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Written Testimony of

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Examining Facebook’s Proposed Cryptocurrency and Its Impact on Consumers,
Investors, and the American Financial System

“99 Problems”

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2128 Rayburn House Office Building

Chairwoman Waters, Ranking Member McHenry, and Members of the Committee:

Thank you for inviting me to testify at this hearing. My name is Chris Brummer. I recently concluded my term as the Agnes N. Williams Research Professor of Law at Georgetown University Law Center, and serve as the Faculty Director of the Institute of International Economic Law, where I teach courses on securities law, cryptoassets and the law, and international financial regulation, among other topics.¹ I am here today solely in my academic capacity and am not testifying on behalf of any entity.

White papers have emerged as a common tool through which cryptocurrency firms and digital asset companies communicate with potential consumers and investors about new projects and ventures. However, as their importance has grown, white papers have faced mounting criticism—for their hyperbolic language, false promises, and omissions of material information consumers would need before purchasing a digital asset.²

¹ Georgetown’s Institute of International Economic Law is the focal point for the study of law and international economic policy at Georgetown University, and hosts dialogues, lectures, conferences and executive training for senior government officials and private sector professionals on issues relating to fintech, financial regulation, trade, tax and monetary affairs.

² See Shaanan Cohn et al., *Coin-Operated Capitalism*, 119 COLUM. L. REV. (2019) (discussing problems of white paper disclosures); EY RESEARCH: INITIAL COIN OFFERINGS (Dec, 2017), [https://www.ey.com/Publication/vwLUAssets/ey-research-initial-coin-offerings-icos/\\$File/ey-research-initial-coin-offerings-icos.pdf](https://www.ey.com/Publication/vwLUAssets/ey-research-initial-coin-offerings-icos/$File/ey-research-initial-coin-offerings-icos.pdf) (noting that many white papers contain clichés that attract inexperienced investors, with no reasonable justification for blockchain use).



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Indeed, the last time I was here to share my views before many members of this very committee, we discussed precisely that matter, and I suggested the need to rethink cryptocurrency regulation along the lines of just what kind of information everyday purchasers of utility tokens might need in order to make adequately informed decisions about how they spend their hard earned money.³

Today we have a twist. Until now, criticisms of white paper disclosures have focused largely on early stage, cash-strapped startups. Rarely have they been directed at multinational technology companies with the resources to marshal top flight legal as well as technological talent.

Yet this time is different.

The Libra White Paper (“White Paper”) is peppered with big promises and few details, and the project even in this cursory outline involves risks to purchasers (and, at least potentially, the financial system) that are not disclosed.⁴ As a matter of public policy, this is, at a minimum, disappointing. The White Paper is no mere public brainstorming exercise or technical exposition, but is instead intended to condition the market for the adoption of a product the sponsors wish to sell to billions of people around the world. And the lapses are all the more problematic given the the securities-like features of Libra coins, and the possible implication of U.S. securities laws.

Given the limited time available, I want to focus on some of the most problematic red flags:

- The Libra White Paper fails, most fundamentally, to inform potential holders in unambiguous terms that they can lose money, and that runs on the coin are possible.
- The White Paper fails to clearly disclose that Libra holders will be exposed to counterparty risk in the form of mismanagement of reserve investments.
- The White Paper fails to disclose governance risks, including the negative impact Libra Association decisions, and conflicts of interest, could have on the nature and value of Libra coins.

³ See Chris Brummer, *What Should Be in an ICO White Paper?*, U.S. H. COMM. ON FIN. SERVS. (Mar. 14, 2018), https://financialservices.house.gov/uploadedfiles/03.14.2018_chris_brummer_testimony.pdf.
See also, Brummer et. al, *What Should be Disclosed in initial Coin Offering in CRYPTOASSETS: LEGAL AND MONETARY PERSPECTIVES* (forthcoming, Oxford University Press, 2019), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3293311.

⁴ One of the odd particularities of the White Paper is the website itself. There is what is alternatively described as the “Official White Paper” and (merely) “White Paper” document, with links in it that references a “technical paper” along with important “documents” that repeat and elaborate claims made in the White Paper. My testimony today, while citing the particular webpages, will refer them collectively as the White Paper.



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- The White Paper fails to disclose how the decentralized application interfaces it is envisioning could compromise the “secure, scalable, and reliable blockchain” Facebook is promising, as well as AML compliance and cybersecurity.
- Depending on how the White Paper is interpreted, Libra potentially comprises a source of systemic risk.

I do want to emphasize that these concerns represent only the tip of a regulatory iceberg. There are additional, critical questions concerning banking, the transmission of monetary policy, privacy, cybersecurity and other issue areas that potential holders of Libra would want to know before purchasing coins.

