THE CRYPTIC NATURE OF CRYPTO DIGITAL ASSETS REGULATIONS: THE RIPPLE LAWSUIT AND WHY THE INDUSTRY NEEDS REGULATORY CLARITY

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ABSTRACT

The tension and associated time lag between technology and regulation has been well documented. Paradigmatic of this phenomenon is the global evolution of blockchain technology and digital assets. Digital assets in the blockchain allow users to transact directly without financial intermediaries. However, the regulatory guidelines for the assets, their issuance, and the subsequent transactions are unclear. The Securities and Exchange Commission (SEC) has filed an action to apply its existing regulations and the judicial interpretations to Ripple’s issuance of XRP, its token, and Ripple’s control over subsequent user transactions of XRP. This Note uses SEC v. Ripple as a case study to determine how digital assets are treated for securities purposes. It will also discuss the general regulatory and policy concerns of digital asset transactions. SEC regulations require disclosures and minimize price manipulations to protect users and market integrity. The SEC has provided a framework, and Chairmen and Commissioners have given speeches regarding how digital asset transactions on exchanges would be regulated. However, the SEC has mainly used litigation to enforce its jurisdiction over certain digital assets by applying the Howey test; thus, its guidelines are based on an amalgamation of the facts and circumstances from different cases instead of what they should be: a robust regulatory framework specifically and thoughtfully tailored to

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how these digital assets might be regulated as users transact. This note
reasons that regulatory clarity is necessary for this industry to flourish.

Digital assets may be issued as a security but after time, as the digital
assets are transferred between users and the network decentralizes,
they begin to function more like a consumer token. Not only are digital
assets valuable to society, but they are also transforming the financial
industry. The Commodity Futures Trading Commission (CFTC) has
also offered guidance on how it would regulate digital assets within
its jurisdiction. Yet, the question remains which digital assets fall
under CFTC jurisdiction, which are in the SEC’s jurisdiction, and how
the digital asset community can know the difference. To provide
greater clarity, this Note argues that the SEC should adopt
Commissioner Hester Peirce’s Safe Harbor Proposal 2.0, which
proposes monitoring these digital assets while allowing sufficient time
for decentralization. If decentralized, the digital asset would be
regulated by the CFTC, and, if not, the digital asset would be regulated
by the SEC.

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INTRODUCTION

Individuals and companies now use digital assets in a variety of settings including business and user transactions and as a store of value.\(^1\) Globally, digital asset exchanges have grown in use and market size.\(^2\) As their prevalence increases, regulators need to sort through all policy considerations and implement clearer rules for the use digital assets while emphasizing their untapped potential.\(^3\)

Digital assets have diverse uses, and the overall scheme and structure of the digital asset determines how it is treated for securities purposes.\(^4\) Initial Coin Offerings, or offerings where investors purchase digital assets from the issuer, are considered securities and regulated by the Securities and Exchange Commission (SEC).\(^5\) Some tokens are listed on exchanges

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3. See infra Section II.C.1.
4. See infra Part I.
5. Initial Coin Offerings are usually securities. Former Chairman Clayton once said “Every ICO I’ve seen is a security” and Chairman Gensler agrees, comparing digital asset regulation to the “wild west.” See Gary Gensler, Chairman, U.S. Sec. & Exch. Comm’n,
with users transacting directly with one another, and these transactions function in a gray regulatory area with the applicable framework ill-defined. The regulations of these subsequent direct user transactions will be the focus of this Note.

In general, the SEC regulates securities and investment contracts. The multi-faceted Howey test is used to determine whether something is an investment contract. The SEC monitors with a mix of “functional definitions and regulation via enforcement” which “risks increasing uncertainty for market participants and undermining regulatory clarity.” If a digital asset is deemed an investment contract under Howey, it is required to comply with security regulations unless it falls into an exemption, even though digital asset networks structures may vary widely. If the digital asset is considered a security, it would likely be removed from token exchanges since securities cannot be transferred on an unregulated securities exchange. Additionally, digital asset users with large amounts of tokens could be considered an investment company and be forced to comply with the Investment Act of 1940.

The SEC has been using litigation with fact specific inquiries to enforce its regulations on digital assets. Previously SEC litigation involving Telegram explained that a “security” may be determine by the


7. See generally infra Section I.B.
8. See id.
10. See id.
11. See Cohen, supra note 6, at 97.
12. See id.
13. Peirce and Roisman have been outspoken about the shortcomings of the SEC to provide clarity in the world of digital assets. They continue to propose innovative ideas to balance all interests and give the platforms the greatest opportunity to thrive. Hester M. Peirce & Elad L. Roisman, Comm’rs, U.S. Sec. & Exch. Comm’n, Public Statement: In the Matter of Coinschedule (July 14, 2021), https://www.sec.gov/news/public-statement/peirce-roisman-coinschedule [https://perma.cc/B6K3-NRUR].
continuous offering scheme of the digital asset.14 The court focused on the economic reality of Telegram’s representations to users and whether reasonable users would rely on Telegram and purchase Gram, the digital token, as an investment.15 In another action SEC v. Kik, the court held that the term “investment contract” is not vague and the Howey test puts digital asset providers on notice that investment contracts, even in the form of digital assets, will be regulated by the SEC.16 The SEC has also settled with Munchee Inc. on its self-titled “utility token,” finding that the token functioned as a security, and that the labeling of the token is irrelevant if it still functions as an investment contract.17 Currently, the SEC action against Ripple Labs (“Ripple”) and the outcome of the subsequent lawsuit may provide guidance on how similar digital assets will be regulated in the future.

This Note argues that robust and clear regulations for the transactions of digital assets between users require extensive research and involve significant policy concerns that should be the responsibility of the regulators. As shown later in this Note, SEC regulation of some digital asset transactions may be unsuitable. The Commodity Futures Trading Commission (CFTC) may provide a more suitable regulatory framework for these digital assets. The SEC should adopt Commissioner Hester Peirce’s Safe Harbor Proposal 2.0, which gives networks three years after their inception to decentralize and then self-certify what agency to report to. The time to decentralize without SEC intervention and clear classification after three years will ideally provide regulatory clarity and minimize confusion among the issuers and users as to how the digital asset functions for securities purposes.

Although the SEC’s guidelines are written vaguely enough to encompass the vastness of securities,18 it should not use this catchall to

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15. See id. at 371-72.
impose its will over digital asset transactions between subsequent users on exchanges when there are other, more well-suited options. The SEC has pointed to this ambiguous language in various press statements to reinforce its position that it has the authority to regulate digital assets. However, as some SEC regulators have pointed out, complying with SEC regulations is almost impossible for decentralized networks.

The SEC has put forth a Framework for “Investment Contracts” Analysis of Digital Assets that outlines digital asset characteristics that would likely pass the Howey test, requiring the application of securities regulations. Former SEC Director William Hinman explained that the applicability of securities laws to digital assets is based on the level of decentralization. As a result, he does not believe that Bitcoin and Ether, two popular tokens, are currently securities. Decentralization itself has not been clearly defined, further demonstrating the depth of the regulatory vagueness surrounding this issue. The SEC has since backtracked on Director Hinman’s analysis, stating that it was his opinion and “there is no action that [the SEC] took to say Bitcoin is not a security,

Disclosure and GHG Reduction, 25 FORD. J. CORP. & FIN. L. 155, 158 (2020) (explaining that regulators are attempting to combat climate change through securities regulations).

19. See infra Section II.C.1.


23. See infra Section I.B.


25. See id.

[or] Ether is not a security,” sending further mixed signals and adding confusion.27

SEC Commissioners Hester Peirce and Elad Roisman acknowledge the quagmire, pointing out that “although the Commission staff has provided some guidance, the large number of factors and absence of weighing cut against the clarity the guidance was intended to offer.”28 They find that the Howey test “is helpful, but, often, including with respect to digital assets, the application is not crystal clear.”29

Issuance schemes are treated as securities; however, the difference between the issuing scheme and the object for use is more difficult to determine for digital assets than for other goods or assets.30 For example, in the case of Howey, the scheme for citrus groves where the managers would continue to market and tend to the citrus groves constituted an investment contract.31 The investment in the citrus groves production is different than the citrus that is consumed and the citrus itself is not regulated as a security. In the case of digital assets, the distinction between the initial issuance scheme of the digital asset and the subsequent transactions between users for use is less apparent.32 As the network decentralizes, there is a greater likelihood that the digital asset can exist without reliance on the initial issuer and the token is considered for use.33

There is much controversy as to when the reliance on the initial issuer disappears, as outlined in The Blockchain Debate Podcast episode Motion: Legally speaking, tokens are more like commodities than like securities (Lewis Cohen v. Gabriel Shapiro).34 Gabriel Shapiro argues

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29. Id.
30. See Cohen, supra note 6, at 84.
32. See infra notes 34-38 and accompanying text.
33. See Cohen, supra note 6, at 108.
that regardless of whom the users are directly transacting with, the users will rely on the issuer for token profit.\textsuperscript{35} In other words, the issuer’s initial token sale and promises for profit could be interpreted as an open-ended promise to all users that there would be a profit; thus, subsequent users will also rely on the issuer and the original issuing scheme to succeed.\textsuperscript{36} On the other hand, Lewis Cohen argues that when users are transacting with an asset directly with subsequent users, they will no longer be sufficiently connected to the issuing scheme to rely on the issuer.\textsuperscript{37} Cohen contends that the token may require some aid from the issuers, but the nexus between the issuer and the user will dissipate and the token is for use instead of as an investment.\textsuperscript{38} In her personal press release, SEC Commissioner Peirce also addresses user reliance on the issuer’s promises and statements in asserting that “there are circumstances in which the security label fits; but, in other cases, promises made about the tokens increasing in value are nothing more than expressions of the hope that a network will succeed and be used by lots of people.”\textsuperscript{39}

