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## Cryptocurrency and Security Issues: The Tide Awaiting *Ripple's* Decision

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# CRYPTOCURRENCY AND SECURITY ISSUES: THE TIDE AWAITING *RIPPLE'S* DECISION

By *Robel Tsegu\**

## ABSTRACT

Bitcoin passed the test. Ethereum passed the test. Now, it is XRP's turn. At the time of this writing, the SEC has the opportunity, through common law, to determine how to regulate the unregulated cryptocurrency world. This is a unique moment because guidance on SEC violations is usually promulgated through statutes, no-action letters, and quotes from SEC Commissioners, rather than common law. Therefore, the decision in *SEC v. Ripple* will pivot the direction on how cryptocurrencies and digital assets forever be used. Will this pivot be a "hard" or "soft" fork in how we use cryptocurrencies?

This Case Note argues that XRP is not a security (investment contract) under the *Howey* test. The test consists of three elements (1) an investment of money (2) in a common enterprise and (3) with the expectation of profits derived from efforts of others. XRP does not satisfy all three factors. Although seemingly controversial, this Case Note explains why XRP is not an investment contract but, rather, a universal currency, allowing users to change payments instantly and cheaply into their local currency. It concludes by discussing an alternative classification for XRP created by the SEC.

## I. INTRODUCTION

On December 22, 2020, the last day of Jay Clayton's position as SEC Chairman,<sup>1</sup> the SEC filed a complaint in the Southern District of New York (SDNY)<sup>2</sup> against Ripple Labs, Inc. and two of its executives, Bradley Garlinghouse, Ripple Labs CEO, and Christian Larsen, Ripple Labs co-founder, executive chairman, and former CEO.<sup>3</sup> The SEC alleged that "[d]efendants

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1. Paul Jossey, *SEC Discovery Tactics Belie Lofty Pronouncements in Ripple Case*, COMPETITIVE ENTER. INT'L BLOG (July 6, 2021), <https://cei.org/blog/sec-discovery-tactics-belie-lofty-pronouncements-in-ripple-case/> [<https://perma.cc/KE4H-4F8N>].
2. Rodrigo Seira & Nancy Wojtas, *Alert: SEC v. Ripple*, COOLEY LP (Mar. 12, 2021), <https://www.jdsupra.com/legalnews/alert-sec-v-ripple-8276325/> [<https://perma.cc/Y5XM-73M5>].
3. SEC, *SEC Charges Ripple and Two Executives with Conducting \$1.3 Billion Unregistered Securities Offering*, U.S. SECURITIES AND EXCHANGE COMMIS-

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“engaged in and are currently engaging in the unlawful offer and sale of securities in violation of Sections 5(a) and 5(c)<sup>4</sup> of the Securities Act of 1933 . . . , and Larsen and Garlinghouse also aided and abetted Ripple’s” unregistered sales of securities.<sup>5</sup> The SEC’s proper relief is to permanently enjoin defendants from violating Sections 5(a) and 5(c), disgorge ill-gotten gains, pay interest, ban “[d]efendants from engaging in any initial coin offerings (ICO),” and impose civil penalties.<sup>6</sup>

On January 29th, 2021, Ripple filed its answer.<sup>7</sup> Ripple notes that the SEC allowed the XRP open market to grow by filing this Complaint eight years after XRP was created and five years after the DOJ and FinCEN classified XRP as a virtual currency.<sup>8</sup> Ripple stated it did not sell or distribute XRP as an investment contract and that there is no relationship between the vast majority of XRP holders—who purchased XRP from third parties on the open market.<sup>9</sup> Additionally, Ripple “never held an ICO (initial coin offering), never offered or contracted to sell future tokens to raise money to build an ecosystem, and never explicitly or implicitly promised profits to any XRP holder.”<sup>10</sup> Also, Ripple states the SEC’s theory is stretching the word “contract” out of “investment contract” from the Supreme Court’s test in *SEC v. W.J. Howey Co.*<sup>11</sup> Therefore, Ripple claims, it “never held an ICO, never offered future tokens to raise money, and has no contracts with the vast majority of XRP holders.”<sup>12</sup>

To prevail, the SEC will need to show that XRP, under the *Howey* test, is an investment contract.<sup>13</sup> In addition to proving the defendants aided and

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SION (Dec 22, 2020), <https://www.sec.gov/news/press-release/2020-338> [<https://perma.cc/D8KN-U4LX>].

