

Reconciling Disjunct Cryptocurrency Securities Enforcement with Purchaser Expectations

*Jacob E. Simmons**

ABSTRACT

The Southern District of New York’s July 2023 decision in *SEC v. Ripple Labs, Inc.* has been touted as a monumental win for cryptocurrency purchasers and related businesses. The *Ripple* court held that, except institutional investor transactions, all sales of Ripple’s XRP token were not investment contracts, a class of security subject to federal securities law. The court’s ruling meant that Ripple could not be held liable for the unregistered trading of XRP beyond its sales to institutional investors. *Ripple* adds new insights to a pervasive policymaking dilemma addressed in this Note: is the Securities and Exchange Commission’s (SEC) regulatory approach effectively serving purchasers? This Note answers this question in the negative and explores the disconnect between the SEC’s approach and the actual protection of purchasers. First, it briefly surveys the value of cryptocurrency like XRP to outline the many forms digital assets take beyond a passive, speculative investment. Second, it outlines the framework for SEC enforcement under the Supreme Court’s *Howey* test for “investment contracts” and securities registration requirements in Section 5 of the Securities Act. Third, it examines the *Ripple* court’s holding regarding reasonable expectation of profit to distinguish XRP trading activity from investment contracts under *Howey*. Fourth, it contends that the *Ripple* court’s focus on enforcing securities law to protect reasonable investor expectations of profit is a proper step toward addressing a larger regulatory disconnect between the SEC and the investing public it is entrusted to serve.

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INTRODUCTION

National surveys suggest a majority of Americans are not confident in the safety and reliability of cryptocurrency.¹ Skepticism is also common among financial experts.² The SEC has brought over a hundred suits and fifty administrative proceedings against parties engaged in the sale or exchange of cryptocurrency.³ But while public perception of cryptocurrency is mixed at best, market value tells another story. The global cryptocurrency market capitalization is well over a trillion dollars.⁴ Institutional investors have successfully prompted the SEC to approve spot Bitcoin exchange-traded funds after years of lobbying.⁵ Despite the general public's distrust toward cryptocurrency, a recent survey suggests one in four Americans with an investment account own cryptocurrency.⁶ In the backdrop, industry leaders have persistently provided regulators with rulemaking proposals to clarify the required disclosures for various cryptocurrencies.⁷

A question that continues to loom over cryptocurrency is whether it may be classified as a “security” under certain circumstances. Broadly, a

1. E.g., Michelle Faverio & Olivia Sidoti, *Majority of Americans Aren't Confident in the Safety and Reliability of Cryptocurrency*, PEW RSCH. CTR. (Apr. 10, 2023), <https://www.pewresearch.org/short-reads/2023/04/10/majority-of-americans-arent-confident-in-the-safety-and-reliability-of-cryptocurrency/> [<https://perma.cc/VJC8-UWM5>].

2. See, e.g., Eswar Prasad, *The Brutal Truth About Bitcoin*, BROOKINGS (July 20, 2021), <https://www.brookings.edu/articles/the-brutal-truth-about-bitcoin/> [<https://perma.cc/B8ZE-SUP8>].

3. SIMONA MOLA, CORNERSTONE RSCH., SEC CRYPTOCURRENCY ENFORCEMENT 2 (2023), <https://www.cornerstone.com/wp-content/uploads/2024/01/SEC-Cryptocurrency-Enforcement-2023-Update.pdf> [<https://perma.cc/4UYT-SFM3>].

4. DAVID DUONG, DAVID HAN & MARK MEADOWS, COINBASE, 2024 CRYPTO MARKET OUTLOOK 3 (2023), <https://coinbase.bynder.com/m/c8c6fdc663f44b5/original/2024-Crypto-Market-Outlook-V3.pdf> [<https://perma.cc/LE6U-DGBT>].

5. Gary Gensler, *Statement on the Approval of Spot Bitcoin Exchange-Traded Products*, SEC (Jan. 10, 2024), <https://www.sec.gov/news/statement/gensler-statement-spot-bitcoin-011023> [<https://perma.cc/6DY7-UQJE>].

6. Larissa Bundziak, *Unchained Study Reveals One in Four Americans Own Bitcoin*, BUS. WIRE (Nov. 29, 2023), <https://www.businesswire.com/news/home/20231129165815/en/Unchained-Study-Reveals-One-in-Four-Americans-Own-Bitcoin> [<https://perma.cc/7AAK-CXBA>].

7. See *infra* Part II (surveying the development of the SEC's enforcement regime); *infra* Part IV (identifying a regulatory disconnect in effective rulemaking). Petitions for federal agency rulemaking are common. See, e.g., Daniel E. Walters, *Capturing the Regulatory Agenda: An Empirical Study of Agency Responsiveness to Rulemaking Petitioners*, 43 HARV. ENV'T L. REV. 175, 195 (2019) (assessing a dataset of 290 petitions for rulemaking from 2000–16). The benefits of industry input in administrative law are intuitive, as articulated by Sean Croston in the context of “agency guidance documents”:

Using petitions for rulemaking as a vehicle to challenge agency guidance documents “would confer several advantages.” Namely, it would allow any interested stakeholder (not just a regulated entity) to “engage an agency on the substance of a guidance document,” and it would force the agency “to respond in a reasoned way” and “supply coherent reasons for its guidances,” which “would in turn make judicial review of these documents more effective.” . . . [P]etitions would force agencies to simply but reasonably explain the substance of any controversial guidance document, rather than hiding behind procedural exemptions to standard notice-and-comment rulemaking.

Sean Croston, *The Petition Is Mightier than the Sword: Rediscovering an Old Weapon in the Battles Over “Regulation Through Guidance”*, 63 ADMIN. L. REV. 381, 389 (2011) (footnotes omitted).

security is an investment the SEC can regulate, but the outer boundary of what constitutes an investment is opaque.⁸ Securities must be registered with the SEC or qualify for an exemption to registration.⁹ Registration is costly and cumbersome.¹⁰ One plausible argument is that the current registration system is impossible for many crypto issuers to comply with because they lack necessary information required for disclosure.¹¹ The SEC has nevertheless brought countless enforcement actions for failure to register various cryptocurrencies as a security—raising concerns over SEC policy, clarity, and legitimacy.¹²

The Southern District of New York's decision in *SEC v. Ripple Labs, Inc.* lends critical insights to the debate over SEC enforcement.¹³ Under *Ripple*, sales of XRP tokens on the secondary market were not securities because traders did not have a reasonable expectation of profit from the efforts of Ripple.¹⁴ The court's analysis is critical because it goes to the core of cryptocurrency functionality. The reasonable expectation with cryptocurrency trading, at least on the secondary market, is the function of the crypto network, *not* the efforts of the original crypto issuer. This Note adds to the regulatory discussion by considering cryptocurrency as more than an investment in Part I, outlining the SEC's approach to securities law enforcement in Part II, considering the *Ripple* court's focus on reasonable expectation of profit in Part III, and proposing the SEC refocus on

8. See *infra* Section II.

9. See *infra* Section II.A (specifying the SEC's basis to regulate under federal securities law).

10. The time and cost to register a security with the SEC is not fixed. The few cryptocurrencies that have registrations do not have well publicized financials, but the likelihood such registrations took a multi-year, multi-million-dollar commitment is not out of question. Eleanor Terrett (@EleanorTerrett), X (Mar. 2, 2023, 1:17 PM), <https://x.com/EleanorTerrett/status/1631403307984879621?s=20> [<https://perma.cc/EET4-RP4L>] (Fox Business reporter relaying that one of the few crypto registrations “took 953 days and cost around \$2 million”); Brady Dale, *The Few Crypto Firms that Have Registered with the SEC*, AXIOS (Mar. 6, 2023), <https://www.axios.com/2023/03/06/crypto-register-sec-securities-exchange-commission> (accounting that of the crypto firms to attempt registration, three “are gone,” two “took new forms,” and four “have carried on” in various forms); Eleanor Terrett (@EleanorTerrett), X (Feb. 28, 2023, 6:40 PM), <https://x.com/EleanorTerrett/status/1630759832968998912?s=20> [<https://perma.cc/Q3RD-3P7V>] (reporting release from SEC Chair Gary Gensler that there have been only nine crypto registrations; five “as a result of settlements under [Gensler's predecessor]”; and “[n]o companies have registered under Gensler”).

11. The SEC contests this claim, but it has merit as explored in Section II.B. See also Letter from Paul Grewal, Chief Legal Officer, Coinbase Global, Inc., to Vanessa Countryman, Sec'y, SEC, Petition for Rulemaking—Digital Asset Securities Regulation 15–16 (July 21, 2022), <https://www.sec.gov/files/rules/petitions/2022/petn4-789.pdf> [<https://perma.cc/RW86-G26U>] [hereinafter *Coinbase Rulemaking Petition*] (“Digital assets that the SEC may claim are securities often function on decentralized protocols with many contributors, and every holder of a digital asset security can typically examine for themselves the functionality and governance structure of the asset. As a result, the existing disclosure requirements are both under-inclusive and overinclusive of the information that is relevant to an investor in a digital asset security.”).

12. See *infra* Section II.B.

13. *SEC v. Ripple Labs, Inc.*, No. 20 Civ. 10832, 2023 WL 4507900 (S.D.N.Y. July 13, 2023).

14. *Id.* at *11–14.

regulating cryptocurrency only based on sales that invoke a reasonable expectation of profit in Part IV.

I. CRYPTOCURRENCY AS MORE THAN AN INVESTMENT

This Part overviews some of the benefits of cryptocurrency. A criticism of cryptocurrency, and basis for securities regulation, is that cryptocurrency is nothing more than a speculative investment—an argument more thoroughly introduced and explored in Part II. This Part surveys cryptocurrency to suggest that the criticism of cryptocurrency as a shallow investment ploy is an oversimplification—and it sets up the legal analysis in Parts III and IV. It is important to qualify this analysis because cryptocurrency is not a homogenous category of assets. Uses for cryptocurrency are new and still evolving; some specific examples are covered in Section I.B. A general familiarity with cryptocurrency, particularly outside an investment context, is necessary for an informed discussion of regulation. Section A begins with a background on cryptocurrency and blockchain technology generally, with the first cryptocurrency, Bitcoin, used to illustrate. Section B examines more closely the specific utilities of cryptocurrency. Section C briefly explains some of the nuances of different cryptocurrencies that make them difficult to regulate en masse. Section D explores some of the emerging and forthcoming use cases—expanding the importance of cryptocurrency even for those uninterested in holding the assets for themselves.

A. Generally

Cryptocurrency, commonly abbreviated as “crypto,” is a class of digital asset that uses cryptography to secure transactions.¹⁵ Crypto is a store of value held on an online public ledger called a blockchain.¹⁶ A new code is added to the ledger for each transaction of the currency. The ledger contains a record of every transaction in the history of the currency.¹⁷

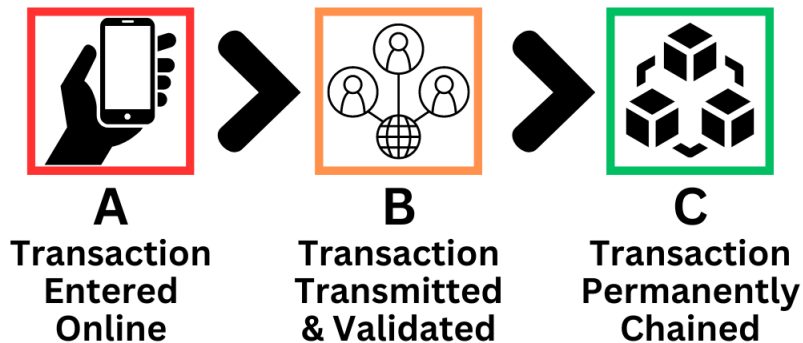
15. Kate Ashford, *What Is Cryptocurrency?*, FORBES (Feb. 16, 2023), <https://www.forbes.com/advisor/investing/cryptocurrency/what-is-cryptocurrency/> [https://perma.cc/3RQK-PN3Y]; *What Is Cryptography?*, COINBASE, <https://www.coinbase.com/learn/crypto-basics/what-is-cryptography#:~:text=is%20all%20about.-,Cryptography%20is%20the%20study%20and%20practice%20of%20sending%20secure%2C%20encrypted,message%2C%20making%20it%20legible%20again> [https://perma.cc/KKS5-RPS2] (“Cryptography is the study and practice of sending secure, encrypted messages or data between two or more parties.”).

