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Does Cryptocurrency Staking Fall Under SEC Jurisdiction?

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DOES CRYPTOCURRENCY STAKING FALL UNDER SEC JURISDICTION?

*Nicholas E. Gonzalez**

ABSTRACT

Bitcoin, the first blockchain and cryptocurrency (crypto), launched in 2009 when the Bitcoin network opened to the public. A blockchain is a digital ledger technology where transactions are aggregated and permanently recorded into blocks of information. Maintenance of a blockchain is typically conducted by decentralized managers who own and operate network computers (“Nodes”) and serve the functions normally handled by central intermediaries to validate and confirm transactions. All Nodes follow a blockchain protocol. In Bitcoin’s and most cryptos’ cases, this protocol is known as a Proof-of-Work protocol which requires a large amount of energy consumption. Consequently, Proof-of-Stake protocols (“PoS”) were introduced into crypto blockchains as a solution to the power consumption problem.

In light of the advancement of blockchain technology, many have postulated whether PoS validation, a practice known as “Staking,” poses regulatory risks for Node Managers. Although a robust regulatory regime is far from complete, several federal agencies have engaged with the topic of crypto as early as 2014. The Securities and Exchange Commission, the agency that regulates investment contracts, is one of them. Under the Supreme Court’s *Howey* and *Marine Bank* Tests, which interpret the Securities Act of 1933, an investment contract is “a contract, transaction, or scheme whereby a person invests her money in a common enterprise and is led to expect profits solely from the efforts of the promoter or a third party.” Staking arrangements involve individual investors contributing crypto to Staking pools with the expectation of receiving a reward while relying

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on the efforts of the pool's Node Manager. A court using the *Howey* and *Marine Bank* analyses would find Staking arrangements are investment contracts. Fortunately, developers and Node Managers can charge flat fees, disincentivize large pools, and implement delegation to escape such regulatory classification and scrutiny.

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I. INTRODUCTION

From Bitcoin to non-fungible tokens (“NFTs”), blockchain-based digital assets have risen in popularity over the past decade, and increasingly so as the Covid-19 pandemic spurred a new population of investors.¹ The discussion of digital assets is far from quiet, with headlines about the topic popping up every day, in both industry and mainstream sources.² The market is also quite large; for example, in March 2021, the digital artist known as Beeple sold a digital photo linked to a blockchain as a NFT for \$69 million.³ With a market capitalization reaching over \$1 trillion and trading volume reaching \$1.4 billion for Bitcoin alone, it is fair to say blockchain-based digital assets are in the mainstream.⁴

The rising popularity of blockchain-based digital assets like cryptocurrency (crypto) has forced regulatory agencies, such as the Securities and Exchange Commission (SEC), to interpret longstanding laws quickly and comprehensively. While cryptos were classified as commodities like gold or oil by the Commodity Futures Trading Commission (CFTC),⁵ new technologies continuously compel regulators to evaluate whether cryptos fit under different classifications. “Staking” is one of the new technologies to find itself in the agencies’ sights, so

1. Gregory Sirico, *Tales from the Crypto*, BEST LAWS. (July 13, 2021, 8:00 AM), <https://www.bestlawyers.com/article/cryptocurrency-on-rise-during-covid-19/3787> [<https://perma.cc/B9P2-2UVG>].

2. Peter Santilli et al., *From Bitcoin to Dogecoin: What’s Driving Cryptocurrencies’ Rise and the Challenges Ahead*, WALL ST. J. (May 17, 2021), <https://www.wsj.com/articles/the-factors-driving-crypto-markets-boom-and-the-challenges-ahead-11621243809> [<https://perma.cc/M8CF-356R>].

3. Jacob Kastrenakes, *Beeple Sold an NFT for \$69 Million*, VERGE (Mar. 11, 2021), <https://www.theverge.com/2021/3/11/22325054/beeple-christies-nft-sale-cost-everydays-69-million> [<https://perma.cc/4TT5-YL55>].

4. *Market Capitalization (USD)*, BLOCKCHAIN, <https://www.blockchain.com/charts/market-cap> [<https://perma.cc/KR4E-DRJQ>].

5. See *Coinflip, Inc.*, CFTC Docket No. 15-29, CFTC, <https://www.cftc.gov/sites/default/files/idc/groups/public/@lrenforcementactions/documents/legalpleading/enfcoinfliporder09172015.pdf> [<https://perma.cc/NL44-PRM3>] (“Bitcoin and other virtual currencies are encompassed in the [commodity] definition and properly defined as commodities.”) (last accessed July 2, 2022). See also, Press Release, Commodity Futures Trading Comm’n, In Case You Missed It: Chairman Tarbert Comments on Cryptocurrency Regulation at Yahoo! Finance All Markets Summit (Oct. 10, 2019), <https://www.cftc.gov/PressRoom/PressReleases/8051-19> [<https://perma.cc/X573-66E6>].

much so that both SEC Chair, Gary Gensler, and former CFTC Chairman, Heath P. Tarbert, have publicly discussed its likelihood of falling under SEC jurisdiction.⁶ Staking is the process by which investors of a particular crypto are given rewards, typically newly minted crypto and transaction fees, in exchange for locking up their crypto within a blockchain protocol over a given period.⁷

The SEC regulates investment contracts and is the most well equipped to grapple with Staking. The SEC's mission is to "protect investors, maintain fair, orderly, and efficient markets, and facilitate capital formation."⁸ The SEC uses the Supreme Court's *Howey* Test to determine whether a given contract, transaction, or scheme is an investment contract.⁹ Under *Howey*, an investment contract is defined as "an investment of money in a common enterprise with profits to come solely from the efforts of others."¹⁰ Here, Staking arrangements involve investors contributing crypto with the expectation of receiving a reward.

While the SEC has yet to speak definitively on the topic, debates regarding how Staking should be classified have emerged around the blockchain community.¹¹ Advocates of stronger regulation reason the practice of Staking looks more like an investment contract than typical

6. Interview by David Ignatius with Garry Gensler, Chair, U.S. Sec. & Exch. Comm'n (Sept. 21, 2021), <https://www.washingtonpost.com/washington-post-live/2021/09/21/transcript-path-forward-cryptocurrency-with-gary-gensler/> [<https://perma.cc/5G4D-TGAS>]. See also Nikhilesh De, *CFTC Chairman Heath Tarbert Talks Ethereum, Defi and the Next BitMEX*, COINDESK (Oct. 14, 2020, 3:25 PM), <https://www.coindesk.com/policy/2020/10/14/cftc-chairman-heath-tarbert-talks-ethereum-defi-and-the-next-bitmex> [<https://perma.cc/L4ZB-HGAJ>].

7. *What is Staking?*, COINBASE, <https://www.coinbase.com/learn/crypto-basics/what-is-staking> [<https://perma.cc/STV6-7L3C>] (last visited Feb. 19, 2022).

8. *What We Do*, U.S. SEC. & EXCH. COMM'N (Nov. 22, 2021), <https://www.sec.gov/about/what-we-do> [<https://perma.cc/LD6H-Q9P8>].

9. See Sec. & Exch. Comm'n v. W.J. Howey Co., 328 U.S. 293 (1946); *Framework for "Investment Contracts" Analysis of Digital Assets*, U.S. SEC. & EXCH. COMM'N (Apr. 3, 2019), <https://www.sec.gov/corpfin/framework-investment-contract-analysis-digital-assets> [<https://perma.cc/A5MJ-KSWJ>]; Jacqueline Hennelly, *The Cryptic Nature of Crypto Digital Assets Regulations: The Ripple Lawsuit and Why the Industry Needs Regulatory Clarity*, 27 FORDHAM J. CORP. & FIN. L. 259, 262 (2022).

10. *Howey*, 328 U.S. at 301.

11. Darren J. Sandler, *Citrus Groves in the Cloud: Is Cryptocurrency Cloud Mining A Security?*, 34 SANTA CLARA HIGH TECH. L.J. 250, 279-80 (2018). See also *Securities Law Considerations for Staking Services*, BLOCKCHAIN ASS'N, <https://theblockchainassociation.org/securities-law-considerations-for-staking-services> [<https://perma.cc/VU5G-NPA2>] (last visited Feb. 19, 2022).

blockchain validation practices and should, therefore, be regulated.¹² Proponents of free crypto markets contend that Staking is not an investment contract because the practice of Staking fails the *Howey* Test.¹³ Crypto exchanges further contend they have repeatedly asked the SEC for guidance but are given the cold shoulder, making it impossible to know what regulations to follow.¹⁴

This Note addresses whether Staking arrangements should qualify as investment contracts under securities law. Part II provides a background of cryptos, Staking, and Proof-of-Stake protocols. Part III explores whether a Proof-of-Stake protocol exposes cryptos to regulatory hurdles. Part IV argues that Staking falls within the existing regulatory framework for investment contracts, as well as provides solutions for how crypto developers can mitigate the consequent regulatory risks. Part V summarizes this Note and provides a forward outlook.

