

# RIPPLE EFFECTS: HOW IN RE RIPPLE LABS INC. LITIGATION COULD SIGNAL THE BEGINNING OF THE END OF THE PAYMENT PLATFORM

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## ABSTRACT

*Ripple Labs provides an international payment network that allows financial institutions to transfer money more cheaply and quickly than traditional international payments. Ripple's native digital currency, XRP, supports global payments by acting as intermediate currency between different currencies, eliminating correspondent bank's need to hold deposits in foreign currencies. In an ongoing class action lawsuit, XRP purchasers claim that the digital asset qualifies as a security under federal securities laws and that Ripple illegally offered and sold XRP as an unregistered security. Given Ripple's rising prominence as a tool for financial institutions, this pending case will impact cryptocurrency markets and international payments. Because XRP is most likely a security subject to regulation by the Securities and Exchange Commission (SEC), this matter poses an existential threat to the Ripple network. This note examines the legal issues leading up to the Ripple litigation and explains why XRP is most likely a security. It concludes by discussing the SEC's likely approach to Ripple's unregistered Initial Coin Offering (ICO).*

## INTRODUCTION

Today, most global payments rely on outdated technology.<sup>1</sup> To transact with entities in foreign countries, financial institutions must be members of the Society for Worldwide Interbank Financial Telecommunications (SWIFT) network<sup>2</sup> and maintain a correspondent banking relationship with a bank in that foreign country.<sup>3</sup> The process is slow, expensive, and carries risks that international payments will not reach their intended destination due to the lack of an international central settlement institution.<sup>4</sup>

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<sup>1</sup> *Our Company*, RIPPLE, <https://ripple.com/company> (last visited Nov. 14, 2019).

<sup>2</sup> Shobhit Seth, *How the SWIFT System Works*, INVESTOPEDIA (Feb 11, 2020), <https://www.investopedia.com/articles/personal-finance/050515/how-swift-system-works.asp>; see *infra* Part I Section A (explaining SWIFT, a messaging system used by banks and financial institutions to send and receive money transfer instructions).

<sup>3</sup> Chelsea Allison, *What is SWIFT?*, FIN (Mar. 1, 2019), <https://fin.plaid.com/articles/what-is-swift/>.

<sup>4</sup> See Marcel T. Rosner & Andrew Kang, *Understanding and Regulating Twenty-First Century Payment Systems: The Ripple Case Study*, 114 MICH. L. REV. 649, 656–57 (2016).

Founded in 2012, technology company Ripple Labs recognized this shortcoming and sought to revolutionize global payments using blockchain technology and digital assets.<sup>5</sup> Ripple's international payments network enables financial institutions to complete global payments instantly, reliably, and cheaply.<sup>6</sup> Its native digital currency, XRP, supports liquidity in the network by acting as a bridge between different currencies.<sup>7</sup> Several prominent financial institutions, including Santander, American Express, and MoneyGram, have taken advantage of Ripple's innovative technology.<sup>8</sup>

Due to recent legal developments, Ripple may face an existential threat. On May 3, 2018, Ryan Coffey, an XRP purchaser, filed a class action lawsuit against Ripple on behalf of all XRP purchasers.<sup>9</sup> He claimed that Ripple illegally offered and sold XRP as an unregistered security in violation of federal securities laws.<sup>10</sup> Although Coffey voluntarily dismissed his suit,<sup>11</sup> several other class action lawsuits making similar claims followed, resulting in consolidation in *In re Ripple Labs Inc. Litigation*.<sup>12</sup>

This note contextualizes the issues leading up to the litigation surrounding Ripple and XRP and predicts the likely outcome. Part I provides an overview of Ripple Labs and how the company disrupts traditional international payments. Part II provides an overview of United States securities laws and how they have been applied to digital assets historically. Part III discusses *In re Ripple Labs Inc. Litigation* to date. Part IV argues why XRP is most likely a security subject to regulation by the SEC. Part V predicts how the SEC may resolve the case.

## I. OVERVIEW OF RIPPLE LABS

Ripple is an open-source payment system that allows users to make payments across national borders in multiple currencies.<sup>13</sup> The Ripple protocol uses a distributed ledger that enables users to conduct international payments more quickly, cheaply, and efficiently than traditional payment systems.<sup>14</sup> This Part describes the structure of traditional international payment systems and provides an overview of Ripple's underlying technology and its native digital currency, XRP.

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<sup>5</sup> *Our Company*, *supra* note 1.

<sup>6</sup> *Id.*

<sup>7</sup> *Id.*

<sup>8</sup> *Id.*

<sup>9</sup> Complaint at 1, *Coffey v. Ripple Labs Inc.*, 333 F. Supp. 3d 952 (N.D. Cal. 2018) (No. 18-566271).

<sup>10</sup> Sasha Hodder, *Got Rippled?*, MEDIUM (July 19, 2018), <https://medium.com/@sashahodder/got-rippled-5f862e98606b>.

<sup>11</sup> Notice of Voluntary Dismissal Without Prejudice at 1–2, *Coffey v. Ripple Labs Inc.*, 333 F. Supp. 3d 952 (N.D. Cal. 2018) (No. 18-566271).

<sup>12</sup> 369 F. Supp. 3d 950 (N.D. Cal. 2019); Nikhilesh De, *Combined Class-Action Lawsuit Against Ripple Moves to Federal Court*, COINDESK (Nov. 12, 2018), <https://www.coindesk.com/combined-class-action-lawsuit-against-ripple-moves-to-federal-court>.

<sup>13</sup> Rosner & Kang, *supra* note 4, at 650.

<sup>14</sup> *Id.*

### A. *Traditional International Payment Systems*

A payment system facilitates the transfer of funds from one bank to another by settling obligations between them.<sup>15</sup> Before 1973, the only available means of message confirmation for international funds transfer was Telex.<sup>16</sup> Telex was slow, insecure, and prone to human error.<sup>17</sup>

In 1973, a group of banks established the Society for Worldwide Interbank Financial Telecommunication (SWIFT) as an alternative to Telex.<sup>18</sup> Within three years, SWIFT housed a messaging platform, a computer system to validate and direct messages on the platform, and a set of standards for the messages sent on the platform.<sup>19</sup> SWIFT functions as a messaging network to securely transmit information for financial institutions making international money transfers.<sup>20</sup> SWIFT facilitates communication between member institutions by assigning members a unique code for them to transfer payment messages.<sup>21</sup> Once the financial institutions receive SWIFT messages about incoming payments, they clear and credit the money to their institution's appropriate accounts.<sup>22</sup> Given that the SWIFT network only sends messages, not actual money, the financial institutions must have a banking relationship to move funds.<sup>23</sup>

This relationship between financial institutions in different countries is called a correspondent-banking relationship.<sup>24</sup> The relationship is a contractual arrangement through which a bank in one country holds deposits denominated in its native currency but owned by a bank in another country.<sup>25</sup> Because many international payments involve two banks that do not have a correspondent-banking relationship, the payments must first move through a domestic settlement institution.<sup>26</sup> This system is costly because the parties initiating the transfer must pay fees to each bank involved in the transfer.<sup>27</sup> The system also carries risks that failure to complete a transfer in the sequence will halt payments.<sup>28</sup>

Today, SWIFT is involved in most international money transfers.<sup>29</sup> Members must pay to join the SWIFT network, annual fees to remain in the network, and fees for each message based on its type and

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<sup>15</sup> *Id.* at 653.

<sup>16</sup> Seth, *supra* note 2.

<sup>17</sup> *Id.*

<sup>18</sup> Allison, *supra* note 3.

<sup>19</sup> *Id.*

<sup>20</sup> Seth, *supra* note 2.

<sup>21</sup> *Id.*

<sup>22</sup> *Id.*

<sup>23</sup> Allison, *supra* note 3.

<sup>24</sup> Rosner & Kang, *supra* note 4, at 656.

<sup>25</sup> *Id.*

<sup>26</sup> *Id.*

<sup>27</sup> *Id.* at 656–57.

<sup>28</sup> *Id.* at 657.

