December 1, 2022

In *Securities and Exchange Commission v. LBRY, Inc.*, a federal court in New Hampshire found that under the *Howey* test, digital tokens sold by LBRY were securities, and that LBRY's offer and sale of those unregistered securities therefore violated Section 5 of the Securities Act of 1933.[1]

In mid-2016, LBRY publicly launched its LBRY Network, a digital platform for distributing content in a decentralized manner using blockchain technology similar in its cryptography and consensus mechanism to the first widely adopted blockchain network, Bitcoin. LBRY's professed long-term goals for the LBRY Network included serving as an alternative for YouTube and Amazon.[2] The rules that LBRY developed to publicly guide the operation of the LBRY Network allowed for the creation of one billion digital tokens native to the LBRY Network called LBRY Credits (LBC), of which 400 million would fall under the control of LBRY for various uses.[3]

One of these uses was to fund the LBRY Network's "continued development and provide profit for the [LBRY] founders" with 100 million LBC.[4] Another use was the sale of 53.9 million LBC to the public directly through applications developed by LBRY itself and indirectly through third-party digital asset trading platforms.[5]

In March 2021, the SEC brought an action against LBRY in the US District Court for the District of New Hampshire, claiming that LBRY had violated Sections 5(a) and 5(c) of the Securities Act by offering and selling unregistered securities, seeking from LBRY civil penalties, disgorgement of monies LBRY obtained through these offerings, and injunctive relief.[6] LBRY raised two defenses to this claim:

1. LBC was not, indeed, offered as a security.
2. LBRY's right to due process was violated because the SEC did not provide fair notice that its offerings were subject to securities law.

After discovery in the matter, both parties filed motions for summary judgment.

On November 7, 2022, Judge Paul J. Barbadoro granted the SEC's motion. In determining whether an offering of securities occurred, the *LBRY* court applied the well-known *Howey* test, which was first laid out in Securities and Exchange Commission v. W.J. Howey Co. Both parties agreed that the first two prongs of the test had been met (i.e., that the offerings of LBC constituted "investment[s] of money in a common enterprise"). However, LBRY contended that there was no "expectation of profits to be derived solely from the efforts of … a third party" in its offerings of LBC – the third *Howey* prong – because LBC had a utility within the LBRY Network and some purchasers, thus, bought LBC for its consumptive use and not with a view to profit. LBRY further argued that most of LBRY's public communications did not discuss the future value of LBC.[7]

Watch all communications related to token distribution

The *LBRY* court rejected LBRY's arguments regarding what LBRY characterized as the relative few communications it made regarding the future value of the token. The *LBRY* court noted numerous instances in which LBRY made private and public statements connecting the value of LBC to its development of the LBRY Network and the future efforts LBRY would be taking to develop the network. For example, it noted that LBRY had asserted in a blog post that "[o]ver the long-term, the interests of LBRY and the holders of [LBC] are aligned," and that LBRY contended in an email to a private investor that "[i]f our product has the utility we plan, the [LBC] should appreciate accordingly."[8]

The retention of tokens may be a factor

In its analysis, the *LBRY* court also indicated that LBRY's choice to hold 100 million LBC to fund LBRY Network's development and profit its founders was evidence that the offering and sale of LBC was made pursuant to an expectation of profits to be derived from the efforts of others. The court reasoned that "any reasonable investor who was familiar with [LBRY's] business model would have understood the connection" between LBRY profiting

by holding onto a certain amount of LBC and its advancement of LBC's value.[9]

Having a utility does not in itself impact *Howey* analysis for a token

The court also rejected LBRY's argument that the purchase of LBC for consumptive, and not speculative, use by **some** of its buyers suggests that LBC is not a security for **any** of its buyers. The court suggested that the intended use of the token by a subset of LBC purchasers was of limited relevance to the overall analysis, which ultimately indicated that LBC was a security under the Securities Act.[10]

SEC's lack of prior similar enforcement action does not constitute lack of notice

In arguing that the SEC had deprived LBRY of due process by not providing fair notice that LBC was a security, LBRY relied on its claim that this was the first enforcement case brought by the SEC for a digital token that was not issued pursuant to an "initial coin offering" (ICO). LBRY cited *Upton v. Securities and Exchange Commission*, in which the US Court of Appeals for the Second Circuit found that the SEC's novel interpretation of a rule, after a long history of interpreting that same rule in a different way, could not be wielded against an unsuspecting defendant for behavior that the rule did not expressly prohibit, prior to the SEC publicly acknowledging its new interpretation.[11] However, the court distinguished *Upton* on the grounds that the SEC was not relying on a novel interpretation of a rule but on long-standing US Supreme Court precedent (*Howey)*. The *LBRY* court found that regardless of whether this was the first time the SEC had brought an action against a token issuer that had not conducted an ICO, LBRY could not claim it had not received fair notice that its conduct was unlawful.

Notes

1. Order, *Securities and Exchange Commission v. LBRY, Inc.*, Civil Action No. 1:21-cv-00260, Dkt. No. 86.
2. SEC MSJ Opp *Securities and Exchange Commission v. LBRY, Inc.*, Civil Action No. 1:21-cv-00260, Dkt. No. 1 (D.N.H. filed March 29, 2021) at 4.
3. Order*, Securities and Exchange Commission v. LBRY, Inc.*, Civil Action No. 1:21-cv-00260, Dkt. No. 86 at 3-4.
4. *Id.* at 16.
5. *Id.* at 5.
6. Complaint, *Securities and Exchange Commission v. LBRY, Inc.*, Civil Action No. 1:21-cv-00260, Dkt. No. 1 (D.N.H. filed March 29, 2021).
7. Order, *Securities and Exchange Commission v. LBRY, Inc.*, Civil Action No. 1:21-cv-00260, Dkt. No. 86 at 7.
8. *Id.* at 10-11.
9. *Id.* at 15.
10. *Id.* at 17-21.
11. *Upton v. Securities and Exchange Commission*, Civil Action No. 287, Dkt. No. 95-4044 (2d Cir., decided January 18, 1996).

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