16. See *What Is Blockchain?*, IBM, <https://www.ibm.com/topics/blockchain> [https://perma.cc/H4JV-RA8Z].

17. Benedict George, *The Genesis Block: The First Bitcoin Block*, COINDESK (Jan. 3, 2023), <https://www.nasdaq.com/articles/the-genesis-block:-the-first-bitcoin-block> [https://perma.cc/4S4Y-H7EH].

Blockchain is intended to promote transparency and user autonomy in finance.¹⁸ Users have a record of the universe of financial transactions and can be confident in the validity of their own transactions on the blockchain.¹⁹ Because transactions are validated through the network of existing users, costly traditional financial intermediaries are unnecessary to store and secure user information.²⁰

Figure 1: Blockchain Transaction Process



Cryptocurrencies are generally stored in individually held electronic accounts called wallets.²¹ Like their physical counterparts, wallets are held solely by the owner that possesses the unique keys to the cryptocurrency.²² The concept of code being a store of value is abstract, but so is the store of value through fiat money used throughout the global financial marketplace.²³ Digital asset exchanges have emerged to make the ownership

18. *What Is Decentralization in Blockchain?*, AMAZON WEB SERVS., [https://aws.amazon.com/blockchain/decentralization-in-blockchain/#:~:text=In%20blockchain%2C%20decentralization%20refers%20to,thereof\)%20to%20a%20distributed%20network](https://aws.amazon.com/blockchain/decentralization-in-blockchain/#:~:text=In%20blockchain%2C%20decentralization%20refers%20to,thereof)%20to%20a%20distributed%20network) [https://perma.cc/2KQF-S7UZ].

19. *Id.*

20. *See id.* (“By having a decentralized data store, every entity has access to a real-time, shared view of the data.”).

21. Coryanne Hicks, *What Are Crypto Wallets?*, FORBES (Jan. 25, 2024), <https://www.forbes.com/advisor/investing/cryptocurrency/crypto-wallets/> [https://perma.cc/5GVP-7TTM].

22. *Id.* (“A crypto wallet stores the public and private keys necessary to send, receive and store cryptocurrency.”).

23. David Wolman, *A Short History of American Money, From Fur to Fiat*, ATLANTIC (Feb. 6, 2012), <https://www.theatlantic.com/business/archive/2012/02/a-short-history-of-american-money-from-fur-to-fiat/252620/> [https://perma.cc/ZD2W-HQLS] (“What do animal pelts, tobacco, fake wampum, gold, and cotton-paper bank notes have in common? At one point or another, they've all stood for the same thing: U.S. currency.”).

process more approachable for those new to cryptocurrency.²⁴ For example, Coinbase is one of the most popular U.S. exchanges and offers an online platform for cryptocurrency purchase, storage, and transfer.²⁵ Coinbase is moving cryptocurrency purchase into mainstream finance; it is a publicly traded company and has met extensive reporting requirements since listed on the Nasdaq exchange in 2021.²⁶ Account registration is accessible with only five requirements: user age of eighteen or older, government-issued photo ID, internet access, cell phone number, and latest web browser or app access.²⁷

The growth of the blockchain industry is best articulated with the context of how far the technology has come. The first cryptocurrency, Bitcoin, was released in 2008 by an anonymous publisher using the pseudonym Satoshi Nakamoto.²⁸ Bitcoin was described in a nine-page white-paper document summarizing the technology.²⁹ Bitcoin, like the simplified model in Figure 1, was pitched to the public as a novel tool for users to autonomously record and verify transactions. While necessarily oversimplified for purposes of this Note, Nakamoto described the following protocol:

- Bitcoin transactions are completed and verified by the owner signing with the code of the previous transaction.³⁰
- Timestamps for each transaction are imbedded in the blockchain to reinforce the validity of the transaction history.³¹
- The code assigned to a transaction (a “hash”) must be calculated for each transaction and requires increasing computing power (a “proof-

24. *Coinbase Announces Effectiveness of Registration Statement and Anticipated Listing Date of Its Class A Common Stock on the Nasdaq Global Select Market*, COINBASE (Apr. 1, 2021), <https://www.coinbase.com/blog/coinbase-announces-effectiveness-of-registration-statement-and-anticipated-listing-date-of-its> (“[Coinbase] started in 2012 with the radical idea that anyone, anywhere, should be able to easily and securely send and receive Bitcoin. Today, we offer a trusted and easy-to-use platform for accessing the broader cryptoeconomy.”).

25. *See About Coinbase*, COINBASE, <https://www.coinbase.com/about>.

26. *See generally*, e.g., Coinbase Global, Inc., Registration Statement (Form S-1) (Feb. 25, 2021), <https://www.sec.gov/Archives/edgar/data/1679788/000162828021003168/coinbaseglobal-incs-1.htm> [<https://perma.cc/3AY4-FVKU>].

27. *Create a Coinbase Account*, COINBASE HELP, <https://help.coinbase.com/en/coinbase/getting-started/getting-started-with-coinbase/create-a-coinbase-account> [<https://perma.cc/APG6-JV7J>].

28. SATOSHI NAKAMOTO, BITCOIN: A PEER-TO-PEER ELECTRONIC CASH SYSTEM (2008), <https://bitcoin.org/bitcoin.pdf> [<https://perma.cc/29A4-AHUU>] [hereinafter BITCOIN WHITEPAPER]; Pete Rizzo, *The Bitcoin White Paper Is Now Officially 15 Years Old*, FORBES (Oct. 31, 2023), <https://www.forbes.com/sites/peterizzo/2023/10/31/15-facts-about-the-satoshi-white-paper-on-bitcoins-15th-birthday/?sh=216737ed4482> [<https://perma.cc/5LG5-CK9L>].

29. *See generally* BITCOIN WHITEPAPER, *supra* note 28.

30. *Id.* at 2 (Transactions).

31. *Id.* (Timestamp Server).

of-work” system), which further prevents a bad actor from fabricating or disrupting the blockchain.³²

- New transactions are broadcasted to all computers in the network (“nodes”), which work to complete the proof-of-work and add the transaction to the universal blockchain ledger.³³
- The first transaction completed in a block grants the node that completed the proof-of-work a new Bitcoin—an incentive to support the proof-of-work system underlying the blockchain.³⁴
- The ledger saves storage space by removing excess data from old transactions and preserving the necessary “root.”³⁵
- As additional transactions are added to the blockchain, prior payments can be reliably and simply verified.³⁶
- Transactions can be combined and split; they are not dependent on a 1:1 Bitcoin transfer.³⁷
- Privacy on the public blockchain ledger can be maintained by keeping the “public keys” that identify a user on the blockchain anonymous.³⁸
- The proof-of-work transaction system is designed to prevent bad actors from being able to use nodes to hijack the blockchain.³⁹

Bitcoin is representative of the general mechanics of cryptocurrencies but is still just one example.⁴⁰ The Bitcoin proof-of-work system has been widely criticized for its dependence on high energy output required to verify and secure transactions.⁴¹ Other large cryptocurrencies like Ethereum have since adopted a proof-of-stake system that instead verifies new blocks based on current Ethereum ownership.⁴²

32. *Id.* at 3 (Proof-of-Work).

33. *Id.* at 3–4 (Network).

34. *Id.* at 4 (Incentive).

35. *Id.* (Reclaiming Disk Space).

36. *Id.* at 5 (Simplified Payment Verification).

37. *See id.* (Combining and Splitting Value).

38. *Id.* at 6 (Privacy).

39. *Id.* at 6–8 (Calculations). The mechanics of this algorithm are beyond the scope of this Note but are explained in detail in the whitepaper. *Id.*

40. *See infra* Section I.C (comparing key differences across cryptocurrencies, primarily from a regulatory lens).

41. Jon Huang, Claire O’Neill & Hiroko Tabuchi, *Bitcoin Uses More Electricity than Many Countries. How Is That Possible?*, N.Y. TIMES (Sept. 3, 2021), <https://www.nytimes.com/interactive/2021/09/03/climate/bitcoin-carbon-footprint-electricity.html>.

42. @nhsz, *Proof-of-Stake (POS)*, ETHEREUM (Jan. 25, 2024), <https://ethereum.org/developers/docs/consensus-mechanisms/pos> [<https://perma.cc/Q6LC-NYDZ>]. The author writes,

Beyond their technical function, cryptocurrency has gained significant public attention in recent years. A Pew Research Center study suggests 17% of adults in the United States have invested, traded, or used cryptocurrency.⁴³ A majority of Americans are still skeptical of the technology,⁴⁴ but use has significantly increased since the start of the COVID-19 pandemic.⁴⁵ A study by JPMorgan Chase & Co. adds that individual investors have “transferred money into crypto accounts when prices were higher, suggesting lower investment returns.”⁴⁶ With increased interest from inexperienced users looking to invest, and the potential for unexpected financial losses, governments have come under pressure to develop regulation that protects consumers.⁴⁷ Meanwhile, institutional investor involvement with cryptocurrency has steadily increased⁴⁸—as has venture capital investment through cryptocurrency-centric and adjacent entrepreneurship.⁴⁹

Proof-of-stake is a way to prove that validators have put something of value into the network that can be destroyed if they act dishonestly. In Ethereum’s proof-of-stake, validators explicitly stake capital in the form of ETH into a smart contract on Ethereum. The validator is then responsible for checking that new blocks propagated over the network are valid and occasionally creating and propagating new blocks themselves. If they try to defraud the network (for example by proposing multiple blocks when they ought to send one or sending conflicting attestations), some or all of their staked ETH can be destroyed.

Id.

43. Faverio & Sidoti, *supra* note 1.

44. *See id.*

45. Chris Wheat & George Eckerd, *The Dynamics and Demographics of U.S. Household Crypto-Asset Use*, JPMORGAN CHASE & CO. (2022), <https://www.jpmorganchase.com/institute/research/financial-markets/dynamics-demographics-us-household-crypto-asset-cryptocurrency-use> [<https://perma.cc/J3W6-8BYZ>] (describing figures showing surges in first time crypto interactions and trading volume in 2018, 2021, and 2022).

46. *Id.*

47. *See infra* Part II.

48. *See, e.g.*, Brian McGleeson, *Institutional Investors Poised for Increased Crypto Activity in 2024, Analysts Say*, BLOCK (Dec. 25, 2023), <https://www.theblock.co/post/265684/institutional-investors-poised-for-increased-crypto-activity-in-2024-analysts-say> [<https://perma.cc/4DPJ-SE3Y>] (“Since late October [2023], there’s been a noticeable uptick in institutional activity, largely driven by the anticipation surrounding the potential ETF news expected in January and strategic positioning by clients for this event.” (quoting Deribit Chief Commercial Officer Luuk Strijers)); Sara Elinson & Prashant K. Kher, *Staying the Course: Institutional Investor Outlook on Digital Assets*, EY PARTHENON (May 10, 2023), https://www.ey.com/en_us/financial-services/how-institutions-are-investing-in-digital-assets [<https://perma.cc/B2GW-Y7TL>] (surveying increased institutional investor positive sentiment, investment allocations, confidence, and interest in tokenization); COINBASE, INSTITUTIONAL INVESTOR, 2023 DIGITAL ASSETS OUTLOOK SURVEY, <https://coinbase.bynder.com/m/2519c5820cdf414/original/2023-Institutional-Investor-Digital-Assets-Outlook-Survey.pdf> [<https://perma.cc/QX4N-7LUS>].

49. The volume of new venture capital investments fluctuates, and the market has experienced downcycles—but new investments continue. *E.g.*, Hannah Miller, *VC Firm Blockchain Capital Raises \$580 Million for Crypto Gaming, DeFi Bets*, BLOOMBERG (Sept. 18, 2023), <https://www.bloomberg.com/news/articles/2023-09-18/crypto-vc-firm-blockchain-capital-raises-580-million-for-two-new-funds>; Jacquelyn Melinek, *6 Crypto Investors Talk About DeFi and the Road Ahead for Adoption in 2023*, TECHCRUNCH (Jan. 10, 2023), <https://techcrunch.com/2023/01/10/six-crypto-investors-talk-about-defi-and-the-road-ahead-for-adoption-in-2023/> [<https://perma.cc/MP9Z-FWZP>].