The (Non-) Disclosure of Consumer and Systemic Risk

Libra describes itself as a “simple global currency and financial infrastructure that empowers billions of people.”⁵ Its goals: “Reinvent money. Transform the global economy. So people everywhere can live better lives.”⁶

These are laudable and ambitious goals, and an upgrade of the payments system could truly improve the lives of millions of people around the world. But global currencies are no small ventures. Indeed, it usually takes hundreds of years in the case of national fiat currencies to establish themselves as practical, global payment options for everyday users of money. One of the reasons why is that currencies depend, ultimately, on rules and trust. People need to know that when they purchase currencies, those currencies will have utility as instruments of payment and savings and that they will maintain a steady value. And to help achieve this kind of trust, currency systems tend to have at least three basic features:

- A currency (as an instrument of payment and savings);
- A trusted backer of that currency (liquidity provider); and
- A rules-based messaging, value transmission, and clearing and settlement to enable money transfers to occur.

Libra’s private ecosystem is intended in part to provide a private analogue to such currency system through:

- The issuance of a currency (Libra coins);
- “Backed” by a reserve of fiat currencies and government securities (that are presumably low risk); and

⁵ See *Libra White Paper*, LIBRA, at 1, https://libra.org/en-US/wp-content/uploads/sites/23/2019/06/LibraWhitePaper_en_US-1.pdf (last visited July 13, 2019).

⁶ See *Welcome to Libra*, LIBRA, <https://libra.org/en-US/> (last visited July 13, 2019).



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- Operating according to a blockchain infrastructure for value transmission designed at least initially by the Libra Association.

Facebook's apparent strategy is that in order to launch a global currency, it needs to generate trust in the system; and as a private actor, the best way to do this is to ensure that the currency is tied to not just one, but several existing, and presumably trusted, fiat currencies and government securities.⁷ In this way, the White Paper argues, the coin can attain an "intrinsic" value.

The consequences of this design choice are not, however, without tradeoffs, something the White Paper neglects to mention. Instead, the White Paper consistently and deliberately gives the impression that because of its reserve backing, the Libra coin is relatively immune to the possibility of dropping in value:

"To drive widespread adoption, Libra is designed to be a currency where any user will know that the value of a Libra today will be close to its value tomorrow and in the future. Just as consumers in Europe know the number of Euros it takes them to buy a coffee today will be similar to the number of Euros it will take them tomorrow, holders of Libra, too, can be confident the value of their coins today will be relatively stable across time.

The reserve is the key mechanism for achieving value preservation. By fully backing each coin with a set of stable and liquid assets (described later) and by working with a competitive group of exchanges and other liquidity providers, users can have confidence that they will be able to sell any Libra coin at or close to the value of the reserve at any time. This gives the coin intrinsic value on day one and helps protect against the speculative swings of other cryptocurrencies."⁸

Throughout the White Paper, Facebook consistently plays on the word "value." And as seen above, **the White Paper routinely suggests and doubles down on the idea that the Libra will provide stability in terms of the purchasing power of the currency** (in this particular instance, with relation to coffee). But that's not really the case: the currency's actual goal is stability of Libra's value in terms of a basket of currencies which, due to its diverse holdings, Facebook expects will exhibits minimal price fluctuations.

The problem becomes all the more significant because while making such claims **the White Paper fails to ever disclose or explain in plain English that Libra comes with**

⁷ See Claudio Borio, *On Money, Debt, Trust and Central Banking*, (Bank for Int'l Settlements, Working Paper No. 763, 2019), <https://www.bis.org/publ/work763.pdf>.

⁸ See *The Libra Reserve*, LIBRA, at 1, https://libra.org/en-US/wp-content/uploads/sites/23/2019/06/TheLibraReserve_en_US.pdf (last visited July 13, 2019).



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a notable downside, namely the fact that when purchasing the coins Libra holders take on foreign exchange and currency risk.

This risk could arise in various ways. Let's start with an obvious scenario first: If, for example, there is a run on one of the currencies in the basket, then Libra itself loses value. This could in turn then create incentives to liquidate Libra for the strongest currency in the basket (possibly upending relatively weaker ones in a fire sale). In theory, the risks of such a run should be minimal, especially if the assets in the basket are low-risk. However, the White Paper does not disclose specifically which currencies are in the basket. Moreover, whatever the initial allocation may be, the contents of the basket can change.⁹ Because portfolio managers may be incentivized, or later instructed by the Libra Association, to realize high returns on their investments, they could incrementally steer the Reserve into ever riskier assets.¹⁰

Moreover, runs on the Libra could also be catalyzed for reasons that have nothing to do with the underlying basket. For example, runs on Libra could ensue if there are concerns with the economic stability of Facebook, or a key member of the Libra Association or an authorized reseller. Exogenous events could spark runs as well. A hack on the Calibra wallet or gateway Libra infrastructures, or failures to maintain proper data safeguards and separation between Facebook and Calibra, could spark a panic, prompting massive redemption requests.¹¹ Or operational blackouts or malware attacks targeting apps built on the platform could likewise drive large and unexpected redemption requests—an important issue given that apps are built on what is intended to be a “decentralized” platform not subject to any review process.¹²

In the case of a run, the key concern would be whether or not there are sufficient fiat currencies and government securities backing the Libra to support redemption requests. If there are not, and if the size of the Libra network was large enough¹³—a run could

⁹ Eric Posner, *The Trouble Starts If Facebook's New Currency Succeeds*, THE ATLANTIC (June 25, 2019), <https://www.theatlantic.com/ideas/archive/2019/06/dont-trust-libra-facebooks-new-cryptocurrency/592450/>.