<sup>29</sup> Seth, *supra* note 2.

length.<sup>30</sup> Nearly 11,000 financial institutions are members of the SWIFT network.<sup>31</sup>

### B. Ripple Labs

Ripple Labs is a private company founded in 2012 and headquartered in San Francisco, California.<sup>32</sup> Its global payment network is called RippleNet, and its native digital asset is XRP.<sup>33</sup> Ripple offers an attractive alternative to traditional international payment systems because it facilitates the international movement of money through distributed settlement without relying on the SWIFT messaging system or correspondent-banking relationships.<sup>34</sup>

#### 1. How Ripple Works

Financial technology experts often analogize the Ripple payment protocol to a Hawala system.<sup>35</sup> The Hawala system emerged in South Asia during the eighth century, and it allows people to transfer funds through a network of dealers on the hawala network.<sup>36</sup> A user initiates a hawala transaction when that user, “User A,” gives a hawala dealer, “Dealer A,” the amount of money he wants another user, “User B,” to receive, along with information about User B and a password.<sup>37</sup> Dealer A then contacts a hawala dealer in User B’s city, “Dealer B,” and asks Dealer B to give User B the money if User B correctly states the password.<sup>38</sup> Then, Dealer B transfers money to User B, and Dealer A will owe Dealer B a debt for that money.<sup>39</sup> The Hawala system depends on the trust between hawala agents.<sup>40</sup>

The Ripple payment system is similar to the Hawala system, but the network comprises Ripple gateways instead of Hawala dealers.<sup>41</sup> Ripple gateways are typically financial institutions.<sup>42</sup> If there is no trust relationship connecting two gateways involved in a transaction, Ripple uses a chain of trust to interconnect the gateways.<sup>43</sup> For example, in the previously described Hawala system hypothetical, if there were no trust relationship between Dealer A and Dealer B, they would need another

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<sup>30</sup> *Id.*

<sup>31</sup> *Id.*

<sup>32</sup> *Ripple*, CRAFT, <https://craft.co/ripple-labs> (last visited Oct. 25, 2019).

<sup>33</sup> *Id.*

<sup>34</sup> *Cf.* Rosner & Kang, *supra* note 4, at 657 (explaining that Ripple uses distributed settlement).

<sup>35</sup> *See, e.g.*, Justin Cata, *Everything to Know About Ripple – Part 1: How Ripple Works*, MEDIUM (July 23, 2018), <https://medium.com/@jcata018/everything-to-know-about-ripple-part-1-how-ripple-works-f7404aa4a8d1> (“Ripple runs similar to that of the Hawala system . . .”).

<sup>36</sup> Julia Kagan, *Hawala*, INVESTOPEDIA (Feb. 10, 2020), <https://www.investopedia.com/terms/h/hawala.asp>.

<sup>37</sup> *Id.*

<sup>38</sup> *Id.*

<sup>39</sup> *Id.*

<sup>40</sup> *Id.*

<sup>41</sup> Cata, *supra* note 35.

<sup>42</sup> *Id.*

<sup>43</sup> *Id.*

hawala dealer to interconnect them.<sup>44</sup> They may both trust a third hawala dealer, “Dealer C,” who would serve as an indirect link of trust between them.<sup>45</sup> In the Ripple protocol, “market makers” enable exchanges between gateways by facilitating fund transfers between users where no direct link of trust exists.<sup>46</sup> Market makers are individuals and financial institutions that provide liquidity to the Ripple network by holding funds in multiple currencies.<sup>47</sup> They are “foreign-exchange trader[s] who post[ ] bids and offer[ ] to trade currencies on Ripple’s network.”<sup>48</sup> Market makers match buyers and sellers in the Ripple network, and earn profits from the difference between the price at which they buy and sell an asset.<sup>49</sup> Because the Ripple protocol routes every transaction to the cheapest path and cheapest offer, market makers compete for the lowest price.<sup>50</sup>

To keep track of how much money different Ripple gateways owe each other, all the Ripple network’s servers simultaneously update a public ledger of accounts, balances, and debts.<sup>51</sup> Users, who function as validating nodes, update the public ledger by consensus when they vote to verify a transaction’s authenticity.<sup>52</sup> Ripple requires 80 percent of nodes to vote for the transaction before it is reflected in the ledger.<sup>53</sup> This process of secure, real-time settlement eliminates the need for the central authority of traditional payment systems.<sup>54</sup> This technology, the Ripple Protocol Consensus Algorithm (RPCA), contrasts with Bitcoin and Ethereum’s blockchain technology,<sup>55</sup> which relies on a proof-of-work consensus protocol.<sup>56</sup> Proof-of-work involves solving complex equations, which requires extensive time and resources.<sup>57</sup>

In a Ripple transaction, there is no risk that a payment will not reach its destination once the user initiates the transaction.<sup>58</sup> If a particular market maker cannot facilitate the transaction, the protocol will bypass the

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<sup>44</sup> *Id.*

<sup>45</sup> *Id.*

<sup>46</sup> Bryant Gehring, *What Are Market Makers?*, RIPLE (Oct. 16, 2014), <https://perma.cc/XC57-9A6K?>.

<sup>47</sup> *Id.*

<sup>48</sup> Rosner & Kang, *supra* note 4, at 660.

<sup>49</sup> *Id.*

<sup>50</sup> *Id.* at 660–61.

<sup>51</sup> Anthony Lewis, *Ripple Explained: Medieval Banking with a Digital Twist*, COINDESK (May 12, 2014), <https://www.coindesk.com/ripple-medieval-banking-digital-twist>.

<sup>52</sup> Rosner & Kang, *supra* note 4, at 659.

<sup>53</sup> *Id.* at n.69.

<sup>54</sup> *Id.* at 658.

<sup>55</sup> *What Is Ripple. Everything You Need To Know*, COINTELEGRAPH, <https://cointelegraph.com/ripple-101/what-is-ripple> (last visited Oct. 24, 2019).

<sup>56</sup> *Ripple Vs. Bitcoin: Key Differences*, COINTELEGRAPH, <https://cointelegraph.com/ripple-101/ripple-vs-bitcoin-key-differences> (last visited Oct. 24, 2019).

<sup>57</sup> David Bold, *Why Is Ripple So Much Faster than Bitcoin?*, COINCODEX, <https://coincodex.com/article/3365/why-is-ripple-so-much-faster-than-bitcoin/> (last visited Dec. 15, 2019).

<sup>58</sup> Rosner & Kang, *supra* note 4, at 661.

market maker and find another one.<sup>59</sup> The transaction may pass through several market makers, but it cannot get stuck at a single market maker, ensuring that the transaction completes.<sup>60</sup>

Ripple refers to its global payment network as “RippleNet.”<sup>61</sup> Users can transfer any currency or cryptocurrency through this network, as long as connecting gateways can form a chain of trust for the currency or cryptocurrency being transferred.<sup>62</sup>

## 2. XRP

While the Ripple network can potentially transfer any currency or cryptocurrency, the Ripple gateways accept through the chains of trust described above, Ripple’s native currency is XRP.<sup>63</sup> If there is no chain of trust between two gateways, the gateways can transfer XRP as an intermediate currency between the two parties.<sup>64</sup> In 2014, Ripple Labs provided XRP incentives and technical support for businesses working as gateways on the Ripple network.<sup>65</sup> In such a transaction, the sender’s payment in his native currency converts to XRP, and then the XRP is converted to the receiver’s native currency.<sup>66</sup> The entire transaction takes three seconds.<sup>67</sup> When exchanging currencies using XRP, the network does not use the system of debts associated with the Hawala system; rather, the gateways send and receive XRP.<sup>68</sup> Ripple refers to this method of international payment as “On-Demand Liquidity.”<sup>69</sup>

Ripple’s founders created 100 billion XRP initially in 2013, and the company still owns about sixty percent of the tokens.<sup>70</sup> Creating additional XRP would require a significant code change to the XRP ledger software.<sup>71</sup> Hence, unlike Bitcoin, which users mine for a Bitcoin reward,

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<sup>59</sup> *Id.*

<sup>60</sup> *Id.*

<sup>61</sup> *The World’s Most Reliable Global Payments Network*, RIPPLE, <https://www.ripple.com/wp-content/uploads/2019/09/RippleNet-Overview.pdf> (last visited Oct. 25, 2019).

<sup>62</sup> Lewis, *supra* note 51.

<sup>63</sup> *Id.*

<sup>64</sup> *Id.*

<sup>65</sup> *How Ripple Labs Supports Gateways*, RIPPLE (Sept. 22, 2014), <https://ripple.com/insights/ripple-labs-helps-gateways/>. The webpage states that this program is no longer active. *Id.*

<sup>66</sup> *On-Demand Liquidity*, RIPPLE, <https://ripple.com/rippletnet/on-demand-liquidity/> (last visited Oct. 24, 2019).

<sup>67</sup> *Id.*

<sup>68</sup> Cata, *supra* note 35.

<sup>69</sup> *On-Demand Liquidity*, *supra* note 66.

<sup>70</sup> Penny Crosman, *Could Ripple’s XRP Replace Correspondent Banks? This Bank Says Yes*, AMERICAN BANKER (Jan. 8, 2019), <https://www.americanbanker.com/news/could-ripples-xrp-replace-correspondent-banks-this-bank-says-yes>.

