

Will the Coffey Class Action have a Ripple Effect?

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The question as to whether crypto-assets should be classified as securities has been widely discussed both in Canada and the United States, with the Canadian Securities Administrators (CSA) recently publishing guidance on this point in [CSA Staff Notice 46-308 - Securities Law Implications for Offerings and Tokens](#). Now, thanks to a class action lawsuit launched against Ripple Labs, the United States federal court also has a **chance to weigh in on this issue**. Coffey v Ripple Labs Inc., is a class action lawsuit filed by Ryan Coffey in May of this year in which it is alleged that Ripple Labs' XRP tokens constitute securities and, as such, their unregistered sale violates state and federal securities laws. The proceeding is filed as a class action on behalf of Ripple owners, believed to be in the thousands by the plaintiff, and could have potential implications for other crypto-asset issuers and owners.

The Facts

Ripple, a currency exchange network that is ranked in the top three by market capital, uses XRP tokens as its native currency. Unlike some other crypto-assets, XRP tokens are created by Ripple, not mined. Out of the 100 billion XRP tokens created at the protocol's establishment, **a little over 8 billion are held by Ripple, slightly over 39 billion are distributed**, and close to 53 billion are held in escrow. It is important to note that the "distributed" XRP token figure includes the 20 billion retained by the creators at the project's inception, as well as pending business development agreements. **Ripple's protocol doesn't allow for any additional XRP tokens to be created.**

This centralization of tokens is one of the biggest criticisms against Ripple from the crypto-community. The statement of claim from Coffey asserts that "the XRP Ledger relies on trusted nodes operated by Ripple Labs to verify the legitimacy of transactions and maintain agreement on the network" and that "the trusted nodes are either selected or controlled by Ripple Labs itself". One of the most attractive features of Blockchain and crypto-assets for many users and investors is the fact that they are decentralized, which minimizes the risk of data manipulation and promotes openness in transactions.

Risks associated with third party intermediaries are still present in Ripple and its payment protocol.

Despite other allegations against Ripple by Coffey (including a never-ending ICO, corruption and attempted bribery of popular cryptocurrency exchanges), the question at the heart of the claim is whether the XRP token should be classified as a security. Due to the differing characteristics of crypto-assets, it is hard to classify the entire class of assets as a currency, a security or other traditional financial instruments. One end of the spectrum has cryptocurrencies like Bitcoin, which are used mainly to store and transfer value over a decentralized peer-to-peer network without a need for an intermediary, such as a bank. On the other end of the spectrum, Blockchain tokens sold through the DAO, a digital decentralized autonomous organization, functioned very differently. The DAO was essentially a crowdfunded and investor directed venture capital fund, where token holders made collective decisions on investments and would share in the upside of DAO funded enterprises. The DAO token sales were all classified as securities by the U.S. Securities and Exchange Commission ("SEC") as early as July 2017. In the Securities Enforcement Forum West 2018, the panel covering cryptocurrencies and ICOs agreed that as long as the SEC and other regulators continue to treat token issuances as securities offerings, the number of investor class actions inevitably will increase. Many crypto-assets (especially tokens) display characteristics of both classic currencies and securities, which is why some jurisdictions, including Canadian ones, use a case-by-case analysis to determine the classification of these digital assets. However, this can cause confusion and uncertainty in the marketplace amongst both ICO issuers and investors.

The Howey Test

While the technology behind crypto-assets is a new one, the question of whether an instrument constitutes a security is not. In the United States, section 2(a)(1) of the Securities Act of 1933 includes an "investment contract" as the definition of a security. The leading case from the U.S. Supreme Court is Securities and Exchange Commission v W J Howey Co (1946), which introduced the test to determine whether an instrument can be classified as an "investment contract". The test, known as the Howey Test, **states that "a contract, transaction or scheme whereby 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, it being immaterial whether the shares in the enterprise are evidenced by formal certificates or by nominal interests in the physical assets employed in the enterprise" will be deemed to be an investment contract and therefore a security.**

The complaint by Coffey is premised on the argument that the Howey Test is met because "the success of the XRP Ledger, and the profits the Class reasonably expected to derive from investing in XRP are dependent solely on the technical, entrepreneurial, and managerial efforts of Defendants and their agents and employees" and that the **XRP scheme is built upon "structured agreements so that their partners' compensation is tied to appreciation of XRP – just as companies often do with shares to ensure that their interests are aligned"**. According to the Howey Test, whether XRP constitutes a security is based on whether the profits arise solely from the efforts of the promoter or a third party. However, the SEC report on the classification of DAO tokens as securities took a less stringent route and found it was the "undeniably significant" efforts of the DAO Curators that was essential to the success and profitability of these investments and, as such, these tokens should be classified as securities.

The case against Ripple is not the only claim that examines this issue. Other cases filed against ICO issuers in the U.S. include:

- In re Tezos Securities Litigation, Nos. 17-cv-06779, 17-cv-06829, 17-cv-07095 – claiming unregistered sale of Tezos tokens
- Rensel v. Centra Tech Inc., No. 17-cv-24500– **claiming Centra’s ICO constituted an unregistered offering and sale of securities**
- Hodges v. Monkey Capital, LLC, No. 17-cv-81370– **claiming fraudulently issuing securities ahead of the ICO**
- Balestra v. ATBCOIN, LLC, No. 17-10001– **claiming ATBCoin issued unregistered securities**
- Stormsmedia, LLC v. Giga Watt, Inc., No. 17-cv-00438– **claiming violation of the Securities Act by issuing unregistered securities**
- Moss v. Giga Watt, Inc., No. 18-cv-00100– **claiming violation of the Securities Act by issuing unregistered securities**

Implications for Canada

The decisions in these lawsuits will impact the Canadian crypto-market. While not binding, Canadian courts and regulators often look to their American counterparts in order to have a cohesive market. The term "investment contract" is also used in the definition of a security in Canada and, like the U.S., the term is undefined in most provinces (**Manitoba and Québec have a definition for investment contracts in their respective securities acts**).

In Canada, the two main tests to determine a security’s existence are adapted and modified from their U.S. counterparts. The first test in Canada is derived from the Howey Test and requires a common enterprise in which the expectation of profits flow from the "undeniably significant" efforts of persons other than the investor. The second test is an adaptation of the risk capital test from *Hawaii v Hawaii Market Center* (1971). This test looks at the risks of an enterprise over which the offeree exercises no control and whether the investment is induced by representations of profits by the offeror. However, while these tests can be used to find the existence of a security, the Supreme Court of Canada has taken a broader approach and found that an instrument can constitute a security even if the two tests are ineffective. Given the broad definition of a security in Canada, if XRP tokens are found to be a security in the U.S., it is likely that they will be classified as a security in Canada as well.

Even if XRP tokens are classified as a security by the United States federal court or the SEC, this decision may not be conclusive on how to classify other crypto-assets. The differences between XRP tokens and other crypto-assets, including decentralization and the business practices of Ripple, are significant ones. Other assets would have to be evaluated on their own merits. As such, while a decision in the case against Ripple will be important for the crypto-community, each token needs to be considered in light of its own circumstances. Even with the recently provided guidance from the securities regulatory bodies, an influx of lawsuits against crypto-companies can be expected in order to provide a greater level of certainty.

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