B. Specific Utility

Beyond a robust proof of concept and investor interest, cryptocurrency offers a spectrum of utilities to users. Understanding the unique utilities of cryptocurrency is an important preface to the SEC's mass enforcement actions against cryptocurrency issuers and exchanges.⁵⁰ This sub-Section surveys these functions that differentiate cryptocurrencies from other financial assets.

1. Inflation Hedge

A central concern in traditional finance is inflation.⁵¹ The Federal Reserve controls the United States monetary system, including increasing the money supply and managing interest rates.⁵² With this control comes the risk of inflation.⁵³ Commentators have heralded Bitcoin and other cryptocurrencies as an inflation-proof asset for investors.⁵⁴ Some critics have responded that this upside is undercut by cryptocurrency's price volatility.⁵⁵ Nevertheless, cryptocurrency with a fixed supply like Bitcoin have an edge over the United States Dollar and other fiat currencies in terms of inflation.⁵⁶

2. Smart Contracts

The blockchain technology underlying cryptocurrency also has the potential to revolutionize transactions. For example, the term "smart contracts" has been coined for agreements stored on the blockchain.⁵⁷ Attorneys Stuart D. Levi and Alex Lipton describe smart contracts as "computer code that automatically executes all or parts of an agreement and is stored

50. See *infra* Section II.B.

51. See, e.g., Ines Ferré, Josh Schafer & Karen Friar, *Stock Market Today: Stocks Slump After Hot Inflation Print*, YAHOO! FIN. (Mar. 14, 2024), <https://finance.yahoo.com/news/stock-market-today-stocks-slump-after-hot-inflation-print-160639297.html> [<https://perma.cc/3YQL-ZHVG>].

52. See, e.g., Christopher Rugaber, *Federal Reserve Officials Caution Against Cutting US Interest Rates Too Soon or Too Much*, ASSOCIATED PRESS (Feb. 22, 2024), https://apnews.com/article/inflation-federal-reserve-economy-7fdd01c4a65a762d3edf2db61194b4a2?utm_source=copy&utm_medium=share [<https://perma.cc/E8QW-4Y57>].

53. See *id.*

54. Dan Weil, *Is Bitcoin an Inflation Hedge? Here Are the Arguments on Both Sides*, WALL ST. J. (Oct. 8, 2023), <https://www.wsj.com/finance/currencies/bitcoin-inflation-hedge-84f6b840>.

55. See generally Dimitrios Bakas, Georgios Magkonis & Eun Young Oh, *What Drives Volatility in Bitcoin Market?*, 50 FIN. RSCH. LETTERS 103237 (2022) ("Cryptocurrencies are in general highly volatile, and are subject to sudden, massive price swings.")

56. Increase in money supply is one cause of inflation. Walter Frick, *What Causes Inflation?*, HARV. BUS. REV. (Dec. 23, 2022), <https://hbr.org/2022/12/what-causes-inflation> [<https://perma.cc/VWW4-DXC7>]. An asset with a fixed supply avoids this cause of inflation. See *id.*

57. Stuart D. Levi & Alex B. Lipton, *An Introduction to Smart Contracts and Their Potential and Inherent Limitations*, HARV. L. SCH. F. ON CORP. GOV. (May 26, 2018), <https://corp.gov.law.harvard.edu/2018/05/26/an-introduction-to-smart-contracts-and-their-potential-and-inherent-limitations/> [<https://perma.cc/LQY2-SSGT>].

on a blockchain-based platform.”⁵⁸ Smart contracts have massive implications for day-to-day finance:

The decentralization, auto-enforcing ability, and verifiability characteristics of smart contracts enable their encoded business rules to be executed in a peer-to-peer network, where each node is “equal” and none has any special authority without the involvement of a trusted authority or a central server. Thus, smart contracts are expected to revolutionize many traditional industries, such as financial, healthcare, energy, etc.⁵⁹

A study in 2017 assessed 834 smart contract transactions on the Ethereum⁶⁰ and Bitcoin blockchains.⁶¹ In the fourth quarter of 2022, there were an estimated 4.6 million smart contract transactions on the Ethereum blockchain.⁶² The potential mass adoption of smart contracts has been responded to with warranted scrutiny from legal commentators due to user risks and other legal concerns—but the technology offers benefits that may revolutionize the efficiency, security, and accessibility of digital transactions.⁶³

58. *Id.*

59. Hamed Taherdoost, *Smart Contracts in Blockchain Technology: A Critical Review*, 14 INFORMATION 117, 132–33 (2023).

60. “Ethereum is a decentralized global software platform powered by blockchain technology.” *What Is Ethereum and How Does It Work?*, INVESTOPEDIA (Mar. 2, 2024), <https://www.investopedia.com/terms/e/ethereum.asp> [<https://perma.cc/TE3P-EE7G>]. The Ethereum blockchain is similar to the Bitcoin blockchain and the many technical differences are beyond the scope of this Note.

61. Massimo Bartoletti & Livio Pompianu, *An Empirical Analysis of Smart Contracts: Platforms, Applications, and Design Patterns*, in FINANCIAL CRYPTOGRAPHY & DATA SECURITY 494, 502 (Michael Brenner, Kurt Rohloff, Joseph Bonneau, Andrew Miller, Peter Y.A. Ryan, Vanessa Teague, Andrea Bracciali, Massimiliano Sala, Federico Pintore & Markus Jakobsson eds., 2017).

62. Andrew Asmakov, *Ethereum Smart Contracts Deployment Jumped 293% in 2022: Alchemy Developer Report*, DECRYPT (Jan. 17, 2023), <https://decrypt.co/119371/ethereum-smart-contracts-deployment-jumped-293-2022-alchemy-developer-report> [<https://perma.cc/3H6V-PWT3>].

63. Levi & Lipton, *supra* note 57 (summarizing challenges to widespread adoption of smart contracts such as lay-party negotiations, reliance on “off-chain” resources, modifications to smart contracts, security risks, and more). Despite well-reasoned criticisms of smart contracts at present, Levi and Lipton write that there is reason for optimism for the long-term future of the technology:

Today, smart contracts are a prototypical example of “Amara’s Law,” the concept articulated by Stanford University computer scientist Roy Amara that we tend to overestimate new technology in the short run and underestimate it in the long run. Although smart contracts will need to evolve before they are widely adopted for production use in complex commercial relationships, they have the impact to revolutionize the reward and incentive structure that shapes how parties contract in the future. To that end, and when thinking about smart contracts, it is important not to simply think how existing concepts and structures can be ported over to this new technology. Rather, the true revolution of smart contracts will come from entirely new paradigms that we have not yet envisioned.

Id.

3. Distributed Computing

Cryptocurrency and blockchain technology also offer benefits outside of corporate transactions and investing. For example, a feature by the American Bar Association describes crypto use as a “logistical and scaling solution for tech sectors such as distributed computing.”⁶⁴ Amazon Web Services (AWS) defines distributed computing as “the method of making multiple computers work together to solve a common problem.”⁶⁵ In the context of cryptocurrency, the computers are nodes that validate transactions on the blockchain.⁶⁶ But the benefits of distributed computing are not specific to finance. AWS has developed an *Amazon Managed Blockchain*, which it describes as “a fully managed service designed to help [users] build resilient Web3 applications on both public and private blockchains.”⁶⁷ Amazon is just one of many tech powerhouses offering what a McKinsey & Company report termed “Blockchain as a Service (BaaS).”⁶⁸ AWS’s BaaS consumer-base is robust, including corporate partners like Nestle, BMW, Workday, and more.⁶⁹

Nonfinancial distributed computing applications are also trending toward mainstream personal use. Several European nations have adopted a blockchain ledger system to track land titles.⁷⁰ As the United States digitizes its existing physical land titles, it is more likely to employ similar technology.⁷¹ Similar potential for improved transparency subsists with

64. Vincent Chang, *Practical Uses for Cryptocurrencies*, AM. BAR ASS’N (Feb. 11, 2022), https://www.americanbar.org/groups/gpsolo/publications/gp_solo/2022/january-february/practical-uses-cryptocurrencies/ [<https://perma.cc/XM4N-C6WC>].

65. *What Is Distributed Computing?*, AMAZON WEB SERVS., <https://aws.amazon.com/what-is/distributed-computing/> [<https://perma.cc/7LPA-24K9>].

66. *See supra* Section I.A.

67. *Amazon Managed Blockchain*, AMAZON WEB SERVS., <https://aws.amazon.com/managed-blockchain/> [<https://perma.cc/PJS5-P8CT>].

68. Gaurav Batra, Rémy Olson, Shilpi Pathak, Nick Santhanam & Harish Soundararajan, *Blockchain 2.0: What’s in Store for the Two Ends—Semiconductors (Suppliers) and Industrials (Consumers)?*, MCKINSEY & CO. (2019), <https://www.mckinsey.com/industries/industrials-and-electronics/our-insights/blockchain-2-0-whats-in-store-for-the-two-ends-semiconductors-suppliers-and-industrials-consumers> [<https://perma.cc/44GZ-BKVP>]; e.g., *IBM Blockchain*, IBM, <https://www.ibm.com/blockchain> [<https://perma.cc/73MC-SDDY>]; *Aptos x Microsoft Expanding Web3 Global Access*, APTOS (Aug. 8, 2023), <https://aptosfoundation.org/currents/aptos-microsoft-expanding-web3-global-access> [<https://perma.cc/SC7K-QTE5>].

69. *Blockchain on AWS*, AMAZON WEB SERVS., <https://aws.amazon.com/blockchain/> [<https://perma.cc/4HB7-QHSN>].

70. Dawson Sanders, *The Blocktitle Revolution: Are Land Titles Moving to the Blockchain?*, USC GOULD SCH. L. BUS. L. DIG. (Jan. 19, 2023), <https://lawforbusiness.usc.edu/the-blocktitle-revolution-are-land-titles-moving-to-the-blockchain/> [<https://perma.cc/W2SE-FJH7>] (“Conversely, Sweden had a highly advanced land registry when it began experimenting with a blockchain in 2016 and successfully implemented a test-system with relative ease.”).

71. *Id.* (“As countries like Sweden and Georgia continue to demonstrate the advantages of applying blockchain technology to land registries, blocktitle’s potential benefits for the U.S. become clearer.”).

personal property.⁷² Among other unique advantages, blockchain ledgers can be used to locate counterfeit products, track cross-border transactions, and trace materials through complex supply chains.⁷³ While particularly beneficial for large businesses due to economies of scale, all market participants benefit from more efficiently sourced and reliable data.⁷⁴

Cryptocurrency and blockchain, as surveyed in Section I.A, are interconnected. With the revolutionary technological implications of blockchain comes more mainstream use of cryptocurrency. To confound cryptocurrency's forward-looking potential with its recent industry blights is shortsighted.

4. Staking

An enticing benefit for cryptocurrency holders at present is “staking.”⁷⁵ Staking is the process of contributing to the proof-of-stake protocol in return for an incentive.⁷⁶ Many issuers and exchanges offer a return of additional cryptocurrency tokens or other benefits for holding a certain amount of cryptocurrency.⁷⁷ Staking has been a major contention in the ongoing regulatory debate because it encourages investment, sometimes in substantial volume.⁷⁸ Given its relative simplicity compared to other cryptocurrency utilities, a more thorough discussion of staking is addressed in Part II.

72. Vishal Gaur & Abhinav Gaiha, *Building a Transparent Supply Chain*, HARV. BUS. REV., May–June 2020, at 94.

73. *Id.*

74. See, e.g., *Getting Started with Amazon Managed Blockchain*, AMAZON WEB SERVS., <https://aws.amazon.com/managed-blockchain/getting-started/> [<https://perma.cc/L4H6-PLN3>]. This is not to write off the otherworldly market power of many modern corporations and the inequities that small businesses face trying to compete. For a relevant contribution to this side-note from now-Federal Trade Commission Chair Lina Khan, see Lina M. Khan, *Amazon's Antitrust Paradox*, 126 YALE L.J. 710 (2017).

75. Ethan D. Trotz, *Million Dollar Bash: A Nuanced Approach for Calculating Tax Liability for Participants in Decentralized Finance*, 54 TEX. TECH L. REV. 575, 578 (2022) (citing ARVIND NARAYANAN, JOSEPH BONNEAU, EDWARD FELTEN, ANDREW MILLER & STEVEN GOLDFEDER, *BITCOIN AND CRYPTOCURRENCY TECHNOLOGIES* 233 (2016)) (“In a PoS consensus mechanism, persons ‘stake’ their cryptocurrency and computing power to validate transactions. This process creates new blocks on the blockchain, and as part of the creation of a new block, participants create new tokens which constitute rewards that go back to the stakers.”).