There are varying viewpoints amongst the blockchain community\textsuperscript{40} as well as regulators at the SEC.\textsuperscript{41} Commissioner Peirce has radically different views on how digital assets should be treated for securities purposes than Commissioner Crenshaw and Chairman Gensler.\textsuperscript{42} Their varying views and unclear regulatory guidance for digital assets once they

\begin{flushleft}
\textsuperscript{35} Id.
\textsuperscript{36} Id.
\textsuperscript{37} See Cohen, supra note 6, at 108.
\textsuperscript{38} Id. at 119.
\textsuperscript{39} See Peirce, supra note 21.
\textsuperscript{40} See supra notes 26-29 and accompanying text.
\textsuperscript{41} See supra note 32 and accompanying text.
\textsuperscript{42} Compare Peirce, supra note 21 (discussing Commissioner Peirce’s belief that SEC regulation of digital assets who destroy the digital asset and advocates for regulations that can protect the innovative nature of these digital assets), with Gensler, supra note 5 (dealing with Chairman Gensler point of view that most crypto assets are highly speculative investments and securities regulations should be applicable to many of the crypto transactions to protect users), and with Caroline A. Crenshaw, Comm’r, U.S. Sec. & Exch. Comm’n, Digital Asset Securities – Common Goals and a Bridge to Better Outcomes (Oct. 12, 2021). Commissioner Crenshaw believes that the digital asset creators should accept responsibility for regulatory compliance and comply with the applicable requirements and in doing so there will be balance that promotes innovation, while protecting the users and market integrities. She believes that many of the networks would be regulated as securities.
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are exchanged among users create a lack of clarity as to jurisdiction, and therefore digital assets may not be on notice of regulatory violations.\footnote{Eileen Lyon, the general counsel for Kik, a digital asset that was sued by the SEC, stated that the SEC “should engage in proper rulemaking, including the opportunity for public commentary, rather than force our industry to hunt for regulatory clues among the SEC’s conflicting statements, Commissioner and staff speeches, no-action letters, closed-door meetings with the SEC and nonprecedential settlements.” Nikhilesh De, \textit{Judge Rules Kik’s Token Sale Violated US Securities Law}, COINDESK https://www.coindesk.com/markets/2020/09/30/judge-rules-kiks-token-sale-violated-us-securities-law/ [https://perma.cc/Z5TV-3ETA] (last visited Dec. 11, 2021).}

In the opinion outlined in this Note, the SEC treatment of digital assets needs to be carefully constructed since regulatory intervention can destroy the digital asset before it has a chance to be successful. As a case study, this Note will focus on the SEC action against Ripple and its treatment of the digital asset XRP, as well as the underlying principles of regulation. According to Ripple, XRP, a digital asset created by Ripple, specializes in transfers between various international currencies.\footnote{\textit{See infra} Section I.A.} Ripple explains XRP is a bridge currency intended for companies who perform cross-currency transactions or individuals sending money to their families in foreign nations, since it, arguably, eliminates sizeable currency conversion fees and minimizes transfer time.\footnote{\textit{See infra} Section I.A.} Ripple argues that from XRP’s inception, it has made significant strides in decentralization.\footnote{\textit{See infra} Part I.} It also argues that there was insufficient notice that it was in violation of securities laws, so the SEC violated Ripple’s due process rights.\footnote{\textit{See Answer of Defendant Ripple, to Plaintiff’s Complaint at 91, Sec. & Exch. Comm’n v. Ripple Labs (2021) (No. 20-CV-10832) [hereinafter Ripple Answer].} On the contrary, the SEC argues that Ripple’s control over XRP causes it to function as an unregulated continuous securities offering, and for that reason it must comply with SEC regulations and the disclosures required to protect the public.\footnote{\textit{See infra} Part II.} The SEC also argues that its policies towards digital assets are clear because it had issued guidance regarding digital assets and the \textit{Howey} test, and the agency had previously brought actions against other token issuers; thus, Ripple was on notice.\footnote{\textit{See infra} Section II.B.} Irrespective of the outcome, the digital asset community needs more guidance on what defines decentralization and how security regulations would apply to user transactions of digital assets. The SEC, CFTC, and Congress should put forth guidance on how these digital assets are to be regulated.
Part I of this Note will outline the characteristics of Ripple and XRP, discuss how the SEC determines what schemes to regulate, and outline fair notice requirements. Then, Part II of this Note will analyze whether XRP should be treated as a continuous securities offering by the SEC, examine the various SEC Commissioners’ ideas for regulation of digital assets, and offer alternative regulatory options. Finally, Part III will explain why Ripple will likely be considered a security and, more generally, why the SEC should implement a safe harbor at each digital asset network’s inception, allowing it to become sufficiently decentralized without stagnating the digital asset network’s progression. Then, there will be on clear notice if the digital asset is within the SEC or CFTC’s regulatory jurisdiction.

I. THE CRASHING WAVES OF THE SEC, XRP, AND RIPPLE

It is well understood that the SEC regulates securities and investment contracts to protect investors and ensure fairness in the market. A primary tool to achieving this is disclosure requirements that minimize information asymmetries between the regulated company and its investors. The SEC first applied the court-interpreted Howey test to regulate digital assets in 2017 in the Report on DAO tokens (the “DAO Report”). After the investigation, the SEC determined and demonstrated its regulations apply to those digital assets that function identically to an investment contract. The SEC uses the Howey test to determine whether an investment, contract, transaction, or scheme is an investment contract. Under Howey, an investment contract exists where “a person invests his money in a common enterprise and is led to expect profits solely from the efforts

51. *See id.*
52. *See Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934: The DAO, Exchange Act Release No. 81207 (July 25, 2017).* The DAO was a for-profit organization that funded various projects and the SEC realized that it was an investment contract where the users were expecting to profit off the various projects DAO funded.
53. *See id.*
54. *SEC Framework, supra note 22.*
of the promoter or a third party.” The scheme to advance the digital asset’s popularity may include speculative statements, targeted marketing techniques, and price discounts, all of which are characteristics of an investment contract.

According to Ripple, XRP is a digital asset on a decentralized network where Ripple-invented technologies facilitate almost instantaneous XRP transactions with low costs. XRP’s token creator, Ripple, arguably has considerable control over the network, minimizing decentralization. Based on Ripple’s relationship with XRP, the SEC has found that XRP constitutes a security. Ripple, however, takes the position that the decentralized network’s structure and the token’s overall purpose cause XRP to function as a digital asset for use, not an investment contract. Ripple and the SEC also argue over whether there was fair notice of Ripple’s legal violations. In order to understand both sides’ arguments, it is first imperative to have a grasp on the background; this Section will examine Ripple’s structure and analyze Ripple behavior towards XRP under the Howey test and the fair notice requirement.

A. Ripple and XRP

Ripple is a private software company founded by Chris Larsen and Jeb McCaleb, and the current Chief Executive Officer is Brad

56. See generally Complaint at 2, 49, 55, Sec. & Exch. Comm’n v. Ripple Labs, (2020) (No. 20-CV-10832) [hereinafter SEC Complaint] (reasoning that Ripple’s speculative statements, targeted marketing techniques, and price discounts resemble an investment contract).
58. See SEC Complaint, supra note 56, at 2, 9.
59. See id.
60. See Ripple Answer, supra note 47, at 1-2.
61. See infra Section II.B.
63. Chris Larsen was a trailblazer in the tech industry who has been involved in a number of extremely profitable startups. See id.
Garlinghouse. The SEC charged Larsen and Garlinghouse in its complaint, reasoning that both played a vital role in Ripple and XRP’s development. Currently, Ripple has nine global offices with 500 employees.

Ripple defines its goal as using blockchain technologies to revolutionize the current financial paradigm. It aims to make an internet of value, where “money moves like information moves today.” The company created unique technology, known as the Ripple Protocol and XRP Ledger, which is an automatic math-based algorithm that removes the need for financial intermediaries and increases the ease with which users transact. Ripple added XRP to its open protocol. Ripple, in its corporate capacity, offers a registered security, and individuals can purchase Ripple stock which supposedly has value separate from the transfers of XRP. To state it differently, Ripple argues that it is the company, and XRP is its product for public use.

65. See SEC Complaint, supra note 56, at 1.
67. Ripple products help facilitate cross border transactions between the United States and Mexico on MoneyGram and within the Philippines in Azimo. See id.
69. SEC Complaint, supra note 56, at 8.
70. See Andrews, supra note 62.
XRP is meant to function as a bridge currency, facilitating fiat or real currency transactions. It is native to the XRP Ledger, a distributed network which is a permissionless and allows for XRP transactions without a central intermediary. Ripple was the creator of XRP and continues to actively participate in the distributed ledger through which users transfer XRP. XRP is an open public forum where around 1.4 billion transactions occurred between 2013 and January 29, 2021. However, despite its intentions, Ripple’s goal for XRP to operate as a bridge currency has not necessarily been accomplished since many users purchase XRP for other purposes.

