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SEC Scores Victory in Ongoing Effort to Classify Cryptocurrencies as Securities

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A recent decision out of the District of New Hampshire underscores the risks proprietary cryptocurrency issuers face and provides ammunition to the SEC in its continued quest to classify cryptocurrencies as securities subject to registration and regulation. In *SEC v. LBRY, Inc.*, Judge Paul J. Barbadoro found that LBRY, Inc. (LBRY) violated the Securities Act of 1933 by selling unregistered securities when LBRY sold its proprietary LBC token in a series of offerings. LBRY did not dispute the facts underlying the SEC's complaint but argued only that the LBC token was not a security subject to SEC regulation.

LBRY launched in 2016 as a blockchain-based content distribution platform designed to allow users to share videos, images, and other digital content without a centralized host — in essence a decentralized YouTube. LBRY's platform includes a proprietary blockchain, the LBRY Blockchain, that forms the backbone of the overall network and provides for decentralized content distribution.

The LBRY Blockchain was released in 2016 on which the proprietary LBC token was stored, transferred, and recorded. The LBC token is used to view premium content on the network and to reward content creators. Users can mine LBC tokens by validating transactions on the network. LBRY reserved a "pre-mine" of 400 million LBC that it would use to incentivize "usage and adoption" of the network and fund LBRY's operations. LBRY sold a substantial portion of its pre-mine to fund its operations. The SEC brought an enforcement action against LBRY in March 2021, alleging that LBRY's sales of LBC tokens violated Sections 5(a) and 5(c) of the Securities Act.

The only issue before the court on summary judgment was whether the LBC token constituted a security such that LBRY was required to either register the token or qualify for an exemption from registration. The court applied the *Howey* test to determine whether the LBC token is an investment contract under U.S. securities laws, *i.e.,* whether the LBC token is "a contract, transaction or scheme whereby a person invests his money in a common enterprise and is led to expect profits solely from the efforts of the promoter or a third party." The court's decision focused on the third prong of the *Howey* test — whether LBRY's offering of LBC tokens led to an expectation of profits from LBRY's managerial efforts.

The court first noted that in LBRY's communications to LBC purchasers, LBRY repeatedly stated that the long-term value proposition of the LBC token was inextricably tied to the overall success and adoption of the larger LBRY network. In one Reddit post, an LBRY spokesperson wrote that LBC would only be "worth something in the future" if "LBRY delivers on their promise to create a revolutionary way to monetize and sell content." The court also examined LBRY's business plan, which noted that LBRY's long-term profitability and success depended on the increasing value of the LBC token. As the court reasoned, "by retaining hundreds of millions of LBC for itself, LBRY also signaled that it was motivated to work tirelessly to improve the value of its blockchain for itself and any LBC purchasers."

LBRY argued that because LBC is a token designed for use in the LBRY network that some users acquired to use in transactions, LBC could not be a security subject to SEC regulation. The court rejected this argument, noting that even though some purchasers may have had a consumptive rather than a speculative/investment intent, the overall character of LBC suggests it is primarily an investment and thus, a security. In reaching this conclusion, the court emphasized that purchasers' subjective intent to use the LBC tokens for transactions did not overcome LBRY's statements about expected future value as the LBRY network grew. Similarly, the court rejected LBRY's contention that the company's disclaimers that it was not offering the LBC token as an investment meant it fell outside the scope of securities laws. Following the same reasoning from *SEC v. Telegram Grp., Inc.*, another enforcement action in the cryptocurrency space, the court noted that LBRY's disclaimers "cannot undue the objective economic realities of [the] transaction." The structural workings and incentives behind the LBC token rendered it a security under the *Howey* test despite LBRY's statements to the contrary.

LBRY also argued that it did not have fair notice that its offerings were subject to securities laws because previous SEC actions and guidance related to crypto offerings focused on initial coin offerings (ICO). The court rejected this argument, noting that even if LBRY's assertion were correct, the *Howey* test would be equally applicable to ICO and non-ICO offerings. In taking action against LBRY, the SEC did not act on a "novel interpretation of a rule" requiring fair notice but relied "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." Because the LBC tokens qualified as securities under the *Howey* test, LBRY had fair notice the SEC could take action against it for unregistered sales of the tokens.

The court's decision is the latest in a series of wins for the SEC and demonstrates that even as the agency grapples with how to classify cryptocurrencies as a whole, individual tokens can still be subject to regulation as securities under existing law based on a practical approach to applying the *Howey* analyses to tokens that disregards contractual language. It also indicates that tokens with both consumptive use and speculative purpose can qualify as securities. Proprietary tokens — tokens unique to product that is intertwined with a unique user product — are especially vulnerable to classification as securities under the *Howey* test because the value of proprietary tokens depends significantly on the use and adoption of the overall product. Several courts applying *Howey* have focused on this factor to find that proprietary tokens are securities.

These courts' decisions are likely to have significant impact beyond the securities context. Just four days after the *LBRY* decision was issued, FTX and approximately 130 corporate entities affiliated with it, including Alameda Research and FTX US, filed for bankruptcy — the third major cryptocurrency platform to seek Chapter 11 protection this year. FTX, which, like bankruptcy crypto lender Celsius Network, relied heavily on self-minted tokens for liquidity and net equity, is currently under investigation by the SEC and the CFTC (among others). To the extent that crypto exchanges and lenders in bankruptcy seek to issue proprietary tokens to facilitate their reorganizations, they may find themselves in a far more difficult regulatory environment than previously anticipated. Moreover, a finding that tokens issued pre-bankruptcy were securities may bring transactions in those tokens within the scope of Bankruptcy Code safe harbors and prevent the avoidance of those transactions.

While the overall regulatory landscape is still evolving for cryptocurrencies, issuers and developers should remain mindful that some tokens are subject to regulation under existing precedent that the SEC has had success in applying. Companies developing proprietary blockchains with tokens that are designed to be used within the ecosystem of a larger user product need to be particularly mindful of *Howey* analyses when designing overall product ecosystems and when producing investment materials. Companies should also be mindful that disclaimers stating tokens are not offered as investments will not preclude a court from finding that the tokens constitute a security under the *Howey* test.

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