II. BLOCKCHAIN AND THE EVOLUTION TO PROOF-OF-STAKE PROTOCOLS

A. BLOCKCHAIN, CRYPTO, AND PROOF-OF-WORK PROTOCOLS

Crypto is a virtual currency based on blockchain technology that is secured by cryptography, the most popular being Bitcoin.¹⁵ Bitcoin, the first blockchain and crypto, launched in 2009 when the Bitcoin network opened to the public.¹⁶ Bitcoins, like most cryptos, have no tangible existence, no centralized bank, and are not backed by a governmental authority.¹⁷ Instead, they are balances in a digital ledger, controlled by digital keys (passcodes), and stored in digital wallets (computer software)

12. Sandler, *supra* note 11.

13. *Securities Law Considerations for Staking Services*, *supra* note 11.

14. Matt Levine, *Lending Bitcoins is Tricky*, BLOOMBERG (Sept. 8, 2021, 12:56 PM), <https://www.bloomberg.com/opinion/articles/2021-09-08/lending-bitcoins-is-tricky>.

15. Jake Frankenfield, WHAT IS CRYPTOCURRENCY? INVESTOPEDIA, <https://www.investopedia.com/terms/c/cryptocurrency.asp> [<https://perma.cc/6B78-525P>] (last visited May 2, 2022).

16. Paulina Likos & Coryanne Hicks, *The History of Bitcoin, the First Cryptocurrency*, U.S. NEWS (Feb. 4, 2022), <https://money.usnews.com/investing/articles/the-history-of-bitcoin> [<https://perma.cc/SD3G-XPF6>].

17. Julia Finch, *From Silk Road to ATMs: The History of Bitcoin*, GUARDIAN (Sept. 14, 2017), <https://www.theguardian.com/technology/2017/sep/13/from-silk-road-to-atms-the-history-of-bitcoin> [<https://perma.cc/HNU3-SD55>].

that exist on either an investor's local device or online with a wallet service provider.¹⁸ Once stored, cryptos can be transferred to other wallets directly or traded for other currencies through crypto exchanges.¹⁹ All of these transactions are recorded on the given crypto blockchain.²⁰

Blockchain is a technology involving a digital ledger within which transactions are aggregated and permanently recorded into blocks, that are subsequently added in chronological order creating a chain.²¹ The blockchain operates through a network of computers ("Nodes") that records, verifies, and distributes the ledger according to a specific computer programming code known as a "protocol."²² Typically, the more decentralized a blockchain network is, by distributing and replicating the digital ledger on each Node, the more valuable it is. This is because decentralization eliminates a central point of failure, which ensures the network is fraud free and continuously operational.²³

The blockchain is maintained by decentralized managers who own and operate Nodes ("Node Managers") and serve the functions normally handled by central intermediaries.²⁴ Each Node is a validator on the network that not only stores a copy of the ledger but also monitors the

18. Andrey Sergeenkov, *What is Bitcoin?*, COINDESK, <https://www.coindesk.com/learn/what-is-bitcoin/> [<https://perma.cc/N2K2-Q7W5>] (last visited Apr. 13, 2022). See also Carol Goforth, *The Lawyer's Cryptionary: A Resource for Talking to Clients About Crypto-Transactions*, 41 CAMPBELL L. REV. 47, 58 (2019).

19. Kendall Little, *Want to Buy Crypto? Here's What to Look for In a Crypto Exchange*, TIME (Apr. 18, 2022), <https://time.com/nextadvisor/investing/cryptocurrency/what-are-cryptocurrency-exchanges/> [<https://perma.cc/YBG7-2QJD>].

20. Jake Frankenfield, *Block (Bitcoin Block)*, INVESTOPEDIA, <https://www.investopedia.com/terms/b/block-bitcoin-block.asp> [<https://perma.cc/K5FK-YF4T>] (last updated, Jan. 9, 2022).

21. *Id.*

22. See generally Satoshi Nakamoto, *Bitcoin: A Peer-to-Peer Electronic Cash System* (unpublished manuscript, 2009), <https://bitcoin.org/bitcoin.pdf> [<https://perma.cc/BXM4-ANVF>]; Crypto Glossary - Cryptopedia, GEMINI, <https://www.gemini.com/cryptopedia/glossary> [<https://perma.cc/63F3-RKMS>] (last visited May 2, 2022).

23. Sander, *supra* note 11, at 254.

24. Jordan Tuwiner, *What is Bitcoin Mining and How Does it Work?*, BUY BITCOIN WORLDWIDE, <https://www.buybitcoinworldwide.com/mining> [<https://perma.cc/DZ37-7PTX>] (explaining that Bitcoin miners solve "a computational problem which allows them to chain together blocks of transactions") (last updated Feb. 11, 2022); *Bitcoin Nodes vs. Miners: Demystified*, BRAINS, <https://brains.com/blog/bitcoin-nodes-vs-miners-demystified#:~:text=Ultimately%2C%20miners%20must%20play%20by,true%20rulers%20of%20the%20network> [<https://perma.cc/779M-SAMG>] (last visited Apr. 13, 2022).

network for newly-announced transactions.²⁵ All Nodes follow a blockchain consensus protocol to accomplish the recording, validation, and distribution process.²⁶ In Bitcoin's and most cryptos' cases, this protocol is a Proof-of-Work protocol ("PoW").²⁷ In PoW, a transaction is reported to the network, after which each Node examines its copy of the digital ledger to ensure the transaction is legitimate; this is done by verifying that, based on transaction history, a given wallet has the requisite crypto to transfer.²⁸ Once verified, the transaction is aggregated with other transactions for "miners" to form a potential block in the chain.²⁹

Miners are network contributors who own and operate specialized Nodes.³⁰ Miners receive the aggregated transactions and compete by performing "work" to confirm transactions and secure the network for the chance to record all new entries into the block.³¹ For this chance, however, miners must solve a mathematical proof presented by the previous block, often by guessing the solution.³² Once guessed, the solution is sent back to the Nodes for verification, after which the winning miner is granted the right to record the block and is rewarded with newly minted crypto and transaction fees for their efforts.³³

While Bitcoin and PoW are known for their originality, transparency, and security, unfortunately their energy cost is larger than

25. Andrey Sergeenkov, *What is Bitcoin?*, COINDESK, <https://www.coindesk.com/learn/what-is-bitcoin/> [<https://perma.cc/2W22-XT3T>] (last visited Apr. 13, 2022). *See also*, Tuwiner, *supra* note 24 (explaining that "[m]iners, like full nodes, maintain . . . and monitor the network for newly-announced transactions").

26. Sergeenkov, *supra* note 25.

27. *What is "Proof of Work" or "Proof of Stake"?*, COINBASE, <https://www.coinbase.com/learn/crypto-basics/what-is-proof-of-work-or-proof-of-stake> [<https://perma.cc/LZ3R-GBUF>] (last visited Jan. 21, 2022).

28. Goforth, *supra* note 18, at 64.

29. *Id.*

30. *Bitcoin Nodes vs. Miners: Demystified*, *supra* note 24.

31. Goforth, *supra* note 18, at 64 (explaining that "a miner then performs work in an attempt to fit all new, valid transactions into the current block"). *See* Jake Frankenfield, *Proof of Work (POW)*, INVESTOPEDIA, <https://www.investopedia.com/terms/p/proof-work.asp#citation-2> [<https://perma.cc/3SKG-LMEA>] (last updated July 22, 2021).

32. *See What is "Proof of Work" or "Proof of Stake"?*, COINBASE, <https://www.coinbase.com/learn/crypto-basics/what-is-proof-of-work-or-proof-of-stake> [<https://perma.cc/727V-SC7F>] (last visited Jan. 21, 2022).

33. Goforth, *supra* note 18, at 64.

that of other transaction systems.³⁴ If the Bitcoin network was a country, its annual energy consumption would range between that of Thailand and Vietnam.³⁵ This large footprint is due to the significant amount of electricity required to validate and confirm transactions.³⁶ A single Bitcoin transaction is equivalent to the carbon footprint of 2,302,133 Visa transactions or to the electricity consumed by an average U.S. household over 70 days.³⁷ Although Bitcoin is the most popular crypto, over 9,000 different cryptos are in circulation that require similar energy needs.³⁸

PoW is often blamed for the high energy consumption.³⁹ In PoW, a security feature called “Difficulty” protects the network from being spammed, controlled, or attacked by miners seeking to alter the blockchain.⁴⁰ Difficulty is the complexity of the mathematical proof that miners must guess to record a block.⁴¹ PoW increases the proof’s Difficulty as the number of miners increases, which translates into greater competition among miners and greater energy costs.⁴² In popular cryptos like Bitcoin, which has an estimated 1 million miners, the Difficulty has increased dramatically since its launch and so has the energy cost.⁴³

34. See *Bitcoin Energy Consumption Index*, DIGICONOMIST, <https://digiconomist.net/bitcoin-energy-consumption> [<https://perma.cc/YQ6Q-M4RN>] (noting that a single bitcoin transaction is equivalent to the carbon footprint of 2,302,133 VISA transactions) (last visited Jan. 22, 2022).

