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BLOG

Blockchain Token LBC Ruled a Security in Non-ICO Offering

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OVERVIEW

On November 7, 2022, the United States District Court for the District of New Hampshire ruled that the digital asset LBRY Credits (LBC), offered to purchasers by LBRY, Inc., is an unregistered security for U.S. federal securities law purposes. This summary judgment follows a March 2021 Securities and Exchange Commission (SEC) enforcement action in which the agency claimed that LBRY's offer and sale of LBC violated Sections 5(a) and 5(c) of the Securities Act of 1933 prohibiting unregistered offerings or sales of securities in interstate commerce. Ruling in favor of the SEC, the court determined that LBRY offered LBC as a security and rejected LBRY's argument that it lacked "fair notice."

BACKGROUND

LBRY is the blockchain protocol on which the LBRY Network, including media platform Odysee, is built. Blockchain is a technological system in which a digital list of records is stored across a decentralized network of computers. Blockchain is the primary technology of cryptocurrencies but can be used to store a wide variety of information. LBC, LBRY's native token released in 2016, is used to compensate LBC miners as well as reward viewers and creators alike for using the LBRY Network.

In March 2021, the SEC filed an enforcement action against LBRY alleging that the company did not file required registration of its LBC offerings with the SEC. Raised on both parties' cross-motions for summary judgement was whether LBRY offered LBC as a security and whether the SEC gave LBRY fair notice that its offerings were subject to securities laws.

ISSUES

LBC As a Security

In ruling that LBRY offered LBC as a security, the court relied on the definition of an "investment contract" established in the seminal U.S. Supreme Court decision *SEC v. W.J. Howey Co*. As discussed in a previous Non-Fungible Insights post, "First Civil Litigation in the U.S. Brought in Response to the Crash of the Stablecoin TerraUSD", under the *Howey* test, a financial instrument is an investment contract, a type of security, when there is: (1) the investment of money; (2) in a common enterprise; (3) with an expectation of profits; (4) derived solely through the efforts of others. Here, LBRY disputed only the third and fourth prongs of the *Howey* test.

(a) LBRY's Representations to Potential Purchasers

In favor of the SEC, the court emphasized a series of LBRY public communications with potential purchasers that LBC would grow in value through the company's managerial and entrepreneurial efforts. The court delved into numerous LBRY blog posts, emails between company officials and potential purchasers, LBRY's communications with Reddit users, interviews with company officials, and essays- all content that the court determined showed an indication of an expectation of profits. For example, the court highlighted a blog statement by LBRY's CEO, Jeremy Kauffman, where he placated LBC holders when the LBC price was down in November 2016. The court noted that Kauffman was publicly encouraging LBRY's holders to "hold onto [their LBC] (or spend it to buy some of [LBRY's] great content" and stressed LBRY's long term goal of "building a product that is compelling enough to change people's habits" that could even replace YouTube and Amazon. The court held that LBRY had been sending a consistent message to its holders that "the long-term value proposition of LBRY is tremendous," ever since the launch of the LBRY Network in June 2016.

(b) LBRY's Business Model

The court likewise held that even if LBRY had not been so public about its profit expectations, LBRY's profitability necessarily turned on its ability to grow LBC's value through the company's managerial and entrepreneurial efforts. The court explained that any reasonable purchaser would understand that, since the beginning, LBRY's profitability would necessarily turn on the company's ability to grow the value of LBC by increasing the usage of the LBRY Network. To support its holding, the court once again pointed to Kauffman's prior statements and posts on LBRY's website: highlighting one post that stated "since Credits only gain value as the use of the protocol grows, the company has an incentive to continue developing this open-source project."

(c) Consumptive Uses for LBC

Last, the court explicitly rejected LBRY's arguments that LBC could not be a security because LBC purchases were made with consumptive intent. The court rejected statements from several LBC holders explaining that they had purchased LBC with limited relevance in determining whether LBRY was offering LBC as a security. Instead, the court stated that the inquiry should be focused on what the purchasers were offered or promised, and the court made it clear that "nothing in the case law suggests that a token with both consumptive and speculative uses cannot be sold as an investment contract."

Fair notice by the SEC

The court then considered whether LBRY received fair notice from the SEC that its offerings were subject to federal securities laws. LBRY argued it lacked fair notice that its issuance of digital tokens would be subject to registration requirements because the SEC had previously focused its guidance and enforcement efforts exclusively on the issuance of digital assets in the context of initial coin offerings (ICOs).

Rejecting this argument, the court noted that LBRY did not offer a persuasive reading of *Howey* that only ICOs are subject to registration requirements. The court also noted that the SEC has never suggested companies need to comply with registration requirements only when conducting an ICO. Determining that "the SEC…based its [enforcement action] on a straightforward application of a venerable Supreme Court precedent" and not "a novel interpretation of a rule that by its terms does not expressly prohibit the relevant conduct," the court found that LBRY received fair notice that its unregistered issuance of LBC was unlawful.

IMPLICATIONS

This ruling, while limited in its precedential impact, is likely to embolden the SEC's aggressive position regarding which digital assets constitute securities under U.S. law. As the court noted, "this is the first case in which the SEC has attempted to enforce the registration requirement against an issuer of digital tokens that did not conduct an ICO." Focusing on the "economic realities" of LBRY's offerings rather than the transactions' forms, the court concluded that while participation in an ICO may be relevant to the *Howey* analysis, it alone is not dispositive. There are several other pending civil and governmental actions concerning the same core issue, and it remains to be seen whether other courts will take the same position.

Digital assets, such as LBC, will likely be subject to greater scrutiny and regulatory enforcement in the near future as the SEC continues focused efforts on digital asset issuers.

We will continue to monitor developments in the digital assets and blockchain technology industry and provide friends of the firm with updates as they become available.

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