For XRP transactions, there are nodes on the network to validate user transactions. When users transact, the consensus algorithm ensures that the transaction is correct before adding it to the ledger. Usually, Ripple, or one of its approved trusted third parties, validates the transaction. In this way, Ripple and its algorithm play a vital role in the operation of the network. There are 36 active validators. Ripple controls six, and universities, exchanges, and financial institutions control the other 30.

XRP was pre-mined and created by simply placing one hundred billion XRP on a network and eliminating the possibility of adding more

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74. Ripple is targeting an extremely lucrative market that has not been tapped into and has the potential to revolutionize the financial world. See Bitcoin Mkt. J., Ripple (XRP) Analyst Report 6 (2018).
75. See XRP: The Best Digital Asset for Global Payments, supra note 57.
78. See Ripple Answer, supra note 47, at 6.
79. Many use XRP for its speculative value. See SEC Complaint, supra note 56, at 17.
81. Mining networks are validated by miners, not an algorithm. See id. at 4.
82. Shailak Jani, An Overview of Ripple Technology & Its Comparison with Bitcoin Technology 5 (2018). See also Ripple Answer, supra note 47, at 15 (stating that Ripple has “a specific set of trusted validators, or Unique Node List (“UNL”); [but] anyone can run a node or validator; and users are free to use any UNL they prefer. Ripple further admits that Ripple publishes a UNL that validators may choose to adopt, but they are not required to do so”).
83. See id. at 2.
84. See XRP: The Best Digital Asset for Global Payments, supra note 57.
85. See id.
XRP in the future. Of the initial 100 billion XRP, Ripple received 80 billion, and the founders received 20 billion, giving Ripple and its associates extensive control over the day to day operations, and arguably, motivating them to create speculative value and target users and empowering them to drive XRP’s successes and failures. As of April 25, 2021, Ripple owned 6,159,773,344 XRP, distributed 46,030,731,641 XRP, and an escrow account held 47,800,000,013 XRP. Based on these numbers, Ripple owns approximately 11.8 percent of the outstanding XRP and approximately 6.2 percent of the total XRP.

Generally, the principles of supply and demand determine the exchange rate of the tokens. The token’s supply is often fixed or capped, and the rate fluctuations can be impacted by demand. Ripple has, at times, engaged in XRP purchases and managed the release and return of XRP to escrow which raise the exchange rate. Therefore, Ripple has affected and can continue to impact and profit off selling XRP tokens.

There is substantial evidence that Ripple has also engaged in distributing, promoting, and marketing mechanisms of XRP to increase demand. The SEC accuses Ripple of large-scale marketing campaigns that targeted individuals who had no use for XRP to increase its popularity. To further increase XRP’s popularity, the SEC alleges that Ripple sold tokens to investment officers at discount prices, allowing them to purchase XRP at a rate that differs from its exchange rate and essentially guaranteeing a profit. The SEC argues that these mechanisms

86. SEC Complaint, supra note 56, at 9.
87. See id.
89. See id.
91. Most networks have a limited number or limited potential number of tokens so increasing the demand and popularity increases its profitability. See id. at 3.
93. See SEC Complaint, supra note 56, at 12.
95. See SEC Complaint, supra note 56, at 14.
96. See id. at 18.
through which Ripple obtained new members were similar to “speculative investment trading” or encouraging market prices that may not correlate with the token’s actual rate.\footnote{Speculative trading occurs when there is a real risk of loss, but the large profit potential is emphasized. See SEC Complaint, supra note 56, at 10.}

Throughout the SEC v. Ripple Complaint, the SEC made numerous claims regarding the extent of Ripple’s and its CEO’s troublesome control over XRP and efforts to increase XRP’s value through speculative statements.\footnote{See generally id. at 11-27.} However, Ripple refuted the level of control, arguing that the SEC is taking their statements out of context.\footnote{See Ripple Answer, supra note 47, at 67.} Ripple contends its executives are not attempting to fuel any speculative value when their statements are read in their entirety.\footnote{See id. at 68-77.}

Additionally, the SEC had issues with the methods used by Ripple’s executives.\footnote{See SEC Complaint, supra note 56, at 17.} The SEC believes that Larsen and Garlinghouse often had final decision-making authority over XRP price discounts and actively participated in XRP marketing campaigns.\footnote{See id. at 13-14.} The ability for individuals to alter and determine XRP’s price is concerning.\footnote{See generally id., at 37-42. It is important to note that the speaker’s true intent is unclear, and these quotes may be taken out of context.} However, most CEOs, no matter the industry, have final decision-making authority.\footnote{What is a CEO (Chief Executive Officer)?, CORP. FIN. INSTIT., https://corporatefinanceinstitute.com/resources/careers/jobs/what-is-a-ceo-chief-executive-officer/ [https://perma.cc/FQ35-2Q4H] (last visited Mar. 25, 2021).} In addition, the SEC is also concerned by Ripple paying some of its executive’s in XRP.\footnote{Hamid Mehran & Joseph Tracy, The Effect of Employee Stock Options on the Evolution of Compensation in the 1990s, FED. RES. BANK N.Y. ECON. POL’Y REV. 17, 27 (2001).} Payment in free products or stocks is a common practice to increasingly intertwine the managers’ interest with that of the company.\footnote{“Paying or getting paid with digital coins is the norm in the cryptocurrency sector.” Lubomir Tassev, How to Pay Employees or Get Paid with Bitcoin, BITCOIN.COM (June 29, 2019), https://news.bitcoin.com/how-to-pay-employees-or-get-paid-with-bitcoin/ [https://perma.cc/Y2GJ-ZR3].} In the crypto sector, cryptocurrency compensation is popular since many individuals prefer it.\footnote{SEC Complaint, supra note 56, at 20.
Regarding other tokens, former SEC Director Hinman has publicly stated that he does not believe that Bitcoin\(^\text{108}\) and Ether\(^\text{109}\) are currently investment contracts under Howey due to their levels of decentralization.\(^\text{110}\) Importantly, the specific requirements for decentralization have yet to be precisely defined.\(^\text{111}\) XRP differs from Bitcoin in two significant characteristics, which could provide clarity on why the SEC does not consider XRP a decentralized network. First, XRP’s authentication process diverges from that of Bitcoin. Bitcoin allows independent users’ mining efforts to validate transactions\(^\text{112}\) while, in contrast, XRP transactions are mostly validated by Ripple or one of its approved trusted third parties.\(^\text{113}\) Second, XRP’s token creation process varies from Bitcoin’s. Ripple simply offered its initial tokens and capped the number at 100 billion XRP,\(^\text{114}\) whereas Bitcoin was truly decentralized from the start, and Bitcoin users mine for their tokens and then sell or transfer them.\(^\text{115}\) Ripple argues that the elimination of mining makes it significantly more environmentally friendly.\(^\text{116}\) Regardless, it appears the issuers of XRP play a more key role than those of Bitcoin.

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\(^{112}\) See Soylu et al., *supra* note 76.


\(^{114}\) See Kapen, *supra* note 94.

\(^{115}\) Most networks either have users mine for tokens and exchange them on the exchange or initially release tokens for purchase and then exchange them on the network. See id.

\(^{116}\) See Ripple Answer, *supra* note 47, at 4.
B: Howey Framework for Investment Contracts

The specific offering techniques and level of decentralization of the network determine how the digital asset will be treated for securities purposes.\(^{117}\) The SEC regulates if the digital assets are securities, which include investment contracts.\(^{118}\) The agency uses the Howey test to determine whether the digital asset transactions should be treated as investment contracts.\(^{119}\) Under Howey, an investment contract is found if “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.”\(^{120}\) Investment contracts cover a wide variety of schemes that may be non-obvious or uncommon.\(^{121}\)

1. Prong One: Investment

Investments are commonly understood as “a transfer of something of value in exchange of future return rather than a present one.”\(^{122}\) Companies do not need to have a formal contract to be an “investment contract”; instead, courts analyze the structure, scheme, or enterprise of the entity, focusing on the economic reality of the transaction.\(^{123}\)

2. Prong Two: Common Enterprise

Courts require either broad or narrow vertical commonality or horizontal commonality to fulfill the common enterprise prong.\(^{124}\) Narrow vertical commonality is satisfied when the interests of investors and managers are intertwined,\(^{125}\) broad vertical commonality is satisfied when

\(^{117}\) Other popular cryptocurrencies, such as Bitcoin, are regulated by the CFTC. See LABCFTC, A CFTC PRIMER ON VIRTUAL CURRENCIES 11 (2017).

\(^{118}\) See SEC Framework, supra note 22.

\(^{119}\) See Rosenberg, supra note 18.


\(^{121}\) See Rosenberg, supra note 18.


\(^{124}\) See Howey, 328 U.S. at 298-99.

\(^{125}\) JAMES D. COX ET AL., SECURITIES REGULATION CASES & MATERIAL 42 (9th ed. 2019).