<sup>71</sup> Thomas Silkjæer, *14 Common Misunderstandings About Ripple and XRP*, FORBES (Mar. 7, 2019), <https://www.forbes.com/sites/thomassilkjaer/2019/03/07/14-common-misunderstandings-about-ripple-and-xrp/#4f23fc1071d0>.

XRP is non-minable, with a maximum supply of 100 billion tokens.<sup>72</sup> The company sells 1 billion XRP per month to fund the network's growth and development.<sup>73</sup> Investors can buy and trade XRP on digital currency exchanges using fiat currencies or other cryptocurrencies.<sup>74</sup> However, XRP is used as an intermediary between currencies, rather than a form of money itself.<sup>75</sup> While the Securities Act requires companies offering securities to the general public to follow specific registration provisions, Ripple has never treated XRP as a security.<sup>76</sup> Thus, Ripple has not registered XRP as a security with the Securities and Exchange Commission.<sup>77</sup>

Each transaction on the Ripple network requires a fee of 0.00001 XRP,<sup>78</sup> which has a value of approximately \$0.0000016.<sup>79</sup> To pay this fee, each account on the Ripple network must hold a reserve of twenty XRP.<sup>80</sup> The XRP is destroyed in the transactions, so XRP holders benefit from the decrease in supply.<sup>81</sup> A transaction with XRP takes under five seconds to complete, whereas a Bitcoin transaction completes in about an hour.<sup>82</sup> Bitcoin mining requires extensive time and computational power; since Ripple has already produced the maximum supply of XRP, the validation and transaction process is much simpler and quicker.<sup>83</sup>

### 3. Who Uses Ripple?

Traditional international payment systems require financial institutions to use the SWIFT messaging network and hold accounts at correspondent banks in foreign countries to settle payments.<sup>84</sup> With Ripple, however, financial institutions can transfer money across borders using XRP as an intermediate currency, minimizing the need to keep deposits at foreign banks.<sup>85</sup> Ripple transactions are quicker than traditional international transfers, with the network processing an average of 1,500 transactions per second, whereas SWIFT may take at least a day to complete a transaction.<sup>86</sup>

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<sup>72</sup> *Ripple Vs. Bitcoin: Key Differences*, *supra* note 56.

<sup>73</sup> Crosman, *supra* note 70.

<sup>74</sup> *How to Buy Ripple*, COINTELEGRAPH, <https://cointelegraph.com/ripple-101/how-to-buy-ripple> (last visited Oct. 24, 2019).

<sup>75</sup> *Ripple Vs. Bitcoin: Key Differences*, *supra* note 56.

<sup>76</sup> Ethan Silver & William Brennan, *Is XRP a Security? We May Never Know*, COINTELEGRAPH (Sept. 29, 2019), <https://cointelegraph.com/news/is-xrp-a-security-we-may-never-know>.

<sup>77</sup> *See id.* (summarizing class action lawsuit where plaintiffs claim that Ripple sold XRP as an unregistered security).

<sup>78</sup> Rosner & Kang, *supra* note 4, at 660.

<sup>79</sup> *See XRP Price*, COINBASE, <https://www.coinbase.com/price/ripple> (last visited Mar. 21, 2020) (stating price of XRP in USD is \$0.15).

<sup>80</sup> Rosner & Kang, *supra* note 4, at 660.

<sup>81</sup> Cata, *supra* note 35.

<sup>82</sup> *Ripple Vs. Bitcoin: Key Differences*, *supra* note 56.

<sup>83</sup> Bold, *supra* note 57.

<sup>84</sup> Crosman, *supra* note 69.

<sup>85</sup> *Id.*

<sup>86</sup> *Id.*

Recognizing Ripple as a convenient alternative to the traditional international payment system, over two hundred financial institutions have joined RippleNet.<sup>87</sup> Payment companies and credit unions take advantage of XRP as a bridge currency,<sup>88</sup> and banks are beginning to use Ripple because it allows them to initiate payments without correspondent-banking relationships.<sup>89</sup> Prominent banks such as PNC, Santander, and Bank of America are Ripple customers as well.<sup>90</sup>

## II. SECURITIES REGULATION AND DIGITAL CURRENCIES

Securities markets in the United States are subject to regulation by the SEC under the Securities Act of 1933 and the Securities Exchange Act of 1934.<sup>91</sup> Under the Securities Act, if a company issues a security, it must file a registration statement with the SEC.<sup>92</sup> Recently, the rise of technologies such as Bitcoin and Ethereum has led to questions about how digital currencies fit into this regulatory framework.<sup>93</sup> This Part will provide an overview of securities regulation in the United States and describe how authorities have applied these regulations to digital assets.

### A. Federal Securities Regulation

In *Securities and Exchange Commission v. W.J. Howey Co.*, the Supreme Court laid out a test for determining what constitutes an investment contract subject to SEC regulation under the Securities Act.<sup>94</sup> Two Florida corporations offered prospective customers a land sales and service contract for their citrus property,<sup>95</sup> and they represented that customers could expect a return on their purchase over 10 years.<sup>96</sup> The issue before the Court was whether this arrangement was an investment contract.<sup>97</sup> The Court stated that the test of whether an agreement was an investment contract was “whether the scheme involves an investment of money in a common enterprise with profits to come solely from the efforts of others.”<sup>98</sup> Applying the test, the Court found that the arrangement

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<sup>87</sup> *Id.*

<sup>88</sup> David Floyd, *Ripple Event Reveal: 3 Companies are Now Using XRP for Real Payments*, COINDESK (Oct. 3, 2018), <https://www.coindesk.com/ripple-event-reveal-3-companies-are-now-using-xrp-for-real-payments>.

<sup>89</sup> Crosman, *supra* note 69.

<sup>90</sup> Nathan DiCamillo, *Blockchain-Shy Bank of America Quietly Pilots Ripple Technology*, COINDESK (Oct. 17, 2019), <https://www.coindesk.com/blockchain-shy-bank-of-america-quietly-pilots-ripple-technology>.

<sup>91</sup> See Michael Mendelson, *From Initial Coin Offering to Security Tokens: A U.S. Federal Securities Law Analysis*, 22 STAN. TECH. L. REV. 52, 64 (2019).

<sup>92</sup> Securities Act of 1933 § 5, 15 U.S.C. § 77e(a) (2012); Mendelson, *supra* note 91, at 65.

<sup>93</sup> See Mendelson, *supra* note 91, at 54–55 (“It is not obvious that cryptocurrencies and digital tokens fit neatly into a single category of regulation.”).

<sup>94</sup> Benjamin Akins, Jennifer L. Chapman & Jason Gordon, *The Case for the Regulation of Bitcoin Mining as a Security*, 19 VA. J.L. & TECH. 669, 684–85 (2015).

<sup>95</sup> Sec. & Exch. Comm’ v. W.J. Howey Co., 328 U.S. 293, 295 (1946).

<sup>96</sup> *Id.* at 296.

<sup>97</sup> *Id.* at 297.

<sup>98</sup> *Id.* at 310.



between the investors and the corporations met the criteria for an investment contract.<sup>99</sup> Today, securities practitioners refer to this test as the “*Howey* test.”<sup>100</sup> The four-part *Howey* test asks whether an arrangement is: (1) an investment of money, (2) in a common enterprise, (3) with the expectation of profits, and (4) solely from the efforts of others.<sup>101</sup> Over seventy years later, the *Howey* test remains generally unchanged for determining the existence of an investment contract subject to the Securities Act.<sup>102</sup>

### *B. Securities Regulation and Digital Currencies*

To raise money to develop digital assets networks, companies often sell tokens or coins in an initial coin offering (ICO).<sup>103</sup> These ICOs offer an alternative to selling shares, issuing notes, or obtaining bank financing.<sup>104</sup> Before July 2017, most ICOs launching digital currencies occurred without the filings required under the Securities Act.<sup>105</sup> ICOs operated with little regulation, leaving purchasers vulnerable to fraud.<sup>106</sup> It was unclear whether digital currencies were securities fitting into the traditional regulatory framework created by congressional legislation and enforced by the SEC.<sup>107</sup>

On July 25, 2017, the SEC released a report of its investigation to determine whether the creators of The Decentralized Autonomous Organization (DAO) violated federal securities laws.<sup>108</sup> The DAO existed on the Ethereum blockchain.<sup>109</sup> Its creators obtained Ether by selling DAO tokens to investors and used the Ether to fund projects.<sup>110</sup> Investors could purchase tokens by sending Ether from their Ethereum blockchain address to an address associated with The DAO.<sup>111</sup> When the ICO closed, the total

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<sup>99</sup> *Id.* 299–310.

