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Alert | Blockchain & Digital Assets

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SEC v. LBRY, Inc.: The SEC's Latest Crypto Victory

On Nov. 7, 2022, the U.S. District Court for the District of New Hampshire granted the Securities and Exchange Commission's motion for summary judgment in *SEC v. LBRY, Inc.*, awarding the SEC another victory in the cryptocurrency space. In its complaint, the SEC alleged that defendant LBRY Inc.'s offer and sale of its LBC digital token constituted an unregistered securities offering in violation of section 5 of the Securities Act of 1933. In granting the SEC's summary judgment motion, the court agreed, declaring that "no reasonable trier of fact could reject the SEC's contention that LBRY offered LBC as a security." Practitioners should note some key language in the court's opinion given the SEC's ongoing cryptocurrency enforcement campaign.

Background

LBRY operates a blockchain-based file sharing and payment network. A "blockchain" is a distributed ledger that tracks the current and historical state of accounts, transactions, and/or events occurring on a network of computers. In 2016, LBRY released the LBC digital token, which was stored, transferred, and recorded on the LBRY blockchain. According to the SEC's complaint (filed in March 2021), at various times between 2016 and 2020, LBRY offered the LBC token directly to secondary market purchasers despite not having registered these offerings with the SEC.

At the core of the dispute between the parties was whether LBRY was required to register the LBC token, or qualify for an exemption to such registration—i.e., whether LBC could be considered an "investment contract" subject to the U.S. securities laws. While the term is not defined by statute, the U.S. Supreme Court in *SEC v. W.J. Howey Co.* set forth an analysis to determine what constitutes an "investment

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contract." Under *Howey*, an investment contract must involve: (1) the investment of money; (2) in a common enterprise; (3) with an expectation of profits to be derived from the efforts of the promoter or a third party.

The Parties' Arguments

In May 2022, the SEC and LBRY each filed motions for summary judgment. In its motion for summary judgment, the SEC urged that LBRY's offering of LBC was an "investment contract" because it satisfied all three prongs of the *Howey* test. LBRY did not dispute that the first two prongs of *Howey* were satisfied, and thus the SEC focused on *Howey's* third prong: that a reasonable purchaser of LBC would have expected profits to be derived from LBRY's efforts. The SEC stressed that LBRY repeatedly announced that it expected LBC to increase in value as the company's products were further developed. The SEC also noted that LBRY held much of the LBC it created, giving the company a large financial stake in increasing the price of LBC by developing its network and applications. According to the SEC, this signaled to LBC purchasers that LBRY would undertake efforts to increase LBC's price.

LBRY argued the LBC tokens were not securities. Specifically, LBRY focused on the fact that: (1) LBRY did not conduct an Initial Coin Offering (ICO); and (2) LBRY's blockchain was fully developed and launched *prior to* the sale of any LBC tokens. In LBRY's view, these facts distinguished it from past SEC cryptocurrency cases such as *SEC v. Telegram Group*, in which cryptocurrency purveyors have used ICOs to develop and launch their blockchain or ecosystem. According to LBRY, the SEC historically has focused its cryptocurrency enforcement efforts exclusively on ICO-related issues, and as a result, its enforcement here constituted a "substantial change in its enforcement policy" such that LBRY lacked fair notice that the securities laws might apply to its offering. LBRY also emphasized that LBC could not constitute an "investment contract" under *Howey* because it was marketed for its consumptive use—not as an investment product.

The Court's Decision

In siding with the SEC, the court began its opinion by reciting the *Howey* test's guidelines. As noted above, only the third component of the *Howey's* test was in dispute, as LBRY did not dispute that *Howey's* "investment of money" and "common enterprise" requirements were satisfied. Focusing on LBRY's representations regarding the LBC token, the court explained that *Howey's* third prong was satisfied because LBRY "made no secret in its communications with potential investors that it expected LBC to grow in value through its managerial and entrepreneurial efforts." The court pointed to various LBRY statements to support its decision on this core issue. For instance, the court highlighted LBRY's statement that its long-term value was "dependent on our team staying focused on the task at hand: building this thing," and that "[o]ver the long-term, the interests of LBRY and the holders of [LBC] are aligned." The court emphasized that these statements, among others, illustrated LBRY's overall messaging regarding LBC, and thus concluded that potential investors understood LBRY to be offering a speculative investment contract in the form of a digital token.