\(^{126}\) Sec. & Exch. Comm’n v. SG Ltd., 265 F.3d 42, 49 (1st Cir. 2001).
the investors are dependent on the central entity’s expertise,126 and horizontal commonality is satisfied when all investors share profits and risks, essentially pooling their resources for gains.127

For digital assets, it is easier for the SEC to show horizontal commonality than vertical commonality, because the decentralized nature of the network makes it difficult to point to a central entity in control.128 Thus far, circuit courts agree that digital asset networks link users for profitability and success, fulfilling horizontal commonality.129

3. Prong Three: Profits Expected from the Efforts of Others

Although there are arguments supporting and opposing the applicability of each prong of the Howey test to digital assets, the most prominent issue is whether the users expect profits solely from others’ efforts.130 Significantly, profits derived from price changes resulting from external market forces would not fulfill this prong.131 Rather, the managers must participate in targeted efforts to increase profits and the speculative value must be similar to that of an investment.132

After Howey, some circuit courts decided to drop “solely” and instead evaluate if the efforts of others are significant or essential to the network’s success.133 The SEC asks courts to look at “the economic reality of the transaction”134 and inquire into whether the users are relying on

126. See id.
127. Cox et al., supra note 124.
129. The issue of horizontal commonality on a cryptocurrency network has yet to reach the Supreme Court, but most circuit courts that have addressed the issue have found that this prong was fulfilled. See SEC Framework, supra note 22 (citing SEC v. Int’l Loan Network, Inc., 968 F.2d 1304, 1307 (D.C. Cir. 1992)).
130. Cox et al., supra note 124.
131. Such profits are not based on the efforts of others. See id.
132. See also SEC Framework, supra note 22.
133. This matter has not been decided by the Supreme Court. See Sec. & Exch. Comm’n v. Glenn W. Turner Enters., 474 F.2d 476, 482 (9th Cir. 1973), cert. denied, 414 U.S. 821 (1973). See also Sec. & Exch. Comm’n v. Scoville, 913 F.3d 1204, 1221 (10th Cir. 2019).
134. See SEC Framework, supra note 22.
others’ efforts, if the reliance is reasonable in context, and the economic reality of the situation.

For digital asset networks, the analysis often turns on the level of network decentralization. When there is sufficient decentralization, users can no longer rely on others’ efforts for profits. Usually, the digital asset issuers initially retain a high level of control before the digital asset network becomes fully functional and decentralized. With that said, courts must analyze the decentralization of the current, not the past, network structure. Both the SEC and Ripple argue over the current extent of decentralization and whether it is enough to be considered a security.

C. FAIR NOTICE DEFENSE

Both parties argue over whether there was fair notice of regulatory violations. Under the due process clause of the Fifth Amendment, regulations must give fair notice of punishment. The court analyzes whether a “person of ordinary intelligence [had] a reasonable opportunity to know what is prohibited, so that he may act accordingly.” In other

135. Although not dispositive, if a manager is responsible for the ongoing operation and promotion, has certain tasks they must perform, continued decision-making power, supports the market creation, or their ownership portion leads investors to reasonably expect them to undertake efforts to promote their own interests, it is likely that the users are relying on the efforts of others. See id.

136. There is likely a reasonable reliance when the asset is offered broadly instead of targeting expected users, the market price does not necessarily correlate to the purchasing or offering price, the managers benefit from holding their assets which are the same as the public, and the managers continue to use funds to upgrade the network. See id.

137. If these factors are met, it is more likely that the network is an investment contract. If the network is marketed for investor gains, not its functions as a digital asset, it should be treated as an investment contract. See id.

138. See Hinman, supra note 20.

139. It is likely that Ether was a security at the start of the network, but it has decentralized since then and currently does not appear to be one. See id.

140. See, e.g., id. (In the past, Ether’s centralization would have likely rendered it a security; however, in recent years the network has become more decentralized and can no longer be classified as one).

141. See Ripple Answer, supra note 47, at 8.

142. See infra Section II.A.

143. See infra Section II.B.


words, the SEC is required to give parties an indication that their actions are in violation of its regulations.\textsuperscript{146}

\section*{II. THE RIPPLES OF SEC REGULATION FOR DIGITAL ASSETS}

\subsection*{A. THE XRP-\textit{H}OWEY \textit{D}EBATE}

Ripple’s involvement with XRP and XRP’s structure and function have similarities to an investment contract.\textsuperscript{147} This Section will outline the SEC’s arguments in support of and Ripple’s arguments in opposition to how Ripple conduct towards XRP fits in each prong of the \textit{Howey} test.

\subsection*{1. XRP: Investment or Currency}

The SEC contends that under Ripple’s “scheme,” XRP is issued in exchange for cash and the idea of future gains.\textsuperscript{148} It argues that Ripple promised its investors to work on increasing the price and popularity of the network.\textsuperscript{149} There is no need for a formal contract for a court to find an “investment contract”; rather, the enterprise’s structure or scheme must reflect an investment.\textsuperscript{150} Thus, the SEC believes Ripple’s scheme exchanges a present XRP token for a higher token value in the future, fulfilling the idea of an investment.\textsuperscript{151}

Ripple refutes the SEC’s claims and does not believe XRP is an investment.\textsuperscript{152} It reasons that XRP contracts prevent third-party beneficiaries,\textsuperscript{153} and, because of this, the contract explicitly eschews the scheme and structure of an investment.\textsuperscript{154} Moreover, Ripple’s proponents agree, arguing that the purpose and economic reality of XRP is that it

\textsuperscript{146} See id.

\textsuperscript{147} In a previous interview with President Biden’s elected SEC Commissioner, Gary Gensler stated that Ripple is more likely to be deemed a security than other cryptocurrencies. \textit{See, e.g.}, Betsy Vereckey, \textit{Is a Cryptocurrency a Security? Depends}, MIT MGMT. SLOAN SCH. (May 4, 2018), https://mitsloan.mit.edu/ideas-made-to-matter/a-cryptocurrency-a-security-depends [https://perma.cc/5LR6-4LMP].

\textsuperscript{148} See SEC Complaint, supra note 56, at 35-36.

\textsuperscript{149} See id. at 43.


\textsuperscript{151} See generally SEC Complaint, supra note 56, at 35-36.

\textsuperscript{152} Ripple Answer, supra note 47, at 5.

\textsuperscript{153} See Garlinghouse, supra note 72 (arguing that third party beneficiaries are users benefiting off the token’s value aside from its purchase).

\textsuperscript{154} See Ripple Answer, supra note 47, at 2.
“functions as a store of value, a medium of exchange and a unit of account.”

2. Ripple Management and XRP’s Users’ Relationship: Common Enterprise

a. Narrow Vertical Commonality

The SEC claims narrow vertical commonality is fulfilled since Ripple’s managers and XRP’s users have overlapping interests. It claims the managers’ and users’ interests overlap because the founders still own a large portion of the available XRP tokens. There is evidence that Ripple’s managers are also paid bonuses in XRP, potentially encouraging them to increase the currency’s speculative value and further uniting their interests with that of its users. According to the SEC, Ripple has gone as far as to state that its incentives are identical to those of its users. On this basis, the SEC believes Ripple’s managers’ interests are inherently combined with the users’ interests since both benefit when XRP’s prices rise.

Ripple refutes the SEC’s narrow vertical commonality claim, and Ripple’s CEO, Garlinghouse, explains that it views the interest of Ripple managers’ as inherently separate from the interest of the users. He argues that Ripple’s directors have fiduciary duties to Ripple’s investors who are independent of XRP users, and its CEO contends that XRP users do not benefit from Ripple’s success. He considers Ripple and XRP two separate entities with two distinct functions.

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155. See Giancarlo & Bahlke, supra note 122.
156. See SEC Complaint, supra note 56, at 47.
157. See id. at 43.
158. See id. at 20.
159. See Mehran & Tracy, supra note 106 (arguing that payment in stock options increase the managers interest in company growth).
160. See SEC Complaint, supra note 56, at 43.
161. See id. at 44.
162. See Garlinghouse, supra note 72.
163. See id.
164. See id.
b. Broad Vertical Commonality

The SEC argues that there is broad vertical commonality, reasoning that users rely on Ripple’s expertise for success.\(^{165}\) Ripple played a key role in the Ripple Protocol, \(^{166}\) the authentication algorithm that has been integral to XRP’s success.\(^{167}\) The SEC also argues that Ripple emphasized its team’s expertise and experience in relation to XRP.\(^{168}\) The SEC believes that users rely on and require Ripple’s continued presence.\(^{169}\)

However, Ripple insists that since XRP’s inception, Ripple has made significant efforts to minimize its presence and decentralize the network.\(^{170}\) The users are relying on the open market, not Ripple’s management, for success.\(^{171}\) Thus, Ripple denies the SEC’s claims that users rely on its and its managers’ expertise.\(^{172}\)

c. Horizontal Commonality

The SEC argues that there is horizontal commonality as users share in risks and profits.\(^{173}\) As is the case for most digital assets, the network itself requires the pooling of efforts, and all users share in the risk and profit.\(^{174}\) Thus, all users who transact on the network are tied to each other to some extent.\(^{175}\)

Ripple, on the other hand, argues that although digital assets users participate on a common network, they are not pooling assets, making the SEC’s characterization improper.\(^{176}\) Ripple’s proponents contend that users are transacting for a personal benefit, unconnected to other users.\(^{177}\) Further, it is the network’s popularity and external market forces that

\(^{165}\) See SEC Complaint, supra note 56, at 45.