<sup>100</sup> Mendelson, *supra* note 91, at 66.

<sup>101</sup> *Id.*

<sup>102</sup> *Id.*

<sup>103</sup> See William Hinman, Director, Division of Corporate Finance, SEC, Digital Asset Transactions: When *Howey* Met Gary (Plastic), Remarks at the Yahoo All Markets Summit: Crypto (June 14, 2018) [hereinafter Hinman Speech], <https://www.sec.gov/news/speech/speech-hinman-061418> (“Promoters, in order to raise money to develop networks on which digital assets will operate, often sell the tokens or coins rather than sell shares, issue notes, or obtain bank financing.”).

<sup>104</sup> *Id.*

<sup>105</sup> Mendelson, *supra* note 91, at 53.

<sup>106</sup> See *id.* at 54 (“The exuberance in the marketplace has made ICOs, and token purchasers the targets of scams, pyramid schemes, large cyberthefts, and flash price crashes.”).

<sup>107</sup> See *id.* at 54 (“ICOs had operated in a regulatory gray area, with many turning a blind eye to whether securities regulation applied.”).

<sup>108</sup> SECURITIES AND EXCHANGE COMMISSION, REPORT OF INVESTIGATION PURSUANT TO SECTION 21(A) OF THE SECURITIES EXCHANGE ACT OF 1934: THE DAO 1 (2017) [hereinafter DAO REPORT], <https://www.sec.gov/litigation/investreport/34-81207.pdf>.

<sup>109</sup> *Id.*

<sup>110</sup> *Id.*

<sup>111</sup> *Id.* at 6.

amount of Ether raised by The DAO was approximately \$150 million.<sup>112</sup> Promotional materials distributed by the creators stated that token holders would receive rewards produced by The DAO's projects, and the holders could then vote to either use the rewards to fund new projects or distribute Ether to token holders.<sup>113</sup> The DAO came to the SEC's attention when a hacker stole approximately one-third of the Ether raised by the original DAO offering on June 17, 2016.<sup>114</sup>

In its report, the SEC considered the facts surrounding the offer and sale of the DAO tokens to show that federal securities laws applied to the new paradigm of ICOs.<sup>115</sup> Applying the *Howey* test, the SEC concluded that the DAO tokens were securities subject to SEC regulation.<sup>116</sup> First, the SEC concluded that DAO tokens met the first prong of the *Howey* test,<sup>117</sup> investment of money,<sup>118</sup> because investors in The DAO used Ether to make their investments and received tokens in exchange for the Ether.<sup>119</sup> Next, the SEC concluded that the DAO tokens met the *Howey* test's second and third prongs,<sup>120</sup> an investment in a common enterprise with the expectation of profits.<sup>121</sup> The token holders were investing in a common enterprise and were motivated by the possibility of profits on their investment of Ether in The DAO.<sup>122</sup> Finally, the report found that DAO tokens met the final prong of the *Howey* test,<sup>123</sup> profits derived solely from other's efforts.<sup>124</sup> The creators of The DAO closely oversaw the organization, and the token holders had minimal voting rights.<sup>125</sup> Hence, the token holders relied significantly on The DAO founders' managerial efforts for return on their investment.<sup>126</sup>

Concluding that the tokens were a security and that the DAO was the issuer, the SEC found that The DAO was required to file a registration statement with the SEC.<sup>127</sup> While the SEC chose not to pursue enforcement action,<sup>128</sup> it emphasized the obligation of emerging technology companies to comply with regulations mandating securities registration.<sup>129</sup> The SEC

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<sup>112</sup> *Id.* at 3.

<sup>113</sup> *Id.* at 6.

<sup>114</sup> *Id.* at 9.

<sup>115</sup> *Id.* at 11.

<sup>116</sup> *See id.* (stating that DAO tokens were securities and citing components of the Sec. & Exch. Comm'n v. W.J. Howey Co., 328 U.S. 293 (1946) opinion).

<sup>117</sup> *See id.* (concluding investors in DAO invested money).

<sup>118</sup> Mendelson, *supra* note 91, at 66.

<sup>119</sup> DAO REPORT, *supra* note 108, at 11.

<sup>120</sup> *See id.* at 11 (finding that DAO token purchases invested in a common enterprise and reasonably expected to earn profits).

<sup>121</sup> Mendelson, *supra* note 91, at 66.

<sup>122</sup> DAO REPORT, *supra* note 108, at 11–12.

<sup>123</sup> *See id.* at 12 (finding profits were derived from the managerial efforts of others).

<sup>124</sup> Mendelson, *supra* note 91, at 66.

<sup>125</sup> DAO REPORT, *supra* note 108, at 13–14.

<sup>126</sup> *Id.* at 14.

<sup>127</sup> *Id.* at 16.

<sup>128</sup> *Id.* at 1.

<sup>129</sup> *Id.* at 2.

report put the ICO community on notice that failure to comply with securities regulations may lead to enforcement action.<sup>130</sup>

Moving forward, the SEC has confirmed that they will use a case-by-case approach to the *Howey* test to determine whether ICOs qualify as securities offerings.<sup>131</sup> During remarks at the Yahoo Finance All Markets Summit on June 14, 2018, William Hinman, the Director of the SEC's Division of Corporate Finance, implied that it was possible for a digital asset offered as a security to become something other than a security over time.<sup>132</sup> Hinman emphasized that the profit of an investment depends on a third party's efforts, so learning the essential information about the third party is necessary to make an informed investment decision.<sup>133</sup> Because ICOs usually give coin holders a financial interest in the company and depend on the promoter's efforts for profitability, most ICOs fit within the traditional regulatory framework for securities.<sup>134</sup> However, Hinman raised the issue that a digital asset may no longer be a security if its network is "sufficiently decentralized."<sup>135</sup> According to Hinman, if the efforts of the promoter are no longer crucial to determining the profitability of the investment, such as in a decentralized network, the asymmetry of information between the investor and the issuer would no longer be material.<sup>136</sup> Hinman stated that neither Bitcoin nor Ether was a security because each was decentralized.<sup>137</sup> Knowing that these sufficiently decentralized assets may not be securities is promising to an ICO community hoping to avoid SEC regulation.<sup>138</sup> However, the SEC has not offered an explicit definition of "sufficiently decentralized" or an operational test to apply to digital assets.<sup>139</sup>

In April 2019, the SEC released guidance to determine whether digital assets qualified as investment contracts under the *Howey* test.<sup>140</sup> The SEC addressed each element of the *Howey* test and listed relevant characteristics of a digital asset that may qualify as a security subject to SEC regulation.<sup>141</sup> First, the SEC only briefly addressed *Howey* test's first and second prongs, an investment of money and common enterprise,

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<sup>130</sup> Mendelson, *supra* note 91, at 68–69.

<sup>131</sup> *Id.* at 71.

<sup>132</sup> Hinman Speech, *supra* note 103.

<sup>133</sup> *Id.*

<sup>134</sup> *Id.*

<sup>135</sup> *Id.*

<sup>136</sup> *Id.*

<sup>137</sup> Bob Pisani, *Bitcoin and Ether are not Securities, but Some Initial Coin Offerings May Be*, *SEC Official Says*, CNBC (June 14, 2018), <https://www.cnbc.com/2018/06/14/bitcoin-and-ethereum-are-not-securities-but-some-cryptocurrencies-may-be-sec-official-says.html>.

<sup>138</sup> *Id.*

<sup>139</sup> *Id.*

<sup>140</sup> *Framework for "Investment Contract" Analysis of Digital Assets*, U.S. SEC & EXCHANGE COMMISSION (Apr. 3, 2019) [hereinafter *SEC Framework*], <https://www.sec.gov/corpfin/framework-investment-contract-analysis-digital-assets>.