¹⁰ *Id.* See also the following discussion on “Governance,” below.

¹¹ See also Yogita Khatri, *Nearly \$1 Billion Stolen In Crypto Hacks So Far This Year: Research*, COINDESK (Oct. 11, 2018), <https://www.coindesk.com/nearly-1-billion-stolen-in-crypto-hacks-so-far-this-year-research>.

¹² See *Libra White Paper*, *supra* note 5, at 4.

¹³ There has been considerable debate about the likely size of the Libra network. Given the many open questions concerning the project, I think any guess at this point would be purely speculative. That said, it is clear that Facebook has the intent of scaling the program to billions of customers, and has the platform to do so, globally, in fairly short order. Additionally, I think it is worthwhile to consider from a regulatory and prudential standpoint just how large that network could quickly become if just several members of the Libra Association—say, Uber, Lyft and Facebook—all decided to require Libra tokens for services on their platforms, or provided steep discounts to customers that did.



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conceivably have serious cross border, and possibly systemic consequences.¹⁴ Holders of Libra could find themselves with “money” that has—despite the assurances saturating the document—significantly diluted purchasing power.

Governance

The broader operational vulnerability of the currency raises important questions about governance in the Libra ecosystem. For most investments, governance is a key aspect of risk management, and is part and parcel of the information shared with potential investors.¹⁵ Consequently, in U.S. corporate and securities law, mandatory disclosures routinely include those relating to key personnel, how the corporate entity is overseen, how the decisionmaking will take place, and conflicts of interest faced by key employees and management.¹⁶

The Libra Association

The White Paper, to its credit, makes some effort to spell out its basic management structure. It informs readers that the Libra Association is made up initially of 27 technology companies that each runs one of the validator nodes that form the network that operates the Libra Blockchain. Additionally, it informs the reader that Facebook is still largely in charge of the effort until Libra’s launch in 2019, at which point in time “Facebook, and its affiliates, will have the same commitments, privileges, and financial obligations as any other Founding Member.”¹⁷

The governing body of the Libra Association will be the Libra Association Council, which is comprised of a representative of each member of the association.¹⁸ As in most corporate structures, the Libra Association Council will then delegate many of its executive powers to the association’s management. However, the Council retains authority to override delegated decisions and keep key decisions to itself, with the most important ones requiring a greater than two-thirds supermajority.¹⁹

¹⁴ See *Libra White Paper*, *supra* note 5, at 5.

¹⁵ Luis A. Aguilar, *Looking at Corporate Governance from the Investor’s Perspective*, HARV. L. SCH. F. ON CORP. GOVERNANCE AND FIN. REG. (Apr. 24, 2014), <https://corpgov.law.harvard.edu/2014/04/24/looking-at-corporate-governance-from-the-investors-perspective/>.

¹⁶ Frank H. Easterbrook & Daniel R. Fischel, *Mandatory Disclosure and the Protection of Investors*, 70 Va. L. Rev. 669 (1984).

¹⁷ See *The Libra Association*, LIBRA, at 1, https://libra.org/en-US/wp-content/uploads/sites/23/2019/06/TheLibraAssociation_en_US-1.pdf (last visited July 13, 2019).

¹⁸ *Id.*

¹⁹ *Id.* at 3.



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Finally, the White Paper discloses that the voting powers in the Council will be “proportional to stake (initially in the Libra Investment Token and, in the future, in Libra), which is a reflection of the level of commitment of the member (validator node) toward the network.”²⁰ However, voting rights will be capped for any one Founding Member to avoid concentration of power.”²¹ Specifically, a single Founding Member can only be represented by the greater of one vote or 1 percent of the total votes in the council.²²

This basic structural overview is helpful. But it’s far from the kind of information needed to understand how it—and for that matter, the broader Libra ecosystem—will operate, and core governance questions abound. For one, if voting power is determined according to members’ stake in Libra Investment Tokens, and ultimately Libra coins, **will there be disclosures of the largest stakes (or amount of coins and Libra Investment Tokens purchased by individual members) in order for users to be able to identify the primary decisionmaking entities on the network?**²³

Moreover, **what, if any “commitments, privileges and financial obligations” do Libra Association members have beyond their initial buy-in?** Are members required to act in the best interest of the currency (and by extension the currency stakeholders) or are they permitted to put their financial interest first? **Are there any public policy or contractual commitments they have with respect to assisting in the maintenance of financial stability and financial integrity?** How are members expected to balance their roles as profit-seeking businesses building applications on the network with the safety and soundness of the Libra system?