4. Compl. at 9, *SEC v. Ripple Labs, Inc.*, No. 20-CV-10832, 2021 WL 1335918 (S.D.N.Y. Apr. 9, 2021) (20 Civ. 10832) (referring to the statute’s requirement that “whenever an issuer of securities, its control person, or affiliate offers or sells securities to the public, those securities must first be registered with the SEC, absent certain exemptions.”).
5. *Id.* at 6, 9.
6. *Id.* at Prayer for Relief I, II, III, IV.
7. *See* Answer, *SEC v. Ripple Labs, Inc.*, No. 20-CV-10832, 2021 WL 1335918 (S.D.N.Y. Apr. 9, 2021) (20 Civ. 10832).
8. *Id.* at 4.
9. *Id.* at 8.
10. *Id.*
11. *Id.* at 13 (emphasizing that Ripple is unlike the “schemes devised by those who seek the use of the money of others on the promise of profits.” (quoting *SEC v. W.J. Howey Co.*, 328 U.S. 293, 299 (1946))).
12. *Id.*
13. *See* *SEC v. W.J. Howey Co.*, 328 U.S. 293, 298-99 (1946) (holding that an “investment contract . . . means a contract, transaction or scheme whereby a

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abetted Ripple's unregistered sales of securities, the SEC must show that defendants "knew or recklessly disregarded that Ripple's offerings and sales of XRP required registration as securities."<sup>14</sup>

This note will analyze security regulations on digital assets and then predicts the likely outcome that will establish a meaningful precedent for the application of securities law to the sale of digital assets. Part I covers the overview of securities and cryptocurrencies. Part II covers the background on Ripple and XRP. Part III covers the application of the *Howey* test in Ripple. Part IV covers relevant alternatives if XRP is deemed a security. Part V concludes.

## II. OVERVIEW ON SECURITIES AND CRYPTOCURRENCIES

As cryptocurrencies become more globalized, regulatory agencies are being pressured to quickly configure how the digital asset will be classified.<sup>15</sup> If a regulatory agency, such as the SEC, determines cryptocurrencies as investment contracts and, therefore a security, then cryptocurrencies would be required to be registered as a security or forfeit.<sup>16</sup> Once registered, the SEC regulations maintain oversight and require certain disclosures of documents to protect against market manipulation.<sup>17</sup> These types of burdensome requirements make it critical for the SEC to classify digital assets correctly.<sup>18</sup>

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person invests his money in a common enterprise and is led to expect profits solely from the efforts of a promoter or a third party. . ."); *SEC v. Aqua-Sonic Prod. Corp.*, 687 F.2d 577, 582 (2d Cir. 1982) (finding that the Supreme Court had moved away from a literal interpretation of "solely" in the *Howey* test, and toward an economic realities and totality of the circumstances view of the alleged scheme); *Glen-Arden Commodities, Inc. v. Costantino*, 493 F.2d 1027, 1034 (2d Cir. 1974) ("The question therefore becomes whether . . . in light of the economic reality and the totality of circumstances . . . the customers were making an investment").

14. See 15 U.S.C. § 77o(b) (2010); *SEC v. Apuzzo*, 689 F.3d 204, 206 (2d Cir. 2011); *SEC v. Ripple Labs, Inc.*, No. 20-CV-10832, 2021 WL 1335918 (S.D.N.Y. Apr. 9, 2021).
15. See SoFi, *Is Crypto a Commodity or Security?* (Apr. 27, 2021), SoFi <https://www.sofi.com/blog/crypto-commodity-vs-security/> [<https://perma.cc/HD2A-3Y5H>].
16. David Borsack & Cole Schotz, *Cryptocurrencies And The Securities And Exchange Commission*, JD SUPRA (Aug. 4, 2021), <https://www.jdsupra.com/legalnews/cryptocurrencies-and-the-securities-and-6989064/> [<https://perma.cc/QWT9-ZD4A>].
17. SoFi, *supra* note 15.
18. See *id.*

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### A. What is a Cryptocurrency?