<sup>141</sup> *Id.*

explaining that most digital assets meet that criteria.<sup>142</sup> Moving to the third and fourth prongs, a reasonable expectation of profits derived from others' efforts, the SEC divided them into two characteristics—reliance on the efforts of others and the reasonable expectation of profits—and examined them in detail.<sup>143</sup>

For the “reliance on the efforts of others,” the SEC listed characteristics, the stronger presence of which would make it more likely that the purchaser of a digital asset relies on the efforts of others.<sup>144</sup> One characteristic is that a third party is responsible for developing, improving, operating, and promoting the digital asset.<sup>145</sup> The third party may also create or support a market for the digital asset, or the third party may have a lead role in the direction of the digital asset's ongoing development.<sup>146</sup> Another characteristic is that the third party would hold a continuing managerial role in the characteristics of the asset, including how the asset would be traded, who would receive the asset, and the rights associated with ownership of the asset.<sup>147</sup> The purchasers would also reasonably expect the third party to make efforts to promote its interest and enhance the value of the digital asset.<sup>148</sup>

The SEC also listed characteristics that indicate purchasers of a digital asset have a “reasonable expectation of profits.”<sup>149</sup> The purchaser of a digital asset may have a reasonable expectation of profits if the digital asset gives the holder the right to share in the enterprise's income or realize a gain from capital appreciation.<sup>150</sup> The digital asset may be offered broadly to potential purchasers or traded through secondary markets.<sup>151</sup> Another characteristic is that the third party continues to expend funds from the proceeds of its operation to enhance the digital asset's value.<sup>152</sup> While this publication served as guidance for the cryptocurrency community, it did not function as a rule or regulation.<sup>153</sup>

### III. *IN RE RIPPLE LABS INC. LITIGATION* OVERVIEW

In 2018, purchasers of XRP filed class action lawsuits against Ripple Labs for the sale of unregistered securities.<sup>154</sup> This Part will provide an overview of the pending litigation, up to the most recently available information.

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<sup>142</sup> *Id.*

<sup>143</sup> *Id.*

<sup>144</sup> *Id.*

<sup>145</sup> *Id.*

<sup>146</sup> *Id.*

<sup>147</sup> *Id.*

<sup>148</sup> *Id.*

<sup>149</sup> *Id.*

<sup>150</sup> *Id.*

<sup>151</sup> *Id.*

<sup>152</sup> *Id.*

<sup>153</sup> *Id.*

<sup>154</sup> Molly Jane Zuckerman, *Class Action Lawsuit Against Ripple Alleges Sale of Unregistered Securities*, COINTELEGRAPH (May 4, 2018), <https://cointelegraph.com/news/class-action-lawsuit-against-ripple-alleges-sale-of-unregistered-securities>.

### A. *Original Cases*

On May 3, 2018, in California state court, Ryan Coffey filed a class action lawsuit on behalf of all investors who purchased XRP issued and sold by Ripple against Ripple Labs and its co-conspirators.<sup>155</sup> In his complaint, Coffey alleged that XRP had all the requisite characteristics of a security, but that Ripple Labs did not register XRP as a security per federal securities laws.<sup>156</sup> Coffey requested that he and the other members of his class receive damages and that the court prevent Ripple Labs from continuing to violate securities laws through the unregistered sale of XRP.<sup>157</sup>

Although he voluntarily dismissed his case,<sup>158</sup> Coffey's complaint provided a strong foundation for future lawsuits against Ripple.<sup>159</sup> In the months following Coffey's first class action, Vladi Zakinov, David Oconer, and Avner Greenwald filed class actions against Ripple in California state court,<sup>160</sup> making similar allegations to Coffey's.<sup>161</sup>

### B. *Consolidated Case*

The California state court consolidated the Zakinov, Oconer, and Greenwald class actions and renamed them *In re Ripple Labs Inc. Litigation*.<sup>162</sup> Ripple later removed the class action to the United States District Court for the Northern District of California.<sup>163</sup> Following the consolidation and removal, the plaintiffs filed an amended complaint with new arguments.<sup>164</sup> A notable difference between the new complaint and the previous complaint is that the new complaint cited the SEC's framework for determining whether a digital asset is a digital security.<sup>165</sup> The plaintiffs claimed that XRP is a security based on the SEC's framework, arguing that XRP purchasers invested money in a common enterprise with a reasonable expectation of profits and that the success of XRP required the efforts of Ripple.<sup>166</sup> Ripple responded to the amended complaint by filing a motion to dismiss the class action on September 19,

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<sup>155</sup> Complaint, *supra* note 9, at 1.

<sup>156</sup> *Id.* at 2–3.

<sup>157</sup> *Id.* at 29.

<sup>158</sup> Notice of Voluntary Dismissal Without Prejudice, *supra* note 11, at 1–2.

<sup>159</sup> See Hodder, *supra* note 10 (stating that *Zarinkov* complaint copies much of Coffey's complaint).

<sup>160</sup> *Id.*; Complaint at 1, Greenwald v. Ripple Labs Inc., No. 18CIV03461 (Cal. App. Dep't Super. Ct. July 3, 2018) [hereinafter Greenwald Complaint].

<sup>161</sup> Hodder, *supra* note 10; Greenwald Complaint, *supra* note 160.

<sup>162</sup> Notice of Removal at 2–3, Zakinov v. Ripple Labs Inc., 369 F. Supp. 3d 950 (N.D. Cal. 2019) (No. 18-6753).

<sup>163</sup> *Id.* at 1.

<sup>164</sup> Consolidated Complaint for Violations of Federal and California Law, Zakinov v. Ripple Labs Inc., 369 F. Supp. 3d 950 (No. 18-6753) [hereinafter Consolidated Complaint].

<sup>165</sup> Nikhilesh De, *SEC Guidance Gives Ammo to Lawsuit Claiming XRP Is Unregistered Security*, COINDESK (Aug. 13, 2019), <https://www.coindesk.com/investors-suing-ripple-cite-sec-guidance-to-argue-xrp-is-a-security>.

<sup>166</sup> Consolidated Complaint, *supra* note 164, at 29–33.

2019.<sup>167</sup> Rather than arguing why XRP is not a security,<sup>168</sup> Ripple claimed that the plaintiffs were unable to raise their federal securities claims due to a three-year limitation in the statute.<sup>169</sup> Ripple only addressed whether XRP was a security in a footnote, arguing that XRP was not an investment contract under *Howey* because purchasing XRP did not constitute an investment in Ripple and that there was not a common enterprise between Ripple and XRP purchasers.<sup>170</sup> Ripple also argued that it did not promise to generate profit for XRP holders and that the XRP Ledger was decentralized.<sup>171</sup> On February 26, 2020, the judge for the United States District Court for the Northern District of California allowed the suit to proceed, only dismissing some of the claims filed under California state law.<sup>172</sup>

#### IV. PREDICTED CLASSIFICATION OF XRP

The pending class action lawsuit and its broader consequences pose an existential threat to Ripple Labs. Even if Ripple wins this particular lawsuit, it will remain a constant target for lawsuits and regulatory action due to XRP's ambiguous security status.<sup>173</sup> This Part will argue that XRP is a security by examining the digital asset in the context of the *Howey* test, legal precedent regarding digital assets, and other indicators.

##### A. XRP and the *Howey* Test

XRP qualifies as a security subject to regulation by the SEC under *Howey*—the sale of XRP involves an investment of money in a common enterprise with profits derived solely from others' efforts.<sup>174</sup> The section will discuss how each prong of the *Howey* test applies to XRP.

First, XRP involves an investment of money because individuals can purchase XRP through various exchanges using fiat currencies or

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<sup>167</sup> Notice of Motion and Motion to Dismiss at 1, *Zakinov v. Ripple Labs Inc.*, 369 F. Supp. 3d 950 (No. 18-6753) [hereinafter Motion to Dismiss].

<sup>168</sup> See Nikhilesh De, *Ripple Avoids Securities Question in Motion to Dismiss XRP Lawsuit*, COINDESK (Sept. 20, 2019), <https://www.coindesk.com/ripple-avoids-securities-question-in-motion-to-dismiss-xrp-lawsuit> (“Notably absent from the motion to dismiss is a full-fledged argument over why XRP is not a security.”).

<sup>169</sup> Motion to Dismiss, *supra* note 167, at 1.

<sup>170</sup> *Id.* at 21 n.19.

<sup>171</sup> *Id.*

<sup>172</sup> Nikhilesh De, *Ripple Class-Action Lawsuit Can Proceed, Judge Rules*, COINDESK (Feb. 26, 2020), <https://www.coindesk.com/ripple-class-action-lawsuit-can-proceed-judge-rules>.

<sup>173</sup> See Nikhilesh De, *What's Next in the Securities Case Against Ripple Over XRP*, COINDESK (Nov. 4, 2019), <https://www.coindesk.com/whats-next-in-the-securities-case-against-ripple-over-xrp> (referring to statements of attorneys following the case).