Finally, the White Paper emphasizes that the number of association members is set to grow. But just how that process will play itself out the extent that new members join, little information is provided. **What will be the criteria for determining new members?** Will they be expected to have any particular level of technological expertise or an ability to ensure that they can support proper risk management and financial stability and be competent decisionmakers if a crisis arose? Will the views of users be represented? And again, how will any potential conflict of interest concerns be handled?

²⁰ See *The Libra Association*, *supra* note 17, at 3.

²¹ *Id.*

²² *Id.* at 4. The cap on voting rights does not apply to validator nodes that are not Founding Members, i.e. that join the network only through holding Libra in custody. *Id.*

²³ See Josh Constine, *We Still Don’t Know How Much of Libra Facebook Owns*, TECHCRUNCH (July 6, 2019), <https://techcrunch.com/2019/07/03/facebook-libra-cryptocurrency/>.



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The Libra Reserve

The description of the Libra reserve compounds the ambiguities abounding in the disclosures concerning the Libra Association by offering little, and at times conflicting, information about how the basket’s portfolio will be managed.

The White Paper, notably, offers no information on the precise composition of the fund. Instead, readers are told that the “reserve will be invested in low-risk assets that will yield interest over time.” Additionally, prospective purchasers are informed that the “reserve will be held by a geographically distributed network of custodians with investment-grade credit rating.”²⁴

The objectives of the fund are also muddled, and contradictory. **Although the White Paper repeatedly states that “the goal [of the reserve] will always be value preservation”** the flow of proceeds from earnings on the proceeds indicate a strong profit motive and incentive for Libra Members. According to the white paper, once money raised from interest earnings have paid for operating in expenses and to fund “investments in the growth and development of the ecosystem,” **any “remaining returns will go to pay dividends to early investors in the Libra Investment Token for their initial contributions.”**²⁵ Other parts of the White Paper add that the responsibility of Libra reserve managers is to “allocate funds...for distribution to nodes and investors per Libra Investment Token terms, Incentives Distribution Policy, and council funds.”²⁶ Notably, there is no disclosure of what in such instances the relevant terms are for either the Libra Investment Tokens or the Distribution Policy.

Ambiguity as to the ultimate goals of the reserve are problematic for a number of reasons. To the extent that dividends influence the decisionmaking of Libra Association members, members will be incentivized to invest in high(er) yielding assets, which some may be risky. Furthermore, **even if value preservation is the ultimate “goal,” management of a risk free float is not easy.**²⁷ This is especially case when, as is currently the case, interest rates are low²⁸ and thus the returns on basket assets may not be sufficient to exceed the basket’s operational costs.²⁹

²⁴ See *The Libra Reserve*, *supra* note 8, at 2.

²⁵ *Id.*

²⁶ See *The Libra Association*, *supra* note 17, at 10.

²⁷ Izabella Kaminska, *Why Dealing With Fintechs is a Bit Like Dealing With Pirates*, ALPHAVILLE (July 3, 2019), <https://ftalphaville.ft.com/2019/07/03/1562126415000/Why-dealing-with-fintechs-is-a-bit-like-dealing-with-pirates/>.

²⁸ Indeed, interest rates may go lower still. See Heather Long, *Federal Reserve Expresses Concern About U.S. Economy and Signals Interest Rate Cuts Are Likely*, THE WASH. POST (June 19, 2019),



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Against this backdrop, **perhaps the most problematic aspect of the White Paper's disclosure is its failure to clearly disclose that holders of Libra are exposed to counterparty risk in the form of mismanagement of reserve investments.**

Authorized Resellers

Omissions also undermine readers' understanding of the Libra ecosystem. The White Paper informs readers that there will be "authorized resellers" that operate analogously to entities supporting Exchange Traded Funds.³⁰ According to the White Paper, they will be the only entities to transact large amounts of Libra in and out of the reserve, and will "integrate" with "exchanges" that buy and sell cryptocurrencies to users.³¹ Presumably, their role will involve helping to keep market prices on exchanges close to the value of reserve portfolio.

That said, the White Paper does not outline what kinds of entities these market participants will be. The operation of U.S. securities law (assuming they are in United States) would likely require that they register as Broker-Dealers. But will they also be banks? **How will they be chosen to fulfill such critical functions?** Will they be subject to minimum capitalization or other requirements?