Cryptocurrency is a math-based, decentralized convertible currency that is secured through cryptography.<sup>19</sup> Cryptography runs on a blockchain—a type of ledger that records transactions that cannot be altered or deleted.<sup>20</sup> In other words, it is a system that makes it impossible to change or hack transactions.<sup>21</sup> Satoshi Nakamoto, a creator of the first cryptocurrency, Bitcoin, describes cryptocurrencies as an electronic payment system based on cryptographic proof instead of trust.<sup>22</sup> This allows any two parties to transact without the need of third-party verification.<sup>23</sup> It operates independently of a government or central bank; therefore, it has no central authority interference or manipulation.<sup>24</sup> The young, however vastly growing, digital currency world has over 6,500 different cryptocurrencies with an aggregate value of 2.4 trillion at the time this note was written.<sup>25</sup>

### B. Example of Cryptocurrencies

Bitcoin (BTC), the prominent cryptocurrency which created in 2009 and has a market valuation of around 1 trillion dollars, has been described as a

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19. Winston & Strawn LLP, *Descriptions of “Crypto Assets”*, WINSTON & STRAWN, LLP (2019), <https://www.winston.com/images/content/1/5/v2/159397/Crypto-Law-Corner-Description-of-Crypto-Assets.pdf> [https://perma.cc/26DJ-WCZ6].
20. *Id.*
21. *See id.*
22. Compare Alyssa Hertig, *What is Proof-of-Work?* COINDESK (Dec. 16, 2020), <https://www.coindesk.com/tech/2020/12/16/what-is-proof-of-work/> [https://perma.cc/AJP6-AXD9] (explaining that since there is no central bank or authority governing cryptocurrencies than there needs to be Proof-of-Work (POW) . . . for example, if “Alice sends Bob \$1, then the bank deducts \$1 from Alice and gives \$1 to Bob, since in cryptocurrency there is no such entity, POW provides the solution.); with Coinbase, *What is “proof of work” or “proof of stake”?*, COINBASE <https://www.coinbase.com/learn/crypto-basics/what-is-proof-of-work-or-proof-of-stake>, [https://perma.cc/X2LT-CGSE] (explaining the difference between proof-of-work and proof-of-stake, proof-of-stake works by rewarding “validators” to the opportunity of validating a new transaction based their contribution or “stake” of their own crypto).
23. Satoshi Nakamoto, *Bitcoin: A Peer-to-Peer Electronic Cash System*, BITCOIN (Oct. 31, 2008), <https://bitcoin.org/bitcoin.pdf> [https://perma.cc/4L36-THL8].
24. *See* Wintson & Strawn LLP, *supra* note 19.
25. Jake Frankenfield, *Cryptocurrency*, INVESTOPEDIA (Aug. 9, 2021), <https://www.investopedia.com/terms/c/cryptocurrency.asp> [https://perma.cc/TNT8-D2XT]; Madana Prathap, *Cryptocurrency Investment 101*, BUS. INSIDER (Dec. 24, 2021), <https://www.businessinsider.in/investment/news/best-cryptocurrencies-to-invest-in-2021/articleshow/86807959.cms> [https://perma.cc/H3GX-NJGP].

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virtual currency that is used like money—it can be traded for fiat currency and be used to purchase goods or services.<sup>26</sup> One of its biggest advantages is that it has a finite amount, capped at 21 million BTC.<sup>27</sup> Ethereum (ETH), second to BTC in market valuation, distinguishes itself as a marketplace for financial services, games, and apps.<sup>28</sup> Unlike BTC, ETH was not created to support a cryptocurrency, it was created to provide an in-house currency for applications built on the ETH blockchain.<sup>29</sup> In 2018, the SEC’s Director of Corporate Finance, William Hinman, announced the SEC will not be treating BTC or ETH as securities.<sup>30</sup> This statement is consistent with the former SEC Chair, Jay Clayton, who stated, “cryptocurrencies are replacements for sovereign currencies . . . they replace the yen, the dollar, the euro with bitcoin . . . that type of currency is not a security.”<sup>31</sup>

### C. What is a Security?

A security is any “note, stock, treasury stock, future, bond . . . [with the] right to subscribe to or purchase.”<sup>32</sup> The common understanding is that it is “property that is given or pledged to guarantee the performance of an obligation.”<sup>33</sup> The purpose of classifying an asset as a security is to “(1) require that investors receive financial and other significant information concerning securities being offered for public sale and (2) prohibit deceit, misrepresentations, and other fraud in the sale of securities.”<sup>34</sup>