76. *Id.*; see also *supra* Section I.A.

77. See *id.*

78. See SEC v. Terraform Labs Pte. Ltd., No. 23-cv-1346, 2023 WL 8944860, at *14 (S.D.N.Y. July 31, 2023) (holding that the tokens at issue were securities in part because of “transaction fees . . . distributed to LUNA stakers in the form of staking rewards”); SEC v. Telegram Grp. Inc., 448 F. Supp. 3d 352, 360, 371 (S.D.N.Y. 2020) (describing the proof of stake protocol as “collateral” in support of a holding that the assets were securities with a reasonable expectation of profit).

C. Key Differences

As explained at the beginning of this Part, cryptocurrencies are not a homogenous class of assets—beyond being a cryptographic store of value. Section I.A summarizes two different mechanisms by which cryptocurrency transactions may be secured: proof-of-work and proof-of-stake. These protocols significantly vary the function of a cryptocurrency on a transactional basis.

Another high-level distinction is the primary purpose of a given token. The three most common cryptocurrency classifications based on use-case are security tokens, utility tokens, and stablecoins. This Section illustrates that even the broadest categorical distinctions of cryptocurrencies blur the lines of securities regulation. Whether securities tokens or stablecoins are subject to securities regulations are both arguable questions. But to hold the two as equal without independent reasoning is clearly erroneous.

1. Security Tokens

Though not a fixed definition, some experts define security tokens as “tokens that share some characteristics with securities.”⁷⁹ Meanwhile, the Second Circuit has framed securities tokens based on what they are not: “[U]nlike ‘utility tokens,’ security tokens do not grant the holder use and access to a particular service or product offered by the issuer. Security tokens are therefore distinct from other classes of crypto-assets that have some present tangible use beyond their potential to appreciate.”⁸⁰ Put differently by the U.S. District Court for the Southern District of New York: “A transaction does not fall within the scope of the securities laws when a reasonable purchaser is motivated to purchase by a *consumptive* intent.”⁸¹

As explored in Part II, security tokens most closely align with existing securities laws because they are driven by an expectation of profit from the efforts of the issuer. This parallels the standards for an investment contract-type security requiring public registration under blackletter law.⁸²

79. Noelle Acheson, *Security Tokens and Tokenized Securities Are Not the Same Thing*, COINDESK (Feb. 15, 2023), <https://www.coindesk.com/consensus-magazine/2023/02/15/we-need-clearer-terminology-for-crypto-tokenization-coindesk/> [<https://perma.cc/2JL8-PCXW>].

80. *Williams v. Binance*, 96 F.4th 129, 134 (2d Cir. 2024).

81. *Telegram*, 448 F. Supp. 3d at 371 (emphasis added).

82. *SEC v. W.J. Howey Co.*, 328 U.S. 293 (1946) (seminal case defining an investment contract as “a contract, transaction or scheme whereby a person invests his money in a common enterprise and is led to expect profits solely from the efforts of the promoter or a third party”); e.g., *SEC v. Ripple Labs, Inc.*, No. 20 Civ. 10832, 2023 WL 4507900, at *5 (S.D.N.Y. July 13, 2023) (applying *Howey*).

2. Utility Tokens

Utility tokens, as the name implies, serve a non-investment purpose.⁸³ The purpose is often to transact within an existing product or service.⁸⁴ For example, the Brave internet browser offers a “Basic Attention Token (BAT)” for users who opt to receive online ads from Brave business partners.⁸⁵ Users can exchange tokens for gift cards or other currencies.⁸⁶ As of January 2024, Brave has 67.18 million monthly active users and 25.3 million daily active users.⁸⁷ The value of BAT, measured by market capitalization, is \$362 million.⁸⁸ The value of BAT, while small relative to Alphabet’s \$272 billion in Google Services revenue for 2023,⁸⁹ is a significant return in value to consumers. For purposes of regulation, it should be noted that investors also trade utility tokens.⁹⁰ An internet search of “top utility tokens” displays results such as a *CoinJournal* article titled “The 18 Best Utility Cryptos to Invest in 2024.”⁹¹ Thus, this survey is not meant to imply that utility tokens do not require investor protection. Rather, understanding the multi-functionality of cryptocurrency is central to *how* the technology can be most sensibly regulated.

3. Stablecoins

A third common category of cryptocurrencies is stablecoins. Stablecoins are “a kind of cryptocurrency whose price is algorithmically pegged to another asset, such as a fiat currency or exchange-traded commodity.”⁹² Where securities and utility tokens are dynamic, stablecoins offer stability akin to the US Dollar. Traded on blockchain technology,⁹³ stablecoins may provide:

lower-cost, safe, real-time, and more competitive payments compared to what consumers and businesses experience today. They could rapidly make it cheaper for businesses to accept payments and

83. Brian Nibley, *What Is a Utility Token?*, SOFI (Dec. 22, 2021), <https://www.sofi.com/learn/content/what-is-a-utility-token/> [https://perma.cc/4KW7-VU3X].

84. *Id.*

85. BASIC ATTENTION TOKEN, <https://basicattentiontoken.org/> [https://perma.cc/3JLX-C7MD].

86. *Brave Rewards*, BRAVE, <https://brave.com/brave-rewards/> [https://perma.cc/L4YC-AHZW].

87. *Transparency Data Feed: Platform Stats & Token Activity*, BRAVE, <https://brave.com/transparency/> [https://perma.cc/WN3C-QS9G].

88. *Basic Attention Token*, COINMARKETCAP, <https://coinmarketcap.com/currencies/basic-attention-token/> [https://perma.cc/HH35-8XN2] (last visited Feb. 15, 2024). BAT is also actively traded. At the time of writing, BAT daily trading volume was over \$22 million. *Id.*

89. Alphabet Inc., Annual Report 35 (Form 10-K) (Jan. 30, 2024).

90. *E.g.*, Milko Trajcevski, *The 18 Best Utility Cryptos to Invest in 2024*, COINJOURNAL (Feb. 11, 2024), <https://coinjournal.net/compare/best-utility-tokens/> [https://perma.cc/FYU3-FLA3].

91. *Id.*

92. SEC v. Terraform Labs Pte. Ltd., No. 23-cv-1346, 2023 WL 4858299, at *1 (S.D.N.Y. July 31, 2023).

93. *See supra* Section I.B (surveying various utilities).

easier for governments to run conditional cash transfer programs (including sending stimulus money). They could connect unbanked or underbanked segments of the population to the financial system.⁹⁴

On one hand, stablecoins present the clearest means for regulators to approach cryptocurrency. The asset value is modeled after traditional currency, other than the underlying blockchain technology that facilitates transactions.⁹⁵ On the other hand, confidence in stablecoins may be displaced. Without any underlying utility, stablecoins may crash unforfeitingly:

[W]ithout robust legal and economic frameworks, there's a real risk stablecoins would be anything but stable. They could collapse like an unsound currency board, "break the buck" like money market funds in 2008, or spiral into worthlessness. They could replicate the turmoil of the "wildcat" banks of the 19th century.⁹⁶

II. THE SECURITIES ENFORCEMENT REGIME

A basic understanding of the functionality of cryptocurrency, surveyed in Part I, is critical for a thoughtful discussion of *Ripple* and securities enforcement. There is a lack of legal consensus in large part because of confusion surrounding what cryptocurrency is and is not. Regulators cannot effectively regulate something they do not comprehensively understand. First, this Part briefly introduces the SEC and its general function. Second, it surveys the SEC's enforcement actions against crypto market participants, namely under Section 5 of the Securities Act. Part III uses this foundation to examine the *Ripple* decision.

A. *The Role of the SEC*

The SEC has primary regulatory authority over cryptocurrency if it is a security.⁹⁷ The SEC has three self-identified goals: (1) "Protect the investing public against fraud, manipulation, and misconduct"; (2) "Develop and implement a robust regulatory framework that keeps pace with evolving markets, business models, and technologies"; and (3) "Support a

94. Christian Catalini & Joe Massari, *Stablecoins and the Future of Money*, HARV. BUS. REV. (Aug. 10, 2021), <https://hbr.org/2021/08/stablecoins-and-the-future-of-money> [<https://perma.cc/9G5Z-N8U7>].

95. *See id.* ("[Stablecoins] are pegged to a reference asset such as the U.S. dollar . . .").

96. *Id.*

97. *The Laws that Govern the Securities Industry*, SEC (Oct. 1, 2023), [https://www.sec.gov/about/about-securities-laws#:~:text=The%20Act%20empowers%20the%20SEC,self%20regulatory%20organizations%20\(SROs\)](https://www.sec.gov/about/about-securities-laws#:~:text=The%20Act%20empowers%20the%20SEC,self%20regulatory%20organizations%20(SROs)) [<https://perma.cc/862H-23U5>] ("The [Securities] Act empowers the SEC with broad authority over all aspects of the securities industry. This includes the power to register, regulate, and oversee brokerage firms, transfer agents, and clearing agencies as well as the nation's securities self regulatory organizations (SROs).").

skilled workforce that is diverse, equitable, and inclusive and is fully equipped to advance agency objectives.”⁹⁸ The SEC has an array of legal authorities at its disposal, predominantly under the Securities Act of 1933⁹⁹ and the Securities Exchange Act of 1934¹⁰⁰ (collectively, the Securities Acts). The SEC was borne out of the Great Depression amidst national economic disaster and widespread distrust in the financial markets.¹⁰¹ Furthermore, the Securities Acts set a framework still in use today meant to maintain public trust and protect the investing public.

One of the primary authorities the SEC relies upon, and the focus of this Note, is the requirement that securities be registered with the SEC or satisfy a registration exemption.¹⁰² The registration requirement is in Section 5 of the Securities Act:

(a) Sale or delivery after sale of unregistered securities

Unless a registration statement is in effect as to a security, it shall be unlawful for any person, directly or indirectly—

(1) . . . [T]o sell such security through the use or medium of any prospectus or otherwise; or

(2) [T]o carry or cause to be carried . . . in interstate commerce . . . any such security for the purpose of sale or for delivery after sale.¹⁰³

The Securities Acts have similar requirements for the registration of securities exchanges¹⁰⁴ and brokers or dealers facilitating transactions on securities exchanges.¹⁰⁵ The SEC has significant authority to regulate market conduct beyond just registration. SEC regulation Rule 10b-5, for example, prohibits securities fraud. Rule 10b-5 is broad and includes:

(a) . . . [A]ny device, scheme, or artifice to defraud,

(b) . . . [A]ny untrue statement of a material fact or [omission of] a material fact necessary in order to make the statements made . . . not misleading, or

98. *Our Goals*, SEC (Apr. 6, 2023), <https://www.sec.gov/our-goals> [<https://perma.cc/CGU8-V2W7>].

99. Codified at 15 U.S.C. § 77a–bbbb.

100. Codified at 15 U.S.C. § 78.

101. This is a vast oversimplification that is necessary for purposes of this Note. For a detailed history, see A.C. PRITCHARD & ROBERT B. THOMPSON, *A HISTORY OF SECURITIES LAW IN THE SUPREME COURT* (2023).

102. *See* 15 U.S.C. § 77e(a).

103. *Id.*

104. *Id.* § 78f.

105. *Id.* § 78o.

(c) . . . [A]ny act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, *in connection with the purchase or sale of any security*.¹⁰⁶

The SEC has broad authority to prosecute securities fraud, but only once established that the asset at issue is a security.¹⁰⁷

This begs the question: what is a security under federal law? Turning again to the U.S. Code for guidance,

The term “security” means any note, stock, treasury stock, security future, security-based swap, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, any put, call, straddle, option, or privilege on any security, certificate of deposit, or group or index of securities (including any interest therein or based on the value thereof), or any put, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency, or, in general, any interest or instrument commonly known as a “security”, or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing.¹⁰⁸

Unfortunately, the enumerated list does not give much guidance. The code does not include either “digital asset” or “cryptocurrency,” and it does not articulate a principle of what a security is for purposes of evaluating a novel asset class.