Equally important, **will authorized resellers have any specific duties, responsibilities or redemption obligations vis a vis holders of Libra coins?** Presumably, they will sell Libra coins on exchanges at a price reflecting the wholesale value of the coins, plus a fee in the form of a bid-ask spread and/or transaction fee. Additionally, they will be able to buy coins back at a slight discount to the wholesale value and/or charging a transaction fee.³² But how such "integration" would work vis a vis coin holders, especially in the event of massive redemption requests, is neither disclosed or specified.

About those AML Promises

Libra's most laudable explicit objectives is that it aims to operate as a payment solution for the unbanked.³³ At the same time, Calibra has registered as a money services business, thereby becoming subject to anti-money laundering (AML) and know-your-

https://www.washingtonpost.com/business/2019/06/19/federal-reserve-expresses-concern-about-us-economy-signals-likely-interest-rate-cut-soon/?utm_term=.ecc0375f81e9.

²⁹ See Kaminska, *supra* note 27.

³⁰ See *The Libra Reserve*, *supra* note 8, at 2. See also the following discussion on Libra as an ETF.

³¹ *Id.*

³² Larry White, *Libra's Unresolved Puzzles*, ALT-M (July 2, 2019), <https://www.alt-m.org/2019/07/02/libras-unresolved-puzzles/>.

³³ See *Libra White Paper*, *supra* note 5, at 1.



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customer (KYC) obligations, and the White Paper declares that “the network’s main endpoints, in the form of exchanges and wallets, will need to follow applicable laws and regulations and collaborate with law enforcement.”³⁴

Facebook does not, however, specify whether or not participants will “need” to comply by function of law enforcement (which would be self-evident) or due to the internal policies of the Libra Association. Yet it is, in any event, almost certain that without rigorous oversight by the Libra Association, the Libra ecosystem will be an environment capable of facilitating money laundering, terrorism financing, and other financial crimes.

There are at least two reasons why. First, **the on and off ramps into the Libra system—especially exchanges and wallets—could operate or establish themselves in jurisdictions with lax AML and KYC rules, surveillance and enforcement of local market participants.** According to the blueprint sketched out in the White Paper, it appears customers could conceivably trade Libra for privacy coins and vice versa abroad, hold Libra in wallets located in an unregulated jurisdiction, and then send Libra coins to Calibra wallet users.³⁵

These challenges are complicated further by the fact that **the Libra blockchain will allow clients to “hold one or more addresses that are not linked to their real world identity.”**³⁶ Besides helping to enable illegal transactions, this may not square with the surveillance and reporting responsibilities of Calibra as a money services business under the Bank Secrecy Act. **By its terms, the Bank Secrecy Act’s “travel rule” requires covered financial institutions (and Calibra would be one) to pass on certain customer information** financial institutions receiving funds from their accounts, **including the name and address of the transmitter.**³⁷

It is of course possible that participants will “need” to comply with as-of-yet undisclosed Libra Association conduct policies. But this will require a purposeful, and explicit commitment to the task—and an outlay of resources. Financial intelligence units would likely be necessary, in multiple time zones, to investigate potential abuses and violations.³⁸ Additionally, AML vendor services will be needed for KYC and transaction monitoring—and evaluated for robustness, even among Libra Association members. **For anti-money laundering, as well as consumer protection and cybersecurity, the strength of the Libra ecosystem will lie in its weakest link. In order to make claims**

³⁴ See *The Libra Reserve*, *supra* note 8, at 3.

³⁵ Yaya J. Fanusie, *3 Ways Facebook Must Address Illicit Financing With Its New Cryptocurrency*, FOUND. FOR DEF. OF DEMOCRACIES (June 25, 2019), <https://www.fdd.org/analysis/2019/06/25/3-ways-facebook-must-address-illicit-financing-with-its-new-cryptocurrency/>.

³⁶ See *Libra White Paper*, *supra* note 5, at 6.

³⁷ 31 CFR § 103.33(g) (2011).

³⁸ Fanusie, *supra* note 35.



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that Libra is safe,³⁹ relies on a “secure, scalable, and reliable blockchain”⁴⁰ and will be regulatorily compliant,⁴¹ a well-considered, unified compliance program will be necessary. Otherwise, users of Libra coins could well find themselves answering questions by law enforcement officials in the wake of what they thought were ordinary Libra purchases. The White Paper fails to disclose this fact, much less how the product it is introducing would address it. And it is, in my view, particularly important at this early stage of the blockchain’s development since once bad actors are in the system, purging their abuse may be especially difficult, if not impossible.

Are Libra Coins Subject to Securities Laws?

My intent thus far has not been to catalogue all of the challenging disclosures in the document, but to instead provide a sense of the kinds of shortcomings that seem to pepper the White Paper. I think it’s now worth turning to the question as to whether as a matter of policy, these kinds of disclosures can create conundrums from the standpoint of investor protection.

