all regarding the SEC's authority will have to continue waiting for another day.

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