

RIPPLE MAKES WAVES

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On December 22, 2020, the Security and Exchange Commission (SEC) sued Ripple over unlawful offer and distribution of securities. The SEC claimed that Ripple failed to register its digital asset XRP as a security, despite having received legal advice that XRP might be considered a security. Not registering XRP as a security required much less disclosure than otherwise, and allowed Ripple to build an information monopoly (SEC v. Ripple 2020). In its defense, Ripple argued that XRP was not a security but rather a cryptocurrency, and referred to security regulators in the UK, Japan, and Singapore who did not classify XRP as a security (SEC v. Ripple 2021a).

The SEC and Ripple faced each other in this high-stakes case about an asset that many investors perceived to be a cryptocurrency. Uncertainty in the markets increased and consequently the price of XRP dropped.

You already hold some XRP. If Ripple wins the lawsuit, now would be the perfect time to invest. However, if the SEC wins, the value of XRP would likely slump. You have to make your decision quickly since Ripple announced an unexpected press conference. Every new piece of information might change the price and potentially the outcome of the lawsuit. Will the court uphold the claims from the SEC or can Ripple successfully defend itself against the allegations? How are you going to update your investment portfolio?

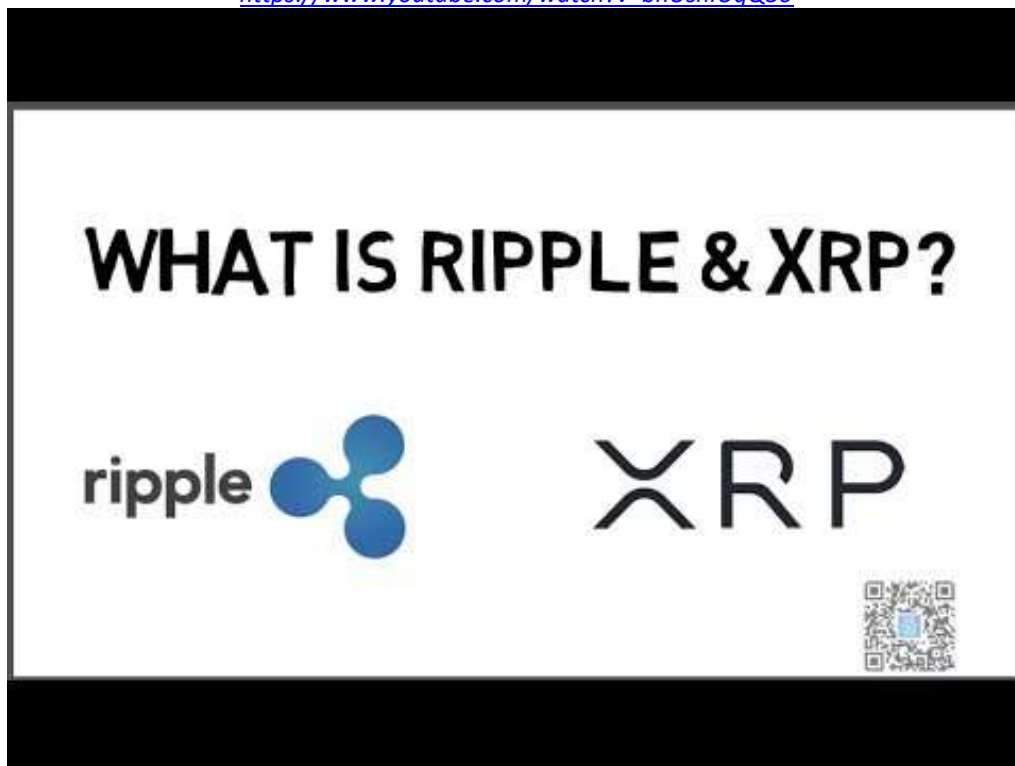
Origins of Ripple and XRP

The three engineers Arthur Britto, Jed McCaleb, and David Schwartz were fascinated by Bitcoin. However, they observed that the mining of Bitcoin was an inefficient process that required much energy and computing power. The problem would only exacerbate as more and more Bitcoin was mined (McCaleb 2011; XRP Ledger Project 2020). Therefore, the trio set out to create a better system and began to build the XRP Ledger (XRP Ledger Project 2020). The XRP Ledger was essentially software code that operated as a peer-to-peer database. The ledger was spread across a large network of computers and recorded data associated with XRP transactions. Along with the code for the XRP Ledger, the three engineers wrote the code for XRP which was a digital asset (SEC v. Ripple 2020). Exhibit 1 provides a general overview of Ripple and XRP.

