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Scoring a victory for the Securities and Exchange Commission in its efforts to qualify digital tokens as securities, a New Hampshire federal court ruled this week that tokens sold by LBRY Inc., known as LBC, are securities and subject to U.S. securities laws. The case, like others in the crypto space, centers on the legal controversy over when a utility token that is marketed as a product that can appreciate in value with the continued success of the issuer, but does not appear to provide any security interest in or right to share in future profits or participate in future governance of the issuer, can nonetheless be deemed a security. The court's holding, premised upon the notion that a token can be deemed to be a security where a purchaser's objective could be to profit from resale or otherwise based on the token's potential appreciation in value, may have far-reaching effects on the rapidly expanding cryptocurrency industry if it is adopted by other cases, subjecting certain digital currencies to existing securities regulation.

As explained by the court, LBRY, Inc. uses blockchain technology to allow users to share videos, images, and other digital content without a centralized host such as YouTube. As part of its business model, LBRY offers a native digital credit, called LBC, which can be spent on the LBRY blockchain to publish content, create channels, purchase paywall content, or "boost" channels or content in search results. Among other things, the court found that LBRY used the initial tranche of LBC circulation for operational purposes and has largely relied on sales and transfers of LBC to fund its operations.

The SEC sued LBRY in 2021, claiming that LBRY's issuance of LBC was an unregistered offering of securities that violated the Securities Act of 1933. In a decision that resolved solely the issue of whether LBC is a security, Judge Paul J. Barbadoro relied on the Supreme Court's broad definition of an investment contract in *SEC v. W.J. Howey Co.*, and specifically focused on the question of whether "the economic realities surrounding LBRY's offerings of LBC led

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investors to have a ‘reasonable expectation of profits to be derived from the entrepreneurial or managerial efforts of others.’”

Answering that question in the affirmative, Judge Barbadoro examined statements made by LBRY that led potential investors to reasonably expect LBC would grow in value, including blog posts, emails to investors regarding private placements, as well as posts on the social media site Reddit. Taking these statements together, the court concluded that “potential investors would understand that LBRY was pitching a speculative value proposition for its digital token,” and rejected LBRY’s argument that it had informed some investors that the company was not offering its token as an investment, finding that “a disclaimer cannot undo the objective economic realities of a transaction.”

In opposition, LBRY argued that LBC is not a security because it was designed largely for use on the LBRY blockchain, and that users acquired it for that purpose rather than with the intention of holding the tokens as an investment. Judge Barbadoro rejected this argument, holding that “[n]othing in the case law suggests that a token with both consumptive and speculative uses cannot be sold as an investment contract.”

Finally, the court rejected LBRY’s argument that it did not receive fair notice that LBC offerings were subject to securities laws, which was based upon the notion that the SEC historically focused its guidance and enforcement efforts on the issuance of digital assets within the context of an Initial Coin Offering, or ICO, which LBRY did not undertake. However, the court held that “[w]hile this may be the first time [securities laws] have been used against an issuer of digital tokens that did not conduct an ICO, LBRY is in no position to claim that it did not receive fair notice that its conduct was unlawful.”

In sum, while the LBRY decision is specific to the facts and circumstances of the company’s issuance of LBCs, the result could impact not only other pending litigation between the SEC and cryptocurrency issuers, but also the SEC’s enforcement stance going forward. Indeed, following the decision, SEC enforcement director Gurbir Grewal was quoted by Law360 as stating that “[digital assets that qualify as securities under the criteria long-ago set out by the Supreme Court cannot be given a pass from the securities laws,” and that “[r]egistering with the Commission ensures that investors have access to important information about the securities and the issuer offering the securities.”

Bracewell’s multi-disciplinary cryptocurrency team is available to assist with IRS, CFTC, SEC, and DOJ regulations and enforcement practices. Our team can effectively help clients navigate the rapidly shifting regulatory and enforcement landscape facing the cryptocurrency industry today.