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26. Winston & Strawn LLP, *supra* note 19; Ryan Haar, *Bitcoin’s Market Capitalization Went Over \$1 Trillion This Year*, NEXTADVISOR (Sep. 21, 2021), <https://time.com/nextadvisor/investing/cryptocurrency/what-is-crypto-market-cap/> [<https://perma.cc/X4WK-9UJP>].
  27. Adam Hayes, *What Happens to Bitcoin After All 21 Million Are Mined?*, INVESTOPEDIA, <https://www.investopedia.com/tech/what-happens-bitcoin-after-21-million-mined> [<https://perma.cc/KR83-ATQD>] (last updated Feb. 15, 2021).
  28. Jake Frankenfield, *Ethereum*, INVESTOPEDIA, <https://www.investopedia.com/terms/e/ethereum.asp> [<https://perma.cc/9YMB-B5R9>] (last updated Jan. 12, 2022).
  29. *Id.*
  30. Kieran May, *SEC Declares Bitcoin and Ether as Non-Securities*, CASSELS (June 26, 2018), <https://cassels.com/insights/sec-declares-bitcoin-and-ether-as-non-securities/> [<https://perma.cc/H2S6-NWZT>].
  31. Rakesh Sharma, *SEC Chair Says Bitcoin Is Not a Security*, INVESTOPEDIA, <https://www.investopedia.com/news/sec-chair-says-bitcoin-not-security> [<https://perma.cc/J82H-G3GS>] (last modified June 25, 2019).
  32. 15 U.S.C § 77b(a)(1).
  33. Cornell Law School, *Security*, LEGAL INFORMATION INSTITUTE, <https://www.law.cornell.edu/wex/security> [<https://www.law.cornell.edu/wex/security>].
  34. SEC, *The Laws That Govern the Securities Industry*, INVESTOR.GOV, <https://www.investor.gov/introduction-investing/investing-basics/role-sec/laws-gov->

### III. BACKGROUND ON RIPPLE: WHAT IT IS AND WHY IT WAS CREATED

In 2004, Ryan Fugger, a software developer, created Ripplepay—a decentralized payment platform to have a financial network that could operate without banks.<sup>35</sup> Ripplepay did not run on blockchain technology but had the purpose of securely transacting money around the world.<sup>36</sup> In 2011, Arthur Britto, Jed McCaleb, and David Schwartz created the XRP Ledger to eliminate the weaknesses they found in Bitcoin, e.g., to eliminate the risk of a fifty-one percent attack.<sup>37</sup> In 2012, the creators of the XRP Ledger acquired Ripplepay from Fugger, and they founded a new company called OpenCoin with full control of what was previously known as Ripplepay.<sup>38</sup> OpenCoin created a new technology using source code that created a “ledger-based payment network for financial institutions.”<sup>39</sup> In 2013, the name changed to Ripple Labs, Inc., and the source code became open-source.<sup>40</sup> Once more, in 2015, the company shortened the name from Ripple Labs, Inc. to Ripple.<sup>41</sup>

Ripple is based in San Francisco and describes itself as a “privately held payments technology company that uses blockchain innovation . . . (including XRP) to allow money to be sent around the world instantly, reliably, and more cheaply than traditional avenues of money transmission.”<sup>42</sup> Ripple’s

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ern-securities-industry [https://perma.cc/RL62-TLF] (citing the Securities Act of 1933).

35. CoinLoan, *The Complete History of Ripple (XRP)*, COINLOAN, https://coinloan.io/article/the-complete-history-of-ripple-xrp/ [https://perma.cc/G87H-FJRH].
36. *Id.*
37. 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=26cd162771d0 [https://perma.cc/2JCX-ZC8N] (“PoW/PoS blockchains are vulnerable by nature, and if one party collectively owns more than 51% of the hashpower, it is possible to ‘replay’ transactions and hence spend the sent amount twice. This phenomenon is often referred to as ‘doublepending’ and ‘51% attacks’”).
38. CoinLoan, *supra* note 35.
39. *Id.*
40. *Id.*
41. *Id.*
42. Answer, SEC v. Ripple Labs, Inc., No. 20-CV-10832, 2021 WL 1335918, at n.3 (S.D.N.Y. Apr. 9, 2021) (20 Civ. 10832) (“technology [that] offers an innovative alternative to traditional ledgers for recording economic transactions. Whereas traditional ledgers are maintained by one entity or individual, a blockchain is a decentralized peer-to-peer database spread across a network of computers that publicly and permanently records all transactions in theoretically unchangeable way, utilizing cryptographic techniques to securely record transactions.”).