Exhibit 1. Overview of Ripple and XRP

Source: XRP CHIZ (2019)

<https://www.youtube.com/watch?v=bhUsnIUqQ3o>



After the first draft of the code for the XRP Ledger had been completed in December 2011 (XRP Ledger Project 2020), Chris Larsen, an angel investor, provided the necessary funding to establish Ripple in September 2012. Larsen became Ripple's CEO, McCaleb became the company's Chief Technology Officer, Schwartz became Chief Cryptography Officer, and Britto adopted an advisory position (XRP Ledger Project 2020). Upon completion of the final code for the XRP Ledger in December 2012, Britto, McCaleb, and Schwartz fixed the worldwide supply of XRP at 100 billion XRP. Of these, 80% were transferred to the company Ripple, and 20 billion were distributed among the founders. Larsen and McCaleb each received 9 billion XRP, and Schwartz received 2 billion XRP, leading to 100% of all XRP being controlled by Ripple and its founders at the end of 2012 (SEC v. Ripple 2020).

After 2013, Ripple pursued three main avenues to distribute XRP. First, Ripple sold XRP directly to investors in the open market, at times by compensating the market maker for executing the trades. Second, Ripple aimed to attract institutional and other sophisticated investors, and to sell them a large amount of XRP at once. Third, Ripple attempted to establish a liquid secondary market for XRP. Among the measures taken to establish a liquid secondary market for XRP were: (1) frequently promoting XRP and its expected returns in company communications and in person by the executives; (2) a bounty program, which compensated programmers with XRP for pointing out problems in the code of the XRP Ledger; (3) executive compensation distributions; and (4) sales of XRP on behalf of other Larsen-founded entities and Ripple-funded projects (SEC v. Ripple 2020). The ways Ripple sold XRP are shown in Exhibit 2.

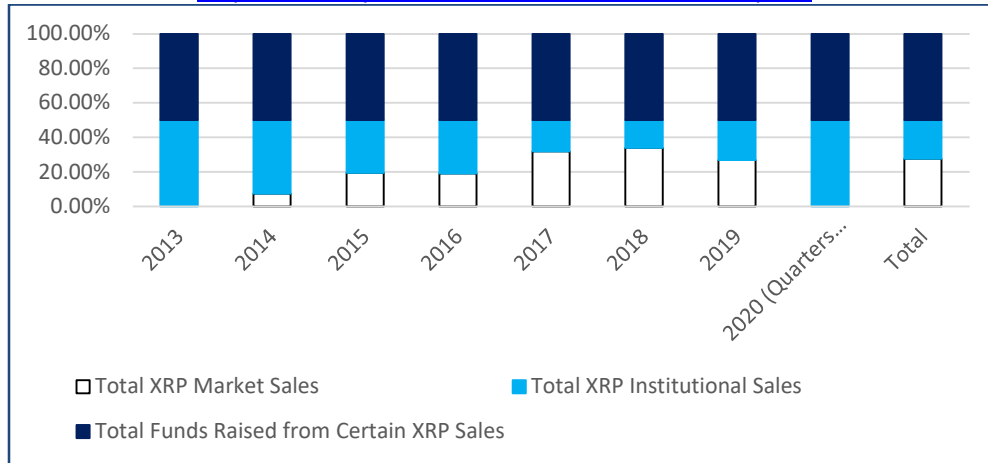
The SEC Complaint

Exhibit 3 clarifies the mission of the SEC. On December 22, 2020, the SEC sued Ripple, Chris Larsen (who stepped down as the CEO of Ripple in December 2016 and then served as the Executive Chairman of Ripple's Board of Directors), and Bradley Garlinghouse (who started as the COO of Ripple and became Ripple's CEO in December 2016).

Exhibit 2. Relative Importance of Ways to Sell XRP

Source: Securities and Exchange Commission v. Ripple Labs, Inc. (2020, p. 20)

<https://www.youtube.com/watch?v=bhUsnIUqQ3o>



The SEC claimed that Ripple and its two executives violated Sections 5(a) and 5(c) of the Securities Act of 1933 in offering and selling XRP without registering these offers and sales with the SEC. Larsen and Garlinghouse additionally aided and abetted Ripple in violating these sections, according to the SEC (SEC v. Ripple 2020).

Exhibit 3. Mission of the SEC

Source: SEC (2016, para. 1)

“The mission of the SEC is to protect investors; maintain fair, orderly, and efficient markets; and facilitate capital formation. The SEC strives to promote a market environment that is worthy of the public’s trust.”

