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SEC v. LBRY: Examining the Implications of the SEC's Latest Victory for Cryptocurrency and Digital Asset Markets

On November 7, 2022, Judge Paul J. Barbadoro of the United States District Court for the District of New Hampshire granted the Securities and Exchange Commission's (SEC) motion for summary judgment in its suit against LBRY, Inc. (LBRY), a blockchain-based video-sharing platform.[1] The Court held that the "LBRY Credit" (LBC) coins that LBRY offered and sold constituted unregistered securities in violation of the registration provisions of Sections 5(a) and 5(c) of the Securities Act of 1933. The Court also rejected LBRY's argument that it lacked fair notice of the application of U.S. securities laws to LBC, even though the SEC's prior enforcement actions in this context had focused principally on tokens characterized by an initial coin offering (ICO)—a form of promotion that LBRY did not use. The ruling is significant for the digital asset industry, as participants seek to achieve clarity regarding which assets qualify as securities, and is sure to be prominently featured going forward in SEC and private litigation contending that various digital assets are securities—including in the SEC's ongoing litigation against Ripple Labs (Ripple) before the Southern District of New York.[2]

Background:

Largely self-funded during its initial development, LBRY was founded as an effort to create a decentralized, open-source digital content sharing platform. In 2016, LBRY launched LBC, the network's native currency, which could be deployed on the LBRY blockchain to publish content, tip creators, buy paywall content, and compensate miners that supported the network. Unlike tokens that launched through ICOs, LBCs were sold directly through the LBRY application, while also being used to compensate employees and incentivize users. LBRY also reserved 400 million LBC tokens (out of a total supply of one billion) for itself.

The SEC brought an enforcement action against LBRY in March 2021, claiming that LBRY had offered and sold LBC as an unregistered security in violation of Sections 5(a) and 5(c) of the Securities Act. The SEC's suit seeks injunctive relief, disgorgement, and civil penalties. Both the SEC and LBRY submitted motions for summary judgment.

Parties' Arguments:

The SEC alleged that, from at least July 2016 to February 2021, LBRY sold LBC to numerous investors, including investors based in the United States. The complaint alleged that LBRY undertook an offering and sale of securities under federal securities laws without filing a registration statement for the offer and sale of the securities or qualifying for an exemption from registration. The complaint further alleged that, by failing to file a registration statement, LBRY denied investors required information about the company and the investment. The SEC alleged that LBRY received approximately $12.2 million in proceeds from its sales of LBC.

The parties filed cross-motions for summary judgment on the issue of whether LBC is a security under the U.S. Supreme Court's *Howey* test.[3] The SEC argued that LBC is a security because (1) LBRY offered and sold LBC for money and other consideration; (2) the LBC purchasers invested into a common enterprise because LBRY pooled the money raised from LBC sales and used it to fund the development and operation of its platform; and (3) a reasonable purchaser of LBC would expect to earn profits derived from the efforts of LBRY. The SEC pointed to various statements made by LBRY personnel to potential investors in blog posts, emails, and interviews, allegedly suggesting that the value of LBC would appreciate as the LBRY network was further developed. The SEC also emphasized that LBRY designated 300 million "pre-mine" LBC tokens for itself, making LBRY the single largest holder of LBC. The SEC argued that LBRY's stake in the LBC coin "made unmistakable to LBC purchasers LBRY's financial incentive to develop the LBRY Network (and thereby increase the long-term value of LBC)."[4]

LBRY argued in support of its motion for summary judgment that LBC coins are not securities because (1) they are consumptive in nature, with purchasers using LBC for on-chain activities rather than investment purposes; (2) the "primary focus" of LBRY's promotional statements and materials was the utility of LBC, not its potential price appreciation; and (3) LBRY stated explicitly in marketing materials that LBC was intended for consumption on the LBRY network, not as an investment. Additionally, LBRY argued that it did not have fair notice that it was subject to U.S. securities laws because the SEC had never brought a similar claim against a coin issuer outside the ICO context.

The Court's Findings:

The Court granted the SEC's motion for summary judgment, concluding that no reasonable trier of fact could reject the SEC's contention that LBRY offered LBC as a security. Based on the parties' stipulations, only the third element of *Howey* was in dispute, so the issue before the Court was whether "the economic realities surrounding LBRY's offerings of LBC led investors to have a reasonable expectation of profits derived from the entrepreneurial or managerial efforts of LBRY."[5] In ruling for the SEC, the Court reasoned that statements by LBRY and its employees in blog posts and interviews signaled to investors that LBC would appreciate in value through LBRY's efforts. For example, in a blog post following a large increase in LBC's market cap, the LBRY team stated that "the long-term value proposition of LBRY is tremendous, but also dependent on our team staying focused on the task at hand: building this thing."[6] Further, in an email to a potential investor, LBRY stated, "[i]f our product has the utility we plan, the credits should appreciate accordingly."[7] The Court rejected the significance of LBC's consumptive uses and of disclaimers by LBRY that LBC was not offered as an investment, holding that such a disclaimer was contrary to the objective economic realities of LBC purchases. Notably, the Court found that, even ignoring such LBRY statements, LBRY's decision to reserve or "pre-mine" hundreds of millions of coins for itself led purchasers of LBC "to expect that they too would profit from their holdings of LBC as a result of LBRY's assiduous efforts."