The running theory supporting SEC regulatory authority is that cryptocurrency is a security under the category of an “investment contract.”¹⁰⁹ The standard for investment contract originated in the 1946 Supreme Court case of *SEC v. W.J. Howey Co.* involving an investment contract for citrus groves.¹¹⁰ In *Howey*, the Court considered the term “investment contract” under the Securities Act having “been crystalized by . . . prior judicial interpretation.”¹¹¹ “[I]t had been broadly construed by state courts so as to afford the investing public a full measure of protection. Form was

106. 17 C.F.R. § 240.10b-5 (2024) (emphasis added).

107. *See id.*

108. 15 U.S.C. § 77b.

109. *See generally* Framework for “Investment Contract” Analysis of Digital Assets, SEC (Mar. 8, 2023), https://www.sec.gov/corpfin/framework-investment-contract-analysis-digital-assets#_ednref1 [<https://perma.cc/YQV4-SHCX>] (originally published April 3, 2019) [hereinafter *SEC Framework Advisory*].

110. 328 U.S. 293 (1946).

111. *Id.* at 298.

disregarded for substance and emphasis was placed upon economic reality.”¹¹² In considering the broad construction of investment contract and strong policy interest, the Court derived what is now known as the *Howey* test:

[A]n investment contract for purposes of the Securities Act means a contract, transaction or scheme whereby a person invests [their] money in a common enterprise and is led to expect profits solely from the efforts of the promoter or a third party, it being immaterial whether the shares in the enterprise are evidenced by formal certificates or by nominal interests in the physical assets employed in the enterprise.¹¹³

The *Howey* test can be broken into three prongs: (1) the investment of money, (2) a common enterprise, and (3) the reasonable expectation of profits from the efforts of others.¹¹⁴

In *Howey*, the Court determined that the transactions at issue were investment contracts under the Securities Act.¹¹⁵ Largely out-of-state participants were paying the citrus grove organizer to manage a pooled operation for which they would be paid a proportional share of profits.¹¹⁶ The Court reversed the lower courts, which had held that no investment contract existed because the transactions were two separate arrangements: one for the sale of land and then a separate service contract for citrus farming on the land.¹¹⁷ Here again the Court put substance over form when it held that the agreements between manager and investor must be taken together to find that an overarching investment contract existed.¹¹⁸

Federal courts have expanded their inquiry since *Howey*, but the framework remains the same. For example, in another landmark case, *Reves v. Ernst & Young*, the Court considered whether promissory notes may be a security subject to the Securities Acts.¹¹⁹ Recall that the definition of “security” defined in U.S. Code at Section 77b begins with “note”,¹²⁰ but notes take many forms. The Eighth and District of Columbia Circuit Courts before *Reves* had applied the *Howey* test to notes.¹²¹ The *Reves* Court, continuing to prioritize substance over form, rejected the investment contract test under these different circumstances:

112. *Id.*

113. *Id.* at 298–99.

114. *Id.*

115. *Id.* at 299–300.

116. *Id.* at 296.

117. *Id.* at 297–98, 301.

118. *Id.* at 298.

119. 494 U.S. 56, 56 (1990).

120. 15 U.S.C. § 77b.

121. *Reves*, 494 U.S. at 64.

We reject the approaches of those courts that have applied the *Howey* test to notes; *Howey* provides a mechanism for determining whether an instrument is an “investment contract.” The demand notes here may well not be “investment contracts,” but that does not mean they are not “notes.” To hold that a “note” is not a “security” unless it meets a test designed for an entirely different variety of instrument “would make the Acts’ enumeration of many types of instruments superfluous,” and would be inconsistent with Congress’ intent to regulate the entire body of instruments sold as investments.¹²²

The Court went on to adopt a new, more general framework to evaluate potential securities not enumerated by statute. The Court termed this new standard the “family resemblance” test.¹²³ If an asset is within the same “family” as a security specified by statute, there is a rebuttable presumption the asset is a security.¹²⁴ However, even if the asset is not in the statutory list, it may still be a security based on four factors:

1. *Motivations*. If a reasonable buyer and seller are prompted by the profits expected from the asset in an enterprise, the asset is more likely a security.¹²⁵

2. *Plan of Distribution*. Planned distribution of the asset around “common trading for speculation or investment” make an asset more likely a security.¹²⁶

3. *Public Expectations*. Reasonable expectations of the investing public may make an asset a security even if the first two factors are not met.¹²⁷

4. *Other Factors Significantly Reducing Risk*. Other factors that significantly reduce the risk of the asset like “existence of another regulatory scheme” may make an asset not a security because it “render[s] application of the Securities Act necessary.”¹²⁸

Taking the four factors into consideration, the *Reves* Court had “little difficulty” concluding that the notes at issue were securities because participants were expressly profit-motivated, the notes were widely distributed, the notes were publicly characterized as an investment, and no risk reducing factors were present.¹²⁹ *Reves*, however, laid the groundwork for evaluating new classes of securities in cases that are far less clear cut.

122. *Id.* (citation omitted) (quoting *Landreth Timber Co. v. Landreth*, 471 U.S. 681, 692 (1985)).

123. *Id.* at 63–65 (adopting the standard originating in the Second Circuit).

124. *Id.*

125. *Id.* at 66.

126. *Id.*

127. *Id.* at 66–67.

128. *Id.* at 67.

129. *Id.* at 67–68.

B. The SEC's Stance on Cryptocurrency

The SEC has had a complicated and evolving stance on cryptocurrency. A survey of the SEC's public thinking on the regulatory issue is necessary for a comprehensive and fair discussion in this Note; but it is also necessarily abridged.

The SEC released its first cryptocurrency advisory in July 2013.¹³⁰ This simple three-page document was an alert to early cryptocurrency Ponzi schemes.¹³¹ The alert contained no new legal guidance or mandate for those involved in the industry.¹³²

The first legally substantive advisory came in July 2017 when the SEC completed an investigative report of an early crypto organization, "The DAO."¹³³ In the SEC's press release, it cautioned purchasers and issuers alike that digital asset investments are still subject to federal securities laws.¹³⁴ The investigative report provided a more articulated picture of *what* made the DAO transactions securities.¹³⁵ Among other things, the report highlighted that the transactions were part of a self-described "crowdfunding contract,"¹³⁶ where purchasers would be entitled to a "return on investment" and other "rewards,"¹³⁷ and the organization raised approximately \$150 million from late April to late May in 2016.¹³⁸ Considering the Supreme Court precedent introduced in the prior Section, the SEC laid out a straightforward case consistent with both the *Howey* and *Reves* standards.¹³⁹ The DAO expressly marketed its offering to purchasers around the expectation of profit from the forthcoming project, sold millions of dollars worth of assets indiscriminately to the general public, and launched its enterprise after being necessarily motivated by the asset sales.¹⁴⁰

130. SEC OFF. OF INV. EDUC. & ADVOC., INVESTOR ALERT: PONZI SCHEMES USING VIRTUAL CURRENCIES (2013), https://www.sec.gov/investor/alerts/ia_virtualcurrencies.pdf [<https://perma.cc/5BWE-463B>].

131. *Id.*

132. *See id.*

133. Press Release, SEC, SEC Issues Investigative Report Concluding DAO Tokens, a Digital Asset, Were Securities (July 25, 2017), <https://www.sec.gov/news/press-release/2017-131> [<https://perma.cc/4CDC-X7SD>] [hereinafter DAO Press Release] (press release describing the report); Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934: The DAO, Exchange Act Release No. 81,207 (July 25, 2017), <https://www.sec.gov/files/litigation/investreport/34-81207.pdf> [<https://perma.cc/39GK-9NEG>] [hereinafter DAO Report] (investigative report).

134. DAO Press Release, *supra* note 133.

135. *See generally id.*

136. *Id.* at 4. "Crowdfunding is an evolving method of raising money via the Internet to fund a variety of projects." *Crowdfunding*, SEC (Feb. 15, 2019), <https://www.sec.gov/securities-topics/crowdfunding> [<https://perma.cc/7NVP-E4QJ>].

137. DAO Report, *supra* note 133, at 5–6.

138. *Id.* at 2–3.

139. *See* discussion *supra* Section II.A.

140. *See* discussion accompanying *supra* notes 135–138.

The more difficult looming question was left unaddressed at the close of the report:

Whether or not a particular transaction involves the offer and sale of a security—regardless of the terminology used—will depend on the facts and circumstances, including the economic realities of the transaction. Those who offer and sell securities in the United States must comply with the federal securities laws, including the requirement to register with the Commission or to qualify for an exemption from the registration requirements of the federal securities laws.¹⁴¹

The report continues to summarize the general mandates of federal securities law, then lists citations to six other enforcement actions “[f]or additional guidance.”¹⁴²

The SEC decided not to pursue an enforcement action in this early case, likely as a warning to others—but the concern for legal clarity had only just begun. Almost two years later, the SEC released a webpage titled *Framework for “Investment Contract” Analysis of Digital Assets*.¹⁴³ There, the SEC essentially summarized the *Howey* factors and considered how they broadly may apply to a digital asset.¹⁴⁴ For example, section C.1. titled “reliance on the effort of others” considers “two key issues: Does the purchaser reasonably expect to rely on the efforts of an [active participant]? Are those efforts ‘the undeniably significant ones, those essential managerial efforts which affect the failure or success of the enterprise,’ as opposed to efforts that are more ministerial in nature?”¹⁴⁵ For the “reliance on the effort of others” sub-section alone, the page goes on to list six factors “[a]lthough no one . . . is necessarily determinative” and includes even more *sub-sub*-factors.¹⁴⁶

This lack of regulatory clarity has caused strife between the SEC and market participants, to say the least.¹⁴⁷ While the 2019 report notes that

141. DAO Report, *supra* note 133, at 17–18.

142. *Id.* at 18 (those cases are *SEC v. Shavers*, *In re Voorhees*, *In re BTC Trading*, *SEC v. Garza*, *In re Bitcoin Investment Trust*, and *In re Sunshine Capital*—all with full citations available in the report).

143. *SEC Framework Advisory*, *supra* note 109.

144. *Id.*

145. *Id.* (quoting *SEC v. Glenn W. Turner Enter., Inc.*, 474 F.2d 476, 482 (9th Cir. 1973), *cert. denied*, 414 U.S. 821 (1973)).

146. *SEC Framework Advisory*, *supra* note 109.

147. See Leo Schwartz & Jeff John Roberts, *Gary Gensler Has Remade the SEC into a Crypto Nemesis and Climate Warrior. Now a Backlash Is Brewing*, FORTUNE (Nov. 28, 2023), <https://fortune.com/longform/gary-gensler-sec-chair-interview-cryptocurrency-climate-change/> [<https://perma.cc/6FDA-PYYV>]; Paolo Tasca, *Gary Gensler Failed the U.S. Crypto Industry, and So Has Congress*, COINDESK (June 28, 2023), <https://www.coindesk.com/consensus-magazine/2023/06/28/gary-gensler-failed-the-us-crypto-industry-and-so-has-congress/>

under the *Howey* investment contract standard “federal courts look to the economic reality of the transaction,” the SEC gives no guidance that is predictive of how it may enforce securities laws on a specific transaction basis.¹⁴⁸ Broad postulating that some digital asset sales may satisfy *Howey* does little to guide market participants to conform to SEC expectations in practice.

In the decade since the SEC’s first advisory, market participants have repeated their interests in receiving clarity.¹⁴⁹ The SEC has denied those requests.¹⁵⁰ Moreover, Chair Gensler responded to one such denial in a manner that suggested his objection as a matter of principle:

Today, the Commission denied a Petition for Rulemaking filed on behalf of Coinbase Global, Inc. I was pleased to support the Commission’s decision for three reasons. First, existing laws and regulations apply to the crypto securities markets. Second, the SEC addresses the crypto securities markets through rulemaking as well. Third, it is important to maintain Commission discretion in setting its own rulemaking priorities.¹⁵¹

Chair Gensler offered reasons, each of which warrant paragraphs of analysis outside the scope of this Note. Nevertheless, Chair Gensler’s take-it-or-leave-it position is “come in and register” all cryptocurrencies as securities.¹⁵² Chair Gensler’s blanket mandate on behalf of the SEC is a starkly different stance than the transaction-specific securities law analysis mandated in *Howey* and *Reves*. Despite the lack of additional rulemaking or clarity, major market participants have tried to take Chair Gensler for his word and “come in and register.”¹⁵³ Former SEC Commissioner and current Robinhood Markets legal executive told reporters: “[Robinhood] went through a 16-month process with the SEC staff trying to register a special purpose broker dealer. And then we were pretty summarily told in

[<https://perma.cc/9VMK-U7RU>]. In fairness, the SEC is necessarily embedded in the political system, and criticisms of the rule of law are on the rise. See, e.g., Jeb Bush & Joe Lonsdale, *Elon Musk and Donald Trump Cases Imperil the Rule of Law*, WALL ST. J. (Feb. 21, 2024), <https://www.wsj.com/articles/trump-and-musk-cases-imperil-the-rule-of-law-new-york-delaware-courts-business-266a5559>.