35. *Id.* See also *Comparisons*, CAMBRIDGE BITCOIN ELEC. CONSUMPTION INDEX (CBECI), <https://ccaf.io/cbeci/index/comparisons> [<https://perma.cc/KW5F-GGQ2>] (last visited Jan. 23, 2022).

36. *Bitcoin Energy Consumption Index*, *supra* note 34.

37. *Id.*

38. See COINMARKETCAP, <https://coinmarketcap.com/> [<https://perma.cc/8CAA-YHXT>] (last visited Jan. 22, 2022). See also *Examining Regulatory Frameworks for Digital Currencies and Blockchain: Hearing Before the S. Comm. On Banking, Hous., & Urban Affairs*, 116th Cong. 2 (2019) (statement of Rebecca Nelson, Specialist in International Trade and Finance) (“[Bitcoin is the] most well-known and widely used cryptocurrency, accounting for 65 [percent] of the [cryptocurrency] market.”).

39. See Audrey Carroll, *The Other Side of the (Bit)coin: Solutions for the United States to Mitigate the Energy Consumption of Cryptocurrency*, 12 GEO. WASH. J. ENERGY & ENV’T. L. 53, 55 (2021).

40. Jake Frankenfield, *What is Cryptocurrency Difficulty?*, INVESTOPEDIA, <https://www.investopedia.com/terms/d/difficulty-cryptocurrencies.asp> [<https://perma.cc/6Z78-B9H4>] (last updated July 26, 2021).

41. *Id.*

42. Sandler, *supra* note 11, at 258.

43. *Bitcoin Energy Consumption Index*, *supra* note 34. See also *Comparisons*, *supra* note 35; Sandler, *supra* note 11, at 258.

The Proof-of-Stake protocol (“PoS”) was introduced as a solution to the power consumption problem.⁴⁴ PoS is estimated to use 99 percent less energy than PoW, as well as reduce the need for ever more expensive and powerful mining Nodes.⁴⁵ PoS is an important alternative for crypto to increase energy efficiency and reduce waste.⁴⁶ This is why Ethereum, the developer of the second most popular crypto, Ether, has started the switch to PoS.⁴⁷ Ether is not alone, as around 10 of the 50 largest cryptos use PoS including Cardano, Solana, and Polkadot.⁴⁸

B. PROOF-OF-STAKE PROTOCOLS

1. *Mechanics of Proof-of-Stake*

First theorized on Bitcoin forums in July 2011, PoS varies substantially from PoW in its consensus mechanics.⁴⁹ In contrast to PoW, where miner Nodes must successfully guess the solution to a mathematical proof, PoS only requires that Nodes lock up crypto and validate transactions (Stake) to obtain the chance to record the next block.⁵⁰ Staking is the process whereby investors store and lock up their crypto in digital wallets and operate a Node, which validates transactions to obtain newly minted crypto and transaction fees.⁵¹ Further unlike PoW, where miners must compete to record blocks, in PoS, validator Nodes

44. Jake Frankenfield, *Proof of Stake Definition*, INVESTOPEDIA, <https://www.investopedia.com/terms/p/proof-stake-pos.asp> [<https://perma.cc/X24G-HCJ5>] (last updated Dec. 17, 2021).

45. Carroll, *supra* note 39, at 57.

46. *Id.* at 55.

47. See *Proof-of-Stake (POS)*, ETHEREUM, <https://ethereum.org/en/developers/docs/consensus-mechanisms/pos/> [<https://perma.cc/5EYT-5D28>] (last visited Jan. 22, 2022).

48. See COINMARKETCAP, *supra* note 38 (filter by “algorithm,” “PoS,” and “DPoS”); *Top 20+ Proof-of-Stake Coins & Tokens by Market Cap*, COINCODEX, <https://coincodex.com/cryptocurrencies/sector/proof-of-stake/> [<https://perma.cc/N8L5-HDVU>] (last visited Feb. 6, 2022); *Pos Archives*, CRYPTOSLATE, <https://cryptoslate.com/cryptos/proof-of-stake/> [<https://perma.cc/3H87-VKS5>] (last visited Feb. 6, 2022).

49. Cryptopedia Staff, *Proof of Stake vs. Delegated Proof of Stake*, GEMINI, <https://www.gemini.com/cryptopedia/proof-of-stake-delegated-pos-dpos#section-history-of-po-s> [<https://perma.cc/DX7U-WR XR>] (last updated Dec. 3, 2021).

50. *Proof-of-stake (POS)*, *supra* note 47.

51. Samuel Becker, *Guide to Crypto Staking: What It Is, How It Works, and How to Get Started*, SOFI (Oct. 22, 2021), <https://www.sofi.com/learn/content/crypto-staking/> [<https://perma.cc/LA6E-749G>].

(Nodes that satisfy the lock-up requirement) are randomly assigned the recording right.⁵² Without miners competing to guess the mathematical proof, PoS drastically reduces energy consumption and electronic waste.⁵³ This lock-up requirement also acts as collateral against which PoS can penalize Nodes for improper validation or malicious behavior.⁵⁴ Generally, the larger the number of crypto Staked by a given Node, the greater the Node's chance of recording the next block and receiving the newly minted crypto and transaction fees.⁵⁵ This incentivizes aggregating and Staking large pools of crypto under the umbrella of one Node.⁵⁶

Several PoS variations are used to determine which Node is assigned the right to record the next block.⁵⁷ As discussed above, the typical method is based on the size of the particular Node's Stake. Alternatively, some protocols employ a lottery system between classes of Stake sizes to ensure fairness and wider distribution of newly minted crypto.⁵⁸ Others randomize this right based on the length of time a given number of crypto has been Staked.⁵⁹ In this last variation, crypto must be Staked for a minimum period to qualify as a validator Node; once the right is granted the counter resets.⁶⁰ In these cases, larger and older sets of Staked cryptos have a greater opportunity to receive the right to record the next block.⁶¹ Another variation includes designated Nodes running specific software ("Master Nodes") that Stake a larger amount than others and facilitate instant transactions, private transactions, and decentralized governance

52. *Proof of Stake FAQs*, ETHEREUM WIKI, <https://eth.wiki/en/concepts/proof-of-stake-faqs> [<https://perma.cc/XJD6-M2B7>] (last visited Jan. 22, 2022).

53. *Proof-of-stake (POS)*, *supra* note 47.

54. *Id.*; *Proof-of-stake (POS)*, *supra* note 47.

55. *Id.*; *What is Proof-of-Stake?*, COINDESK (Mar. 9, 2022, 3:47 PM), <https://www.coindesk.com/learn/2020/12/30/what-is-proof-of-stake/> [<https://perma.cc/23AS-SJTC>].

56. Ameer Rosic, *Proof of Work vs Proof of Stake: Basic Mining Guide*, BLOCKGEEKS (June 19, 2020), <https://blockgeeks.com/guides/proof-of-work-vs-proof-of-stake/> [<https://perma.cc/NH9G-GCK6>]; *What is Proof-of-Stake?*, *supra* note 55.

57. Sandler, *supra* note 11, at 259.

58. *Id.* (citing *Nxt Whitepaper, Revision 4*, NXT (July 12, 2014), https://nxtdocs.jelurida.com/Nxt_Whitepaper [<https://perma.cc/V4MN-A262>] (NXT is a protocol that uses a proof-of-stake lottery)).

59. *Id.* (citing Sunny King & Scott Nadal, *PPCoin: Peer-to-Peer Crypto-Currency with Proof-of-Stake*, PEERCOIN (Aug. 19, 2012), <https://www.peercoin.net/> [<https://perma.cc/4J53-UYZ9>]).

60. *Id.*

61. *Id.*

voting.⁶² Master Nodes further enhance stability and network loyalty by aggregating and centralizing transactions.⁶³

A further PoS variation is known as Delegated PoS. Used by cryptos like Cardano⁶⁴ and TRON,⁶⁵ Delegated PoS allows investors to lock-up their crypto and elect delegates to record the next block on their behalf rather than Staking themselves.⁶⁶ Typically, blockchains limit the number of delegates allowed to Stake for a given block.⁶⁷ If the delegate wins the vote and records the block, the newly minted crypto and transaction fees are shared with investors who voted for that delegate.⁶⁸ Similar to typical PoS, the greater the Stake (in this case, the number of votes) the higher the reward share.⁶⁹ According to proponents, this is more democratic than traditional PoS because delegates must earn a reputation for operating quality Nodes.⁷⁰

2. *Proof-of-Stake Incentives*

The value of crypto is its decentralized nature.⁷¹ For crypto to be decentralized, developers must incorporate incentives for Node Managers to build and operate the network.⁷² While the main incentive for Node

62. Colin Harper, *What Are Masternodes? An Introduction and Guide*, COIN CENT. (Dec. 19, 2017), <https://coincentral.com/what-are-masternodes-an-introduction-and-guide/> [<https://perma.cc/TT59-6PNF>].