The court also rejected LBRY's defense that it did not receive fair notice that its offerings were subject to U.S. securities laws. LBRY had argued that there was no precedent for successfully enforcing registration requirements where a digital asset issuer had not conducted an ICO. The Court reasoned that, although participation in an ICO might be a relevant factor in determining whether a coin offering and sale constitutes a securities offering, that factor is not determinative. The Court instead found that LBRY did have adequate notice, including because the SEC "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."[8]

Implications:

SEC v. LBRY marks another significant victory for the SEC in a line of enforcement against token issuers for unregistered securities offerings.[9] It is also the first time that a federal court has held that a digital asset sold without an ICO is a security—a development consistent with the view of SEC Chairman Gary Gensler, who has unequivocally stated on many occasions that he believes the vast majority of digital asset tokens are securities.

Two aspects of the Court's decision support a broad interpretation of securities laws that, depending on whether and to what extent it is adopted by other courts, could present challenges for token issuers. First, the Court held that whether an ICO took place is only one factor to consider in determining whether a token constitutes a security. While the absence of an ICO has never been a clear safe harbor, the relatively limited weight that Judge Barbadoro accorded that factor here suggests that the industry's shift over the past several years away from ICO structures may do little to insulate digital asset products from being treated as securities.[10]

Second, the Court endorsed the SEC's argument that LBRY's decision to own a significant amount of LBC was, on its own, enough to trigger the third prong of *Howey*—an expectation of profits based on the efforts of others. The Court stated, albeit *in dicta*, that the mere fact that LBRY insiders stood to gain from an appreciation in the price of LBC was sufficient to create in the minds of LBC purchasers an expectation of profit based on LBRY's conduct. This reasoning

raises new questions as a doctrinal matter, because it tends to collapse the second prong of *Howey* (a common enterprise) with the third. A close alignment of interests between project insiders and digital asset purchasers is often viewed as demonstrating "horizontal commonality" sufficient to satisfy the common enterprise prong. By concluding that this alignment of interests was, in isolation, also sufficient to meet the third prong of *Howey*, the Court's decision could be interpreted to render two of *Howey*'s prongs duplicative of each other. This result is consistent with the SEC's view that a "common enterprise" is not an independent component of the *Howey* test but is inconsistent with substantial case law.[11] The Court's reasoning on this front is also surprising for an additional reason: There are numerous reasons for a project to retain portions of its own coin that would not relate to an expectation that the coin will increase in value. For example, a project may retain a portion of its own coins to facilitate validation of transactions on a proof-of-stake network or to optimize tokenomics across various constituencies—all without any assumption that the coins will appreciate.

It will take some time to assess the full impact of the *LBRY* decision, which follows on the heels of the *Audet v. Fraser*[12] post-trial ruling overturning a jury's verdict that a digital asset was not a security and which comes ahead of the much-anticipated summary judgment decision in the *SEC v. Ripple* case. Ripple is also being pursued by the SEC for allegedly selling XRP tokens as unregistered securities. Like LBRY, Ripple has argued that XRP is a digital asset with substantial utility, that it was sold outside the ICO context, and that Ripple lacked fair notice of the application of securities laws to the offer and sale of XRP. While the Southern District of New York is not bound by Judge Barbadoro's decision, other federal judges may choose to adhere to similar arguments in their rulings. In any event, the decision is an important data point to consider as industry participants look to gain clarity on the intersection of digital assets and U.S. securities laws.

For firms dealing with or looking to enter into the digital asset space, please contact the Ropes & Gray team.

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1. *See SEC v. LBRY*, No. 21-CV-260-PB, 2022 WL 16744741 (D.N.H. Nov. 7, 2022).
2. *See SEC v. Ripple Labs, Inc. et al.*, No. 20-10832 (S.D.N.Y. filed Dec. 22, 2020).
3. *See SEC v. W.J. Howey Co*., 328 U.S. 293 (1946).
4. Mot. Summ. J., *SEC v. LBRY, Inc.*, No. 21-CV-260-PB, Dkt. No. 55 at 8.
5. Order, *SEC v. LBRY, Inc.*, No. 21-CV-260-PB, Dkt. No. 86 at 8.
6. *Id.* at 10.
7. *Id*. at 11.
8. *Id*. at 21.
9. *See*, *e.g.*, *SEC v. Telegram Grp. Inc*., 448 F. Supp. 3d 352 (S.D.N.Y. 2020); *SEC v. Kik Interactive Inc.*, 492 F. Supp. 3d 169 (S.D.N.Y. 2020); *In re Munchee Inc.*, Order Instituting Cease-and-Desist Proceedings Pursuant to Section 8A of the Securities Act of 1933 (Dec. 11, 2017), https://www.sec.gov/litigation/admin/2017/33-10445.pdf.
10. *See*, *e.g*., Prepared Remarks of Gary Gensler On Crypto Markets Penn Law Capital Markets Association Annual Conference, https://www.sec.gov/news/speech/gensler-remarks-crypto-markets-040422; Remarks Before the Aspen Security Forum, https://www.sec.gov/news/speech/gensler-aspen-security-forum-2021-08-03.
11. *See*, *e.g*., *W.J. Howey Co.*, 328 U.S. 293; *Jung v. K. & D. Mining Co.*, 260 F.2d 607 (7th Cir. 1958); *Hector v. Wiens*, 533 F.2d 429 (9th Cir. 1976); *Exch. Nat. Bank, Chicago v. Touche Ross Co.*, 544 F.2d 1126 (2d Cir. 1976).
12. *Audet v. Fraser*, 3:16-cv-940 (MPS), 2022 WL 1912866 (D. Conn., June 3, 2022); *see also* https://www.ropesgray.com/en/newsroom/alerts/2022/july/federal-court-orders-new-trial-to-consider-whether-cryptocurrency-constitutes-a-security.