148. *SEC Framework Advisory*, *supra* note 109.

149. E.g., Coinbase Rulemaking Petition, *supra* note 11.

150. Gary Gensler, Chair, SEC, Statement on the Denial of a Rulemaking Petition Submitted on Behalf of Coinbase Global, Inc., SEC (Dec. 15, 2013), <https://www.sec.gov/news/statement/gensler-coinbase-petition-121523> [<https://perma.cc/6TM8-QHMK>].

151. *Id.* (footnote omitted).

152. Letter from Reps. Mike Flood, Wiley Nickel, Tom Emmer & Ritchie Torres to Gary Gensler, Chair, SEC (Sept. 26, 2023), <https://flood.house.gov/sites/evo-subsites/flood.house.gov/files/evo-media-document/sec-bitcoin-spot-etf-letter-signature-check.pdf> [<https://perma.cc/6WYL-V29U>] [hereinafter Congress Letter to SEC].

153. Jesse Hamilton, *Robinhood Joins Coinbase in Saying It Tried to “Come in and Register” Like SEC Wanted*, COINDESK (June 7, 2023), <https://www.coindesk.com/policy/2023/06/07/robinhood-joins-coinbase-in-saying-it-tried-to-come-in-and-register-like-sec-wanted/> [<https://perma.cc/7LQC-SRSG>].

March that that process was over and we would not see any fruits of that effort.”¹⁵⁴ This has not been a one-off experience, as Coinbase Chief Legal Officer Paul Grewal shared “after months and months of discussion, we’re simply dismissed with no response or any counter proposal or ideas coming back from the SEC.”¹⁵⁵

Only after apparent criticism from all directions has the SEC responded to public input on cryptocurrency. In January 2024, after a decade of petitioning, the SEC approved spot Bitcoin exchange-traded products.¹⁵⁶ This only came after a directed bipartisan signed letter from representatives in Congress in September 2023¹⁵⁷ and years of increasing industry lobbying.¹⁵⁸ This observation is not intended to infer support for these lobbying efforts, or to sway the SEC’s impartiality, or to say that might makes right—but the SEC’s rigidity after years of requests for clarified rulemaking is a critical factor when considering recent cases like *Ripple* that can be interpreted to clarify the law.

III. REASONABLE EXPECTATION OF PROFITS UNDER *RIPPLE*

This Part is a brief interlude from Parts I and II. It introduces *SEC v. Ripple* as a timely case study for cryptocurrency as more than an investment contract and begins a proscriptive account of the regulatory disconnect discussed more fully in Part IV.

A. Ripple’s Creation

Ripple began as “RipplePay” in 2004, created by founder Ryan Fugger “as a way of securely moving money around the world.”¹⁵⁹ Between 2011 and 2012, Arthur Britto, Jed McCaleb, and David Schwartz approached Fugger to merge RipplePay with a blockchain they designed.¹⁶⁰ From this merger, the group created a new entity, “OpenCoin[,] with full control of what was previously known as Ripple[P]ay.”¹⁶¹ Around this time in 2012, Chris Larsen also joined the venture and, at the time of this

154. *Id.*

155. *Id.*

156. Gensler, *supra* note 5.

157. Congress Letter to SEC, *supra* note 152.

158. Joe Light, *Crypto Is Lobbying Congress Hard. It Wants More Than a Bitcoin ETF*, BARRON’S (Oct. 19, 2023), <https://www.barrons.com/articles/bitcoin-etf-crypto-regulation-congress-sec-a4656b22>.

159. *Ripple*, CORP. FIN. INST., <https://corporatefinanceinstitute.com/resources/cryptocurrency/ripple/> [<https://perma.cc/U5CQ-222J>].

160. *Id.*; Thomas Silkjær, *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/?sh=e197b1e71d0b> [<https://perma.cc/ATX7-2CWQ>].

161. Silkjær, *supra* note 160.

writing, is the Executive Chairman and referred to as a co-founder of Ripple.¹⁶² The team raised roughly \$9 million,¹⁶³ returned to the brand name “Ripple Labs, Inc.,”¹⁶⁴ and secured their first banking collaboration in 2014.¹⁶⁵

With the creation of the blockchain in 2012, Ripple created 100 billion XRP.¹⁶⁶ The company reserved 80 billion XRP for itself and divided 20 billion among the founders.¹⁶⁷ Exact figures are still contested between Ripple and the SEC, but “[a]t all times before the end of 2020, Ripple owned between 50 and 80 billion XRP.”¹⁶⁸ From 2013 through the SEC filing its complaint in 2020, “Ripple engaged in various sales and distributions of XRP.”¹⁶⁹

At one point in 2017, XRP was the second-largest cryptocurrency by market capitalization.¹⁷⁰ At the time of writing, XRP is the sixth largest with a market capitalization of about \$34 billion.¹⁷¹ Ripple is seen as a disruptor in the cross-border banking industry.¹⁷² XRP transactions on the blockchain can process currency conversions in a matter of seconds that would ordinarily take days using traditional banking methods.¹⁷³ Ripple has cited a 2016 study from McKinsey & Company to suggest that the “approximately \$5 trillion dollars [is] sitting dormant in [] accounts around

162. *Id.*; *Meet Our Leaders*, RIPPLE, <https://ripple.com/company/leadership/> [<https://perma.cc/EA6V-NDX3>] (“Chris Larsen is Executive Chairman of Ripple’s board of directors. He is a co-founder and former CEO of Ripple.”).

163. Silkjær, *supra* note 160.

164. *Id.*

165. Pete Rizzo, *Fidor Becomes First Bank to Use Ripple Payment Protocol*, COINDESK (Sept. 11, 2021), <https://www.coindesk.com/markets/2014/05/05/fidor-becomes-first-bank-to-use-ripple-payment-protocol/> [<https://perma.cc/NZ7G-8L5D>].

166. SEC v. Ripple Labs, Inc., No. 20 Civ. 10832, 2023 WL 4507900, at *2 (S.D.N.Y. July 13, 2023).

167. *Id.*

168. *Id.*

169. *Id.*

170. Evelyn Cheng, *Digital Currency Ripple Soars Nearly 56 Percent, Becomes Second-Largest Cryptocurrency by Market Cap*, CNBC (Dec. 30, 2017), <https://www.cnbc.com/2017/12/29/ripple-soars-becomes-second-biggest-cryptocurrency-by-market-cap.html#:~:text=Bitcoin%20remains%20the%20largest%20digital,12.1%20percent%2C%20the%20website%20showed> [<https://perma.cc/4S4P-5K8Q>].

171. *Today’s Cryptocurrency Prices by Market Cap*, COINMARKETCAP, <https://coinmarketcap.com/> [<https://perma.cc/8QBB-R743>] (data collected March 17, 2024).

172. Silkjær, *supra* note 160.

173. *Id.* *Compare Consensus Principles and Rules*, XRP LEDGER, <https://xrpl.org/docs/concepts/consensus-protocol/consensus-principles-and-rules> [<https://perma.cc/E97L-JKBG>] (“The XRP Ledger’s technology enables near real-time settlement (three to six seconds) and contains a decentralized exchange, where payments automatically use the cheapest currency trade orders available to bridge currencies.”), *with International Wire Transfers*, BANK OF AM., <https://www.bankofamerica.com/foreign-exchange/wire-transfer/> [<https://perma.cc/JML4-KEDT>] (estimating 1–2 day processing time for international transfers); *How to Wire Money*, CHASE, <https://www.chase.com/personal/banking/education/basics/how-to-wire-money> [<https://perma.cc/VTE9-RW94>] (estimating 1–5 business days for international transfers).

the world” to facilitate international transfers.¹⁷⁴ Ripple has already made practical headway in its business plan. Ripple Labs advertises on its website a partnership with SCB, “Thailand’s longest established bank and one of the largest banks in terms of market capital assets, offering four models for inbound services with >\$300M.”¹⁷⁵ Ripple has also raised a plausible argument that their growth has been stunted in the United States due to legal risks and the costs those risks impose on any domestic banking partnerships.¹⁷⁶

B. The SEC Complaint

The SEC complaint, filed December 2020, named Ripple, former CEO Chris Larsen, and current CEO Brad Garlinghouse as defendants.¹⁷⁷ The SEC alleged that defendants collectively violated Sections 5(a) and 5(c) of the Securities Act—with Larsen and Garlinghouse also aiding and abetting Ripple’s violations.¹⁷⁸ Recall from Section II.A that Section 5 concerns securities registration.¹⁷⁹ Specifically, the SEC alleged that Ripple sold unregistered securities, Section 5(a),¹⁸⁰ and that Ripple engaged in interstate commerce to *offer* to sell or buy unregistered securities, Section 5(c).¹⁸¹

The complaint is a dense, seventy-one page account of the *Ripple* defendant’s alleged offer and sale of unregistered XRP securities.¹⁸² The allegations can be fairly summarized in the structure of the *Howey* test—and such a summary is consistent with the SEC’s headers organizing the complaint:

174. *Liquidity Explained*, RIPPLE (Mar. 20, 2018), <https://ripple.com/insights/liquidity-explained/> [<https://perma.cc/DH6T-SKEX>] (citing MCKINSEY & CO., GLOBAL PAYMENTS 2016: STRONG FUNDAMENTALS DESPITE UNCERTAIN TIMES (2016), <https://www.mckinsey.com/~media/McKinsey/Industries/Financial%20Services/Our%20Insights/A%20mixed%202015%20for%20the%20global%20payments%20industry/Global-Payments-2016.ashx> [<https://perma.cc/2ADB-6Y4B>]). It is not apparent to the Author where Ripple derived the \$5 trillion figure. Though Ripple’s claim is consistent with the report, as the McKinsey findings suggest removing this need for liquidity may save “as much as 35 percent of total costs per payment.” MCKINSEY, *supra* at 21–22.

175. *Ripple Helps Siam Commercial Bank Drive Innovation with Instant Cross-Border Remittances*, RIPPLE, <https://ripple.com/customer-case-study/scb/> [<https://perma.cc/R4Y4-QYTJ>].

176. See Ryan Browne, *Ripple Says U.S. Banks Will Want to Use XRP Cryptocurrency After Partial Victory in SEC Fight*, CNBC (July 18, 2023), <https://www.cnbc.com/2023/07/17/ripple-hopes-judge-ruling-in-sec-case-will-lead-to-us-banks-using-xrp.html> [<https://perma.cc/SXU8-ZAE3>].

177. Complaint at 1, SEC v. Ripple Labs, Inc., 2023 WL 4507900 (2023) (No. 4), <https://www.sec.gov/files/litigation/complaints/2020/comp-pr2020-338.pdf> [<https://perma.cc/URP5-ZELQ>] [hereinafter *Ripple Complaint*].

178. *Id.* at 3.

179. See *supra* Section II.A.

180. 15 U.S.C. § 77e(a); *Ripple Complaint*, *supra* note 177, at 3.

181. *Id.* § 77e(c).

182. See generally *Ripple Complaint*, *supra* note 177.

1. Ripple based its XRP distribution on a speculative business model requiring investors to invest in future use of the “speculative trading market.”¹⁸³

2. Defendants selectively disclosed information about their activities on the XRP ledger they control.¹⁸⁴

3. XRP was a security through all relevant times in the complaint under *Howey*.¹⁸⁵ Defendants led the investors to reasonably expect the success of Ripple from their efforts.¹⁸⁶ The sales of XRP were an investment in a common enterprise.¹⁸⁷ Ripple led investors to reasonably expect profit from investing in XRP.¹⁸⁸

4. Ripple did not sell XRP for a non-investment use, nor does such a use exist.¹⁸⁹

5. Ripple has never registered XRP with the SEC.¹⁹⁰

Note that the summary above does not exactly match the *Howey* test outlined in Section II.A. Recall from *Howey* that an investment contract security requires (1) an investment of money, (2) a common enterprise, and (3) a reasonable expectation of profit derived from the effort of others.¹⁹¹ Surveying the SEC’s complaint, the summary is repetitive and convoluted. Separate sections state conclusively that XRP is a security and survey the *Howey* elements. One section alleges defendants selectively disclosed their business activities; the relevance to *Howey*, and Section 5 jurisprudence generally, is unclear.

