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Ripple Token Case Highlights Need For SEC Clarity On Crypto

By **Joseph Hall** (January 25, 2021, 4:56 PM EST)

Serving on staff at the U.S. Securities and Exchange Commission during the era of former President George W. Bush, I was once surprised to hear gossip about the unlikelihood — read, inappropriateness — of my appointment, given my Democratic voter registration and trail of campaign contributions.

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It hadn't occurred to me that regulation of the securities markets was a partisan matter. Although a few years later we're all less naive about the currents of debate in Washington, I still know the staff — the heart of the agency — is focused squarely on investor protection and health of the markets, regardless of political persuasion, which, for the record, runs the gamut from libertarian to progressive.

Leadership of the agency will soon change with last week's official confirmation that President Joe Biden intends to nominate Gary Gensler for the top spot. In several areas, one can predict that Gensler, the former head of the U.S. Commodity Futures Trading Commission during the Obama administration, will chart a different course from recently departed SEC Chairman Jay Clayton.

With luck, the agency's heretofore skeptical approach to the regulation of digital assets, or cryptocurrency, will be one of them — particularly with the SEC's decision, a day before Clayton's late-December departure, to file a suit against Ripple Labs Inc. over its cryptocurrency XRP.

Clayton took charge of the agency in early 2017. This was about a decade after the invention of bitcoin, amid the boom in initial coin offerings, or ICOs, in which developers sold coins or tokens — that is, unique lines of software code — on the promise that these digital assets would play a role in a broader solution to a real-world problem, like how to keep track of ingredients in a food manufacturer's supply chain or harness fallow data storage capacity at scale.

While many ICOs were centered on creative applications of nascent distributed ledger, or blockchain, technology, others seemed more aimed at separating investors from cash with utopian claims about the wonders of an imagined ecosystem, which naturally would lead to appreciation in the cryptocurrency sold in the ICO.

In other words, some ICO promoters were essentially selling speculative common equity in startups without first registering it with the SEC.

Despite being the nation's foremost protector of the investing public, the SEC lacks authority to police activity merely because investors risk a fleecing. A security must be present, and nothing in our Depression-era laws says that lines of computer code are securities.

So the SEC looks to the curious term "investment contract," a thing that is indeed a security. The term was first given meaning by the U.S. Supreme Court in SEC v. W.J. Howey Co., a 1946 case dealing with investment opportunities in a Florida citrus grove.

Imagine trying to explain what an iPhone is in language your great-grandfather would have understood just after World War II. That's how easy it is to predict which digital assets are securities under the post-war Howey test. The stakes are high for anyone wanting to build a business on blockchain technology — if in hindsight your digital asset is a security, you can expect SEC enforcement action along with fines, restitution and liability that in a recent case against Telegram Group Inc. topped $1 billion.

It's difficult to overstate the impact this uncertainty has on the development of blockchain technology in the U.S. Outside the venture capital community, corporations, major investors and banks are understandably skittish about risking serious sums of money on technologies their lawyers can't assure them comply with law — even when a technology holds the potential to improve the efficiency of managing vast amounts of data across countless industries, or the potential for frictionless, inexpensive transfers of value over smartphones and other widespread consumer tools.

Which brings us to the SEC's case against Ripple Labs. The securities law status of XRP — a digital asset used to simplify cross-border payments — was probably always going to be a tough call after Clayton's SEC first laid out its views on how to apply Howey to crypto.

This came in a July 2017 report explaining why the agency declined to sue promoters of The DAO, a "'virtual' organization embodied in computer code and executed on a distributed ledger or blockchain." The SEC concluded that The DAO's promoters erred by not registering their digital asset with the agency before selling it to the public, as any issuer of a security must do.

But, recognizing the commission hadn't yet plainly articulated its views on digital assets, the agency noted that it had "decided not to bring charges in this instance ... but rather to caution the industry and market participants."

By the time the SEC issued its DAO report, XRP had been trading in the crypto markets for several years and its creator Ripple Labs was a Silicon Valley wunderkind with a hefty private market valuation and a credible business model centered on disrupting the enormous market for interbank funds transfers.

A year later, when Bill Hinman, then director of the SEC's Division of Corporation Finance, said in a speech that the popular cryptocurrency Ethereum might have been born a security but later morphed into a nonsecurity, it was a fair bet that XRP would get the same treatment. In other words, maybe there were some issues with early sales of XRP, but at this point surely XRP itself was in the clear. Right?