63. *Id.*

64. *Stake Pool Delegation*, CARDANO, <https://cardano.org/stake-pool-delegation/> [<https://perma.cc/BJ8K-YMDK>] (last visited Feb. 9, 2022).

65. TRON, *ADVANCED DECENTRALIZED BLOCKCHAIN PLATFORM 10* (2018) https://tron.network/static/doc/white_paper_v_2_0.pdf [<https://perma.cc/TM7X-3DEK>].

66. *What Are Proof of Stake and Delegated Proof of Stake?*, GEMINI (Dec. 3, 2021), <https://www.gemini.com/cryptopedia/proof-of-stake-delegated-pos-dpos#section-history-of-po-s> [<https://perma.cc/CL7T-B82S>].

67. *Id.*

68. *Id.*

69. *Id.* See also Elliot Hill, *Choosing a Stake Pool and Delegating Your Ada*, MEDIUM (Aug. 26, 2020), <https://medium.com/cardanorss/choosing-a-stake-pool-and-delegating-your-ada-113d71b0963f> [<https://perma.cc/B4B4-92ZT>].

70. *What Are Proof of Stake and Delegated Proof of Stake?*, *supra* note 66. See also Hill, *supra* note 69.

71. *What is Bitcoin?*, COINDESK, <https://www.coindesk.com/learn/what-is-bitcoin/> [<https://perma.cc/G78J-WCHE>] (last visited Apr. 13, 2022).

72. See *Bitcoin Nodes vs. Miners: Demystified*, *supra* note 24. See also *Proof-of-Stake (POS)*, ETHEREUM, <https://ethereum.org/en/developers/docs/consensus-mechanisms/pos/> [<https://perma.cc/AHV5-FDND>] (last visited Apr. 14, 2022).

Managers is the reward of newly minted crypto and transaction fees, developers also focus on other incentives.⁷³ As stated previously, a core incentive to operate a PoS Node is the reduced energy cost.⁷⁴ A crypto protocol that does not require Nodes to compete with one another is more cost-effective both in terms of energy and equipment, making the protocol more sustainable and profitable for Node Managers.⁷⁵

PoS also provides more security incentives than PoW by addressing the two most prominent security risks: “double spending” and a “51 percent attack.”⁷⁶ Double spending is where an investor attempts to spend the same crypto twice.⁷⁷ The PoS consensus mechanism commonly mitigates double spending by verifying that, based on transaction history, a given wallet has the requisite crypto to transfer.⁷⁸ The other main concern is a 51 percent attack, where a person or group controls 51 percent of a given crypto’s mining Nodes and uses that majority power to alter the blockchain or confirm and record fraudulent transactions to a block.⁷⁹ Generally, cryptos are protected from this type of attack because volunteers utilize the blockchain’s public ledger to identify irregularities and there are too many miner Nodes for any one group to control.⁸⁰ Within PoS, however, rather than obtaining 51 percent of miner Nodes, attackers must obtain 51 percent of all Nodes by acquiring 51 percent of the Staked crypto.⁸¹ This burden is significantly higher than what a PoW attacker would face, which adds another protective layer to the network.

73. See *Bitcoin Nodes vs. Miners: Demystified*, *supra* note 24. See also *Proof-of-Stake (POS)*, *supra* note 72.

74. See Section II.A.

75. See *Bitcoin Energy Consumption Index*, DIGICONOMIST, <https://digiconomist.net/bitcoin-energy-consumption> [<https://perma.cc/Q7NT-AQU4>] (last visited Jan. 22, 2022).

76. See *Proof-of-Stake (POS)*, *supra* note 72. See also *What is Proof-of-Stake?*, COINDESK, <https://www.coindesk.com/learn/2020/12/30/what-is-proof-of-stake/> [<https://perma.cc/TP4S-ZYUU>] (last visited Apr. 14, 2022). See generally, *Crypto Glossary - Cryptopedia*, *supra* note 22.

77. *What is Proof-of-Stake?*, *supra* note 76.

78. *Id.*

79. Pawan Nahar, *What are 51% Attacks in Cryptocurrencies?*, ECON. TIMES (Aug. 31, 2021), <https://economictimes.indiatimes.com/markets/cryptocurrency/what-are-51-attacks-in-cryptocurrencies/articleshow/85802504.cms?from=mdr> [<https://perma.cc/QY C9-VA3J>].

80. *Id.*

81. See *Proof-of-Stake (POS)*, *supra* note 72. See also *What is Proof-of-Stake?*, *supra* note 76.

PoS has the added security incentive of penalizing Node Managers through a process known as “slashing,” whereby a portion of the Staked crypto can be automatically destroyed when triggered.⁸² Node Managers can be slashed if they act maliciously, disconnect from the network, or fail to validate a transaction.⁸³ Slashing disincentivizes Node Managers from operating in bad faith or conflicting with the majority of the network.⁸⁴ Additionally, this heightened security further incentivizes Node Managers to operate in the network’s best interest and store more crypto in a given wallet, making it prohibitively expensive to take over a network.⁸⁵

The primary incentive in PoS, however, is the Staking reward of newly minted crypto and transaction fees, which furthers other goals of the network. The reward encourages those who Stake to act in the network’s best interest, which in turn strengthens the crypto’s price stability and value of earned rewards.⁸⁶ PoS also incentivizes Node Managers to Stake more of a given crypto for a greater chance of earning the block recording right, increasing loyalty to the network.⁸⁷ Often, PoS will require Staking a minimum amount of crypto to qualify as a validator Node eligible to receive rewards.⁸⁸ For example, the second most popular crypto, Ether, will complete the transition to PoS within the next few years.⁸⁹ The transition project known as “Ethereum 2.0,”⁹⁰ will require Node Managers to Stake a minimum of 32 ETH (over \$96,000 on April

82. Vitalik Buterin, *Why Proof of Stake (Nov 2020)*, VITALIK BUTERIN (Nov. 6, 2020), <https://vitalik.ca/general/2020/11/06/pos2020.html> [<https://perma.cc/F47C-DDQX>].

83. *Stake Your ETH to Become an Ethereum Validator*, ETHEREUM, <https://ethereum.org/en/eth2/staking/> [<https://perma.cc/BD9F-CSB4>] (last visited Jan. 22, 2022).

84. Jake Frankenfield, *Proof-of-Stake (PoS)*, INVESTOPEDIA (Dec. 17, 2021), <https://www.investopedia.com/terms/p/proof-stake-pos.asp> [<https://perma.cc/YVB8-FLXZ>].

85. Sandler, *supra* note 11, at 260.

86. *Id.*

87. *Id.* at 258-59.

88. Paul Wackerow et al., *Proof-of-Stake (POS)*, ETHEREUM (Jan. 26, 2022), <https://ethereum.org/en/developers/docs/consensus-mechanisms/pos/> [<https://perma.cc/4XA2-K8NR>].

89. *Id.*

90. *The great renaming: What happened to Eth2?*, ETHEREUM FOUND. BLOG (Jan. 24, 2022), <https://blog.ethereum.org/2022/01/24/the-great-eth2-renaming/> [<https://perma.cc/3RLK-R7MP>].

14, 2022) to qualify as a validator.⁹¹ A minimum Stake of 32 ETH may be too steep for some investors, preventing them from participating in Staking.⁹² This burden, however, “is quickly solved with the help of pools of depositors accepting various crypto[.]”⁹³

By aggregating crypto into a large Staking pool, Node Managers offer investors the chance to receive the reward of newly minted crypto and transaction fees.⁹⁴ In return, the third-party Node Managers who operate these pools receive either a fixed or variable fee for their service.⁹⁵ Today, many Node Managers help investors Stake crypto; the two most popular avenues for crypto investors are exchanges and independent Staking pools.⁹⁶ Staking pools generally allow investors to Stake small amounts of crypto by transferring ownership of the crypto to the pool during the lock-up period.⁹⁷ The Node Manager then maintains the Node’s operation and connection to the network while periodically distributing earned rewards to pool contributors.⁹⁸ Exchanges, such as Coinbase and Kraken, operate such Staking pools in addition to other crypto products like wallet and exchange services.⁹⁹

91. *Stake Your ETH to Become an Ethereum Validator*, *supra* note 83 (indicating that a miner needs 32 ETH2 to become a validator). *See also*, *Ethereum 2 (ETH2) Price, Charts, and News*, COINBASE, <https://www.coinbase.com/price/ethereum-2> [<https://perma.cc/Z8FC-PC6L>] (last visited Apr. 14, 2022).