<sup>174</sup> See *Sec. & Exch. Comm'n v. W.J. Howey Co.*, 328 U.S. 293, 300 (1946) (providing a test for whether a scheme is an investment contract).

cryptocurrencies.<sup>175</sup> The Ripple website even provides a list of thirty exchanges on which individuals can purchase XRP.<sup>176</sup>

Second, an investment in XRP constitutes an investment in a common enterprise because the fortunes of the XRP purchasers can be linked to the success of Ripple's efforts.<sup>177</sup> Ripple has conceded that it "sells XRP to fund its operations and promote the network," but the website featuring this statement has been removed.<sup>178</sup> Moreover, the SEC concluded that a common enterprise typically exists when evaluating a digital asset.<sup>179</sup>

Third, XRP purchasers reasonably expected profits from their investment.<sup>180</sup> XRP possesses many of the characteristics that the SEC lists as increasing the likelihood that there is a reasonable expectation of profits.<sup>181</sup> For example, individuals may purchase XRP on a variety of secondary exchanges,<sup>182</sup> and realize a gain from the appreciation of XRP by selling XRP on one of those secondary exchanges.<sup>183</sup> Additionally, XRP is broadly offered to potential purchasers because anyone with access to cryptocurrency exchanges may purchase the digital asset.<sup>184</sup>

Finally, XRP purchasers relied on the efforts of Ripple's managers for the success of the entire enterprise.<sup>185</sup> Ripple supports the market for XRP by controlling the creation and issuance of XRP and limiting its supply.<sup>186</sup> In the fourth quarter of 2017, Ripple cryptographically-secured 55 billion XRP in an escrow account to control the supply of XRP.<sup>187</sup> In

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<sup>175</sup> See *How to Buy Ripple*, *supra* note 74 (providing instruction for how to buy XRP).

<sup>176</sup> See *XRP Buying Guide*, RIPPLE, <https://www.ripple.com/xrp/buy-xrp/> (last visited Nov. 11, 2019) (providing a list of exchanges to purchase XRP).

<sup>177</sup> See *SEC Framework*, *supra* note 140, n.11 (explaining why the SEC's experiences have indicated that digital assets have constituted investment in a common enterprise).

<sup>178</sup> See Silver, *supra* note 76 (citing an archived website, *Ripple Credits*, WIKI.RIPPLE, [https://web.archive.org/web/20170928101259/https://wiki.ripple.com/Ripple\\_credits](https://web.archive.org/web/20170928101259/https://wiki.ripple.com/Ripple_credits) (last modified July 12, 2014)).

<sup>179</sup> *SEC Framework*, *supra* note 140.

<sup>180</sup> See *id.* (summarizing indicators that a digital asset involves a reasonable expectation of profits).

<sup>181</sup> *Id.*

<sup>182</sup> *XRP Buying Guide*, *supra* note 176.

<sup>183</sup> See *SEC Framework*, *supra* note 140 ("The digital asset gives the holder rights to share in the enterprise's income or profits or to realize gain from the capital appreciation of the digital asset.").

<sup>184</sup> *XRP Buying Guide*, *supra* note 176.

<sup>185</sup> See *SEC Framework*, *supra* note 140 (summarizing indicators that a digital asset involves reliance on the efforts of others).

<sup>186</sup> See *id.* (illustrating that a third party can support a market by "(1) control[ing] the creation and issuance of the digital asset; or (2) tak[ing] other actions to support a market price of the digital asset, such as by limiting supply or ensuring scarcity").

<sup>187</sup> Cory Johnson & Miguel Vias, *Q3 2018 XRP Markets Report*, RIPPLE (Oct. 25, 2018), <https://ripple.com/insights/q3-2018-xrp-markets-report/>.

each of its XRP quarterly markets reports, Ripple shares updates on the XRP market “to continually improve the health of XRP markets globally,” indicating support for the market of the digital asset.<sup>188</sup> Further, in distinguishing itself from other cryptocurrencies in a 2017 XRP report, Ripple noted that “it’s clear Ripple’s consistent and steadfast support of XRP is a major advantage as the payments industry continues to seriously consider it as an alternative liquidity solution.”<sup>189</sup> Hence, before the litigation began, Ripple presented its control over XRP as a strength.<sup>190</sup> Even taking into account Director Hinman’s statements,<sup>191</sup> Ripple is not sufficiently decentralized to escape classification as an investment contract. XRP purchasers still expect Ripple’s directors to carry out essential managerial functions, and Ripple’s managers remain critical in determining the network’s success.<sup>192</sup>

### B. *New Legal Precedent*

Given the relative recency of the ICO, case law determining whether a digital asset qualifies as an investment contract under *Howey* is limited. Recently, several lawsuits have been filed on behalf of plaintiffs who purchased digital assets that were not registered as securities under the Securities Act. In many of the cases, the courts are quick to classify the digital as a security, foreshadowing a similar outcome for *In re Ripple Labs Inc. Litigation*.

#### 1. *Balestra v. ATBCOIN LLC*

ATBCOIN, or ATB, was a technology start-up company launched to facilitate rapid, inexpensive digital financial transactions through blockchain technology.<sup>193</sup> The founders of the company offered digital ATB Coins to the general public in exchange for digital assets without filing a registration statement with the SEC.<sup>194</sup> The ICO’s purpose was to provide funding to create and launch the network for the coins to operate.<sup>195</sup> On December 21, 2017, purchasers of the digital assets filed a class action lawsuit in New York federal district court, claiming that the ATB’s founders violated the Securities Act by offering and selling unregistered securities.<sup>196</sup> In response to the defendants’ motion to dismiss for failure to state a claim, the court analyzed ATB Coins within the *Howey* test context.<sup>197</sup> Concluding that the plaintiffs plausibly alleged facts supporting that the digital asset was an “investment contract,” the court

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<sup>188</sup> *E.g., id.*

<sup>189</sup> Miguel Vias, *Q4 2017 XRP Markets Report*, RIPLE (Jan. 24, 2018), <https://ripple.com/insights/q4-2017-xrp-markets-report/>.

<sup>190</sup> *See id.* (describing Ripple’s support of XRP as an advantage).

<sup>191</sup> Hinman Speech, *supra* note 103.

<sup>192</sup> *See* Arjun Govind, *Should Ripple’s XRP Be Classified as a Security?*, MEDIUM (July 21, 2019), <https://medium.com/swlh/should-ripples-xrp-be-classified-as-a-security-409ec3662d94> (“[A]ny capital gains that result from the appreciation of XRP will be through third-party effort . . .”).

<sup>193</sup> *Balestra v. ATBCOIN LLC*, 380 F. Supp. 3d 340, 346 (S.D.N.Y. 2019).

<sup>194</sup> *Id.* at 347–48.

<sup>195</sup> *Id.* at 347.

<sup>196</sup> *Id.* at 348.

<sup>197</sup> *See id.* at 352–57.



denied the defendants' motion to dismiss.<sup>198</sup> While the *Balestra* case is not yet resolved, the recent denial of the motion to dismiss has troublesome implications for the pending ruling on Ripple's motion to dismiss. Moreover, the parallels between XRP and the ATB Coin—digital assets meant to be used on a digital payment network—foreshadows a similar classification fate for XRP.<sup>199</sup>

## 2. *Hodges v. Harrison*

Monkey Capital, LLC scheduled an ICO and solicited investors in its token, representing to investors that the token would increase in value.<sup>200</sup> Monkey Capital was promoted as a decentralized hedge fund invested in SpaceX contracts and digital assets.<sup>201</sup> The hedge fund did not register the token with the SEC or obtain an exemption from registration requirements.<sup>202</sup> The ICO never occurred, and individuals who contributed cryptocurrency worth millions of dollars in advance of the ICO filed a motion for summary judgment in Florida federal district court,<sup>203</sup> claiming that Monkey Capital's offer and sale of unregistered securities in violation of the Securities Act. Concluding that the token satisfied all of the requirements of an investment contract under *Howey*, the district judge granted the plaintiffs' motion.<sup>204</sup> While Ripple did not fail to launch an ICO for XRP, the court's eagerness to classify the digital asset as an investment contract in *Hodges* may have harmful implications for XRP.

## 3. *Solis v. Latium Network Inc.*

Latium was a tasking platform that allowed users to pay each other with its cryptocurrency, LatiumX tokens.<sup>205</sup> Latium conducted an ICO, and investors could purchase the tokens with either U.S. dollars or Ether.<sup>206</sup> On June 6, 2018, one of the investors filed a class action against Latium, alleging that the founders violated the Securities Act by offering and selling unregistered securities in the form of LatiumX tokens.<sup>207</sup> The federal district of New Jersey concluded that the plaintiffs adequately alleged that LatiumX tokens were investment contracts under *Howey*.<sup>208</sup> Accordingly, the court denied the defendants' motion to dismiss.<sup>209</sup> Considering XRP is also a digital asset intended for use on its creator's platform, the court in *In re Ripple Labs Inc. Litigation* may deploy the *Latium* court's reasoning and conclude that XRP is an investment contract.

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<sup>198</sup> *Id.* at 357.

<sup>199</sup> *See id.* at 347 (describing the characteristics of ATB Coin).

<sup>200</sup> *Hodges v. Harrison*, 372 F. Supp. 3d 1342, 1347 (S.D. Fla. 2019).