In two legal memoranda from February 8, 2012 and October 19, 2012, Ripple received legal advice that XRP could be considered an investment contract and thus a security under the jurisdiction of federal security laws (SEC v. Ripple 2020). Exhibit 4 defines the most important investment vehicles in the context of this lawsuit.

Exhibits 5 and 6 additionally explain the differences between securities and cryptocurrencies.

Exhibit 4. Definitions of Investment Vehicles

Investment Vehicle	Definition
Security	“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.” (Securities Act, 1933 § 77b (1))
Currency	“The coin and paper money of the United States or of any other country that is designated as legal tender and that circulates and is customarily used and accepted as a medium of exchange in the country of issuance. Currency includes U.S. silver certificates, U.S. notes and Federal Reserve notes. Currency also includes official foreign bank notes that are customarily used and accepted as a medium of exchange in a foreign country.” (31 CFR, 2014, §1010.100(m))
Cryptocurrency	“A cryptocurrency is a digital or virtual currency that is secured by cryptography, which makes it nearly impossible to counterfeit or double-spend. Many cryptocurrencies are decentralized networks based on blockchain technology – a distributed ledger enforced by a disparate network of computers. A defining feature of cryptocurrencies is that they are generally not issued by any central authority, rendering them theoretically immune to government interference or manipulation.” (Frankenfield 2020, para. 1)
Exchange Token	“[Exchange tokens] offer holders discounts on trading fees and other benefits.” (Moore 2020, para. 4)
Investment Contract	“[A] contract, transaction or scheme whereby a person invests his [or her] 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.” (Security & Exchange Commission v. W.J. Howey Co. <i>et al.</i> 1946, pp. 298-299)

Exhibit 5. William Hinman, Director of the Corporate Finance Division of the SEC, on Cryptocurrencies and Securities

Source: Hinman (2018, para. 16)

“[...] And so, when I look at Bitcoin today, I do not see a central third party whose efforts are a key determining factor in the enterprise. The network on which Bitcoin functions is operational and appears to have been decentralized for some time, perhaps from inception. Applying the disclosure regime of the federal securities laws to the offer and resale of Bitcoin would seem to add little value.[9] And putting aside the fundraising that accompanied the creation of Ether, based on my understanding of the present state of Ether, the Ethereum network and its decentralized structure, current offers and sales of Ether are not securities transactions. And, as with Bitcoin, applying the disclosure regime of the federal securities laws to current transactions in Ether would seem to add little value. Over time, there may be other sufficiently decentralized networks and systems where regulating the tokens or coins that function on them as securities may not be required. And of course, there will continue to be systems that rely on central actors whose efforts are a key to the success of the enterprise. In those cases, application of the securities laws protects the investors who purchase the tokens or coins. [...]”

Exhibit 6. SEC Chairman Jay Clayton on Cryptocurrencies and Securities

Source: CNBC (2018)

<https://www.youtube.com/embed/8YtZJRUak8E?feature=oembed>



In multiple internal documents and public disclosures from 2013 to 2016, Ripple indicated at several points in time that XRP holdings were speculative in nature and that XRP could be considered a security. In a disclosure from December 7, 2015, Ripple stated that “XRP might be

deemed a security as compared to other virtual currencies and Ripple Labs might be deemed to be operating as an unregistered securities exchange, broker, or dealer under federal and State securities laws” (as cited in SEC v. Ripple 2020: 35). However, Ripple never acted on the legal advice and proceeded to distribute XRP without registration. From 2013 through 2020, Ripple and its executives sold more than 14.6 billion units of XRP (see Exhibit 7) in exchange for more than \$1.38 billion (see Exhibit 8). Profits were in part used to fund Ripple’s operations and to develop and maintain XRP trading markets. Additionally, Larsen and Garlinghouse gained approximately \$600 million from the sales of XRP (SEC v. Ripple 2020).

