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Ripple's Discovery Wins Over SEC Offer Defense Strategies

By **Kevin O'Brien** (August 2, 2021, 11:58 AM EDT)


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The recent success of Ripple Labs Inc. in gaining access to U.S. Securities and Exchange Commission files, as well as the right to take testimony from a former agency director, could be a watershed event in SEC enforcement actions.

Lawyers representing defendants sued by the SEC often seek internal evidence of staff decisions and thought processes, hoping to undermine the agency's public positions underpinning the complaint, but they almost never succeed.

The reasons given for denying these requests are familiar: The SEC's representations and legal opinions stand or fall on their merits, without the need for any discovery, and its good faith, to the extent it might be relevant, should ordinarily be assumed.

SEC v. Ripple Labs is now before the U.S. District Court for the Southern District of New York. The case, in which the SEC has taken on a leading blockchain technology company, breaks the mold.

The question posed in the case is whether Ripple's digital token, XRP, is an investment contract and therefore a security under the federal securities laws.

If the answer is anything other than yes, the SEC has no case and no jurisdiction to proceed.

Back in February, at the first case status conference, both sides staked out aggressive discovery positions on this question.

Ripple announced it was considering a motion — which it ultimately brought — to compel the SEC to produce documents reflecting internal discussions, as well as discussions with third parties, about whether the agency considered XRP sales to constitute an unregistered securities offering.

For its part, the SEC claimed it was entitled to legal memos that Ripple's leadership reportedly received in which the company was warned these sales could in fact involve securities.

The agency lost both battles. In June, U.S. Magistrate Judge Sarah Netburn, overseeing discovery in the case, denied the SEC's motion for access to the memos because they were protected by the attorney-client privilege. She specifically rejected the standard argument that the defendant had effectively waived the privilege by raising a reliance on counsel defense or in some other way putting "its subjective state of mind" in issue.

She clarified that Ripple's defense instead, according to its answer, was that the SEC had failed to provide fair notice to the market that XRP might be considered an investment contract.

This defense, the court concluded, "does not involve the company's own understanding about XRP's legal status."

That conclusion may or may not be correct — it can be argued either way — but Ripple's farsighted pleading of the fair notice defense carried the day.

In contrast, Ripple's bid for the SEC's internal files was successful, despite the apparent odds.

In April, ruling from the bench, Judge Netburn held that as a general matter, SEC minutes and memos "expressing the agency's interpretation or views" on XRP were discoverable, subject to specific arrangements between the parties.

The court appeared to give credence to Ripple's complaints that the SEC had kept silent for eight years before bringing suit, apparently unsure whether XRP was a security or not. The SEC, in allegedly keeping its doubts to itself, may have failed to provide fair notice.

However, the biggest setback for the SEC was Ripple's discovery that in June 2018 former SEC Division of Corporation Finance Director Bill Hinman had given a speech opining that two other cryptocurrencies, bitcoin and ether, were not in fact securities.

Ripple went back to court earlier this month to enforce a subpoena to depose Hinman in order to shed light on the agency's position on XRP.

The SEC opposed the move on the usual grounds, arguing that Hinman had no firsthand knowledge of the facts and that the court should not open the door to routine depositions of high-ranking agency officials, even if they spoke publicly about positions that underlie enforcement actions. Deposing SEC officials on such a thin basis, the agency said, would "disrupt the functioning of government" and deter qualified people from entering public service.

The court took issue with the agency's dire forecast, ordering Hinman to sit for the deposition.

"This is not a run-of-the-mill SEC enforcement case," the court explained, and therefore Hinman's deposition would not "open the floodgates." The case "involves significant policy decisions in our markets, the amount in controversy is substantial, and the public's interest in this case is significant."

Defense lawyers will find it hard to resist the conclusion that their SEC cases, too, far from being run-of-the mill, present significant policy decisions that must be explored through discovery.

Good candidates will not be difficult to find, since making policy for the securities industry is part of the reason why the SEC brings enforcement actions.

Of course, this is only the start. The goal for defense lawyers is to build a predicate for persuading a court, as Ripple did, that the agency may be saying one thing behind closed doors and something else in court, requiring disclosure of the agency's inner workings.

This project requires being alert to every circumstance that suggests inconsistent positions or lack of candor on the part of the government.

It also requires hard work, the devotion of possibly hundreds of hours of investigation and document review scouring the record for inconsistencies, which the Ripple lawyers obviously put in.

The project may also require luck. Clarifying moments or epiphanies like Hinman's speech do not happen often.

Without them, the defense has to try to accumulate enough details calling into question the government's credibility to open up lines of inquiry that may bear fruit later on and support offensive discovery.

Small victories, sometimes, can lead to larger ones down the road.

Meanwhile, though, an aggressive approach has other rewards. Chipping away at the SEC's credibility can convince the court to shed its reflexive deference to the agency, which can be hugely valuable in an enforcement case, removing the invisible shield that protects the agency from the consequences of its own mistakes — a protection the defense almost never enjoys.

Credibility attacks also put the government on the defensive, compelling it to devote time and manpower to running down claims, searching for documents and formulating responses.

In addition, playing defense tends to be demoralizing. SEC lawyers, like those of any government agency, are accustomed to wearing the white hat. When they have to answer repeatedly for their erroneous or questionable representations, as the SEC attorneys in Ripple have had to do, they lose their focus.

As one SEC lawyer complained to Judge Netburn at the hearing in April, defendants are trying to put the SEC on trial.

Finally, an offensive strategy can create possibilities for settlement that otherwise would not be available, although it is unlikely that Ripple is contemplating settlement now, when it does not yet know what SEC documents or testimony it will obtain.

Ripple's ability to have the complaint dismissed without a full-blown trial is far from certain. Its success to date, though, has already put the SEC on the defensive and sensitized the court to government errors and misstatements, intentional or otherwise.

Both are significant tactical advantages in a closely contested litigation where the fate of the company may be at stake.

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