<sup>201</sup> *Team Monkey Capital*, ICO BENCH, <https://icobench.com/ico/monkey-capital/team> (last visited Dec. 15, 2019).

<sup>202</sup> *Hodges*, 372 F. Supp. 3d at 1347.

<sup>203</sup> *Id.* at 1345.

<sup>204</sup> *Id.* at 1348–49.

<sup>205</sup> *Solis v. Latium Network*, No. 18-10255 (SDW) (SCM), 2018 U.S. Dist. LEXIS 20778, at \*1 (D.N.J. Dec. 10, 2018).

<sup>206</sup> *Id.*

<sup>207</sup> *Id.*

<sup>208</sup> *Id.* at 2–3.

<sup>209</sup> *Id.* at 4.

### C. Other Indicators

Other recent developments in the cryptocurrency community indicate that XRP is likely a security subject to registration requirements under the Securities Act. Prominent cryptocurrency exchanges, including Coinbase Inc., Kraken, Circle Internet Financial Ltd., and Bittrex, Inc., have cooperated to create the Crypto Rating Council.<sup>210</sup> The Crypto Rating Council developed a system to rate digital assets based on how strongly an asset's characteristics are consistent with those of a security, with an asset with a rating of 1 having the least characteristics, and an asset rating of 5 having the most characteristics.<sup>211</sup> The council bases ratings on how closely each asset meets the four prongs of the *Howey* test.<sup>212</sup> The group lists the ratings of twenty different digital assets and provides a brief explanation for the rating.<sup>213</sup> The council gave XRP a rating of 4, citing the securities-like language used by Ripple, Ripple's decentralized development and usage, the sale of XRP before it was useful on the platform, and the marketing by Ripple, suggesting an opportunity to earn profits.<sup>214</sup>

## V. POSSIBLE RESOLUTION

The SEC has responded to several unregistered ICO issuances similar to Ripple's offering of XRP.<sup>215</sup> Hence, there is a potential template in place for the SEC's resolution of Ripple's illegal ICO. This Part will examine how the SEC has resolved past illegal ICOs and how the SEC may apply its existing regulatory framework to Ripple.

### A. SEC's Treatment of Past Unregistered ICOs

The SEC resolved its first cases imposing civil penalties exclusively for ICO securities offering registration violations in November 2018.<sup>216</sup> The SEC settled charges against two companies, Airfox and Paragon Coin Inc., that sold digital tokens through ICOs without

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<sup>210</sup> Dave Michaels, *Cryptocurrency Exchanges Including Coinbase Disclose Ratings of Digital Assets*, WALL ST. J. (Sept. 30, 2019), <https://www.wsj.com/articles/cryptocurrency-exchanges-including-coinbase-to-rate-digital-assets-11569835801>.

<sup>211</sup> *Id.*

<sup>212</sup> *About Our Asset Rating Framework*, CRYPTO RATING COUNCIL, <https://www.cryptoratingcouncil.com/framework> (last visited Nov. 13, 2019).

<sup>213</sup> *See CRC Securities Framework Asset Ratings*, CRYPTO RATING COUNCIL, <https://www.cryptoratingcouncil.com/asset-ratings> (last visited Nov. 13, 2019) (providing the list of assets and their rating).

<sup>214</sup> *Id.*

<sup>215</sup> *See, e.g., SEC Charges ICO Incubator and Founder for Unregistered Offering and Unregistered Broker Activity*, U.S. SEC. & EXCHANGE COMMISSION (Sept. 18, 2019) [hereinafter *ICOBox Press Release*], <https://www.sec.gov/news/press-release/2019-181> (providing a summary of the SEC's complaint against ICOBox and Evdokimov for an illegal ICO).

<sup>216</sup> *Two ICO Issuers Settle SEC Registration Charges, Agree to Register Tokens as Securities*, U.S. SEC. & EXCHANGE COMMISSION (Nov. 16, 2018) [hereinafter *Airfox and Paragon Press Release*], <https://www.sec.gov/news/press-release/2018-264>.

registering per federal securities laws.<sup>217</sup> Airfox and Paragon's ICOs raised approximately \$15 million and \$12 million, respectively.<sup>218</sup> The SEC's orders imposed \$250,000 in penalties against each company and required them to compensate harmed investors who purchased the digital assets in illegal offerings.<sup>219</sup> The companies were also required to register their digital assets per federal securities laws and file periodic reports with the SEC for one year.<sup>220</sup>

On June 4, 2019, the SEC sued Kik Interactive Inc. for conducting a \$100 million ICO without registering its tokens.<sup>221</sup> According to SEC, Kik marketed its tokens as an investment opportunity.<sup>222</sup> The SEC requested that the court enjoin Kik from violating securities laws, order Kik to disgorge their gains from the ICO, and pay civil penalties.<sup>223</sup>

On September 18, 2019, the SEC filed a complaint against ICOBox and its founder for conducting a \$14.6 million ICO without proper registration.<sup>224</sup> In their complaint, the SEC requested that the court prevent ICOBox from violating federal securities laws, order ICOBox to disgorge funds received through their illegal ICO, and order ICOBox to pay civil penalties.<sup>225</sup>

On September 30, 2019, the SEC announced that it settled charges against Block.one for conducting an unregistered ICO in violation of federal securities laws.<sup>226</sup> Block.one raised approximately \$4 billion in an ICO to raise capital for general expenses and to develop software and promote blockchains based on that software.<sup>227</sup> Block.one agreed to pay a \$24 million civil monetary penalty.<sup>228</sup>

On October 11, 2019, the SEC announced that it filed an emergency action and obtained a temporary restraining order against Telegram Group and its subsidiary TON Issuer Inc. for conducting a \$1.7 billion unregistered ICO in violation of federal securities laws.<sup>229</sup> The SEC

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<sup>217</sup> *Id.*

<sup>218</sup> *Id.*

<sup>219</sup> *Id.*

<sup>220</sup> *Id.*

<sup>221</sup> *SEC Charges Issuer With Conducting \$100 Million Unregistered ICO*, U.S. SEC. & EXCHANGE COMMISSION (June 4, 2019) [hereinafter *Kik Press Release*], <https://www.sec.gov/news/press-release/2019-87>.

<sup>222</sup> *Id.*

<sup>223</sup> Complaint at 48, SEC v. Kik, No. 19-cv-5244 (S.D.N.Y. June 4, 2019).

<sup>224</sup> *ICOBox Press Release*, *supra* note 215.

<sup>225</sup> Complaint at 24, SEC v. ICOBox, No. 19-cv-08066 (C.D. Cal. Sept. 18, 2019).

<sup>226</sup> *SEC Orders Blockchain Company to Pay \$24 Million Penalty for Unregistered ICO*, U.S. SEC. & EXCHANGE COMMISSION (Sept. 30, 2019) [hereinafter *Block.one Press Release*], <https://www.sec.gov/news/press-release/2019-202>.

<sup>227</sup> Kate Rooney, *A Blockchain Start-up Just Raised \$4 billion Without a Live Product*, CNBC (May 31, 2018), <https://www.cnbc.com/2018/05/31/a-blockchain-start-up-just-raised-4-billion-without-a-live-product.html>.

<sup>228</sup> *Block.one Press Release*, *supra* note 226.

<sup>229</sup> *SEC Halts Alleged \$1.7 Billion Unregistered Digital Token Offering*, U.S. SEC. & EXCHANGE COMMISSION (Oct. 11, 2019) [hereinafter *Telegram Press Release*], <https://www.sec.gov/news/press-release/2019-212>.

intended its emergency action to prevent Telegram from introducing the illegally sold digital assets to United States markets.<sup>230</sup>

*B. The SEC's Approach to Ripple and its Impact*

When asked whether the SEC would implement enforcement actions against Ripple, SEC Chairman Jay Clayton refused to comment, only revealing that “there are a number of factors that go into the assessment of any remedial action.”<sup>231</sup> Although the SEC has not yet filed a complaint against Ripple, its historical treatment of unregistered ICOs indicates that it will likely take steps to resolve Ripple’s unregistered sale and issuance of XRP.<sup>232</sup>

The SEC’s approach to Ripple would likely begin with a complaint filed against the company for selling XRP without registering their offer and sale as required by federal securities laws.<sup>233</sup> In the complaint, the SEC would request that the court prevent Ripple from continuing to sell XRP in violation of the Securities Act, order Ripple to relinquish any profits it made from the unregistered sale of XRP, and order Ripple to pay a civil monetary penalty.<sup>234</sup> In reality, the SEC would likely settle charges with Ripple, and the resolution would resemble settlements reached with other unregistered ICO issuers.<sup>235</sup> To continue selling XRP, the SEC would require Ripple to register XRP as a security under the Securities Act.<sup>236</sup> Through the registration process, the Ripple would disclose essential financial information to the SEC, including a description of Ripple’s properties and business, a description of XRP, information about the management of Ripple, and financial statements certified by independent accountants.<sup>237</sup> The SEC may also require Ripple to file periodic reports for one year to ensure compliance with federal securities laws.<sup>238</sup>

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<sup>230</sup> *Id.*

<sup>231</sup> *See Is XRP a Security? SEC Chief Faces Direct Question on Key Ripple Concern*, DAILY HODL (Oct. 25, 2019), <https://dailyhodl.com/2019/10/25/is-xrp-a-security-sec-chief-faces-direct-question-on-key-ripple-concern/> (providing comments by Jay Clayton that “[w]e don’t comment on specific enforcement matters or whether matters are under review”).