The complaint can be studied at length because it includes detailed figures alleging defendants’ business plan for Ripple Labs,¹⁹² the stable growth of the XRP ledger,¹⁹³ and the distribution of XRP over the years.¹⁹⁴ These facts, where they are dispositive, are reserved for discussion of the July 2023 decision as relevant to the court’s findings.

183. *Id.* at 12.

184. *Id.* at 29.

185. *Id.* at 34.

186. *Id.* at 36.

187. *Id.* at 45.

188. *Id.* at 49.

189. *Id.* at 56.

190. *Id.* at 62.

191. See discussion accompanying *supra* note 113.

192. See, e.g., Ripple Complaint, *supra* note 177, at 8–11, 29–34.

193. See, e.g., *id.* at 14–26.

194. See, e.g., *id.* at 16, 20, 26.

C. The July 2023 Decision

In July 2023, the U.S. District Court for the Southern District of New York decided cross-motions for summary judgment in the *Ripple* case.¹⁹⁵ A *Reuters* commentary labeled it a “groundbreaking decision”;¹⁹⁶ the *New York Times* characterized it as an “early victory”;¹⁹⁷ and Ripple tweeted, “XRP is not a security. This victory for @Ripple is a win for the entire industry and a step toward regulatory clarity in the U.S.”¹⁹⁸

On review of the cross-motions for summary judgment, the court partially granted Ripple’s motion based on undisputed evidence that some of the XRP transactions were not securities under *Howey*.¹⁹⁹ The court ruled that most of Ripple’s sales did not lead purchasers to have a reasonable expectation of profit, evading the standard of an investment contract security.²⁰⁰ First, the court rejected a novel “essential ingredients test” offered by defendants that relied on pre-1933 state securities cases for the position that investment contracts require contracted investor rights including post-sale obligations on the seller and a right to share in profits.²⁰¹ The court then reiterated *Howey* and cited *Reves* and its progeny to set its focus on investors’ expectation of profits—regardless of the precise form the agreement takes.²⁰²

The court then considered the nature of XRP as a whole.²⁰³ Recall the SEC’s contention from Section III.B that XRP serves no non-investment purpose.²⁰⁴ Ripple responded that “XRP does not have the ‘character in commerce’ of a security” but instead is a commodity like other “ordinary assets.”²⁰⁵ The court used this point to clarify: “XRP, as a digital token, is not in and of itself a ‘contract, transaction[,] or scheme’ that embodies the *Howey* requirements of an investment contract.”²⁰⁶ Rather, the

195. See generally SEC v. Ripple Labs, Inc., No. 20 Civ. 10832, 2023 WL 4507900 (S.D.N.Y. July 13, 2023).

196. Alex Drylewski, Daniel Michael & Spurthi Jonnalagadda, *Ripple Effects: Developments Following Groundbreaking Decision in SEC v. Ripple Labs*, REUTERS (Dec. 5, 2023), <https://www.reuters.com/legal/legalindustry/ripple-effects-developments-following-groundbreaking-decision-sec-v-ripple-labs-2023-12-05/>.

197. David Yaffe-Bellany, *Crypto Industry Secures Early Victory in Legal Battle with Regulators*, N.Y. TIMES (Jul. 13, 2023), <https://www.nytimes.com/2023/07/13/business/crypto-ripple-ruling.html>.

198. Ripple, X (July 13, 2023 12:44 PM), <https://twitter.com/Ripple/status/1679577577210675200> [<https://perma.cc/ADM5-G9VK>].

199. *Ripple*, 2023 WL 4507900, at *8–14.

200. See *id.*

201. *Id.* at *6.

202. *Id.* at *7.

203. *Id.*

204. Ripple Complaint, *supra* note 177, at 56.

205. *Ripple*, 2023 WL 4507900, at *7.

206. *Id.* at *8.

court examines the totality of circumstances surrounding defendants' different *transactions and schemes* involving the sale and distribution of XRP."²⁰⁷ The court's transaction-specific analysis runs counter to the SEC's blanket statements classifying cryptocurrencies as securities.²⁰⁸

After framing its Section 5 analysis around the transactions at issue, the court proceeded to evaluate each transaction type individually.²⁰⁹ The court divided the offers and sales into four types, discussed in turn: (1) institutional sales,²¹⁰ (2) programmatic sales,²¹¹ (3) other distributions,²¹² and (4) Larsen's and Garlinghouse's offers and sales.²¹³ The court held that the first category, institutional sales, was securities transactions and the remaining three categories were not securities transactions for various reasons.²¹⁴

1. Institutional Sales

The SEC alleged Ripple sold approximately \$728.9 million in XRP to institutional buyers (characterized as "primarily institutional buyers, hedge funds, and [on demand liquidity] customers").²¹⁵ Ripple argued that the institutional sales did not meet prong one of *Howey*, the investment of money.²¹⁶ Ripple attempted to distinguish these purchases from *Howey* by characterizing them as "payments" rather than investments.²¹⁷ The court responded that the term "payments" versus "investments" was a difference without a distinction and that the payment prong was satisfied.²¹⁸

The court also held that the second prong, "common enterprise," was satisfied.²¹⁹ A common enterprise under *Howey* may be satisfied with either "vertical commonality" or "horizontal commonality."²²⁰ Both vertical and horizontal commonality cover the pooling of investments with the reasonable expectation of profit.²²¹ Here, "horizontal commonality" was

207. *Id.* (emphasis added).

208. See discussion *supra* Section II.B (recounting the Commission's often shallow framing of securities analysis, i.e., telling market participants to "come in and register" without specific guidance).

209. *Ripple*, 2023 WL 4507900, at *8–14.

210. *Id.*

211. *Id.* at *11.

212. *Id.* at *13.

213. *Id.* at *14.

214. *Id.* at *8–14.

215. *Id.* at *2.

216. *Id.* at *8; see discussion accompanying notes 113–118.

217. *Ripple*, 2023 WL 4507900, at *8.

218. *Id.*

219. *Id.* at *8–9.

220. The common enterprise prong is outside the scope of this Note, but see *Revak v. SEC Realty Corp.*, 18 F.3d 81, 87–88 (2d Cir. 1994) for a discussion of the nuances of vertical commonality and a circuit split that has resulted.

221. See *generally* *Revak v. SEC Realty Corp.*, 18 F.3d 81, 87–88 (2d Cir. 1994).

proven in the record by the pooling of institutional investor proceeds that were used to further the Ripple Labs business plan and deliver profit to institutional investors.²²²

Last, the court held that the third prong was satisfied because the institutional investors had a reasonable expectation of profit.²²³ The court made extensive findings in the record to support a reasonable expectation of profit.²²⁴ As mandated by precedent, the court's "inquiry [was] an objective one focusing on the promises and offers made to investors; it [was] not a search for the precise motivation of each individual participant."²²⁵ Among the findings supporting a reasonable expectation of profit were: (1) the distribution of promotional brochures to institutional investors beginning in 2013, "tout[ing] XRP as an investment tied to the company's success";²²⁶ (2) later "XRP Market Reports" tying XRP price increase to the Ripple business efforts;²²⁷ (3) public statements from senior leadership emphasizing the business focus on price increase;²²⁸ and (4) investment-like purchase conditions such as lockup provisions and resale restrictions.²²⁹

2. Programmatic Sales

The next transaction type the court assessed was programmatic sales.²³⁰ Programmatic sales were all other XRP purchases facilitated by Ripple between 2013 and 2020.²³¹ Unlike the institutional sales, the programmatic sales were "blind bid/ask transactions," meaning buyers did not know who they were purchasing from and initiated the purchase with a bid for their desired XRP.²³²

The different transactional nature of the programmatic sales was dispositive to the court's holding that these sales were not securities.²³³ Even if investors had a speculative motive for purchase, it was not "derived from the entrepreneurial or managerial efforts of [Ripple]."²³⁴ Recall from the *Ripple* court's first holding regarding the institutional sales: the expectation of profits prong is an objective inquiry based on the promises of the

222. *Ripple*, 2023 WL 4507900, at *9.

223. *Id.* at *9–10.

224. *See id.* at *9–11.

225. *Id.* at *9 (quoting *SEC v. Telegram Grp. Inc.*, 448 F. Supp. 3d 352, 371 (S.D.N.Y. 2020)).

226. *Ripple*, 2023 WL 4507900, at *10.

227. *Id.*

228. *Id.* at *10–11.

229. *Id.* at *11.

230. *Id.*

231. *See id.*

232. *Id.*

233. *Id.* at *11–12.

234. *Id.* at *12 (quoting *United Housing Found., Inc. v. Forman*, 421 U.S. 837, 852 (1975)).

offeror.²³⁵ The purchasers' decisions to enter the programmatic sales were not informed by any promise or offer from Ripple, nor did they have an extensive history of investor-like communications that preceded the transactions with non-institutional investors.²³⁶

3. Other Distributions

Review of the third and fourth transaction types need only be cursory because the court based its holdings on the analysis of the institutional and programmatic sales.²³⁷ The transactions labeled "other distributions" were employee compensation and incentives for third parties to develop XRP-based applications for the blockchain.²³⁸ Unlike the institutional and programmatic sales, the recipients paid nothing.²³⁹ Because these offerings were not based on a purchase or other consideration, the first prong of *Howey*, the payment of money, was not satisfied, and the transactions cleared further Section 5 review.²⁴⁰

4. Larsen's and Garlinghouse's Offers and Sales

The SEC separately alleged Section 5 violations against Larsen's and Garlinghouse's offers and sales.²⁴¹ These sales, like the programmatic sales, were blind bid transactions, meaning the court held the third *Howey* prong was not met under the same rationale in Section III.C.2.²⁴²

IV. *RIPPLE* ILLUSTRATES A BROADER REGULATORY DISCONNECT FOR SECURITIES REGISTRATION

The *Ripple* decision illustrates a broader disconnect in the SEC's approach to securities registration. This Part looks a step further and briefly explores a broader regulatory disconnect from the SEC and the recent cases outside of *Ripple*.

This final Part posits that the SEC and other recent cases misplace their focus on digital assets when the priority should be on issuer-purchaser communications. Second, it compares two examples of investor communications to further the point. Third, it briefly proposes a new approach that the SEC and courts may take to better address the underlying problem of securities fraud.

235. *Ripple*, 2023 WL 4507900, at *12.

236. *Id.*

237. *See id.* at *13–14.

238. *Id.* at *13.

239. *Id.*

240. *Id.*

241. *Id.* at *14.

242. *Id.*

A. The SEC's Misplaced Focus

As explored in Section II.B, much of the SEC's focus in its cryptocurrency enforcement actions has been on Section 5 of the Securities Act. Section 5 presents a necessary threshold question for the SEC's authority in the industry. If cryptocurrency is a security, the Securities Acts apply and the SEC can exercise its authority to regulate, sanction, and litigate. If cryptocurrency is not a security, the SEC has little to no role to play. This binary incentivizes the SEC to broadly define cryptocurrency as a security.

This Note in Parts I, II, and III illustrates a disjunct and sometimes conflicting perspective on cryptocurrency in industry practice, agency regulation, and the law. This disjunction has led to costs that are incontestable. Taking the *Ripple* case study alone, the ongoing litigation has spanned nearly four years.²⁴³ In addition to the discrete costs from the litigation itself, parties have incurred innumerable intangible costs such as consumer and industry partner relationships lost due to legal risk.²⁴⁴ From the perspective of the SEC, even cases won and settlements reached also impose costs given the agency's strained resources.²⁴⁵ Assessing the regulatory dilemma with a game theory model, Professor Yuliya Guseva concluded:

[Leading up to 2021,] . . . the SEC attempted to reduce information losses and improve regulatory clarity by following a set of well-defined *strategies* during the first years of its crypto-enforcement efforts.