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vision is to have a world in which blockchain enables value to move as seamlessly as information.<sup>43</sup>

### A. Problem That Ripple Fixes

SWIFT, a decades-old international money and security transfer system, is being disrupted by Ripple's innovative products, such as xCurrent and xRapid.<sup>44</sup> SWIFT, founded in 1973, is used by more than 10,000 banks globally and operates by transferring funds from a pre-funded nostro<sup>45</sup> account that a bank has with a local correspondent bank.<sup>46</sup> Ripple is changing cross-border payment and getting rid of the need for nostro accounts, by helping banks receive on-demand liquidity without requiring them to have correspondent relations; because, XRP is being used as the "bridge" between fiat currencies.<sup>47</sup> For example, while using xCurrent, one of Ripple's products, a U.S. bank can transfer dollars (USD) into XRP via an exchange and send the XRP to an exchange in the United Kingdom (UK).<sup>48</sup> Instantly, the bank in the UK can convert the XRP into British pounds (GBP).<sup>49</sup> Compared to SWIFT, the Ripple network is significantly faster because it issues complete transactions in four seconds rather than two to three days.<sup>50</sup> At one point, 38% of the world's top 100 banks used Ripple products.<sup>51</sup> Therefore, Ripple's innovation helps discontinue the requirement of having trillions of dollars tied up in nostro accounts around the world, consequently, increasing global liquidity.<sup>52</sup>

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43. CoinLoan, *supra* note 35.

44. Sanne Wass, *Ripple: "We are not replacing Swift"*, GTR (Mar. 7, 2019), <https://www.gtreview.com/news/fintech/ripple-we-are-not-replacing-swift/> [<https://perma.cc/U3PV-UPE>].

45. Julia Kagan, *Nostro Account*, INVESTOPEDIA (Apr. 24, 2020), <https://www.investopedia.com/terms/n/nostroaccount.asp> [<https://perma.cc/SYM5-6XEQ>] ("to an account that a bank holds in a foreign currency in another bank . . . Nostro accounts simplify the process of exchanging and trading in foreign currencies.").

46. Wass, *supra* note 44.

47. *Id.*

48. *Id.*

49. *Id.*

50. CoinLoan, *supra* note 35, at 2.

51. *Id.* at 3.

52. See Ripple, *Liquidity Explained*, (Mar. 20, 2018), <https://ripple.com/insights/liquidity-explained/> [<https://perma.cc/7JND-H77A>] (explaining that according to the 2016 McKinsey Global Payments report, "[T]here is approximately \$5 trillion dollars sitting dormant in the [nostro] accounts.")



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## B. Difference Between Ripple and XRP

Ripple and XRP are erroneously interchanged. Rather, Ripple is a privately owned company, and XRP is an independent cryptocurrency.<sup>53</sup> XRP acts as an underlying cryptocurrency for products developed by Ripple Labs.<sup>54</sup> Therefore, there are many differences between Ripple and XRP. The purpose of Ripple is to create solutions—software, platforms, etc.—for sending money globally at a low cost.<sup>55</sup> On the other hand, the purpose of XRP is to act as a bridge currency, which is capable of operating on different software platforms.<sup>56</sup> The relationship between Ripple and XRP is nuanced. Ripple uses XRP in its products to provide banks and other financial institutions instant liquidity; however, it does not own or control the technology behind XRP.<sup>57</sup> It is run on an open-source technology that anyone can build or edit.<sup>58</sup> Because anyone can use XRP, it is neither owned nor controlled by any entity or person, rather it operates independently.<sup>59</sup> The control on Ripple resides with its founders, board of directors, employees, and investors. Unlike Ripple, the control in XRP resides with anyone who uses it.<sup>60</sup> Lastly, XRP was created before Ripple;<sup>61</sup> therefore, the foregoing evidence proves that the two are not interchangeable.

## IV. ANALYSIS OF WHETHER RIPPLE IS A SECURITY

In the Supreme Court of the United States' 1946 opinion *SEC v. Howey*, it created a three-prong test that determines what qualifies as an “investment contract,” and therefore, subject to the Securities Act of 1933 and the Securities Exchange Act of 1934.<sup>62</sup> Arrangements are deemed an “investment con-

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53. Nathan Reiff, *Bitcoin vs. Ripple: What's the Difference?*, INVESTOPEDIA (July 27, 2021), <https://www.investopedia.com/tech/whats-difference-between-bitcoin-and-ripple/> [<https://perma.cc/52MF-QXPA>].