Exhibit 7. Total Defendants’ XRP Sales and Distribution in the Offering

Source: Securities and Exchange Commission v. Ripple Labs, Inc. (2020, p. 14)

Type of Sales	Approximate Amount of XRP Sold and Distributed
Market Sales	3.9 billion
Institutional Sales	4.9 billion
Other XRP Distributions	4.1 billion
Individual Sales of Chris Larsen	1.7 billion
Individual Sales of Bradley Garlinghouse	321 million (counted in “Other XRP Distributions” only)
Total Offering	14.6 billion

Exhibit 8. Funds Raised in Offering from Certain XRP Sales

Source: Securities and Exchange Commission v. Ripple Labs, Inc. (2020, p. 20)

Year or Other Time Period	Total XRP Market Sales in USD	Total XRP Institutional Sales in USD	Total Funds Ripple Raised from Certain XRP Sales
2013	\$0.00	\$2,572,286.07	\$2,572,286.07
2014	\$2,535,979.74	\$14,722,984.79	\$17,258,964.53
2015	\$6,912,557.86	\$10,939,378.47	\$17,851,936.33
2016	\$6,239,994.34	\$10,094,945.99	\$16,334,940.32
2017	\$116,709,100.04	\$67,124,274.31	\$183,833,374.35
2018	\$362,727,751.01	\$171,715,041.56	\$534,442,792.57
2019	\$268,249,195.38	\$231,993,578.98	\$500,242,774.36
2020 (Quarters 1-3)	\$0.00	\$115,689,994.15	\$115,689,994.15
Total	\$763,374,578.38	\$624,852,484.32	\$1,388,277,062.70

As a result of not filing a registration statement with the SEC, Ripple never provided material information to investors. Ripple, and specifically Larsen and Garlinghouse, thus essentially controlled the publicly available information about XRP as the only insiders. While Garlinghouse publicly declared that he held a significant long position in XRP (*i.e.*, he expected

his holdings of XRP to rise in value), he did not publicly disclose his frequent sales of XRP which occurred during the same time. Furthermore, Ripple never disclosed how exactly the profits from selling XRP were used to finance its operations or to develop and maintain XRP trading markets (SEC v. Ripple 2020).

At the end of 2020, Larsen, Garlinghouse, and Ripple held 65.4 billion of the total supply of 100 billion XRP. At the same time, no registration statement was in effect which mandated public disclosure of substantial information to investors. According to the SEC, this resulted in a dangerous information monopoly, and undue and substantial risk for investors (SEC v. Ripple 2020).

Ripple's Defense

On January 29, 2021, Ripple filed its response to the SEC complaint, in which its defense was outlined. Ripple argued that XRP was neither a security nor an investment contract. Therefore, Ripple had never needed to register XRP, and the SEC did not have a claim. Instead, XRP was *"primarily used as a means of exchange,"* and thus characterized as an *"[e]xchange token"* (HM Treasury 2021: 5) by security regulators in the UK, Japan, and Singapore (SEC v. Ripple 2021a). In an additional court filing from February 15, 2021, Ripple denominated XRP as a *"currency"* (SEC v. Ripple 2021b: 2).

Ripple also defended itself against the claim of the SEC that it had received legal guidance that XRP could be considered an investment contract and thus a security under the jurisdiction of federal security laws. Ripple stated that the SEC's complaint *"selectively quote[d] and mischaracterize[d] portions"* [of the legal memoranda Ripple had received] (SEC v. Ripple 2021a: 17-18). If the legal memoranda were considered in their original form, they would convey *"counsel's ultimate conclusion [...] that Ripple Credits (as described) [i.e., XRP] did not constitute 'securities' under the federal securities laws"* (SEC v. Ripple 2021a: 18). While Ripple referred the full text of the legal documents to the court, the company did not make them

publicly available. Additionally, Ripple argued that the SEC did not provide fair notice of any conduct that was in violation of any law. Ripple stated that the SEC only selectively prosecuted “virtual currency [...] losers” (SEC v. Ripple 2021a: 3), as other cryptocurrencies such as Bitcoin and Ethereum were not prosecuted. Since about 95% of XRP trades were completed outside of the U.S., Ripple also claimed that the SEC did not have jurisdiction. Finally, Ripple asserted that a statute of limitations applied, which meant the SEC did not file their complaint soon enough and even if the SEC won, there would be no civil penalties (SEC v. Ripple 2021a). Exhibit 9 summarizes Ripple’s defense by its CEO Garlinghouse.

Exhibit 9. Ripple CEO Bradley Garlinghouse Responding to SEC Allegations

Source: CNBC Television (2020)

<https://www.youtube.com/embed/dDxhgCUx7RU?feature=oembed>



What's Your Verdict?

After reviewing the arguments on both sides, the SEC and Ripple, you need to make a decision. Was the SEC right to sue Ripple? Or were the allegations untenable? Can Ripple successfully defend itself? Ripple announced a press conference one hour from now, and you have to update your portfolio before the press conference in order to realize the highest possible return; what will you do?



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