\(^{166}\) See id. at 37.

\(^{167}\) See JANI, supra note 82, at 1.

\(^{168}\) See SEC Complaint, supra note 56, at 41.

\(^{169}\) See generally id. at 45-49.

\(^{170}\) See generally Ripple Answer, supra note 47, at 4.

\(^{171}\) See id.

\(^{172}\) See generally id. at 63-68.

\(^{173}\) See generally SEC Complaint supra note 56, at 45-49.

\(^{174}\) See Uffer, supra note 128 (discussing that all circuits have unanimously agreed that cryptocurrency networks meet the horizontal commonality prong).

\(^{175}\) COX ET AL., supra note 124.

\(^{176}\) See Ripple Answer, supra note 47, at 63.

\(^{177}\) See Giancarlo & Bahlke, supra note 122.
create price fluctuations, not the pooling of the XRP token holders’ resources.178

3. The Final Ripple: Efforts for XRP Profit

While the aforementioned elements are all pieces of the puzzle, the main controversy is whether XRP’s users expect to profit from Ripple’s efforts. This Section will examine the arguments for the dispositive factors of the third prong of the Howey test. The analysis will explore the users’ reliance on others’ efforts, reasonable expectation of profits, and other relevant economic considerations.

a. User Reliance on the Efforts of Ripple

The SEC argues that Ripple’s control minimized the decentralization of the XRP network so it is not sufficiently decentralized and users are forced to rely on Ripple and its agents efforts for success.179 There is an inherent reliance when a central entity is responsible for a network’s decision-making, development, and operations.180 The SEC claims that Ripple still owns a large portion of the outstanding tokens and has adequate control to initiate change.181 If the company’s success is intertwined with the network’s success, users are forced to rely on the company’s attempts to enhance the network’s value.182 Thus, the SEC argues users must rely on Ripple to create a profit.183

Alternatively, Ripple contends that users have no reason to rely on its efforts.184 Ripple believes that XRP would still thrive and function without Ripple,185 the company simply chooses to share in XRP’s success.186 It asserts that XRP is an open market where users “rely on the free and efficient functioning of that market.”187

178. See id. (arguing that price fluctuations from external forces are not considered horizontal commonality).
179. See generally SEC Complaint, supra note 56, at 49-56.
180. SEC Framework, supra note 22.
181. See SEC Complaint, supra note 56, at 48.
182. Id. at 44.
183. See generally id at 49-56.
184. See generally Ripple Answer, supra note 47.
185. See id.
186. See id.
187. See id. at 3.
b. Reasonable Expectation of Profits

To expect profits, the entity must act in a manner that leads users to believe it will work to increase the value of the security. 188 The SEC contends Ripple specifically targets individuals based not on their need for the product but solely to increase XRP’s demand. 189 It has reason to believe that Ripple actively recruits users through expansive marketing campaigns that lead to speculative values. 190 It has further reason to believe that Ripple commonly provides discounts for large purchases. 191 The discounts alter the offering price from the token’s market price and basically guarantees profits. 192 The SEC believes that Ripple acknowledged its efforts and methods to protect public users on XRP. 193 Such a statement could clearly lead reasonable users to rely on Ripple to continue to protect public users on XRP.

In his press releases, Garlinghouse insists that XRP’s price changes and volatility are shared among all digital assets and occur because of external market forces. 194 He contends XRP is a digital asset with price changes incidental to its purpose and not related to Ripple’s actions. 195 The SEC framework states that reasonable profit expectations must extend beyond basic price alterations from market forces. 196 Digital assets may trade at different prices on different exchanges, thus, users can purchase a token on one exchange and immediately sell it on another for a profit, a practice known as arbitrage. 197 The nature of the industry sometimes permits such immediate profits. 198 Moreover, Ripple denies that the SEC Complaint detailing Ripple’s and its management’s statements created user reliance and directs the court to view the

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188. See SEC Framework, supra note 22.
189. SEC Complaint, supra note 56.
190. See id. at 49.
191. See id. at 18.
192. See id.
193. See id. at 30.
194. Natural fluctuations are expected and accepted in cryptocurrency transactions. See Garlinghouse, supra note 72.
195. See id.
196. See SEC Framework, supra note 22.
198. See id.
document in its entirety, reasoning that each “document speaks for itself.”

**c. Other Relevant Considerations**

In explaining the other relevant considerations, the SEC raises the characteristics of Ripple’s treatment of XRP that resemble a security offering scheme. The SEC argues that the marketing tactics, offering structure, and encouragements to hold XRP as an investment favor security regulations.

In contrast, Ripple emphasizes the qualities that make XRP similar to a commodity and other virtual currencies. Ripple proponents point out that XRP has a different niche than other digital assets, so it follows that it is not structurally identical to others.

**B. RIPPLE’S FAIR NOTICE DEFENSE**

In its Answer, Ripple put forth the affirmative defense that Ripple was not given fair notice that it was violating any securities laws, which would be an infringement of Ripple’s due process rights. Ripple argues that in prior settlements with the U.S. Department of Justice and FinCEN, XRP was described as a “convertible virtual currency” and was required to comply with money service business regulations, and the SEC knew of the settlement and had not given Ripple notice that the SEC believed differently. Ripple further claims that former Director Hinman’s

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199. See generally Ripple Answer, supra note 47, at 68-77.
200. See generally SEC Complaint, supra note 56.
201. A senior executive’s email stated that “The primary use case for XRP today is speculative and the exchanges . . . are the main enabler of this use case.” Id. at 35.
202. Initially, XRP was given to the founders, which constitutes an offering and should have been registered. See id. at 10. The founders and Ripple continued to offer XRP on the same markets as Ripple and to investors, regardless of their need for the network, which also constitutes an offering and should have been registered. Id. at 11-15.
203. Ripple made it clear that they intended to hold it as an investment, which made it reasonable for investors to believe the same. Id. at 47.
204. See generally Ripple Answer, supra note 47.
205. See Giancarlo & Bahlke, supra note 122.
206. See Ripple Answer, supra note 47, at 91.
207. See id.
statements explaining that the present state of Ether was not a security led Ripple to believe that XRP would be regarded similarly.\textsuperscript{208}

The SEC refutes this position, claiming instead that there was fair notice since it had “already brought more than seventy cases that subjected other digital assets to the application of the federal securities laws.”\textsuperscript{209} The SEC also states that novel or nontraditional investment contracts have been subject to SEC regulations for the past 75 years.\textsuperscript{210} Thus, the SEC believes Ripple had fair notice.\textsuperscript{211}

\textbf{C: THE TWO SIDES OF THE SEC DIGITAL ASSET REGULATORY TOKEN}

Many individuals do not understand the nuances of each network and the applicable regulations.\textsuperscript{212} Even regulators are struggling to specify rules that balance protecting investors and market integrity while fostering growth and innovation.\textsuperscript{213} Many regulators want clear rules that take into account the digital asset network’s unique, decentralized structure so that it can fuel innovation.\textsuperscript{214} Alternatively, others believe security regulations are sufficient for digital asset regulations to protect investors and market integrity.\textsuperscript{215} This Section will outline both positions.

\textit{1. Flipping Heads: SEC Regulations May Hinder Crypto Growth}

The blockchain industry has long advocated for clear, consistent regulation of crypto assets and have proposed various ways of pursuing this goal.\textsuperscript{216} Many, including SEC Commissioner Peirce, Commissioner Roisman, and former CFTC Chairman Giancarlo, rationalize that SEC regulations require intermediaries at every step, and the utilization of the decentralized network makes transfer agents redundant and alter the

\begin{itemize}
\item \textsuperscript{208} See id. at 91-92.
\item \textsuperscript{209} Plaintiff Sec. & Exch. Comm’n’s Reply Memorandum L. Support its Motion to Strike Defendant Ripple Labs, Inc.’s Fourth Affirmative Def. at 1, Sec. & Exch. Comm’n v. Ripple Labs (2021) (20-CV-10832) [hereinafter SEC Reply].
\item \textsuperscript{210} See id. at 2.
\item \textsuperscript{211} See generally id.
\item \textsuperscript{212} Clayton, supra note 2 (reasoning that users have many questions including regulation and protections).
\item \textsuperscript{213} See infra Section II.C.1-2.
\item \textsuperscript{214} See infra Section II.C.1.
\item \textsuperscript{215} See infra Section II.C.2.
\item \textsuperscript{216} See generally Cohen, supra note 6; Shapiro, supra note 26.
\end{itemize}
innovative nature of this technology.\textsuperscript{217} Thus, these proponents are advocating for regulations that take into account the advancements of this technology.\textsuperscript{218}

Specifically, former CFTC Chairman Giancarlo explains that crypto innovation “presents the opportunity to solve some of the worst elements of our existing structure . . . its slowness, its expensiveness and, most unfortunate, its exclusiveness. . .”\textsuperscript{219} He continues by arguing that “we need to see it as revolutionary and be willing to be flexible with our existing models and look to this innovation to modernize shortcomings.”\textsuperscript{220} Digital assets have a unique technology setup that provides many benefits over traditional banking and, unfortunately, the application of securities regulations may minimize these advantages.\textsuperscript{221} For example, decentralized networks have a distinct ability to perform user transactions directly, quickly, and efficiently without financial intermediaries.\textsuperscript{222} Traditional transactions and bank verifications can take three to five business days and require transfer authentication from up to five parties.\textsuperscript{223} The speed and self–executing abilities of this technology increase transacting capacities.\textsuperscript{224}