54. *Id.*

55. Swati Goyal, *The Separation of Ripple and XRP: Why it Happened? What Does it Mean and What are the Differences?*, FXEMPIRE (Nov. 7, 2021, 2:53 AM), <https://www.fxempire.com/education/article/the-separation-of-ripple-and-xrp-why-it-happened-what-does-it-mean-and-what-are-the-differences-516096> [<https://perma.cc/5F5T-MN8B>].

56. *Id.*

57. *Id.* at 2.

58. See RIPPLE, <https://ripple.com/ripple/> [<https://perma.cc/Q7P3-N3JK>] (clarifying the open-source community as being software engineers, server operators, users, and businesses).

59. Goyal, *supra* note 55, at 2.

60. *Id.*

61. *Id.*

62. *SEC v. W.J. Howey Co.*, 328 U.S. 293, 301 (1946); SEC. EXCH. COMM'N, *Framework for “Investment Contract” Analysis of Digital Assets*, U.S. SECURI-

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tract” when there is (1) an investment of money (2) in a common enterprise and (3) with the expectation of profits derived from the efforts of others.<sup>63</sup> The *Howey* test judges on substance rather than form, even if an investment is not covered under the definition of a security, it may be required to oblige with security regulation.<sup>64</sup>

#### A. An Investment Contract

“Investment” is defined as “the outlay of money usually for income or profit.”<sup>65</sup> Hence, the common understanding of an investment is an allocation of money with the desire for a future profit. It can be argued that using XRP, for its purpose as a liquidity tool, is not an investment of money; rather, a mechanism to transfer currencies. Additionally, because there is no contract, agreement, or privity between XRP and Ripple, it is impossible for a purchaser of XRP to “invest” money into Ripple.<sup>66</sup> However, if one pleases to invest in Ripple, one can purchase their products or, after becoming an accredited investor, invest during a venture capital financing round.

#### B. In a Common Enterprise

To satisfy the “common enterprise” prong, federal courts require that there be either a horizontal or vertical commonality.<sup>67</sup> However, in April 2019, the Commission stated they “[do] not require vertical or horizontal commonality *per se*, nor does it view a ‘common enterprise’ as a distinct

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TIES AND EXCHANGE COMMISSION, <https://www.sec.gov/corpfin/framework-investment-contract-analysis-digital-assets> [<https://perma.cc/Z3V2-VUSZ>].

63. See SEC. EXCH. COMM’N, *supra* note 62.

64. See *Howey*, 328 U.S. at 298 (“form [is] disregarded for substance and the emphasis [is] on economic reality; the term security “embodies a flexible rather than a static principle” in order to meet the “variable schemes devised by those who seek the use of the money of others on the promise of profits.”); See also *Tcherepnin v. Knight*, 389 U.S. 332,336 (1967) (“in searching for the meaning and scope of the word ‘security’ in the [Acts], form should be disregarded for substance and the emphasis should be on economic reality.”).

65. *Investment*, Merriam-Webster.com, <https://www.merriam-webster.com/dictionary/investment> [<https://perma.cc/8P8Q-BXE4>].

66. See Chris Giancarlo and Conrad Bahlke, *Cryptocurrencies and US Securities Laws: Beyond Bitcoin and Ether*, INT’L FIN. L. REV. (June 17, 2020) <https://www.iflr.com/article/b1m2pm9g4n65mk/cryptocurrencies-and-us-securities-laws-beyond-bitcoin-and-ether> [<https://perma.cc/S4L7-SKA3>].

67. See *Revak v. SEC Realty Corp.*, 18 F.3d. 81, 87-88 (2d Cir. 1994) (discussing horizontal commonality as “the tying of each individual investor’s fortunes to the fortunes of the other investors by the pooling of assets, usually combined with the pro-rata distribution of profits” and two variants of vertical commonality, which focus “on the relationship between the promoter and the body of investors”).