The primary means by which digital assets are subject to the U.S. securities laws involves whether or not they are considered to be an “investment contract.” This is a catchall category under section 2(a)(1) of the Securities Act of 1933 with origins in blue sky laws adopted in some of the states before the federal securities laws were enacted.⁴² Notably, however, the term “investment contract” is not defined in the statute. Instead, the definition for purposes of U.S. securities law is laid out in the landmark 1946 Supreme Court case, *SEC v. Howey*.⁴³

The Howey Test

The *Howey* case involved a scheme to induce out of state investors to pool their money and invest in an orange grove harvesting operation in Florida. These investors were offered a strip of land and an optional 10-year service contract whereby one the defendants—a company called Howey-in-the-Hills—would grow oranges. Investors would then receive a pro rata share of the profits earned from the sale of the oranges after they were harvested and pooled together. The SEC sued, seeking to enjoin the defendants from selling such arrangements arguing that the scheme comprised the sale of unregistered securities. The company, meanwhile, argued that the agricultural nature of

³⁹ See *Libra White Paper*, *supra* note 5, at 5. (“We decided to build a new blockchain based on these three requirements: Highly secure, to ensure safety of funds and financial data..”)

⁴⁰ *Id.* at 3.

⁴¹ See above discussion; *See also* White, *supra* note 32.

⁴² Securities Act of 1933, 15 U.S.C. § 77b (2012).

⁴³ *S.E.C. v. W.J. Howey Co.*, 328 U.S. 293 (1946).



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the operation implicated no security, and that no stock or bonds were involved in the transaction.⁴⁴

Reviewing the facts, the Supreme Court held that the combined land and services agreements consisted of an “investment contract” whose substance, if not form, had a number of essential characteristics that together comprised the kinds of risks inherent to securities. Specifically, the Court held that the engagement with investors consisted of:

- (a) “an investment of money” (to purchase the land and operation contracts);
- (b) “in a common enterprise” (the harvesting of the oranges);
- (c) the expectation of profits (from the sale of the oranges);
- (d) to be derived “solely from the efforts of others” (Howey-in-the-Hills).⁴⁵

Collectively, these features rendered investors especially vulnerable to promoters of investments, necessitating the application of the 33 Act. And because the scheme comprised an investment contract, a registration should have been filed with the SEC prior to the offer and sale of the contracts.

Howey Test and Libra coins

To apply this case law to Libra, it’s worth rehearsing the basic parameters of the venture. Libra is, according to the White Paper, a cryptocurrency “backed” by a basket of currencies. Users will exchange fiat (official government) currencies for Libra coins.⁴⁶ Fiat currencies received by Facebook will then be put in a bank account or invested in high quality securities. A new subsidiary, Calibra, will serve as a wallet for Libra.⁴⁷ Finally, Facebook has created the Libra Association, a non-profit based in Switzerland with the purpose of helping facilitate the launch of the coin.⁴⁸ Members of the Libra Association pay-in at least \$10 million for which they receive Libra Investment Tokens.⁴⁹ Libra Investment Tokens entitle holders to dividends they earn from the interest generated by the assets in the reserve.

According to the facts available, it is virtually a certainty that **Libra Investment Tokens are securities**. Libra Association members make an investment of money to receive Libra Investment Tokens. There is an expectation of profit: Libra Investment Tokenholders receive pro rata dividend returns based off of the number of shares they own. There is a common enterprise, the Libra coin and blockchain. And association

⁴⁴ *Id.* at 295–97.

⁴⁵ *S.E.C. v. W.J. Howey Co.*, *supra* note 43, at 301.

⁴⁶ See *Libra White Paper*, *supra* note 5, at 7.

⁴⁷ *Id.* at 4.

⁴⁸ *Id.* at 8.

⁴⁹ See *The Libra Association*, *supra* note 17, at 4.



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members rely primarily on one another and managers to operate and design the ecosystem.

Whether or not the Libra coins are securities under *Howey* is far less clear. We know a little more than that—but not much. So applying securities law with such limited information is like peeling back the layers of an onion blindfolded—and with one hand. But by usual standards, the Libra Association *does* appear to fulfill many of the standards of what might be considered an investment contract under *Howey*.

- 1) There is an investment of money (holders extend fiat currency for Libra);
- 2) In a Common Enterprise (the Libra payment system); and
- 3) Relying on the Efforts of Others (the Libra Association).

The key issue, of course, is whether or not there is an expectation of profit.

Presumably, users wouldn't (or at least shouldn't—and this is an important distinction) be holding the Libra expecting to profit. Libra's price is intended to remain stable (though as we'll see below, it may not). Thus the plan might not run contrary to *Howey*.