The present security framework and its lack of clarity leaves many digital assets vulnerable to unintentional and unknown regulatory violations.\textsuperscript{225} Many networks aim to create a decentralized network that

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\textsuperscript{217} See infra Section II.C.2.
\textsuperscript{218} See id.
\textsuperscript{220} See id.
\textsuperscript{221} See id.
\textsuperscript{222} See Section I.A.
\textsuperscript{223} Tianyi Qiu et al., Ripple vs. SWIFT: Transforming Cross Border Remittance Using Blockchain Technology, 147 PROCEDIA COMPUT. SCI. 428, 430-31 (2019).
\textsuperscript{225} Ripple argues that it did not know, and still does not believe, that it was violating any securities regulations. It argues that XRP’s structure and function disqualifies it from being an investment contract. Ripple further claims that it was not given adequate time to correct its potential violations before the lawsuit was filed. See Garlinghouse, supra note 72. See, also U.S. Sec. & Exch. Comm’n v. Kik Interactive Inc., 492 F. Supp. 3d 169, 182-83 (S.D.N.Y. 2020) (arguing that it was not on notice that the Howey test applies to digital assets). See generally, Peirce & Roisman, supra note 13 (finding that there is a
\end{flushleft}
functions without any intermediaries or central entities that have adequate control over the network.\textsuperscript{226} Thus, demanding networks to comply with securities regulations requires an individual or entity to gather disclosure information for the SEC that would inhibit decentralization.\textsuperscript{227} Moreover, if the digital asset is treated as a security, the exchange where the transactions occur would have to comply with broker-dealer regulations.\textsuperscript{228} Many exchanges wish to avoid such requirements and may stop allowing transfers of the digital asset.\textsuperscript{229} The central entity is counteractive to decentralization and increases the costs of the network.\textsuperscript{230} The new structure would be more costly, involve more extensive monitoring,\textsuperscript{231} and likely render the network unsuitable for its current exchanges.\textsuperscript{232}

Aside from government regulations, each digital asset network is self-regulated by code that controls user conduct.\textsuperscript{233} Thus, it is not a completely lawless regime.\textsuperscript{234} The networks are held accountable since their success is correlated to their popularity and users will likely avoid networks riddled with issues.\textsuperscript{235} In the decentralize network, when

\begin{itemize}
\item lack of clarity in the current crypto regulatory landscape, leaving many unclear on the applicable regulations).
\item See Giancarlo Giudici et al., Cryptocurrencies: Market Analysis and Perspectives, 47 J. INDUS. & BUS. ECON. 1, 2 (2020).
\item See Peirce, supra note 21.
\item Id.
\item See, e.g., Tatum Sornborger, Move Over IPOS: Unicorn Direct Listings May be the New Mythical Beasts in Town, 26 FORD. J. CORP. & FIN. L. 215, 227-28 (2021) (finding in a variety of situations individuals and entities may try to avoid securities regulations due to the extensive fees associated with complying).
\item See Shen & De, supra note 229. For example, many of the exchanges that currently transfer XRP would no longer do so if it had to be registered as a security, causing the company to restructure. Id. Additionally, Regulation A would require trades with a broker-dealer, but the networks wish to eliminate intermediaries. Peirce, supra note 21.
\item See id.
\item See id.
anticipations issues do arise, the expansive network community can work together to remedy them.\textsuperscript{236}

SEC Commissioner Peirce believes when there is a struggle “to find a way both to comply with the law and accomplish their laudable objectives [like the current struggle in the crypto landscape], we need to ask ourselves whether the law should change to enable them to pursue their efforts in confidence that they are doing so legally.”\textsuperscript{237} Aligned with this sentiment, many in the blockchain community want to implement regulations towards digital assets that both provide clarity and fuel innovation.\textsuperscript{238}

2. Flipping Tails: SEC Regulations to Digital Assets to Protect Users and Market Integrity

SEC Chairman Gensler, SEC Commissioner Crenshaw, and former SEC Chairman Clayton believe that, in many instances, digital asset transactions on exchanges should be regulated by the SEC, since the digital assets function as investment contracts.\textsuperscript{239} The SEC regulates all schemes that operate as investment contracts, and insufficient decentralization may cause networks to operate as investment contracts.\textsuperscript{240} The SEC aims to protect investors and ensure fairness in the markets by requiring disclosures to increase information available to investors and minimize price manipulations and “pump and dump” schemes.\textsuperscript{241}

SEC Commissioner Crenshaw is skeptical that digital assets are more than a profit seeking endeavor that can be sustainable in their intended design.\textsuperscript{242} Thus, she encourages digital asset creators to be proactive and work with the SEC to comply with regulations until it is clearly no longer under SEC domain.\textsuperscript{243} Former SEC Commissioner

\begin{thebibliography}{9}
\bibitem{236} Id.
\bibitem{237} Peirce, supra note 21.
\bibitem{238} See generally Cohen, supra note 6.
\bibitem{239} See generally Gensler, supra note 5; Crenshaw, supra note 42; Clayton, supra note 2.
\bibitem{240} Reves v. Ernst & Young, 494 U.S. 56, 61 (1990).
\bibitem{241} U.S. SEC. & EXCH. COMM’N, supra note 50.
\bibitem{242} See Crenshaw, supra note 42.
\bibitem{243} Commissioner Crenshaw states that if the SEC regulations are inapplicable, there may be some opportunity for the creators to come up with “detail plans for how [the creators] will offer a comparable level of disclosure, investor protection, market access, and other important protections guaranteed by the securities laws.” Id.
\end{thebibliography}
Clayton agrees, encouraging issuers to either comply with the applicable securities regulations or demonstrate why it is not a security prior to launching. 244

SEC Commissioner Crenshaw explains that “investors have no way to determine if the prices and market they see is a product of manipulative trading, or if they have received sufficient disclosures about their investment to accurately price for risk.” 245 Thus, users are left with insufficient protections 246 and may be unaware that although the token may resemble an investment, users are not afforded the same protections as traditional investments.

Without SEC regulations, users are susceptible to increased risks. 247 Fraudulent actors often implement expansive schemes to profit off a token’s price volatility. 248 Fake buy and sell orders and “pump and dump” actions drive prices up, but then the bubble pops and the price declines once the fraudulent actor sells. 249 Such a pop is harmful to common investors who often buy when they see a price surge, and then, when there is a sharp price decline, their financial health suffers. 250 Generally, regulations minimize the proliferation of these bad actors. 251

In response to the argument that securities regulations are impracticable due to the digital asset network’s structure, Former SEC Chairman Clayton argues that the impracticability should be irrelevant; it must be regulated as a security if it functions as one. 252

In conclusion, the aforementioned SEC Commissioners, along with many others, believe that SEC oversight aids in minimizing informational asymmetries that increase risk and safeguards against many price

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244. See Clayton, supra note 2.
245. See Crenshaw, supra note 42.
246. See Gensler, supra note 5.
247. See, e.g., id.
249. Id.
250. See Neil Gandal et al., Price Manipulation in the Bitcoin Ecosystem, 95 J. MONETARY ECON. 86, 95 (2018) (explaining that price rose 4% on days when suspicious trading occurred).
251. The SEC has been bringing cases against these harmful fraudulent actors. See Gensler, supra note 5.
252. See Clayton, supra note 2.
manipulations and “pump and dump” schemes that are especially prevalent on the digital assets landscape.\textsuperscript{253}

**D. AS THE COIN SPINS: COMMISSIONER PEIRCE’S SEC SAFE HARBOR PROPOSAL 2.0**

Regardless of whether SEC regulations applies to a mature, decentralized network, in their infancy, digital asset networks often appear as an investment contract.\textsuperscript{254} The questions become: (1) when does the token fundraising scheme that constitutes a security become so separate from the initial scheme that it is now its own token for use; and (2) how should the token be treated for securities purposes? Before a digital asset becomes successful, the network may need to gain momentum to be self-sufficient on a slightly centralized network.\textsuperscript{255} During this time, the scheme in which the token was sold functions similarly to an investment contract.\textsuperscript{256} On account of this, the SEC requires issuer registration and compliance with SEC regulations for initial coin offerings, as it contends such regulations are necessary to protect users.\textsuperscript{257} However, the continued registration requirements may prevent the tokens from achieving its intended design and the network from becoming decentralized.\textsuperscript{258}

SEC Commissioner Peirce has carved out a plan: the Safe Harbor Proposal 2.0.\textsuperscript{259} Under this blueprint, networks would have a grace period where the SEC would provide “no action” notices, permitting the

\textsuperscript{253} See supra notes 232-36 and accompanying text.

\textsuperscript{254} See Peirce, supra note 21.

\textsuperscript{255} See id.

\textsuperscript{256} See id.

\textsuperscript{257} See Gensler, supra note 5.