The court rejected LBRY's argument that LBC could not be an "investment contract" because LBRY publicly disclaimed that LBC was an investment product. Relying on the reasoning set forth in other recent SEC cryptocurrency cases (such as *SEC v. Telegram Group* and *SEC v. Kik Interactive Inc.*; *see* GT Alerts), the court held that "a disclaimer cannot undo the objective economic realities of a transaction." In so holding, the court endorsed a line of thinking that appears to be a burgeoning theme in the arena of cryptocurrency enforcement: contractual disclaimers will not preclude a finding of securities violations where the court views such warranties as conflicting with the economic realities of a transaction.

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Further, in addressing LBRY's business model, the court found that even if LBRY had never broadcasted its expectation that LBC would grow in value through LBRY's managerial and entrepreneurial efforts, "any reasonable investor who was familiar with the company's business model would have understood the connection." As the court summarized: "Simply put, by intertwining LBRY's financial fate with the commercial success of LBC, LBRY made it obvious to its investors that it would work diligently to develop the Network so that LBC would increase in value."

Importantly, in its final point on its *Howey* analysis, the court rejected LBRY's argument that LBC could not be a security because it is a utility token with demonstrated purchases for consumptive, not investment, use. The court found that "[n]othing in the case law suggests that a token with both consumptive and speculative uses cannot be sold as an investment contract." The court summarized its holding: "[w]hile some unknown number of purchasers may have acquired LBC in part for consumptive purposes, this does not change the fact that the objective economic realities of LBRY's offerings of LBC establish that it was offering it as a security."

Finally, the court dispensed with LBRY's argument that it had been deprived of "fair notice" that its offerings were subject to the securities laws. In rejecting LBRY's contention that the SEC's suit constituted a "substantial change in its enforcement policy that was not reasonably communicated to the public" because LBRY did not conduct an ICO, the court held that the SEC's theory fit comfortably within the bounds of prior caselaw, and noted that LBRY had no basis to assert it was unaware of *Howey's* guidelines, even if it sold LBC tokens in a non-ICO context. At the end of the opinion, the court made a critical statement: "The SEC has not based its enforcement action here on a novel interpretation of a rule that by its terms does not expressly prohibit the relevant conduct. Instead, the SEC has based its claim on a straightforward application of a venerable Supreme Court precedent that has been applied by hundreds of federal courts across the country over more than 70 years." Thus, according to the court, even if this was the first time the SEC had brought an action against an issuer of digital tokens that did not conduct an ICO, "LBRY is in no position to claim that it did not receive fair notice that its conduct was unlawful." Thus, the court essentially adopted the rationale SEC Chairman Gary Gensler has espoused publicly, including before Congress, that token issuers should know whether they satisfy the *Howey* test (and that most do). Many issuers, however, may beg to differ.

Implications

The court's ruling constitutes a significant development in the cryptocurrency space. While there remain unanswered questions in the realm of cryptocurrency enforcement, *SEC v. LBRY Inc.* now follows in the footsteps of the *Kik* and *Telegram* decisions in supporting a pragmatic approach to *Howey* analyses; one that favors looking to the "economic realities" behind cryptocurrency offerings in lieu of adopting a strict adherence to contractual disclaimers and formalistic language. Notably, the decision in *SEC v. LBRY Inc.* has perhaps extended the "economic realities" approach to a new frontier, as the court's opinion recognized that LBC may, indeed, have had consumptive use in addition to its speculative purpose. Further, the court's *Howey* analysis—including its fair notice assessment—could be applied to many token issuers, as Chairman Gensler has claimed.

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