However, it is worth noting that there *are* indeed some profit-seekers involved in the fundraise, namely the Libra Association and investors in the Libra Investment Token. And there are potentially open questions, especially given the SEC's ongoing enforcement action against *Kik*, as to whether, and if so when, the profit prong of *Howey* can be satisfied where other similar securities are offered in ways that could heighten speculative interest in Libra coins.⁵⁰

The Reves Test and Libra Coins

The *Howey* test isn't the only way a financial instrument might be deemed a security. Another yardstick is found in the Supreme Court case *Reves v. Ernst & Young*.⁵¹ The heart of the dispute in this case arose when the Farmer's Cooperative of Arkansas and Oklahoma offered high interest, unsecured, not of a fixed term demand notes to the public and to its members. When the Co-op went bankrupt, holders of the notes brought an action against the the Co-op's accountant, Ernst & Young for, among other things, violating antifraud provisions of the Securities Act of 1934 for failing to adhere to industry accounting standards. Ernst & Young countered, arguing that the 1934 Act did not list promissory notes as "securities" and thus that it was not applicable.

⁵⁰ For an interesting take on the similarities between the two offerings, see Darrell Etherington, see <https://techcrunch.com/2019/06/18/how-facebooks-libra-is-similar-in-concept-and-motivation-to-kiks-kin-cryptocurrency/>.

⁵¹ *Reves v. Ernst & Young*, 494 U.S. 56 (1990).



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The Supreme Court reviewed the facts and declared that the notes were indeed securities.⁵² In doing so, the court upheld a Second Circuit standard holding that notes with a term of more than nine months are presumptively securities unless they bear a family resemblance to a certain subset of notes, tied generally to consumer finance, that courts have recognized are not securities.⁵³ The *Reves* court also provides factors to help to determine whether a financial product resembles the items in its list of non-security notes.

The key factors include:

- 1) The seller's and buyers' motives;
- 2) The plan of distribution (suggesting potential speculation by purchasers);
- 3) The reasonable expectations of the investing public; and
- 4) The availability of an alternative regulatory regime.⁵⁴

Unlike *Howey*, however, the court never states that all factors have to be present to meet the test. Instead, *Reves* is generally applied in a more flexible (and less predictable) manner.

In the case of the Co-op, the court concluded that the notes were indeed a security:

- 1) The seller's and buyers' motives suggested a larger investment scheme: categories: the Co-Op sold the notes in an effort to raise capital for its general business operations, and purchasers bought them in order to earn an interest rate constantly revised to keep it slightly above the rate paid by local banks and savings and loans.
- 2) The plan of distribution was large: the Co-Op offered the notes over an extended period to its 23,000 members, as well as to nonmembers, and though the notes were not traded on an exchange, more than 1,600 people held notes when the Co-Op filed for bankruptcy.
- 3) The reasonable expectations of the investing public were that these were securities given the fact they were advertised as investments.
- 4) And finally (though the Court does not address it head on, there was presumably no alternative regulatory regime).

How would *Reves* apply to Libra coins? Well, arguably the coins could be considered “notes” insofar as the purchaser can be viewed as lending fiat to the reserve, and that fiat must be repaid upon demand by authorized resellers. Should the coins satisfy this basic conceptual question, *Reves* could present real challenges for Facebook. Its motives are

⁵² See *Reves v. Ernst & Young*, *supra* note 51, at 58.

⁵³ *Id.* at 63.

⁵⁴ *Id.* at 63-64.



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very much like those of the Co-op in *Reves*; it wants to raise capital for launching the blockchain and business operations for Libra. The prospective buyer's motives are different. As we saw in *Howey*, they are not seeking a profit. That said, they did purchase them in order to presumably enjoy lower rates for payment services than those charged by their local banks and savings and loans.

The plan of distribution is enormous, indeed unprecedented. A global marketing campaign was launched with this White Paper; and Facebook is aiming for billions of customers—with the coins to be traded on an exchange. Finally, there is no alternative exchange should the coins not be securities. At most, they would be considered commodities and their markets could be subject to CFTC oversight indirectly should they become the referenced assets of derivatives products.

Is Libra an Investment Company?

The Libra reserve, like the currency, is inspired by pre-existing facilities and infrastructures. Indeed, it is so much modeled after two kinds of entities—namely money market mutual funds and Exchange Traded Funds—that it is possible, and perhaps even likely, that it will qualify as an investment company and need to be registered as such under the Investment Company Act.

Money-market mutual funds are entities that hold only short-term government bonds and cash equivalents.⁵⁵ As with the assets Facebook has suggested will be in Libra Reserve, the assets held by money market mutual funds are all intended to pose little default risk, are supposed to be highly liquid, and low in duration risk.⁵⁶ Additionally, money-market mutual funds are open-ended, with the number of shares driven by the demand for them. As with Libra issuances, there is no numerical limit to how many shares an open-end fund can offer.⁵⁷

Yet in contrast to many mutual funds, which sell shares directly to the public and allows investors to sell them back directly to the fund, Libra does not allow purchasers to interact directly with the reserve. Instead, only Authorized Resellers are permitted to interact directly with the Libra Reserve:

“Libra is fully backed by a reserve of real assets. A basket of bank deposits and short-term government securities will be held in the Libra Reserve for every Libra that is created....”