\textsuperscript{258} See Alon Harony, Initial Coin Offerings (ICOs): SEC Regulations and Available Exemption From Registration, SMITH GAMBRELL RUSELL, https://sgrlaw.com/initial-coin-offerings-icos-sec-regulation-and-available-exemptions-from-registration/ [https://perma.cc/WCW3-DFT7] (last visited Apr. 7, 2021). However, due to the time and cost of these regulations, many of the digital assets simply avoid issuing in the United States. Id.

networks to decentralize.260 “No action” notices do not force the SEC to concede whether the digital asset is or is not a security, or expend resources investigating the network’s structure.261 As a result, networks have time to increase their membership to function without the founders’ or central entities’ heightened control.262

Under this proposal, networks will have until either “network maturity” or three years before it must concede to SEC or other regulations.263 “Network maturity” occurs when the network achieves sufficient decentralization264 or token functionality.265

Entities in the safe harbor would have to complete certain disclosures, including the source code, transaction history, token economics, plan of development, prior token sales, initial development team and certain token holders, trading networks, sales of tokens by the initial development team, related person transaction, and a warning to token users.266 The digital asset would also have to provide a plan of development and update it semiannually.267 The disclosures would minimize information asymmetries between the networks and users that concern the SEC, while also protecting the network during this fragile

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260. See id. “No action” notices will save the SEC the time and resources of determining if it is an investment contract and allow the currency to grow without being stifled by securities regulations. See id.
261. See id.
262. See id.
263. See id.
264. Decentralization is achieved when it is:

[N]ot economically or operationally controlled and is not reasonably likely to be economically or operationally controlled or unilaterally changed by any single person, entity, or group of persons or entities under common control, except that networks for which the Initial Development Team owns more than 20% of Tokens or owns more than 20% of the means of determining network consensus cannot satisfy this condition.

Id.
265. Id. (stating functionality is “demonstrated by the holders’ use of Tokens for the transmission and storage of value on the network, the participation in an application running on the network, or otherwise in a manner consistent with the utility of the network”).
266. See id.
267. See id.
Arguably, it could provide the digital asset with the time and tools to expand and give the network space to decentralize without regulations that completely stall its growth and make it unmarketable.

At the end of three years or when “network maturity” is achieved, an external counsel will provide an “exit report.” The exit report would include either an analysis by outside counsel explaining why the network is decentralized or functional, or an announcement that the tokens will be registered under the Securities Exchange Act of 1934. The exit report would explain why the network is decentralized or functional through qualitative and quantitative data. The test for both decentralization and functionality would be flexible guidelines that would vary, which Peirce argues will best account for various technological structures.

Peirce’s critics fear that the three-year grace period will simply “kick the can down the road,” and after the safe harbor, if is still considered a security, the networks will again argue they are not a security or ask for more time. However, these claims can be refuted by reasoning that the specific deadline should motivate networks to act within the time window. The same critics are also concerned that the token holders may be exposed to substantial risk since the proposal does not address speculative trading on secondary markets. Yet, the disclosures will increase transparency on the network and ideally, minimize speculative trading on secondary markets since there will vetted information available.

Overall, there are many possibilities for digital asset regulation and substantial arguments in favor and against each. To find the best solution, regulators should balance the interests of the users as well as the potential successes of the networks.

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268. See Peirce, supra note 21.
269. See id.
270. See Peirce, supra note 259.
271. See id.
272. See id.
273. See id. (stating that the framework would not be a bright-line test).
276. See supra Section II.C.1-2.
III. THE MIDDLE GROUND: SEC SAFE HARBOR AND CFTC REGULATION

Digital asset transactions are unlike other regulated structures, and their innovative nature should be protected.277 With that said, there will be instances when the SEC will need to regulate schemes that constitute unregulated securities offerings. This Section will project how the Howey test will apply to XRP and outline a middle ground where both the SEC and the token can fulfill their missions and thrive.

A. PREDICTIONS FOR SEC v. RIPPLE OUTCOME

1. The Howey Test

In the end, the courts will likely find that XRP should be treated as a continuous security offering. The SEC will likely prove Ripple’s continued actions on XRP pass the Howey test, or that XRP was an investment “in a common enterprise and [user are] led to expect profits solely from the efforts of the promoter or a third party.”278

First, even if XRP was not intended to be an investment, it functions as an exchange of a current payment for a future profit, fulfilling the most basic understanding of an investment.279

Secondly, circuit courts have agreed that digital assets pool funds, so XRP would likely fulfill horizontal commonality.280 Moreover, Ripple has continually promoted its managers’ experience and expertise in relation to XRP, fostering user reliance on managerial expertise and showing broad vertical commonality.281 Further, Ripple and its managers own a substantial portion of the tokens, intertwining Ripple’s managers’ and XRP users’ interests and showing narrow vertical commonality.282

Third, XRP’s price fluctuations are caused by Ripple’s managers marketing, targeting, and discounting techniques which creates speculative values and leads to a reasonable user reliance on Ripple’s efforts for profits.283 Ripple contends that the XRP network’s current

277. See Braun, supra note 219.
279. See generally SEC Complaint, supra note 56.
280. See generally id.
281. See id.
282. See id.
283. See Section II.A.3 and accompanying text.
configuration is sufficiently decentralized, removing users’ reliance on Ripple and minimizing the impact Ripple’s activities would have on profits.\textsuperscript{284} Since XRP’s inception, Ripple has decreased its influence substantially, going from controlling 100 percent of the network validators and 80 percent of XRP tokens to approximately 16.6 percent and 11.8 percent, respectively.\textsuperscript{285} Comparatively, in Commissioner Peirce’s Safe Harbor Proposal 2.0, she places decentralization at under 20 percent ownership.\textsuperscript{286} Under this standard, and if its ownership projections are correct, Ripple’s 12 percent ownership of the XRP market would be considered a significant level of decentralization.

However, beyond its ownership of XRP tokens, Ripple, its founders and management play a behind the scenes role, constantly manipulating the price of XRP for their own profits.\textsuperscript{287} There were targeted efforts to draw in users with no intention to use the token for its intended design, price discounts that guaranteed user profit, and speculative statements that created reasonable user reliance on Ripple to increase popularity.\textsuperscript{288} There is also an asymmetry of information where Ripple has detailed information and performs intentional, calculated releases for its benefit.\textsuperscript{289} Thus, the increase in value of XRP tokens appears to be beyond simple market fluctuations, the value derives from Ripple and its founders’ efforts.\textsuperscript{290} Ripple can and is manipulating the prices of XRP and avoiding disclosures so users are left with insufficient protections.\textsuperscript{291}

2. Fair Notice

Ripple’s greatest chance of success would be its fair notice affirmative defense. Ripple claims that the SEC knew Ripple was under the impression that it was not a security based on former settlements with the U.S. Department of Justice and FinCEN, as well as former Director Hinman’s statement that whether or not a digital asset is a security is based on the present state of the token, not prior fundraising scheme, of

\textsuperscript{284} See supra Section II.A.3.
\textsuperscript{285} These numbers are reflective of Ripple’s ownership on March 21, 2021. See Market Performance: XRP Market Metrics, supra note 88.
\textsuperscript{286} Peirce, supra note 259.
\textsuperscript{287} See supra Section II.A.3.
\textsuperscript{288} See generally, SEC Complaint, supra note 56.
\textsuperscript{289} See supra Section II.A.3.
\textsuperscript{290} See id.
\textsuperscript{291} See supra Section II.A. See also supra Section II.C.2.
the digital asset. A similar fair notice notion was put forth by SEC Commissioners Peirce and Roisman regarding Coinschedule, where they argued that market participants have questions, and prior SEC litigation may not be very helpful since “applying those clues to the facts of a completely different token offering does not necessarily produce clear answers.”

However, ultimately, since the Howey test is a flexible standard that has been applied to various nontraditional schemes, including digital assets, and the SEC has outlined a non-exhaustive list of facts applicable to digital assets, it is likely that this claim will fail.

Irrespective of the outcome of Ripple, the policy concerns, specifically unclear notice of when and how regulations apply, put forth in this case need to be ironed out by the SEC, CFTC, and Congress. The Ripple case will provide more fact specific inquiries, but the regulators need more detailed explanations in regard to decentralization. Regulators need to depict a clear framework that will minimize confusion and the gaps in regulation. Going forward, Commissioner Peirce’s Safe Harbor Proposal 2.0 can help digital asset networks reach decentralization. At the end of the safe harbor, the classification of the digital asset will be clear, and all will be on notice of the required regulations.

B. Eliminating the Coin Toss: SEC Safe Harbor Protects Digital Assets

In light of the above, treating digital asset transactions as securities is not the best method to address the concerns enumerated in this Note. The goal of this Note is to analyze how to treat digital assets for securities

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292. *See Ripple Answer, supra* note 47, at 91.
293. *See id.*
294. Coinschedule is a website that publicized current and upcoming digital asset offerings and the SEC ordered that they were offered and sold and investment contract. *See Peirce & Rosiman, supra* note 13.
295. *See id.*
298. *See Peirce, supra* note 259.
299. *See id.* (reasoning that the exit report will define whether the token is a security or not).
purposes and who should regulate digital asset transactions as the network decentralizes. Given the complexity of these arguments, a definitive answer is challenging. However, I propose that the most beneficial form of regulation would be if the SEC adopts a modified version of Commissioner Peirce’s Safe Harbor Proposal 2.0 and then, if sufficiently decentralized, to have the CTFC regulates these digital asset transactions and if not, to turn regulation over to the SEC.