92. *See Stake Your ETH to Become an Ethereum Validator*, *supra* note 83 (indicating that a miner needs 32 ETH2 to become a validator). *See also* *Overview of Cloud PoW and PoS Mining*, HIVE BLOG, <https://hive.blog/ico/@atb-coin/overview-of-cloud-pow-and-pos-mining> [<https://perma.cc/DD7Q-GX5H>] (last visited Jan. 22, 2022).

93. *See Overview of Cloud PoW and PoS Mining*, *supra* note 92.

94. *See id.*

95. *See* Sandler, *supra* note 11, at 262-63. *See also* *Earn Staking Rewards on Coinbase*, COINBASE, <https://www.coinbase.com/staking> [<https://perma.cc/582Y-BZQQ>] (last visited Jan. 23, 2022).

96. *See* Ofir Beigel, *What is Proof of Stake and How to Stake Ethereum*, 99BITCOINS, <https://99bitcoins.com/proof-of-stake/> [<https://perma.cc/CRW2-TBLG>] (last visited Jan. 4, 2022).

97. *See id.*

98. *See* Sandler, *supra* note 11; CRYPTO STAKING: BEST CRYPTO STAKING PLATFORM BINANCE, <https://www.binance.com/en/staking> [<https://perma.cc/2TEE-CAMZ>] (indicating that staking interest is distributed on a daily basis) (last visited Apr. 14, 2022).

99. *See* Beigel, *supra* note 96. *See also* *Earn Staking Rewards on Coinbase*, *supra* note 87; *Features Overview*, KRAKEN, <https://www.kraken.com/en-us/features/> [<https://perma.cc/5LHM-2TPL>] (last visited Jan. 21, 2022).

III. PROOF-OF-STAKE PROTOCOLS' EXPOSURE TO REGULATION

Although a robust regulatory regime is far from complete, several federal regulatory agencies have engaged with the topic of crypto as early as 2014.¹⁰⁰ While commentators and academics alike regularly debate whether crypto practices are investment contracts under SEC jurisdiction, Staking in particular is a promising development in crypto technology that needs clarification. To pursue this clarity, Section III.A. surveys key positions from the Financial Crimes Enforcement Network (FinCEN), the Internal Revenue Service (IRS), the CFTC, and the SEC. Section III.B. applies the current SEC framework to third-party Staking practices.

A. FEDERAL REGULATORY FRAMEWORK

1. *FinCEN*

To detect and prevent money laundering, Congress passed the Bank Secrecy Act of 1970, which required Money Services Businesses (MSBs) to register with FinCEN.¹⁰¹ Certain issuers and exchangers of cryptos have been required to register as MSBs with FinCEN.¹⁰² On March 18, 2013, FinCEN published guidance announcing it would not distinguish between transmitters of government-backed currency and “decentralized convertible virtual currency,” meaning crypto.¹⁰³ The guidance states that exchangers and administrators of cryptos are money transmitters under FinCEN’s regulations and must register as MSBs unless they fall within an exception.¹⁰⁴

100. See Sandler, *supra* note 11, at 263.

101. 31 U.S.C. § 5330 (2012); 31 C.F.R. § 1022.380 (2011).

102. See Sandler, *supra* note 11, at 264.

103. FIN. CRIMES ENF’T NETWORK, DEPT. TREASURY, APPLICATION OF FINCEN’S REGULATIONS TO PERSONS ADMINISTERING, EXCHANGING, OR USING VIRTUAL CURRENCIES, FIN-2013-G001 (Mar. 18, 2013).

104. See Sandler, *supra* note 11, at 265 (citing 31 C.F.R. § 1010.100(ff)(5)(ii)).

An exchanger is defined as a person or entity “engaged as a business in the exchange of virtual currency for real currency, funds, or other virtual currency.” An administrator of virtual currency is defined as a person or entity “engaged as a business in issuing (putting into circulation) a virtual currency, and who has the authority to redeem (to withdraw from circulation) such virtual currency.”

FinCEN updated its guidance in 2014 to exempt miners from the registration, reporting, and recordkeeping regulations required of MSBs.¹⁰⁵ This exception only applies, however, if the miner uses it solely for his or her own purpose and not for the benefit of another.¹⁰⁶ Just as issuers/developers (such as Ethereum) and exchanges (such as Coinbase) must register with FinCEN as MSBs, independent Staking pools may also be considered money transmitters required to register as MSBs.¹⁰⁷ This is because they accept and transmit crypto on behalf of others and are compensated in connection with such services.¹⁰⁸ This requirement, however, is outside the scope of this Note.

2. IRS

On March 25, 2014, the IRS issued Notice IR-2014-36-21, which provides that cryptos are treated as property (not currency) for federal tax purposes.¹⁰⁹ This means that an increase in the fair market value of a given crypto is classified as a taxable gain, similar to tangible property or securities.¹¹⁰ The IRS also announced that taxpayers who mine crypto realize gross income upon receipt of the crypto resulting from those activities.¹¹¹ Meanwhile, in the Build Back Better Act, Congress proposed taxing cryptos more like stocks by subjecting them to “wash sale” rules.¹¹² This would mean that a loss on the sale of crypto is “not [tax] deductible if the taxpayer acquires substantially identical [crypto] within 30 days before or after the sale (61-day period).”¹¹³ The IRS’ view of crypto shows

Id.

105. See Sandler, *supra* note 11, at 265 (citing FIN. CRIMES ENF’T NETWORK, DEPT. TREASURY, *supra* note 104).

106. *Id.*

107. *Id.*

108. See Sandler, *supra* note 11, at 265-66 (explaining that cloud mining companies, similar to independent Staking and pool organizations, may also be considered MSBs under FinCEN guidance).

109. I.R.S. Notice 2014-21 § 4.

110. See *id.*

111. See *id.*

112. See Daren Fonda, *The SEC May Be Coming for Stablecoins, While Congress Aims to Treat Cryptos More Like Stocks*, BARRON’S (Sept. 15, 2021), <https://www.barrons.com/articles/cryptocurrencies-bitcoin-stablecoins-regulation-51631724992> [<https://perma.cc/C7HJ-YVZ9>] (last visited Apr. 14, 2022).

113. See *Proposed Rules Would Apply Wash Sale and Constructive Sale Rules to Cryptocurrency*, WOLTERS KLUWER (Dec. 21, 2021), <https://www.wolterskluwer.com/>

that agencies are comfortable excluding digital assets from the currency classification, while the provisions of the Build Back Better Act demonstrate Congress' comfort in doing the same.

3. CFTC

The CFTC regulates the derivatives markets, which include futures, swaps, and certain kinds of options.¹¹⁴ Its mission is to promote the integrity, resilience, and vibrancy of the derivatives markets.¹¹⁵ The CFTC first found Bitcoin and other cryptos to be defined as commodities in 2015.¹¹⁶ This definition implicates CFTC jurisdiction when crypto is “used in a derivatives contract, or if there is fraud or manipulation involving crypto traded in interstate commerce.”¹¹⁷ Beyond these instances, however, the CFTC does “not oversee exchanges or transactions that do not utilize margin, leverage, or financing.”¹¹⁸

In an October 2019 interview, then-Chairman of the CFTC, Heath P. Tarbert, stated that Ether, similar to Bitcoin, “is a commodity and therefore would fall under [CFTC] jurisdiction[.]”¹¹⁹ Soon after, however, Chairman Tarbert cast doubt on whether Ethereum’s new PoS crypto, Ethereum 2.0, will fall into the same commodity classification as the PoW crypto, but noted that the key attribute of decentralization is present in both.¹²⁰ Tarbert further reasoned that “[t]he more decentralized” the

en/expert-insights/application-of-wash-sale-and-constructive-sale-rules-to-cryptocurrency-and-digital-assets [https://perma.cc/FC2P-XW4U].

114. U.S. Commodity Futures Trading Commommission, USA.GOV, <https://www.usa.gov/federal-agencies/u-s-commodity-futures-trading-commission> [https://perma.cc/CY7F-XG59] (last visited Apr. 14, 2022).

115. See *The Commission*, CFTC, <https://www.cftc.gov/About/AboutTheCommission> [https://perma.cc/VT5Q-9PWB] (last visited Jan. 26, 2022).

116. See *Coinflip, Inc.*, CFTC Docket No. 15-29 (2015).

117. See *A CFTC Primer on Virtual Currencies*, LABCFTC (Oct. 17, 2017), https://www.cftc.gov/sites/default/files/idc/groups/public/documents/file/labcftc_primer_currencies100417.pdf?mod=article_inline [https://perma.cc/62C8-CPZF].

118. See *id.* See also Press Release, CFTC, In Case You Missed It: Chairman Tarbert Comments on Cryptocurrency Regulation at Yahoo! Finance All Markets Summit (Oct. 10, 2019), <https://www.cftc.gov/PressRoom/PressReleases/8051-19> [https://perma.cc/UKA6-2AH8].