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element of the term ‘investment contract.’”<sup>68</sup> Instead, the Commission believes this prong is satisfied when “fortunes of digital asset purchasers have been linked to each other or the success of the promoter’s efforts.”<sup>69</sup>

There is no horizontal commonality or linkage of fortune from digital asset purchasers concerning XRP or XRP holders and Ripple. Even though broad price fluctuations uniformly affect XRP holders, the “currency is not pooled, much less by Ripple or another central party.”<sup>70</sup> Furthermore, ownership of XRP does not give the holder rights to Ripple or expectations to share profits and losses.<sup>71</sup> XRP holders are not in privity by the mere ownership of the currency any more than “two people who hold bitcoin or ether can be said to have ‘tied their fortunes’ to one another.”<sup>72</sup>

There is no vertical commonality or relationship between the investor and promoter.<sup>73</sup> As previously stated, Ripple is a private company, and XRP is an independent currency; therefore, each exists independently of one another.<sup>74</sup> The XRP Ledger, built by an open-source community, would continue to function even if Ripple ceased to exist.<sup>75</sup> Unlike a traditional security, XRP’s price is not a representation of Ripple’s performance.<sup>76</sup> Instead, the price for XRP ignores Ripple’s innovations and parallels the broad movement of cryptocurrencies, such as BTC and ETH.<sup>77</sup> Therefore, since there is no vertical or horizontal commonality, linkage of fortunes, and linkage from promoter efforts, this prong is not satisfied.<sup>78</sup>

### C. Reasonable Expectation of Profits Derived From the Efforts of Ripple

The Commission states that this prong is met when a “promoter, sponsor, or other third party (each, an “Active Participant” or “AP”) provides . . . essential managerial efforts that affect the success of the enterprise, and in-

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68. In re Barkate, 57 S.E.C. 488, 496 n.13 (Apr. 8, 2004); *See also* Joseph Hall, *Are Nonfungible Tokens Securities*, LAW360 (Apr. 14, 2021, 5:32 PM), [https://www.davispolk.com/sites/default/files/2021-08/are\\_nonfungible\\_tokens\\_securities.pdf](https://www.davispolk.com/sites/default/files/2021-08/are_nonfungible_tokens_securities.pdf) [<https://perma.cc/3RPK-S9DF>].

69. *See* S.E.C. v. Int’l Loan Network, Inc., 968 F.2d 1304, 1307 (D.C. Cir. 1992).

70. *See* Goyal, *supra* note 55, at 3.

71. *Id.*

72. *Id.*

73. *See id.*

74. *Id.*

75. *Id.*

76. Giancarlo & Bahlke, *supra* note 66, at 2.

77. *Id.*

78. *Id.*

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vestors reasonably expect to derive profit from those efforts.”<sup>79</sup> Whereas XRP holders do not have a reasonable expectation of profit because Ripple has never marketed XRP as an investment product or promised XRP holders profits, dividends, or return on investment.<sup>80</sup> Yet the SEC disregards that Ripple has emphasized the functionality of XRP as a liquidity tool and settlement mechanism.<sup>81</sup> Despite this, the fact that a party can speculatively acquire a currency with the hope of a positive return cannot be dispositive for satisfying this prong.<sup>82</sup> If it is dispositive, then what can we say about the majority of BTC and ETH speculators?<sup>83</sup>

On the other end, when XRP is used as a utility—meaning the transfer of money across borders or buying and selling goods—there is no expectation of profit.<sup>84</sup> Profit is made when the XRP ecosystem grows by all the participants building products on the XRP Ledger.<sup>85</sup> For example, the XRP community is voting on whether they should implement smart contracts to the ledger; if approved, “the price of XRP could soar once again, just like how the ADA token soared after the Cardano blockchain decided to implement smart contract capabilities.”<sup>86</sup>

Also, there are no “managerial efforts that affect the success of [XRP].”<sup>87</sup> Again, the XRP Ledger is fully autonomous and exists independently of Ripple; therefore, purchasers cannot reasonably rely on the efforts of Ripple—“of all the validators on the XRP Ledger, Ripple runs only about 6%.”<sup>88</sup> If Ripple were to cease, the XRP Ledger would continue to function and still be open to trade on exchanges.<sup>89</sup> Even though a portion of the XRP supply is held by Ripple, most of the XRP is held in escrow and cannot be

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79. *Framework for “Investment Contract” Analysis of Digital Assets*, *supra* note 62, at 2.

80. Giancarlo & Bahlke, *supra* note 66, at 2.

81. *Id.*

82. *Id.*

83. *Id.*

84. *Id.*

85. Silkjær, *supra* note 37, at 12 (explaining that “more than half of the validators on Ripple’s recommended UNL are operated by people or groups external to the company . . . further demonstrates that Ripple’s validators do not wield meaningful power over the XRP Ledger”).

