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The SEC Scored Another Crypto Victory in the LBRY Case, but the Sky Is Not Falling

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Last week's wild ride in the crypto-verse started, of all places, in New Hampshire. On Monday, a federal judge ruled that LBRY Credits ("LBC") are securities, and thus LBRY violated Section 5 of the Securities Act of 1933 by selling LBC.[1] LBRY responded with a tweet describing the ruling as "extraordinarily dangerous precedent that makes every cryptocurrency in the U.S. a security, including ethereum."[2]

SEC v. LBRY, Inc. treads new ground in one sense. It is the first time a federal court has found a token sold outside of an Initial Coin Offering ("ICO") to be a security. The real question is whether the ruling really means every cryptocurrency is a security. A close reading suggests it does not.

The procedural posture of the case was that the parties filed cross-motions for summary judgment. LBRY did not challenge the SEC's assertion that it offered and sold LBC in interstate commerce without a registration statement or contend that its prior offerings met any of the exemptions to the registration requirements. Accordingly, the sole issue before the court was whether LBRY's sale of LBC met the test for an "investment contract" and thus a security under the venerable *Howey* test.

In opposing the SEC's motion for summary judgment, LBRY elected to concede two of the three prongs of the *Howey* test – that (1) LBC purchasers "invested money" in (2) a "common enterprise." That left the parties to fight over whether individuals purchased LBC with (3) an "expectation of profit" derived from "the entrepreneurial or managerial efforts" of LBRY. The New Hampshire federal court granted the SEC's motion for summary judgment and denied LBRY's motion.

What You Say Can and Will Be Used Against You

SEC v. LBRY is a cautionary tale about the importance of disciplined communication statements in light of the way statements can be used against you in litigation. And here, the SEC used many of LBRY's and its officers' external and internal statements to play into its arguments, and the court agreed. A few examples are illustrative.

- *No functional network at the time the tokens were sold*. LBRY's CEO publicly conceded that the platform launched with *"the barest, minimum proof-of-concept."*
- *Future efforts of others in the development of the network*. The LBRY team wrote in a blog post that while the *"long-term value proposition of LBRY is tremendous,"* it is *"dependent on our team staying focused on the task at hand: building this thing."*

- *Expectation of profits*. The *"opportunity is obvious,"* wrote LBRY's COO in an email to a potential investor, *"buy a bunch of [LBC], 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."* The COO also stated in the email that *"LBC are being traded on 'major crypto exchanges' and that trading volume is moving at a healthy clip."*

- *Incentives to undertake efforts to promote mutual interests*. In a blog post on LBRY's website in response to a question *"How does the company behind LBRY make money?,"* it said, *"LBRY Inc. has reserved 10% of all LBRY Credits to fund continued development and provide profit for the founders. Since Credits only gain value as the use of the protocol grows, the company has an incentive to continue developing this open-source project."*[3]

The court found that "[t]hese statements are representative of LBRY's overall messaging about the growth potential for LBC, and thus the SEC is correct that potential investors would understand that LBRY was pitching a speculative value proposition for its digital token." And the court rejected LBRY's attempt to dismiss the significance of its statements by arguing that the relevant tweets and blog posts only constituted 0.25% of LBRY's total of 8,805 posts and messages. Because, as Judge Barbadoro reasoned, LBRY made "no effort to tally the number of comparable statements to those identified by the SEC."

Other Key Takeaways

- *Impact on the Cryptocurrency Industry*. The breathless concern that the LBRY ruling sets a dangerous precedent affecting the entire crypto industry is overstated. Yes, the LBRY court implied that a token with *some* consumptive utility could still be a security. And, yes, the court wrote that a "reasonable investor who was familiar with the company's business model would have understood the connection" between LBRY's managerial efforts and their expectation of profit even if LBRY had not "explicitly broadcast its views on the subject." But these unnecessarily broad statements are arguably dicta. The court found what it considered to be ample support for its ruling in the record. And it is just a single district court decision based on facts and circumstances unique to the case applying the law in just one circuit. Nevertheless, defendants in SEC actions and private securities litigation should be prepared to distinguish *SEC v. LBRY*.