119. Press Release, CFTC, *supra* note 118.

120. See Nikhilesh De, *CFTC Chairman Heath Tarbert Talks Ethereum, Defi and the Next BitMEX*, COINDESK (Oct. 14, 2020), <https://www.coindesk.com/policy/2020/10/14/cftc-chairman-heath-tarbert-talks-ethereum-defi-and-the-next-bitmex>

crypto becomes, and “the more it effectively runs itself, the more likely it [will fall] within the commodity category and not the securities [category].”¹²¹ The issue is contingent, however, on what the SEC decides.¹²² The CFTC generally defers to the SEC’s views on whether something is an investment contract before bringing it under CFTC jurisdiction as a commodity.¹²³

4. SEC

Congress established the Securities and Exchange Commission through the Securities Exchange Act of 1934.¹²⁴ The SEC is the federal agency responsible for regulating securities and investment contracts to protect main street investors and ensure fair and efficient markets.¹²⁵ In terms of crypto, the SEC continues to hear debates about whether they fall into one of the traditional financial product categories.¹²⁶ Advocates of strong regulation and proponents of free crypto markets continuously clash over whether a given crypto product lands under SEC jurisdiction and thus should be classified as an investment contract.

In this instance, the future of PoS regulation comes down to the SEC. The IRS already treats cryptos as appreciable assets and FinCEN may follow suit to require Node Managers to register and report as MSBs. While cryptos like Bitcoin and Ether are currently classified as commodities, the CFTC’s deference to the SEC on such matters makes that status less than secure.¹²⁷ The next Section discusses the SEC’s

[<https://perma.cc/4RG6-Z4MG>]. See also, Jon Buck & Max Moeller, *Ethereum 2.0’s Proof of Stake could be Classified as a Security, Says CFTC*, Chairman, BEINCRYPTO (Nov. 16, 2019), <https://beincrypto.com/ethereum-2-0-proof-of-stake-could-be-classified-as-a-security-says-cftc-chairman> [<https://perma.cc/5SSM-KLB7>] (explaining that “Tarbert told the audience during the interview that the previously held view that Ethereum is a commodity is now in jeopardy”).

121. De, *supra* note 120.

122. See *id.*

123. See *id.*

124. See Securities & Exchange Act of 1934, 15 U.S.C. § 78d.

125. See *What We Do*, *supra* note 8.

126. See *Are Cryptocurrencies Securities? The SEC is Answering the Question*, REUTERS, <https://www.reuters.com/legal/transactional/are-cryptocurrencies-securities-sec-is-answering-question-2022-03-21/> [<https://perma.cc/2GBN-47NV>] (last visited Apr. 14, 2022).

127. *Coinflip, Inc.*, *supra* note 116.

framework for classifying an investment contract, as well as outlines the discussion around PoS.

B. THE SECURITIES ACT AND ITS APPLICATION TO PROOF-OF-STAKE

In the wake of the 1929 market crash, and before the establishment of the SEC, Congress adopted the Securities Act of 1933 (“‘33 Act”) to provide investors with adequate information concerning investment contracts being offered for public sale and “prohibit deceit, misrepresentation, and other fraud in the sale of securities.”¹²⁸ The ‘33 Act defines a “security” as:

[A]ny note, stock, treasury stock, security future, security-based swap, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement. . . investment contract. . . or, in general, any interest or instrument commonly known as a “security”, or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing.¹²⁹

While interpretation of the ‘33 Act’s “security” definition has been litigated many times, the Supreme Court’s decision in *Securities & Exchange Commission v. W.J. Howey Co.* interprets investment contracts under the ‘33 Act.¹³⁰ In *Howey*, a Florida citrus fruit cultivation company sold service contracts that allowed individuals to purchase 10-year leasehold interests in citrus groves cultivated and managed by the W.J. Howey Company.¹³¹

Under *Howey*, the Court ruled a contract constitutes an investment contract if there is (i) an investment of money; (ii) in a common enterprise; (iii) with an expectation of profits; (iv) derived solely from the efforts of a promoter or third party, regardless of “whether the shares in the enterprise are evidenced by formal certificates or by nominal interests

128. *The Laws That Govern the Securities Industry*, U.S. SEC. & EXCH. COMM’N (Oct. 1, 2013), <https://www.sec.gov/answers/about-lawsshtml.html> [<https://perma.cc/2MD7-DPYD>].

129. Securities Act of 1933, 15 U.S.C. § 77b(a)(1) (2012).

130. *See* Sec. & Exch. Comm’n v. W.J. Howey Co., 328 U.S. 293 (1946). *See also* James D. Gordon III, *Defining a Common Enterprise in Investment Contracts*, 72 OHIO ST. L.J. 59, 65 (2011) (“The leading case regarding the definition of investment contracts is *SEC v. W.J. Howey Co.*”).

131. *See Howey*, 328 U.S. at 295-96.

in the physical assets employed by the enterprise.”¹³² This four-pronged test is known as the *Howey* Test.¹³³

Many of the concerns surrounding Staking arrangements between investors and Node Managers are reminiscent of the Supreme Court’s apprehensions in *Howey*. Specifically, the economic incentives, remoteness of investors, insufficient demarcation of property, resulting payment, investor reliance on the manager/promoter, and the economies of scale all indicate that Staking arrangements may be considered securities under the ‘33 Act.¹³⁴ This Section will discuss each prong of the *Howey* Test in turn, outlining the arguments for and against classification of Staking arrangements as investment contracts.

1. *Howey* Test Prong One: Investment of Money

The first prong in the *Howey* Test considers whether there was an investment of money.¹³⁵ By definition, an investment is “an [exchange] of money or capital to gain profitable returns, such as interest, income, or appreciation in value.”¹³⁶ The Ninth Circuit stated the *Howey* Test’s first prong is met where an individual investor “commit[s] his assets to the enterprise in such a manner as to subject himself to financial loss.”¹³⁷ Typically, the investment of money prong is “not a disputed element in a case and is generally understood to include any form of consideration including crypto itself.”¹³⁸

Advocates for stronger regulation argue that Staking arrangements satisfy the first prong of *Howey* because investors contribute crypto to Node Managers who lock up the crypto to validate transactions on the

132. See *id.* at 298-301.

133. See *e.g.*, Sandler, *supra* note 11, at 252-53.

134. See Sandler, *supra* note 11, at 271.

135. See *Howey*, 328 U.S. at 301.

136. See *Investment*, DICTIONARY.COM, <https://www.dictionary.com/browse/investment> [<https://perma.cc/R7P9-YLWH>] (last visited Apr. 14, 2022).

137. *Warfield v. Alaniz*, 569 F.3d 1015, 1020-21 (9th Cir. 2009).

138. See Sandler, *supra* note 11, at 272 (citing *Int’l Bhd. of Teamsters v. Daniel*, 439 U.S. 551, 560 n.12 (1979)); *SEC v. SG Ltd.*, 265 F.3d 42, 46-47 (1st Cir. 2001). See also *Hector v. Wiens*, 533 F.2d 429, 432-33 (9th Cir. 1976); *United States v. Faiella*, 39 F. Supp. 3d 544, 545 (S.D.N.Y. 2014) (“Bitcoin clearly qualifies as ‘money.’”); *SEC v. Shavers*, Civ. No. 4:13-CV-416, 2013 WL 4028182, at *2 (E.D. Tex., Aug. 6, 2013) (stating that paying in bitcoin satisfies the “investment of money” prong of the *Howey* Test).

blockchain.¹³⁹ If granted the recording right, the Node Managers receive the reward and allocate the earnings to investors.¹⁴⁰ They also argue investors commit crypto to the enterprise in a manner as to subject themselves to financial loss through the possibility of theft or slashing.¹⁴¹

Proponents of free crypto markets argue that Staking arrangements do not satisfy this prong because satisfaction depends on whether investors transfer custody of their crypto to a third party or delegate Staking rights without relinquishing custody.¹⁴² They reason that investors who transfer ownership to a Node Manager subject themselves to the risk of theft or slashing, while investors who delegate Staking rights do not expose themselves to that risk.¹⁴³

The majority of Staking arrangements may fulfill the “investment of money” prong of the *Howey* Test because investors typically must transfer ownership of crypto to participate in the Staking pool. Though it is correct that investors who delegate are not exposed to a risk of loss, this argument fails to acknowledge that delegate Staking arrangements are in the minority of PoS cryptos.¹⁴⁴ The majority of PoS arrangements require investors to transfer custody and expose themselves to theft or slashing, meeting the standard for an investment of money under *Howey*.¹⁴⁵

2. *Howey Test Prong Two: In a Common Enterprise*

The second prong of the *Howey* Test considers whether the investment of money was in a common enterprise.¹⁴⁶ After the Supreme Court’s decision in *Howey*, various circuit courts issued decisions that vary in their interpretation of what constitutes a “common enterprise.”¹⁴⁷ Circuits are split among three commonality approaches: (i) horizontal, (ii) broad vertical, and (iii) narrow (strict) vertical.¹⁴⁸ Horizontal

139. *Id.* Sandler, *supra* note 11, at 272.