86. Kim Chua, *XRP Has More Reason to Moon as Ripple Proposes Smart Contracts Capability For XRPL*, YAHOO! (Aug. 24, 2021), <https://www.yahoo.com/now/xrp-more-reason-moon-ripple-175137320.html> [<https://perma.cc/S24L-8XUH>].

87. *Framework for “Investment Contract” Analysis of Digital Assets*, *supra* note 62, at 2.

88. *Id.*; Silkjær, *supra* note 37, at 6.

89. Giancarlo & Bahlke, *supra* note 66, at 2.

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touched by Ripple because its access is restricted by smart contracts—which systemically release XRP.<sup>90</sup> For all these reasons, XRP is not deemed an investment contract under the *Howey* test.<sup>91</sup>

## V. ALTERNATIVES

The Supreme Court or Congress should make a “Ripple Test” to stop the overreach of the SEC. Instead of taking a securities approach, the test would take a utility approach.<sup>92</sup> The SEC has concluded that utility tokens are not securities and cited the six factors in a no-action letter issued in 2019.<sup>93</sup> The appeal of utility tokens is increasing in state legislatures, such as Wyoming, Colorado, and Montana.<sup>94</sup> The Wyoming Utility Token Act states, “open blockchain tokens with specified consumptive characteristics are intangible property and not subject to a securities exemption.”<sup>95</sup>

The specific use of XRP for Ripple’s On-Demand Liquidity (ODL) solution satisfies most of the SEC’s six factors for a utility token approach. ODL was created to “enable banks, financial institutions, and payment provider to utilize XRP as a bridge-asset for fiat transaction by providing near-instantaneous liquidity.”<sup>96</sup> The two issues that would need to be changed to please the utility token approach are (1) XRP would need to be restricted and could only be used on the ODL platform and (2) set to a fixed price.<sup>97</sup>

## VI. CONCLUSION

Clearly, there are bad actors in the cryptocurrency world, and there is a need for regulatory agencies to protect it.<sup>98</sup> Because the cryptocurrency world is rapidly developing, legislators and judiciaries must adopt laws that benefit the future economy and innovation alike. Unlike other digital assets purely driven by irregular speculation, XRP’s innovation is being used by financial institutions, governments, and banks as being the most efficient and fastest

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90. *Id.* at 3; Team Ripple, *Ripple Escrows 55 Billion XRP for Supply Predictability*, RIPLE (Dec. 7, 2017), <https://ripple.com/insights/ripple-escrows-55-billion-xrp-for-supply-predictability/> [<https://perma.cc/GP37-536L>].

91. *See, e.g.*, Giancarlo & Bahlke, *supra* note 66; *Framework for “Investment Contract” Analysis of Digital Assets*, *supra* note 62, at 2; *W.J. Howey Co.*, 328 U.S. at 301.

92. *Compare Framework for “Investment Contract” Analysis of Digital Assets*, *supra* note 62, at 1, with Giancarlo & Bahlke, *supra* note 66, at 3.

93. Giancarlo & Bahlke, *supra* note 66, at 3.

94. *See* H.R. HB0062, 65th Leg., Gen. Sess. (Wyo. 2019)

95. *Id.*

96. Giancarlo & Balhke, *supra* note 66, at 6.

97. *Id.*

98. *See* SEC, *supra* note 34.

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digital asset for payments.<sup>99</sup> To illustrate, it is the only digital asset “with a clear institutional use case designed to solve a multi-trillion-dollar problem—the global payment and liquidity challenges that banks, payment providers, and corporates face.<sup>100</sup> Ultimately, XRP is not an investment contract under the *Howey* test and is, therefore, not a security.<sup>101</sup> Rather, it is a digital asset that serves as the universal currency, which allows users to change payments instantly and cheaply into their local currency.<sup>102</sup>

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99. *Ripple Escrows 55 Billion XRP for Supply Predictability*, *supra* note 90, at 2.

100. *Id.*

101. See Giancarlo & Bahlke, *supra* note 66, at 4; *Framework for “Investment Contract” Analysis of Digital Assets*, *supra* note 62, at 2.

102. Team Ripple, *Liquidity Explained*, RIPLE (Mar. 20, 2018), <https://ripple.com/insights/liquidity-explained/> [<https://perma.cc/V7KX-NXA4>].