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INSIGHTS

What SEC Retreat in Ripple Case Means for Crypto Regulation

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*By: **Keith Blackman***

The US Securities and Exchange Commission (SEC) has made no secret of its regulation by enforcement approach to cryptocurrency policy, choosing to craft its strategy case-by-case rather than through rulemaking.

While this flexible tactic undoubtedly has some benefits, the SEC's recent inability to hold two crypto executives personally responsible for alleged securities law violations demonstrates the limits of its piecemeal approach. It remains to be seen whether the SEC's misadventure is a one-time anomaly or a harbinger of things to come.

SEC Drops Charges Against Ripple Execs

The SEC filed an enforcement action against Ripple Labs and two of its executives, Brad Garlinghouse and Chris Larsen, on December 31, 2020, in the Southern District of New York.***[1]***

The SEC alleged that Ripple raised more than $1.3 billion by selling XRP tokens in unregistered security offerings to investors in the United States and worldwide. Additionally, Ripple allegedly offered billions of XRP in exchange for non-cash services like market-making services and labor. The SEC accused Garlinghouse and Larsen of aiding and abetting Ripple's violations of the securities laws.

The SEC's case against Ripple Labs and its executives hit a significant snag last summer, as the court severely limited the SEC's case on summary judgment. District Court Judge Analisa Torres concluded that Ripple's XRP token was not a security when it was sold on public exchanges and, therefore, did not need to be registered. Judge Torres did, however, rule that Ripple's sales to institutional buyers like hedge funds constituted transactions of unregistered investment contracts in violation of Section 5 of the Securities Act.

With respect to Garlinghouse and Larsen's individual liability, the court reserved for a jury the question of whether the executives knew that XRP was a security when making the institutional sales. In October, the court ruled that its summary judgment ruling was not immediately appealable.

On October 19, the SEC unexpectedly dropped its remaining aiding and abetting claims against Garlinghouse and Larsen.

Impact of SEC's Failure to Regulate

The SEC did not disclose why it chose not to pursue its enforcement action against Garlinghouse and Larsen. Presumably, part of the SEC's rationale was its impatience to complete the trial court proceedings that have been pending for three years so it can appeal the court's summary judgment ruling. But another significant factor was undoubtedly the SEC's pessimism in securing a verdict against the executives.

As the court held on summary judgment, the only element of aiding and abetting that was seriously disputed by the individual defendants was their alleged knowledge that Ripple was violating federal securities laws. When the court denied the SEC's summary judgment motion, it held that a jury would need to determine that the executives knew, or recklessly disregarded, the facts that made Ripple's transactions and schemes illegal, including the fact that XRP was a security when sold to institutional buyers.

For their part, the executives denied any inkling that XRP was a security. They pointed to "the lack of any clear statutory or precedential requirement to treat XRP as a security," as well as the SEC's "own belated guidance on this issue, which injected such confusion as to deny persons of ordinary intelligence any 'reasonable opportunity to know what is prohibited.'"

The executives also highlighted the SEC's eight-year delay in bringing an enforcement action against Ripple despite billions of dollars of transactions and the listing of XRP on more than 200 exchanges.***[2]***

The SEC was somewhat hamstrung in its response. Having affirmatively decided not to promulgate clear-cut, universal regulations defining which cryptocurrencies qualified as securities under the Supreme Court's Howey test, it struggled to demonstrate as a matter of law that Garlinghouse and Larsen could have made this determination themselves.

Due in part to the "SEC's failure to issue guidance on digital assets and its inconsistent statements and approaches to regulating the sale of digital assets as investment contracts," the court permitted the executives to proceed to trial on their argument. The SEC, in dropping its case, evidently had little confidence it could convince a jury that the executives knew they were trafficking in unregistered securities.

What Comes Next?

The SEC's aborted enforcement action against Garlinghouse and Larsen may have been good news for the blockchain executives, but what will the SEC's inability (or unwillingness) to establish clear regulatory guidelines mean for future enforcement actions?

For its part, the SEC has shown no inclination toward rulemaking. Despite a writ of mandamus filed in the Third Circuit by crypto exchange Coinbase seeking to force the SEC to commit to proposing new rules identifying which digital assets qualify as securities, the SEC has declined to move forward.

Six months after Coinbase's petition, the SEC has only reported that its staff has provided an internal recommendation on how to respond to Coinbase's request, without providing any details as to what the recommendation is or the timing of any decision.

It may be the case, however, that the SEC need not act.

In a decision issued just two weeks after this summer's Ripple holding, Judge Jed Rakoff of the Southern District of New York denied crypto asset company Terraform Labs's motion to dismiss the SEC's claims of unregistered securities offerings and fraud, rejecting the defendants' argument that they were unaware that their conduct could be subject to federal securities laws.***[3]***

He held that the Howey test for determining whether an instrument is an investment contract has been clearly established law for over 70 years and that defendants' specific conduct of offering and selling Terraform's LUNA tokens and UST stablecoins without registration falls squarely within the heartland of conduct prohibited by securities laws.

Therefore, despite the SEC's rulemaking equivocation, Judge Rakoff showed no hesitation in ruling that Terraform – and its CEO – were aware that their conduct could violate federal securities laws.

It must be pointed out, however, that the Terraform holding was in the motion to dismiss context and took the allegations of the SEC's complaint at face value. Once evidence is considered by a jury, the answer could be very different.

For example, Ripple itself was able to unearth statements made by an SEC official in 2018 that he personally did not believe that the cryptocurrency "ether" was a security. And internal emails related to that speech suggested that the SEC was worried that those comments could be construed by members of the public – like Garlinghouse and Larsen – to mean that certain digital assets are not securities.

One thing is for certain: following last year's crypto winter, there is no shortage of crypto defendants being pursued by the SEC. Time will tell whether the SEC is able to enforce securities laws against these individual defendants, or if this summer's stumble has a ripple effect into the future.

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[1] *Sec. & Exch. Comm'n v. Ripple Labs, Inc.*, No. 20-CV-10832 (AT).

[2] Indeed, multiple foreign regulators had determined that XRP was not a security, and even the DOJ and Treasury Department had categorized XRP as a "virtual currency" back in 2015.

[3] *Sec. & Exch. Comm'n v. Terraform Labs Pte. Ltd.*, No. 23-CV-1346 (JSR), 2023 WL 4858299, at *10 (S.D.N.Y. July 31, 2023).

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