140. *See* discussion *supra* Section II.B.2.

141. *See* Sandler, *supra* note 11, at 272. *See also* discussion *supra* Section II.B.2.b.

142. *Securities Law Considerations for Staking Services*, *supra* note 11.

143. *See id.*

144. *What is Delegated Proof of Stake (DPoS)?*, BYBIT LEARN (Sept. 10, 2021), <https://learn.bybit.com/blockchain/delegated-proof-of-stake-dpos/> [<https://perma.cc/FC7N-YG2R>].

145. *Id.*

146. *See* Sec. & Exch. Comm’n v. W.J. Howey Co., 328 U.S. 293, 301 (1946).

147. *See* Gordon, *supra* note 130, at 60-61, 68.

148. *See* Sandler, *supra* note 11, at 272.

commonality is satisfied where there is a pooling of funds and profits are dependent upon the overall success of the venture, whereas vertical commonality is satisfied where profits are dependent upon the manager/promoter's efforts.¹⁴⁹ While the Supreme Court has reaffirmed the decision in *Howey*, it has declined to conclusively resolve the circuit split.¹⁵⁰

Advocates for stronger regulation believe the *Howey* analysis turns on whether Staking arrangements fall under "common enterprises."¹⁵¹ Even proponents of free crypto markets point to SEC policy discussions and concede that the "common enterprise" prong will almost always be satisfied and instead suggest that Staking arrangements fail *Howey*'s other prongs.¹⁵² This Section discusses each commonality approach and how it applies to Staking arrangements in turn.

a. Horizontal Commonality

Horizontal commonality is satisfied when there is a pooling of investor funds or assets such that investors share in the risks and losses of the venture *pro rata* (correlated returns).¹⁵³ The Second, Third, Fourth, Sixth, and Seventh Circuits all use horizontal commonality in their *Howey* determinations.¹⁵⁴ The Seventh Circuit held horizontal commonality to consist of "a pooling of interest[] not only between the . . . promoter and each individual 'investor' but also among the 'investors.'"¹⁵⁵ The Second Circuit noted that the "pooling" follows a *pro rata* distribution of profits dependent upon the "profitability of the enterprise as a whole."¹⁵⁶

149. See Gordon, *supra* note 130, at 61, 66-68.

150. See Sandler, *supra* note 11, at 272.

151. *Id.* at 280 ("[T]he prong on which the analysis turns is likely the 'common enterprise.'").

152. *Securities Law Considerations for Staking Services*, *supra* note 11 (citing Framework for "Investment Contract" Analysis of Digital Assets, U.S. SEC. & EXH. COMM'N (Apr. 3, 2019), <https://www.sec.gov/corpfin/framework-investment-contract-analysis-digital-assets> [<https://perma.cc/FV36-V3MJ>]) (last visited Jan. 21, 2022).

153. See Gordon *supra* note 130, at 66-68. See also *Revak v. SEC Realty Corp.*, 18 F.3d 81, 87-88 (2d Cir. 1994); *Wals v. Fox Hills Dev. Corp.*, 24 F.3d 1016, 1017-19 (7th Cir. 1994); *Newmyer v. Philatelic Leasing, Ltd.*, 888 F.2d 385, 394, 396 (6th Cir. 1989); *Salcer v. Merrill Lynch*, 682 F.2d 459, 460 (3d Cir. 1982).

154. See *Revak*, 18 F.3d at 87-88; *Wals*, 24 F.3d at 1018-19; *Newmyer*, 888 F.2d at 394; *Salcer*, 682 F.2d at 460; *Teague v. Bakker*, 35 F.3d 978, 986 (4th Cir. 1994).

155. See *Wals*, 24 F.3d at 1018.

156. See *Revak*, 18 F.3d at 87.

Advocates of stronger regulation argue Staking arrangements satisfy the requirements of horizontal commonality. They reason PoS pooling involves the commingling of investor funds (crypto) into a single digital wallet to meet the minimum validator requirements and increase the likelihood that a given Node will receive the recording right.¹⁵⁷ Each investor's crypto is pooled, such that investors share in the rewards earned per their contribution (Stake).¹⁵⁸ The newly minted crypto and transaction fees earned are then periodically distributed to the investors *pro rata*.¹⁵⁹

Advocates further contend that investors contribute crypto to a pool of capital which are contingent upon the success of the Node and at risk of slashing.¹⁶⁰ It is therefore likely that, in jurisdictions where the standard is horizontal commonality, Staking arrangements meet the commonality requirement under the *Howey* Test.

b. Broad Vertical Commonality

It also may be likely that Staking arrangements meet the broad vertical commonality requirement. Adopted by the Fifth and Eleventh Circuits, broad vertical commonality is met when there is a manager/promotor that investors rely upon to earn a profit.¹⁶¹ The Fifth Circuit further stated that broad vertical commonality is present where

157. See Sandler, *supra* note 11, at 258. See also *How It Works*, STAKEMINERS, <https://stakeminers.com/about.php> (last visited Jan. 23, 2022).

As our staking pool is quite large, over 100 BTC worth of various Altcoins Each week the new altcoins we receive become your earnings which are then paid [sic] out to you based on the percentage of Stakeminers you own. If you own 5% of Stakeminers, then you will receive 5 [percent] of the weeks [sic] earnings. The cycle is simple: the more coins we hold, the more coins we can stake, the more coins we stake, the more earning [sic] generated each week, and the more payout you will receive.

Id.

158. See discussion *supra* Section II.B.2.b.

159. See Sandler, *supra* note 11, at 272-73.

160. See *id.*

161. See Gordon, *supra* note 130, at 67-68. See also *SEC v. ETS Payphones, Inc.*, 408 F.3d 727, 728-32 (11th Cir. 2005); *Long v. Shultz Cattle Co.*, 881 F.2d 129, 133 (5th Cir. 1989).

investors as a collective rely upon the manager/promotor's expertise or skill for the return of a profit rather than themselves.¹⁶²

Advocates of stronger regulation argue broad vertical commonality is likely satisfied in Staking arrangements because of the investor-promoter relationship where users are reliant on the Node Manager to generate rewards.¹⁶³ Here, the Node Manager creates the pooled digital wallet, hosts the Node, runs the applicable protocol, and maintains the Node's connection to the network, while the investor simply contributes crypto.¹⁶⁴ Without the Node Manager, investors must operate Nodes themselves to earn Staking rewards. These advocates claim investors' reliance on a Node Manager's expertise and skill of operating and maintaining the Node is sufficient to satisfy Broad vertical commonality.¹⁶⁵

Proponents of free crypto markets could argue that broad vertical commonality is not met due to the amount of chance involved in a pool receiving the recording rights and the subsequent reward. While investors rely on the expertise of the Node Manager to maintain and operate the Node, it is also true that the reward is largely dependent on the PoS and how it assigns recording rights.¹⁶⁶ Unfortunately, this argument is unlikely to prevail in most instances. Although chance plays a role in a Node Manager's success, expertise is the primary factor in receiving a reward. As discussed previously, Node Managers can increase their ability to make and keep returns by utilizing economies of scale, acting in good faith with the network, and ensuring proper node maintenance to limit slashing.¹⁶⁷ In this sense, Node Managers must compete to manage the pool efficiently and effectively to ensure a regular Staking reward. It is therefore likely that broad vertical commonality is met by a Staking arrangement because of investors' primary reliance upon the expertise of the Node Manager.

162. See *Long*, 881 F.2d at 140-41.

163. See *Sandler*, *supra* note 11, at 275.

164. See *id.* at 278-79.

165. See *id.* at 275-76.

166. *What is Proof-of-Stake?*, *supra* note 76.

167. *Id.*

c. Narrow (Strict) Vertical Commonality

Accepted by the Ninth Circuit, narrow (strict) vertical commonality is met where the returns of the investor and promotor (here the Node Manager) rise and fall together because the promotor is financially linked to the investment at issue.¹⁶⁸ Unlike broad vertical and horizontal commonality, narrow vertical commonality “does not require the pooling of resources relationship to exist between investors [and] an enterprise.”¹⁶⁹ All that is necessary is for the profits of the Node Manager to rise and fall with the individual investor.¹⁷⁰

Advocates of stronger regulation contend that narrow vertical commonality in Staking arrangements largely depends on the fee arrangements of the Node Manager.¹⁷¹ Although some charge a flat fee, many Stake alongside their investors or receive a percentage commission of the newly minted crypto and transaction fees.¹⁷² Node Managers who contribute crypto alongside their investors or receive a percentage commission are more likely to satisfy narrow vertical commonality because their profits and that of the investor rise and fall together.¹⁷³ In this case, the investor’s *pro rata* share of any profits rises based on the Node Manager’s ability to generate rewards and falls if they fail to maintain and operate the Node properly. Thus, Staking arrangements likely fulfill the narrow vertical commonality test of *Howey*’s commonality requirement.