Unfortunately, recent enforcement actions may upend those successful strategies. If the SEC no longer can provide clarity through strategic predictability of a transparent enforcement approach, and if the market finds substantial inconsistencies in the regulator's moves and commitments, the fabric of cooperation between the innovators and

243. Ripple Complaint, *supra* note 177, at 1 (complaint filed December 22, 2020).

244. See, e.g., Tom Wilson & Elizabeth Howcroft, *Crypto Firms Will Develop 'Offshore' Without Clear US Rules*, *Coinbase Chief Says*, REUTERS (Apr. 18, 2023), <https://www.reuters.com/technology/coinbase-ceo-crypto-firms-will-develop-offshore-without-clear-regulations-2023-04-18/> (describing shift of cryptocurrency business offshore due to U.S. legal risks); Paul Grewal, *Coinbase Will Suspend Trading in XRP on January 19*, COINBASE (Jan. 19, 2021), <https://www.coinbase.com/blog/coinbase-will-suspend-trading-in-xrp-on-january-19> (announcing that Coinbase was suspending XRP trading on the Coinbase exchange in light of the SEC lawsuit).

245. See generally U.S. GOV'T ACCOUNTABILITY OFF., GAO-02-302, SEC OPERATIONS: INCREASED WORKLOAD CREATES CHALLENGES (2002), <https://www.gao.gov/assets/gao-02-302.pdf> [<https://perma.cc/5UAC-JZ6H>] (detailing SEC operational challenges including limited resources, high staff turnover, and delayed operations). See SEC OFF. OF THE INSPECTOR GEN., THE INSPECTOR GENERAL'S STATEMENT ON THE SEC'S MANAGEMENT AND PERFORMANCE CHALLENGES 7, 10 (2023), <https://www.sec.gov/files/inspector-generals-statement-sec-mgmt-and-perf-challenges-october-2023.pdf> [<https://perma.cc/4ZCW-N33E>] (SEC Inspector General report describing challenges including a nearly doubled position vacancy rate from 2020 to 2023 and "specialized recruiting challenges" for crypto specialists that would be prohibited from working on matters related to cryptocurrency they own).

the Commission may be broken, leading to a suboptimal outcome for the cryptoasset markets and financial innovations.²⁴⁶

Section II.B details a lack of clarity and a breakdown of cooperation central to Professor Guseva’s important model and analysis. This prompts a discussion of how these costs can be avoided or at least mitigated.

Other scholars have proposed novel doctrines that minimize internal and external costs. Professors M. Todd Henderson and Max Raskin originated two new tests that operationalize *Howey* toward that end: the “Bahamas Test” and the “Substantial Steps Test.”²⁴⁷ Under the “Bahamas Test,” an asset is no longer a security once controlled by more than one entity.²⁴⁸ Under the “Substantial Steps Test,” an asset is no longer a security once an issuer takes substantial steps to develop the underlying network.²⁴⁹

The Author credits existing thought on this subject as a means to add a modest policy proposal.²⁵⁰ Much of the regulatory disconnect explored in this Note is centered on Section 5 of the Securities Act—whether a digital asset is a security. Many of these costs can be avoided, and the SEC’s mandate fulfilled, if the SEC and judiciary focus on the “expectation of profits” prong as the court did in *Ripple*. Ripple’s programmatic sales were not investment contracts because Ripple did not communicate with non-institutional purchasers in a manner that created a promise of profit.²⁵¹

With much of the policy underlying securities law being disclosure and investor protection, investors are protected when regulators focus their attention on communication that is fraudulent.²⁵² The cost, if any, is

246. Yuliya Guseva, *The SEC, Digital Assets, and Game Theory*, 46 J. CORP. L. 629, 677–78 (2021) (emphasis in original).

247. M. Todd Henderson & Max Raskin, *A Regulatory Classification of Digital Assets: Toward an Operational Howey Test for Cryptocurrencies, ICOs, and Other Digital Assets*, 2019 COLUM. BUS. L. REV. 443, 460, 483 (2019).

248. *Id.* at 461.

249. *Id.* at 483.

250. Additional scholarship worthy of mention but limited in reference to this Note include: Harvey L. Pitt & Karen L. Shapiro, *Securities Regulation by Enforcement: A Look Ahead at the Next Decade*, 7 YALE J. ON REGUL. 149 (1990); Carol R. Goforth, *Regulation of Crypto: Who Is the Securities and Exchange Commission Protecting?*, 58 AM. BUS. L.J. 643 (2021); Christian Smith-Bishop, *A Ripple-Turned-Tidal Wave: SEC v. Ripple Labs as an Inflection Point in the Regulatory Approach to Innovation in Complex Systems*, 44 CAMPBELL L. REV. 335 (2022); Kevin Werbach, *Digital Asset Regulation: Peering into the Past, Peering into the Future*, 64 WM. & MARY L. REV. 1251 (2023).

251. See *supra* Section III.C.2.

252. The SEC’s enforcement actions have mistaken fraud for an industry-wide legal crisis. From a 2023 speech by SEC Commissioner Hester Peirce:

What we should *not* learn from the events of 2022 is that the failures of centralized entities are failures of decentralized protocols. Many of the 2022 failures involved crypto market participants doing the same foolish and fraudulent things that participants in other markets have been doing for centuries.

nominal for the SEC and the judiciary to weigh issuer communications more heavily when evaluating enforcement actions. Purchasers and issuers save too, without the looming industry risk and uncertainty.

*B. Issuer-Purchaser Communication Illustrated*²⁵³

This Section briefly builds on the previous Section with an example of the suggested importance of issuer communication underlying “expectation of profits” under *Howey*. These figures are purely for demonstrative purposes, sourced from recent published communications. Rather than imply any fraudulent or illegal activity, these figures illustrate that purchaser expectations are often more influenced by issuer communications than by the functionality of the asset itself.

Pursuing fraudsters, no matter their chosen medium, is important. . . . In judging the SEC’s success at stamping out fraud in crypto, remember that our jurisdiction is limited. Congress did not empower the SEC with general anti-fraud authority and instead limited it to investigating and addressing fraud occurring in connection with securities transactions with a nexus to the United States. And although some might suggest otherwise, everything, everywhere is *not* securities fraud.

Hester M. Peirce, Comm’r, SEC, Outdated: Remarks before the Digital Assets at Duke Conference (Jan. 20, 2023), https://www.sec.gov/news/speech/peirce-remarks-duke-conference-012023#_ftnref23 [<https://perma.cc/95PF-BJLH>] (emphasis in original).

253. The term “hypothetically” should be bolded and underlined. This Part requires consideration of actual instances of issuer-purchaser communications that *may* warrant review for securities fraud under Rule 10b-5, but these examples are sourced from caselaw only for illustrative purposes. No allegations are implied nor should any be inferred from the hypothetical scenarios examined.

Figure 2: NBA Top Shot Communication²⁵⁴



Figure 3: Ripple Communication²⁵⁵



Figure 2 is taken from the record in *Friel v. Dapper Labs, Inc.*, another recent Section 5 case involving the sale of non-fungible tokens (NFTs), a digital asset assessed the same as cryptocurrency for purposes

254. Image sourced from *Friel v. Dapper Labs, Inc.*, 657 F. Supp. 3d 422, 443 (S.D.N.Y. 2023).

255. Image sourced from Ripple, X (Apr. 12, 2021 7:51 PM), <https://twitter.com/Ripple/status/1381620885363249155> [<https://perma.cc/J3WU-RDK6>].

of this Note.²⁵⁶ The *Friel* court rightly gave significant weight to the public Tweets in Figure 2 to bolster its finding that there was a reasonable expectation of profit with the purchase of the NFTs.²⁵⁷ Without any explicit mention of profit,²⁵⁸ the court held that the communication clearly serves to entice purchasers with the potential for financial gain:

Each Tweet promotes a recent sale or statistics of recent sales of Moments on the Marketplace. And although the literal word “profit” is not included in any of the Tweets, the “rocket ship” emoji, “stock chart” emoji, and “money bags” emoji objectively mean one thing: a financial return on investment. [Defendant and issuer founder] Gharagozlou also admits a profit motive. He is quoted promoting Moments to “younger generations” as giving them an opportunity to “benefit financially” from the purchase. And he publicly promotes his own holdings as “valuable.”

. . . . Taken together with the Tweets promoting record high sales, exponentially higher than the price of Moments in a pack, makes plausible that Dapper Labs objectively led purchasers to expect that they would realize the same gains.²⁵⁹

In comparison, Figure 3 is taken from the X (formerly Twitter) profile of Ripple as a counter-example of communications that do not create a reasonable expectation of profit. Similar to the court’s holding in *Ripple*, “some Programmatic Buyers may have purchased XRP with the expectation of profits to be derived from Ripple’s efforts.”²⁶⁰ But under the objective “expectation of profits” test, the focus is on “promises and offers made to investors.”²⁶¹

The *Friel* decision, and comparison of Figures 2 and 3, illustrates that, under the investment contract doctrine, analysis of the communications and of the asset cannot be decoupled. The basis of an investment contract is not the *asset*, it’s the *expectations* underlying the sale of the asset. Figure 2 reasonably conveys a promise of gain; whereas Figure 3 merely shares the benefits of the blockchain network that may incidentally result in financial gain to users in the network.

256. 657 F. Supp. 3d 442 (S.D.N.Y. 2023).

257. *Id.* at 442–46.

258. *Id.*

259. *Id.* at 443–44.

260. SEC v. Ripple Labs, Inc., No. 20 Civ. 10832, 2023 WL 4507900, at *12 (S.D.N.Y. July 13, 2023).

261. *Id.*

Regulation of the communication in Figure 3 should, if at all, be a matter for consumer protection, not securities law.²⁶² In focusing on blanket labeling of most cryptocurrencies as securities,²⁶³ the SEC has lost focus on the purchaser expectations standard that underpins *Howey* investment contract analysis.²⁶⁴ This distinction, while subtle, is critical. If the Commission is to fulfill its policy mandate to protect purchasers against securities fraud, it must hone its focus on purchaser communications that establish a reasonable expectation of profit and are fraudulent.

C. A Refocus on Securities Fraud

Recall the discussion in Section II.A regarding Rule 10b-5, the federal law concerning securities fraud. Rule 10b-5 prohibits:

- (a) . . . [A]ny device, scheme, or artifice to defraud,
- (b) . . . [A]ny untrue statement of a material fact or [omission of] a material fact necessary in order to make the statement made . . . not misleading, or
- (c) . . . [A]ny act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,

*in connection with the purchase or sale of any security.*²⁶⁵

With this Note's focus on issuer communications, the proposal in turn offers promise for investor protection under Rule 10b-5. Sub-section (b) prohibits false or misleading communications in connection with the sale of a security.²⁶⁶ In following the *Ripple* decision, the focus is on issuer communications that create a reasonable expectation of profit. The SEC's current stance oversells its authority to regulate *securities* and considers none of the alternate expectations cryptocurrency users encounter.²⁶⁷

Following this Note's approach, if the other prongs (i.e., payment of money, in a common enterprise) of *Howey* are met, the transaction is an investment contract and subject to the Securities Acts. By more strictly considering issuer communications that create an expectation of profit, the SEC and investors are better served by Rule 10b-5 securities fraud protection. Cryptocurrency transactions not induced by issuer communications like the *Ripple* programmatic transactions are not subject to the arduous

262. Exploration of consumer protection is well beyond the scope of this Note; but the reference to consumer protection is necessary because securities law is focused on investor protection—and Figure 3 is not directed at investors.

263. See discussion accompanying note 153.

264. See *supra* Section II.A (outlining *Howey* and its progeny).

265. 17 C.F.R. § 240.10b-5 (2024) (emphasis added).

266. *Id.*

267. See discussion *supra* Section I.B (outlining several cryptocurrency uses that may inform a decision to purchase any given cryptocurrency).

Section 5 registration requirements. Issuances that are preceded by communication setting a reasonable expectation of profit are investment contracts and immediately warrant a Rule 10b-5 assessment for false or misleading representations.

CONCLUSION

More research is needed to better articulate the relationship between securities registration and fraud prevention in the still-growing blockchain industry. This Note is intended to further the understanding of cryptocurrency in industry practice, agency regulation, and federal courts with *SEC v. Ripple Labs* as an important case study. Taking the court's holding in *Ripple*, the Securities and Exchange Commission and federal courts are well positioned to further emphasize the role of investor communications in the "expectation of profits" prong of *Howey*. This proposal comes at little to no opportunity cost to the SEC and better aligns it with its mandate to protect investors while limiting the costs of litigation under Section 5 that do not clearly present risk of fraud or other harm.