LEGAL UPDATES

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SEC v. LBRY: Is it Time for Blockchain Networks to Register Their Native Tokens?

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The New Hampshire District Court recently granted summary judgment in favor of the Securities and Exchange Commission (SEC) in *SEC v. LBRY, Inc.*, concluding that the native token of the blockchain protocol and network developed by LBRY, Inc. is a security. The decision has opened the door to digital currencies being classified as securities under the Securities Act of 1933, despite their utility as a method of exchange like that of fiat currencies.

In 2015, LBRY began creating and developing its network for accessing and publishing videos, images and other digital content. LBRY intended to create a decentralized publishing platform with the content owned by its users. Following an initial funding through traditional venture capital methods, LBRY began the sale of its tokens to the public market. LBRY initially pitched its tokens as a way to interact with its software, including compensating miners, publishing content and accessing exclusive content; however, in limited public and private communications, LBRY detailed the rapid growth in value of its tokens and tied the future of LBRY and, in turn, the network, to the value of the tokens. The SEC argued—and the Court ultimately agreed—that LBRY offered and sold "investment contracts" when purchasers bought the tokens due primarily to the way LBRY had offered and sold its tokens to consumers.

The SEC brought an enforcement action in March 2021, claiming that LBRY's unregistered offerings of its tokens violated sections 5(a) and (c) of the Securities Act. In the SEC's motion for summary judgment, it argued that the sale of LBRY's tokens was an investment contract under the Supreme Court's *Howey* test. In defense, LBRY argued (1) its tokens were not securities because they functioned as a digital currency serving key utility functions for the LBRY

platform rather than as an investment contract and (2) a due process violation because the SEC did not give LBRY fair notice that offerings of its tokens were subject to the Securities Act.

In its decision, the Court laid out the three prongs of the *Howey* test: (1) an investment of money (2) in a common enterprise (3) with an expectation of profits to be derived from efforts of the promoter or third party. The first two prongs were not at issue. First, purchasers paid money in exchange for the tokens—an investment of money. Second, that money was invested in a common enterprise because LBRY pooled and used the money from its token sales to develop and operate the digital content-sharing service it had created. Thus, the Court focused primarily on the applicability of the third prong—whether LBRY created a reasonable expectation of profit to those buying, using, holding and selling its tokens. To determine whether this expectation was created, the Court looked primarily at LBRY's representations to purchasers over the years.

Despite LBRY's claims to the contrary, the Court found the SEC's argument that LBRY repeatedly represented that it expected its tokens to increase in value to be a determining factor. For example, the SEC entered into evidence a written statement made by a LBRY executive to a potential investor which read, "the opportunity is obvious—buy a bunch of [tokens], put them away safely, and hope that in 1-3 years we've appreciated even 10% of how much Bitcoin has in the past few years. If our product has the utility we planned, a [token] should appreciate accordingly." Externally, crypto enthusiasts published articles touting tokens as an investment, and internally, LBRY labeled its tokens' traders as "investors" and "speculators." In its tokens pitch deck intended for venture capital investors, a slide conveyed that "1 of its Tokens could be worth $100 or more if LBRY becomes protocol of choice for media distribution."

LBRY's representations of its tokens as an investment opportunity led the Court to grant the SEC's motion for summary judgment, agreeing that its tokens were ultimately an investment contract. This finding means that LBRY's tokens are subject to the registration and reporting requirements under the Securities Act.

What this means to you

In rejecting LBRY's due process argument, the Court held that LBRY was provided fair notice based on the consistent utilization and application of the *Howey* test in over 70 years of settled precedent. In other words, it is the responsibility of those offering digital assets to confirm whether or not their actions require compliance and registration under U.S. securities laws. It is certain that the precedent set in LBRY will reverberate throughout the crypto industry as more industry participants are now on notice and must seek to comply with this new legal precedent.

Contact us

Husch Blackwell LLP's team of blockchain professionals are prepared and ready to assist its clients and others to navigate the rapidly changing blockchain environment. Please reach out to us if you have questions or require assistance.