Crypto Regulation- How to Solve A Problem Like Ripple's Crypto-token, XRP?
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On December 22, 2020, the U.S. Securities and Exchange Commission (SEC) initiated a lawsuit against Ripple Labs and its initial and current CEOs, Christian Larsen and Bradly Garlinghouse, respectively, for raising more than $1.38 billion through the sale of its token, XRP, since 2013.

The SEC's legal complaint

At the heart of the SEC's complaint lies the fundamental two-fold- question: what is XRP and what is its use?

Cryptocurrency/utility token vs security token

In order to answer this question it is helpful to consider a brief history of the digital asset's inception.

The idea behind the current XRP dates back to late 2011/ 2012, before the company changed its name to Ripple Labs. The technology behind it, the XRP Ledger, or software code, operates as a peer-to-peer database, spread across a network of computers that records data about transactions, among other things. In order to achieve consensus, each server on the network evaluates proposed transactions from a subset of nodes it trusts not to defraud it. Those trusted nodes are known as the server's unique node list. Although each server defines its own trusted nodes, the XRP Ledger requires a high degree of overlap between the trusted nodes chosen by each server. To facilitate this overlap, Ripple publishes a proposed unique node list.

In 2012 and upon completion of the XRP Ledger, a fixed supply of 100 billion XRP was created and issued. Of those XRP, 80 billion were transferred to Ripple Labs, (the company), and the remaining 20 billion XRP went to a group of founders, including Larsen. At this point in time, Ripple and its founders controlled 100% of XRP.

It is important to understand this in order to understand what happened subsequently, and, how to differentiate XRP from a native cryptocurrency, such as Bitcoin (BTC). This analysis is something that the Court will be conducting in deciding the status of XRP.

The first significant observation to be made is that the way XRP was created and the choices made by its founders represent a hybrid, a compromise, if you like, between the fully decentralized, Bitcoin's peer-to-peer network and a fully centralized network with a single trusted intermediary such as a conventional financial institution.

The second significant observation is that Bitcoin is not designed or intended to be controlled by anybody, let alone by a single entity. Bitcoin's value depends on a protocol-constrained supply of available future coins, (a finite number of BTC to be mined is 21 million), and on an institutionally unconstrained supply, i.e. a free circulation of all available coins. The protocol plays a direct role in determining its supply and, therefore, its value.

By contrast, all XRP was originally issued in a controlled fashion to the company that created it, (Ripple Labs), and to the company's founders.

This hybrid approach to a blockchain-based digital asset and more conventional assets created and controlled by a single entity fuels the SEC's complaint and may well point towards XRP not being a cryptocurrency at all.

According to the SEC's complaint, from 2013 through 2014, Ripple Labs and its CEO, Larsen, made efforts to create a market for XRP by having Ripple distribute approximately 12.5 billion XRP through bounty programs that paid programmers compensation for reporting problems in the XRP Ledger's code. As part of these calculated steps, Ripple distributed small amounts of XRP — typically between 100 and 1,000 XRP per transaction — to anonymous developers and others to establish a trading market for XRP.

It is said that Ripple began more systematic efforts to increase speculative demand and trading volume for XRP. Starting in at least 2015, Ripple decided that it would seek to make XRP a "bridge currency" for banks and other financial institutions to effect money transfers worldwide. According to the SEC, this meant that Ripple needed to create an active, liquid XRP secondary trading market. It, therefore, expanded its efforts to develop a use for XRP while increasing sales of XRP into the market.

The SEC's complaint details that from 2014 through the third quarter of 2020, Ripple sold at least 8.8 billion XRP in the market and institutional sales, raising approximately $1.38 billion to fund its operations. Additionally, the complaint asserts that from 2015 through at least March 2020, while Larsen was an affiliate of Ripple as its CEO and later chairman of the board, Larsen and his wife sold over 1.7 billion XRP to public investors in the market. Larsen and his wife netted at least $450 million from those sales. From April 2017 through December 2019, while an affiliate of Ripple as CEO, Garlinghouse sold over 321 million XRP he

had received from Ripple to public investors in the market, generating approximately $150 million from those sales.