⁵⁵ Justin Pritchard, *The Risks and Benefits of Money Market Funds*, THE BALANCE (Feb. 16, 2019), <https://www.thebalance.com/money-market-funds-risks-and-benefits-315497>.

⁵⁶ *Id.*

⁵⁷ See White, *supra* note 32.



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“Users will not directly interface with the reserve. Rather, to support higher efficiency, there will be authorized resellers who will be the only entities authorized by the association to transact large amounts of fiat and Libra in and out of the reserve. These authorized resellers will integrate with exchanges and other institutions that buy and sell cryptocurrencies to users, and will provide these entities with liquidity for users who wish to convert from cash to Libra and back again.”⁵⁸

This particular structure, too, has a clear (and indeed a transparent) institutional precedent: Exchange Traded Funds (ETFs). ETFs hold a comparatively more diverse array of assets than money market mutual funds (including stocks and bonds).⁵⁹ Moreover, in ETFs, funds do not sell shares directly to the public. Instead, a special kind of institutional investor, called an authorized participant, buys shares of the stocks that make up the index on which an ETF is based, and then sells or exchanges them for new ETF shares at an equal value.⁶⁰ In the process, new ETF shares are “created,” and the authorized participant can then sell the ETF shares in the market for a profit. Conversely, an authorized participant can “redeem,” or sell the relevant ETF shares back to the ETF in exchange for securities that the authorized participant can again sell on the open market.⁶¹

What then are the differences between ETFs and Libra? There do not appear to be many, and there may be none at all. Libra’s basket could end up being comparatively less risky. And it may have fewer securities (and certainly more fiat currencies). But that’s about it—that and, of course, the fact that Libra is assuming that its reserve will not be subject to regulation as an investment company. Whether or not that is the case depends largely on just how many securities are in the Libra reserve portfolio. In short, if the reserve invests in securities whose value exceeds forty percent of the value of the portfolio’s total assets (exclusive of government securities and cash items) on an unconsolidated basis, registration may be mandatory under the Investment Company Act.⁶²

In that case, the fund would be subject to all the disclosure obligations accompanying an ETF—and Libra coins would likely be treated synonymously to shares issued by ETFs.

⁵⁸ See *The Libra Reserve*, *supra* note 8, at 2.

⁵⁹ James Chen, *Exchange-Traded Fund – ETF*, INVESTOPEDIA (June 13, 2019), <https://www.investopedia.com/terms/e/etf.asp>.

⁶⁰ *Id.*

⁶¹ *Id.*

⁶² Investment Company Act, 15 U.S.C. § 80a-3 (2018).



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“Allow Me to Reintroduce Myself”

Facebook’s digital currency roll out was an attempt to do more than kick around ideas to the world to ask for input. It was an attempt to reintroduce itself as not only a tech company, but also a financial services firm behind a brand new product—the Libra coin.

Unfortunately, the white paper Facebook has relied upon to announce its plans is woefully deficient—in terms of the precision relating to its infrastructure, governance, and plans; in terms of the hyperbole obfuscating the possible risks to consumers and even the financial system; and in terms of the promises made to consumers about the technical features that will be available to them.

I think it’s worth asking whether or not such communications should be encouraged, even if—and I think the jury is still out—the Libra coin in fact turns out not to be a security. After all, the White Paper was designed to condition the market, and it’s done so, for better or worse.

Part of the frustrating aspects of conducting an analysis of the legal features and status of Facebook’s Libra is that even if the coins aren’t securities, it is clear that the Libra ecosystem, at a minimum, possess “securities-like” features:

- 1) Everyday consumers are ultimately putting their capital at risk in a common enterprise;
- 2) There are significant information asymmetries between them and a better informed sponsor, Facebook;
- 3) Libra coin holders will be dependent on the Libra Association for the operationalization and value-preservation of their coins;
- 4) There are some actors who are seeking profits from coin holder participation; and
- 5) Structurally, the transaction closely resembles pooled funds that are subject to securities rules and regulations.

These features are more than just a matter of technicality. They indicate varying ways in which potential Libra coin purchasers are far from fully informed, and are not on a level playing field vis a vis Libra’s sponsors.

Indeed, as a matter of public policy, it would seem to me that a more rigorous set of disclosures should be expected of issuers in these circumstance, especially those with the resources and reach of Facebook. The company’s approach is, to be sure, highly innovative and inventive. And the White Paper holds admirable objectives for the future of financial inclusion. But ultimately there are costs—and risks—that hard working people need to understand when being introduced to this product. This White Paper should have been an opportunity to take the time to tackle these issues head on.