The SEC's decision to bring charges against Ripple Labs for ongoing sales of XRP is thus remarkable on several levels. First, the timing — the day before Clayton stepped down — suggests the possibility of a rift among the commissioners as opposed to a case everyone agreed had to be brought immediately in order to avert looming investor harm.

Second, whatever one's views on the merits, before news of the SEC's intentions broke, XRP traded with

a market cap in the $25 billion to $30 billion range, meaning that any precipitous action by the SEC would surely result in heavy investor losses — ending recently around $13 billion.

Finally, and perhaps more interestingly to the securities bar: Why on earth did the agency bring a case that was considerably less a slam dunk than its previous crypto enforcement actions?

Barring a settlement, the Article III courts and not the SEC will ultimately say whether XRP is a security. There are plenty of digital assets with more tenuous use cases than XRP, any one of which might have better helped the SEC etch its views into federal caselaw before taking on a leviathan like Ripple Labs.

And the commission does not have an unblemished record when it comes to defending its prerogatives in federal court — it has lost cases centered on its authority to regulate hedge funds, the reach of its Regulation Fair Disclosure and its ability to prescribe corporate governance standards, among others. A loss on the merits in the XRP litigation could epically damage the SEC's regulatory project when it comes to digital assets.

Perhaps we'll soon learn why the SEC acted against XRP when it did. But speculating over the SEC's motives shouldn't distract from the more important policy question that Gensler and the rest of the agency's incoming leadership will have to grapple with. Cryptocurrency is here to stay, if not in the U.S., then certainly in the rest of the world.

But incredibly, the SEC has yet to formally confirm that any digital asset — including Bitcoin and Ethereum, with a combined trading value approaching half a trillion dollars — is not a security. There have been a few nonbinding statements to the effect that Bitcoin isn't, and that, today at least, neither is Ethereum, and the SEC staff has said it doesn't consider three obscure digital assets to be securities. But as the news about XRP shows, the regulatory status of most crypto, including many widely held digital assets, remains cloudy.

It's not obvious that the SEC's approach to regulating crypto should be grounded in metaphors about oranges and principles articulated in a case decided three-quarters of a century ago which — take it from one who knows — is nearly impossible to apply with consistency and predictability across the digital asset class.

Instead, it's important to step back and ask why this question matters: In other words, why doesn't the cryptocurrency market just comply with the securities laws, given the undeniable investment appeal of many digital assets?

Simple: The regulatory obligations governing transactions in securities make it impractical to use them in many ordinary commercial or peer-to-peer transactions. Digital assets need to flow freely from user to user over a blockchain to enable the exchange of value and information.

But the movement of securities occurs within a framework designed to protect the investing public, in which intermediaries who facilitate trading in securities or hold them for others are subject to pervasive SEC oversight. This framework was not built to govern simple commercial activities like a purchase of services. Shoehorning these activities into the securities regulatory apparatus would increase their cost and complexity to the point of being useless, or at the very least, uncompetitive with existing alternatives.

And so the binary model followed by the SEC in recent years — asking whether a digital asset is an

investment contract and bringing the entire securities regulatory scaffolding crashing down on it if the answer is yes — is not the only way the agency could think about a framework for regulating crypto.

There are surely some aspects of the securities laws, like incentives for clear disclosure, that perhaps ought apply to a sale of investment contract cryptocurrency. But other parts, like channeling all secondary trading through regulated intermediaries, cannot apply to many digital assets without wholly defeating their utility.

Through notice-and-comment rulemaking, the SEC can use tools Congress has already given it to develop a textured model for the regulation of investment-contract digital assets — which it cannot do through the regulate-by-enforcement method. Members of the commission's staff have thought long and hard about this already.

While many expect stepped-up enforcement under the incoming administration, it would be a lost opportunity for crypto regulation to continue with a hardline enforcement-first approach. Certainly, the SEC should continue to make clear that raising risk capital for business propositions is subject to the securities laws.

In his earlier tenure as CFTC chair, Gensler led that agency through a notably robust rulemaking agenda, and in the years since leaving government service he has developed deep crypto expertise through his work with the MIT Media Lab's Digital Currency Initiative.

In order to give desperately needed certainty to the development of one of this century's most promising new technologies — and to prevent further shoving blockchain innovation outside the nation's borders — let's hope that in his new role Gensler makes it a priority to rationalize the application of our securities laws to cryptocurrency.

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