<sup>232</sup> *See, e.g., Airfox and Paragon Press Release*, *supra* note 216.

<sup>233</sup> *See Kik Press Release*, *supra* note 221 (providing a summary of the SEC’s complaint against Kik).

<sup>234</sup> *See id.* (providing a summary of the SEC’s request for relief).

<sup>235</sup> *See, e.g., Airfox and Paragon Press Release*, *supra* note 216 (providing examples of ICO issuers that settled with the SEC).

<sup>236</sup> *See id.* (requiring Airfox and Paragon to register their digital assets with the SEC).

<sup>237</sup> *Registration Under the Securities Act of 1933*, U.S. SEC. & EXCHANGE COMMISSION (Sept. 2, 2011), <https://www.sec.gov/fast-answers/answers-regis33htm.html>.

<sup>238</sup> *See Airfox and Paragon Press Release*, *supra* note 216 (requiring the two companies to file periodic reports with the SEC).

Predicting the number of civil penalties that the SEC would impose against Ripple presents a greater challenge.<sup>239</sup> Since its first quarterly markets report, Ripple has received \$1.2 billion in funding from selling XRP.<sup>240</sup> Based on the current circulating supply,<sup>241</sup> XRP's current market capitalization is \$6.9 billion,<sup>242</sup> and there are still approximately 50 billion XRP locked in escrow for Ripple Labs<sup>243</sup> with a current value of about \$7.8 billion.<sup>244</sup> It follows that Ripple's benefit from previous XRP sales combined with future sales at the current price is approximately \$8.1 billion.<sup>245</sup> Following SEC's approach to Airfox, Paragon, and Block.one,<sup>246</sup> the civil penalties applied to Ripple may be between \$48.6 million and \$170.1 million.<sup>247</sup> Given that Ripple sells 1 billion XRP per month,<sup>248</sup> at current prices, Ripple would be able to pay off the maximum predicted penalty in about a month.<sup>249</sup>

In addition to civil monetary penalties, the SEC required other ICO issuers to return funds to harmed investors.<sup>250</sup> The financial obligation of returning the funds raised from 43 billion XRP would devastate Ripple and likely threaten its existence.<sup>251</sup> Given Ripple's scale,<sup>252</sup> the SEC would more likely impose a fine reflecting a small percentage of funds raised through XRP's sale.

Beyond monetary penalties, classifying XRP as a security would have significant long-term effects on Ripple's future.<sup>253</sup> XRP owners

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<sup>239</sup> See Paul de Havilland, *\$322 Million: How The SEC Should Settle With Ripple Labs Over XRP*, CRYPTO BRIEFING (Oct. 2, 2019), <https://cryptobriefing.com/322-million-sec-ripple-labs-fine-xrp/> (describing methods of calculating a potential penalty).

<sup>240</sup> Greg Cipolaro, *DAR Weekly Crypto Wrap*, MEDIUM (Oct. 25, 2019), <https://medium.com/digitalassetresearch/dar-weekly-10-25-19-d424aebdc25b>.

<sup>241</sup> De Havilland, *supra* note 239.

<sup>242</sup> XRP, COINMARKETCAP, <https://coinmarketcap.com/currencies/ripple/> (last visited Mar. 21, 2020).

<sup>243</sup> De Havilland, *supra* note 239.

<sup>244</sup> XRP, *supra* note 242. The current price of XRP is \$0.158499, so the current value of XRP locked in escrow is approximately \$7.8 billion.

<sup>245</sup> See de Havilland, *supra* note 239 (adding the value of funding from XRP so far with the value of XRP locked in escrow).

<sup>246</sup> See *id.* (providing the penalty imposed as a percentage of the amount raised from the unregistered ICO).

<sup>247</sup> The monetary penalties placed on Airfox, Paragon, and Block.one reflected between 0.6% and 2.1% of the amount raised from the unregistered ICOs. 0.6% of \$8.1 billion is \$48.6 million, and 2.1% of \$8.1 billion is \$170.1 million.

<sup>248</sup> Crosman, *supra* note 70.

<sup>249</sup> See XRP, *supra* note 242 (giving the current market price of XRP). 1 billion XRP is currently worth \$158,499,000.

<sup>250</sup> De Havilland, *supra* note 239.

<sup>251</sup> See *id.* (explaining that returning 43 billion XRP would cost Ripple Labs approximately \$10 billion).

<sup>252</sup> See *Block.one Press Release*, *supra* note 226 (providing that the Block.one ICO raised several billion dollars).

<sup>253</sup> Joyce Lang, *Analysis: Is XRP a Security? What if XRP is Deemed a Security?*, COINNOUNCE (Mar. 6, 2019), <https://coinnounce.com/analysis-is-xrp-a-security-what-if-xrp-is-deemed-a-security/>.

would own shares of the Ripple company.<sup>254</sup> Most analysts believe that current XRP owners would sell their holdings *en masse* in the wake of the cryptocurrency's uncertainty, causing the price to drop dramatically.<sup>255</sup> Even if the price of XRP eventually recovered, XRP would be less useful in international payments due to liquidity restrictions resulting from its security classification.<sup>256</sup> Given that a security classification would threaten both Ripple's finances and XRP's utility to Ripple, an SEC enforcement action would pose an existential threat to the company.

### CONCLUSION

Through the development of its international payment network, Ripple Labs may have revolutionized international payments. Its native currency, XRP, could eliminate the need for the inefficient and expensive communications network and correspondent-banking relationships required by traditional international payment systems. In its development and sale of XRP, however, Ripple almost certainly created a security subject to the cumbersome registration requirements of the Securities Act.

In contrast to the ICO issuers that have been the target of recent SEC enforcement actions, Ripple is a large, influential company, and the XRP token is highly integrated within the cryptocurrency sector.<sup>257</sup> Although the characteristics of XRP have been apparent for several years, the SEC has not yet implemented any action against Ripple.<sup>258</sup> The SEC may be reluctant to bring charges against Ripple because it recognizes the potentially broad impact of classifying XRP as a security.<sup>259</sup> Nonetheless, Ripple has engaged in extensive lobbying efforts to influence industry regulation, including opening an office in Washington, D.C. and hiring former regulators.<sup>260</sup> As more securities class actions arise, and disgruntled XRP purchasers continue to publicize the digital assets' troublesome status, the SEC may have no choice but to bring an enforcement action against Ripple. Hence, *In re Ripple Labs Inc. Litigation* may signal the beginning of the end of Ripple's innovation.

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<sup>254</sup> Anthony Balladon, *Is Ripple's XRP Token a Security and What Happens if the SEC Regulates It as One?*, MEDIUM (Apr. 29, 2019), <https://medium.com/@anthonyballadon/is-ripples-xrp-token-a-security-and-what-happens-if-the-sec-regulates-it-as-one-46370afed6f4>.

<sup>255</sup> *Id.*

<sup>256</sup> *Id.*

<sup>257</sup> See Paddy Baker, *Too Big To Fail: Why XRP Might Escape A Securities Classification*, CRYPTO BRIEFING (Nov. 26, 2018), <https://cryptobriefing.com/xrp-security-ripple-labs/> ("The thing with XRP is it's almost like a too big to fail, too far along.")

<sup>258</sup> See *id.* (explaining that the XRP token sale took place in 2013 and that "the SEC itself hasn't brought charges against Ripple").

<sup>259</sup> See *id.* (comparing XRP to Ether, which labelling a security would "tank most of the market").

<sup>260</sup> See Ben Munster, *Ripple Expands Lobbying Efforts with move to Washington, D.C.*, DECRYPT (Oct. 22, 2019), <https://decrypt.co/10653/ripple-expands-lobbying-efforts-with-move-to-d-c> (explaining Ripple's efforts to expand its lobbying power by opening a Washington, D.C. office and hiring former regulatory officials).