The safe harbor provides networks with time to evolve from a fundraising scheme that is that of a security into a self-sufficient network with tokens that are for use. It puts forth the best method for regulation of digital assets, when they are more centralized and appear to function similar to an investment contract. At the start, it is often unclear if the digital asset will be structured as a security or commodity. Thus, the safe harbor provides networks with time to reorganize and ideally reach their goal setup without being overwhelmed by regulatory requirements.

The modified regulation by the SEC is necessary during the grace period because, due to the volatile nature of digital assets, token price manipulations, and speculative statements by issuers, users can lose large sums of money instantaneously, especially at the inception of the network. When the purpose and direction of the digital asset is unclear, cursory SEC regulations can protect users and help the network achieve long-term success. It makes sense for the tokens to initially follow some SEC rules and work with the agency to decentralize rather than apply the unsuitable SEC regulations quickly once the SEC deems the token to be a security.

To ensure that SEC regulations do not cripple the growth of blockchain technology in businesses and cause quick, massive declines, the safe harbor regulations should reflect digital assets structures. It would require the disclosures outlined in Commissioner Peirce’s Safe Harbor Proposal 2.0, including disclosing the source code, transaction history, token economics, plan of development, prior token sales, initial development team and certain token holders, trading networks, sales of

300. Id.
301. See generally id.
302. See id.
303. Id.
304. See Clayton, supra note 2.
tokens by the initial development team, related person transactions, and a warning to the token users.\footnote{Peirce, supra note 259.}

In addition to disclosing token economics, the SEC should ensure there are guidelines in place that limit the central entity’s targeting mechanisms, purchasing efforts, and ability to give price discounts.\footnote{Ripple’s price discounts and targeted strategies were similar to a security. See generally SEC Complaint, supra note 56.} Guidelines should include limitations on the number of tokens the central entity can repurchase after issuance and on the number of purchases by a singular user to try to minimize “pump and dump” schemes.

Furthermore, the guidelines should address issuance and distribution requirements that specifically prohibit discounts to protect the integrity of the market price. The SEC should create a non-exhaustive list of prohibited statements that would appear to create speculative values.\footnote{A major issue with XRP was the manner Ripple promoted XRP and how it created a false notion of XRP’s purpose. See supra Section II.A.} The issuers may create speculative value through their statements and press releases.\footnote{See id.} Some statements may just represent the issuers hope for the digital asset;\footnote{See Peirce, supra note 21.} however, some statements may be more troublesome and lead to user reliance. Minimizing speculative statements may protect users from manipulations and, ideally, attract those users with the optimal use for the token’s general purpose.

There are various types of digital assets, including those where users mine for tokens, like Bitcoin, and others where the initial funds are created and capped, like XRP.\footnote{See supra Section I.A.} Token issuances lend more to the structure of an investment contract, and more robust guidelines and instructions may be necessary for them to decentralize and succeed.\footnote{Initial coin offerings constitute investment contracts. See Gensler, supra note 5.}

As discussed above, the safe harbor will save the SEC countless resources devoted to analyzing and investigating these networks structures when attempting to determine whether they are securities.\footnote{See supra Section II.D.} Although investment contracts are regulated more strictly than networks in the safe harbor, the SEC can still protect users through the required disclosures and protect the digital assets networks innovative nature as

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305. Peirce, supra note 259.
306. Ripple’s price discounts and targeted strategies were similar to a security. See generally SEC Complaint, supra note 56.
307. A major issue with XRP was the manner Ripple promoted XRP and how it created a false notion of XRP’s purpose. See supra Section II.A.
308. See id.
309. See Peirce, supra note 21.
310. See supra Section I.A.
311. Initial coin offerings constitute investment contracts. See Gensler, supra note 5.
312. See supra Section II.D.
well.\textsuperscript{313} The trade-off for slightly decreased regulations would be beneficial when looking at the bigger picture and growth of the digital assets industry.

Under the safe harbor, tokens are exempt from securities regulations if certain safe harbor conditions are met until the network is sufficiently decentralized or functional.\textsuperscript{314} If it is, I propose it should be regulated as a commodity under the purview of the CFTC. If it is not, the tokens should comply with securities regulations.\textsuperscript{315} Currently, the crypto regulatory space has many gaps.\textsuperscript{316} After the safe harbor period, the classification of the digital asset will be clear, and clear classifications prompt stability.\textsuperscript{317} Notice of the applicable regulatory framework too, regardless of the regulation, will help promote confidence in the digital asset.\textsuperscript{318}

The safe harbor permits a three-year grace period for issuers to gain enough momentum to relinquish control and become adequately decentralized.\textsuperscript{319} Semiannual disclosures minimize information asymmetries and increase transparency, since users will have increased access to data surrounding the network.\textsuperscript{320} Moreover, networks will be motivated to decentralize to avoid continued semiannually reporting to the SEC or compliance with their other requirements.

Critics argue that the safe harbor will simply push the discussion of SEC regulations of digital assets three years later.\textsuperscript{321} However, I disagree. Digital assets need time to develop the network and to gain popularity.\textsuperscript{322} By stopping these innovative actors at the start by treating all transactions as securities, society may lose out on the products of many creative thinkers.\textsuperscript{323} Ideally, after three years, the network will be significantly decentralized and treated as a commodity, not a security. If it does not decentralize, it will have complied with some SEC requirements, so transitioning to full SEC requirements for investment contracts should not be as detrimental to the network as it would otherwise. There will be clear

\textsuperscript{313} See Peirce, supra note 259.
\textsuperscript{314} See id.
\textsuperscript{315} See id.
\textsuperscript{316} See Peirce & Roisman, supra note 13.
\textsuperscript{317} See id.
\textsuperscript{318} See id.
\textsuperscript{319} See id.
\textsuperscript{320} See id.
\textsuperscript{321} See Wink et al., supra note 274.
\textsuperscript{322} See supra Section II.C.2.
\textsuperscript{323} See id.
notice of the applicable, realistic regulatory framework and the creators can plan accordingly.\footnote{See supra Section II.D.}

The network maturity tests are flexible guidelines that will help account for various facts and circumstances of each digital asset.\footnote{See Peirce, supra note 259.} Some fear that the lack of a bright-line test may not adequately account for all structures.\footnote{See Wink et al., supra note 274.} However, a flexible test, specifically created with decentralized technology in mind will account for the various niches and setups that need versatile requirements to facilitate the greatest likelihood that each network can meet the requirements and its own goals.

The SEC and CFTC have been working together to determine digital asset regulations.\footnote{See Jay Clayton, Chairman, U.S Sec. & Exch. Comm’n, Chairman’s Testimony: The Roles of the SEC and CFTC, (Feb. 6, 2016).} The Safe Harbor Proposal 2.0 offers a unique, innovative middle ground. After the safe harbor, the sufficiently decentralized network may be regulated by the CFTC or choose to be a security and comply with SEC’s regulations.

**CONCLUSION**

Currently, there are multiple bills before Congress regarding digital asset regulation.\footnote{See, e.g., Eliminate Barriers to Innovation Act, H.R. 1602, 117th Cong. (2021). As of the filing of this Note, the bill was pending before the Senate). Digital Commodity Exchange Act of 2021, H.R. 117thCong.} Two examples are the bipartisan Eliminate Barriers to Innovation Act, which attempts to establish a digital asset working group between the SEC and CFTC,\footnote{See Eliminate Barriers to Innovation Act, supra note 328.} and the Digital Commodity Exchange Act of 2021, which attempts to provide guidance on digital commodity regulation.\footnote{Under the bill, a digital commodity will be “any form of fungible intangible personal property that can be exclusively possessed and transferred person to person without necessary reliance on an intermediary, and which does not represent a financial interest in a company, partnership, or investment vehicle.” Digital commodities will be regulated by the CFTC. Under the bill’s suggested terms, any presales of such commodities for future value or sales prior to its listings on a registered exchange will be prohibited and may fall into the SEC or other state or agencies domains. Digital Commodity Exchange Act of 2021, supra note 328.} Hopefully, Congress will provide greater regulatory clarity...
and balance the policy concerns regarding digital asset transactions through legislative guidance.

Judge Netburn, the current Judge presiding over SEC v. Ripple, summed it up well—the matter “involves significant policy decisions in our markets, the amount of controversy is substantial and the public’s interest in this case is significant.”331 The outcome of the Ripple action will affect many current and future digital assets and may hinder or heighten the technological innovations in the United States as a result. Due to the massive implications for the U.S. financial and technological sectors, the regulatory regime for digital assets needs to be thoroughly examined with all avenues of regulation explored. The policy concerns should be methodically analyzed and robust framework put forth by Congress, the SEC, and the CFTC.

There will be some networks that ultimately fall under SEC regulations. Still, the digital assets that function in a gray area should be granted the opportunity to transform and comply with a regulatory framework that best fits their innovative structure and overall purpose. Digital assets are a new and exciting field that must be regulated to protect the users of the network. This Note argues that a modified version of the safe harbor proffered in the Safe Harbor Proposal 2.0 balances digital asset innovation and users’ protection. The safe harbor provides a middle ground that addresses the concerns of both those who believe that SEC regulations are needed to protect users and market integrity, as well as those who fear that SEC regulations would stifle the growth of digital assets and blockchain technologies. The safe harbor requires transparency and disclosures that are specifically based on the technological setup of decentralized networks which balance user protections and market integrity with technological growth and innovation.

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