- *Injunctive Relief Regarding Future Token Sales*. LBRY argued that the SEC's request for permanent injunctive relief was not warranted because LBC now have utility, and therefore, the SEC could not "show a likelihood of future violations." Although LBRY relied on the well-known Hinman speech, statements by former SEC Chairman Jay Clayton and the SEC's Framework[4] to argue that "the *Howey* test is transaction-specific and an instrument can evolve from a security to a non-security," it essentially asserted a consumptive use defense under *Forman*.[5] In support of its argument, LBRY submitted evidence including an expert report[6] that purportedly demonstrated that millions of people were currently using LBC for its intended use on the LBRY network. The court summarily dismissed LBRY's argument that it should not be required to register future offerings of LBC. In a footnote in the opinion, Judge Barbadoro held: "I decline to address this argument on the present record because LBRY has not explained why possible future offerings of LBC should be treated differently from the company's past offerings."

- *The Uncertain Impact of Market Forces and Price Movement Event Studies*. It is still an open question whether courts credit expert event studies opining that token prices reflect market forces, rather than the managerial efforts of the project team. LBRY submitted such a report. And the SEC challenged it with both a motion to strike and a *Daubert* motion to exclude the expert opinions. The court denied the motion to strike without prejudice and stayed the *Daubert* motion without further explanation (at least on the record). Regardless, the summary judgment ruling did not mention LBRY's expert opinion.

- *Rejection of the Fair Notice Defense*. Judge Barbadoro resoundingly rejected LBRY's complaint that the SEC had not provided adequate notice that (at least certain) tokens are securities. He found that the SEC's claims were based 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." As the SEC noted in its motion for summary judgment, "[n]o federal court has ever found that the term 'investment contract,' as used in the Securities Act and as construed in *Howey*, is unconstitutionally vague." So far, the fair notice argument has not gained any traction with the courts.

SEC v. LBRY is yet another victory for the SEC, and a reminder of some of the risks and uncertainties for digital asset innovators. But as a single district court decision based on facts and circumstances unique to the case, it may not be the earthquake many fear.

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[1] The case is captioned *SEC v. LBRY, Inc.*, Case No. 21-cv-260-PB (D.N.H. filed Mar. 29, 2021), and the order is available at https://docs.reclaimthenet.org/sec-lbry-memorandum-order-nov-2022.pdf.

[2] https://twitter.com/LBRYcom/status/1589646941465763840.

[3] According to the order, the LBRY network was designed to eventually have a circulation of approximately 1 billion LBC. Most of the LBC would be released in the future to compensate miners, but when the LBRY blockchain launched in June 2016, LBRY reserved a "pre-mine" of 400 million LBC for itself, and allocated 200 million to a community fund for spreading usage and adoption of the network, 100 million to an institutional fund for institutional partnerships, grants and donations, and 100 million to an operational fund for LBRY's operational purposes.

[4] William Hinman, Dir. Sec. Exch. Comm'n Div. Corp. Fin., Digital Asset Transactions: When Howey Met Gary (Plastic) (June 14, 2018), https://www.sec.gov/news/speech/speech-hinman-061418; Nikhilesh De & Mahishan Gnanaseharen, SEC Chief Touts Benefits of Crypto Regulation, CoinDesk (Apr. 6, 2018, 4:16 PM), https://www.coindesk.com/sec-chief-not-icos-bad/; Strategic Hub for Innovation and Financial Technology, Framework for "Investment Contract" Analysis of Digital Assets (Apr. 3, 2019), https://www.sec.gov/corpfin/framework-investment-contract-analysis-digital-assets#_edn1.

[5] *United Housing Found., Inc. v. Forman*, 421 U.S. 837, 853 (1975).

[6] LBRY asserted that its expert's report concluded that the total LBRY on-chain activity was "substantially . . . higher than the secondary market trading activity in the LBC token," and showed that the volume of on-chain transactions had grown exponentially since the launch of the network in 2016, surpassing trading on the secondary market.