XRP is not like Bitcoin or Ether

In the case of both Bitcoin and Ether decentralisation is key to convince a regulator like the SEC that these two digital assets should not be regulated as securities. The Director of the SEC's Division of Corporation Finance, Bill Hinman, gave a statement in June 2018, which is enlightening:

"If the network on which the token or coin is to function is sufficiently decentralized — where purchasers would no longer reasonably expect a person or group to carry out essential managerial or entrepreneurial efforts — the assets may not represent an investment contract.[…]
As a network becomes truly decentralized, the ability to identify an issuer or promoter to make the requisite disclosures becomes difficult, and less meaningful. […]
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."

When applying this analysis to XRP, the inescapable conclusion is that XRP is not like Bitcoin or Ether for the following four main reasons:

1. most of XRP continues to be owned by the company that created it, (Ripple Labs), and,

2. the company, continues to have a significant influence over which nodes will serve as trusted validators for transactions, and,

3. the company, continues to play a significant role in the profitability and viability of the digital asset,

4. and the company and its CEOS can legally be held accountable and answerable to SEC's legal complaint.

In its complaint, the SEC considers XRP to be a security and to satisfy all the elements of the Howey investment contract test under the federal securities laws. The U.S. Securities Exchange Act 1934 and the Securities Act 1933 have introduced a test to determine whether a financial transaction is an investment contract, this is known as the Howey test. The test determines that a transaction represents an investment contract if *'a person invests money in a common enterprise and is led to expect profits solely from the efforts of a promoter or a third party."*

The SEC paints a pattern of sales of XRP that were never registered with the SEC or made pursuant to any exemption from registration. From the perspective of the Commission, this amounts to a sustained practice of illegal sales of unregistered, non-exempt securities under Section 5 of the Securities Act of 1933.

Additionally, both Larsen and Garlinghouse were named personally in an action that seeks primarily to recover for XRP allegedly sold illegally by Ripple.

The thinking behind this must be that they individually also sold significant volumes of XRP — 1.7 billion by Larsen and 321 million by Garlinghouse — and according to the SEC, they "aided and abetted" Ripple in its sales. Ripple would be the primary violator, and both Larsen and Garlinghouse are alleged to have substantially participated in the pattern of Ripple's XRP sales, with the goal of allowing the company to raise funds without registering XRP under the federal securities laws or complying with any available exemption from registration.

How To Solve This Problem?

At a glance and applying the Howey test, the sale of XRP seems to fit all the elements. Most of the purchasers of XRP, arguably have bought an investment. Ripple raised more than $1.38 billion from the sale of XRP, so it is clear that purchasers were paying for something of value, and there does not appear to have been any effort to limit purchasers to the amount of XRP that they might reasonably use for anything other than investment purposes. According to the SEC, Ripple has promoted profitability, including statements that it has made, all of which suggest that a reason for purchasing XRP is the potential for appreciation. The limited functionality of XRP in comparison to its trading supply is another reason relied upon to argue that most purchasers were buying for investment, seeking to make a profit.

Finally, and significantly, it will be undoubtedly argued by the SEC that Ripple Labs, especially given its huge continuing ownership interest in XRP, means that there is a strong case to be made that the profitability of XRP is highly dependent on the efforts of Ripple.

However, in other jurisdictions such as the U.K., the FCA, the financial regulator, has categorised XRP as an unregulated exchange token/cryptocurrency like Bitcoin and Ether, not as a security.

GateHub, a U.K. based cryptocurrency gateway service, has decided to continue listing XRP.

GateHub has recently said that the decision to keep XRP on its platform follows some careful review of the SEC's complaint against Ripple, and that GateHub's position remains that they are confident that XRP is not a security:

"We have never believed that XRP is a 'security' under the prevailing 'Howey' test in the US, and regard XRP primarily as a 'utility' token whose value is based on its use in payments and foreign exchange. Nor have we personally witnessed any improper market conduct by Ripple Labs or its senior officers."

Of note, the SEC's complaint focuses on historic sales of XRP sales going back to 2013, which took place well before the SEC first publicly announced its position

that digital assets should be regulated as securities if they fit within the Howey investment contract test, (which came out in 2017).
What of the categorization of XRP as a currency/exchange/utility token by other jurisdictions?
And last, but not least, in 2015 Ripple had to answer a legal suit initiated by FinCen (which was settled), and on that occasion, the U.S. government determination was that XRP was a digital currency rather than a security under the Howey Test.

These are all important considerations for a court in what will prove to be a momentous trial of 2021 not just for Ripple and XRP, but also for the cryptoasset ecosystem and global regulation in general.

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