3. *Howey* Test Prong Three: With the Expectation of Profit

The third prong of the *Howey* Test considers whether investors expect a profit. Under *Howey*, investors are required to have a clear expectation of future profits for an agreement to constitute an investment

168. See *SEC v. SG Ltd.*, 265 F.3d 42, 49 (1st Cir. 2001) (requiring that the investors’ fortunes be “interwoven with and dependent upon the efforts and success of those seeking the investment or of third parties”).

169. Jacob D. Crawley, *A Security by Any Other Name: An Inquiry into Staking Agreements as Securities*, 9 UNLV GAMING L.J. 201, 213-14 (2019).

170. See Sandler, *supra* note 11, at 275.

171. *Id.*

172. See *id.* at 275-76. See also *How It Works*, STAKEMINERS, <https://stakeminers.com/about.php> [<https://perma.cc/Q88A-ZUND>] (last visited Jan. 23, 2022); *Who We are*, *supra* note 92; Beigel, *supra* note 96.

173. See Sandler, *supra* note 11, at 276.

contract.¹⁷⁴ The Supreme Court defined “profits” to include (1) “capital appreciation resulting from the development of the initial investment,” or (2) “a participation in earnings resulting from the use of investor funds.”¹⁷⁵ To determine investor expectations, courts often consider the marketing language used by the manager/promoter.¹⁷⁶ The SEC advises looking at “the ‘economic reality’ of the transaction” with a list of dispositive factors, including “what character the instrument is given in commerce by the terms of the offer, the plan of distribution, and the economic inducements held out to the prospect.”¹⁷⁷

Advocates for stronger regulation claim Staking arrangements likely produce the characterization of “profits” required by an investment contract. They point to investor participation in earnings of newly minted crypto and transaction fees resulting from the use of their crypto holdings.¹⁷⁸ They also claim investors expect these profits based on the Node Managers’ marketing language.¹⁷⁹ Blockchain developers, exchanges, and independent Staking pools all market the possible investment returns on their websites.¹⁸⁰ Further, investors in Staking arrangements are generally motivated by the expected returns of newly minted crypto and transaction fees generated from Staking.¹⁸¹

Proponents for free crypto markets argue most Staking arrangements are not profit-making mechanisms, but rather “efforts to maintain the

174. See *Sec. & Exch. Comm’n v. W.J. Howey Co.*, 328 U.S. 293, 298-99 (1946).

175. See *Crawley*, *supra* note 169, at 214 (quoting *United Hous. Found., Inc. v. Forman*, 421 U.S. 837, 852 (1975)).

176. See *Howey*, 328 U.S. at 296-97 (“[The investors] are attracted by the expectation of substantial profits. It was represented, for example, that profits during the 1943-1944 season mounted to 20 [percent] and that even greater profits might be expected during the 1944-1945 season . . .”). See also *SEC v. Edwards*, 540 U.S. 389, 390 (2004) (“[T]he investing public is attracted by representations of investment income.”); *Framework for “Investment Contract” Analysis of Digital Assets*, *supra* note 9.

177. See *Framework for “Investment Contract” Analysis of Digital Assets*, *supra* note 9.

178. See *supra*, Section II.B.2.

179. Sandler, *supra* note 11, at 277.

180. See *Staking Assets; Rewards: Crypto Staking*, KRAKEN, <https://www.kraken.com/en-us/features/staking-coins> [<https://perma.cc/YS7F-UKZ7>] (last visited Feb. 1, 2022). See also *Ethereum Staking*, ETHEREUM, <https://ethereum.org/en/eth2/staking/> (last visited Jan. 22, 2022); *Stake Blockchain Assets and Get Rewarded: Tezos (XTZ), Cosmos (Atom) and Other*, P2P VALIDATOR, <https://p2p.org/> [<https://perma.cc/T2CL-JMSF>] (last visited Feb. 1, 2022).

181. Sandler, *supra* note 11, at 277.

value of the member's investment and secure the overall network.”¹⁸² They reason that PoS validation inherently introduces more crypto into the network, leading to inflation.¹⁸³ Further, they say failing to participate in the Staking practice can result in losses, rather than gains, due to inflation.¹⁸⁴

Staking arrangements likely fulfill the “expectation of profits” prong of the *Howey* Test because investors are told that contributing crypto will earn them rewards. While retention of value might seem like a reasonable argument at first, it fails to take into account that inflation is an aspect of all currencies and investing as a means to combat inflation is still an investment with the expectation of profits.¹⁸⁵ For these reasons, Staking arrangements may fulfill the “expectation of profits” prong of the *Howey* Test.

4. *Howey Test Prong Four: Derived Solely from the Efforts of Others*

The fourth prong of the *Howey* Test considers whether the profit is realized through the efforts of someone other than the investor. *Howey* requires that an investment contract includes profits produced “solely from the efforts of others.”¹⁸⁶ The appellate courts all accept the Ninth Circuit's interpretation of the word “solely” as having a more realistic connotation rather than a literal or strict one.¹⁸⁷ This pragmatic standard requires that “the efforts made by those other than the investor are the undeniably significant ones, those essential managerial efforts which affect the failure or success of the enterprise.”¹⁸⁸ The SEC expands on this

182. *Securities Law Considerations for Staking Services*, *supra* note 11.

183. *Id.*

184. *Id.*

185. See Nick Lioudis, *Treasury Bonds vs. Treasury Notes vs. Treasury Bills*, INVESTOPEDIA (Aug. 31, 2021), <https://www.investopedia.com/ask/answers/033115/what-are-differences-between-treasury-bond-and-treasury-note-and-treasury-bill-tbill.asp> [<https://perma.cc/B536-SVFW>]. See also *Treasury Securities & Programs*, TREASURY DIRECT, <https://www.treasurydirect.gov/indiv/products/products.htm> [<https://perma.cc/F7BU-GRMY>] (last visited Feb. 4, 2022).

186. *Sec. & Exch. Comm'n v. W.J. Howey Co.*, 328 U.S. 293, 301 (1946).

187. Sandler, *supra* note 11, at 278; *SEC v. Glenn W. Turner Enters., Inc., et al.*, 474 F.2d 476, 482 (9th Cir. 1973).

188. *Turner* 474 F.2d at 48.

inquiry and instructs courts to focus on whether the purchaser reasonably expects to rely on the manager/promotor's efforts.¹⁸⁹

Advocates of stronger regulation argue applying the Ninth Circuit's realistic test for "solely" to Staking arrangements likely fulfills the fourth prong.¹⁹⁰ They maintain Staking investors have virtually no control over their investment or producing returns once ownership is transferred but instead rely on the Node Manager's efforts.¹⁹¹ In a Staking arrangement, investors contribute crypto to a pooled digital wallet set up by the Node Manager, after which the Node Manager maintains and operates the Node to earn rewards in the form of newly minted crypto and transaction fees.¹⁹²

Proponents of free crypto markets contend the relevant question is whether the investor relinquishes control to the Node Manager or retains control of the crypto by delegating Staking rights.¹⁹³ They argue investors who delegate, retain, and exert control over their cryptos reduce the significance of Node Managers.¹⁹⁴ They also argue Node Managers "only perform a particular function (validating transactions) in a specific way (according to a network's protocol)," which makes their efforts more operational than managerial.¹⁹⁵ Further, they say the success of the network is dependent on the decentralized network at large rather than on a discrete Node Manager's actions.¹⁹⁶ The proponents fail to mention, however, that once delegated investors lock up their crypto and vote for the designated period, they rely on their chosen Node Manager to maintain and operate the Node. Also, while Node Managers "only" validate transactions, this validation process is the very Staking mechanism that earns rewards, the entire goal of the endeavor. Thus, Staking arrangements likely satisfy the derived solely from the efforts of others prong of *Howey*.

189. *Framework for "Investment Contract" Analysis of Digital Assets*, U.S. SEC. & EXCH. COMM'N (Apr. 3, 2019), <https://www.sec.gov/corpfin/framework-investment-contract-analysis-digital-assets> [<https://perma.cc/3E3K-BTY2>].

190. Sandler, *supra* note 11, at 278.

191. Ofir Beigel, *What is Proof of Stake and How to Stake Ethereum*, 99 BITCOIN, <https://99bitcoins.com/proof-of-stake/> (last visited Jan. 23, 2022).

192. *Proof of Stake FAQs*, ETHEREUM WIKI, <https://eth.wiki/en/concepts/proof-of-stake-faqs> [<https://perma.cc/74E6-4X2V>] (last visited Jan. 22, 2022).

193. *Securities Law Considerations for Staking Services*, *supra* note 11.

194. *Id.*

195. *Id.* (citing *S.E.C. v. Glenn W. Turner Enters., Inc.* 474 F.2d 476, 482 (9th Cir. 1973)).

196. *Id.*

C. UNUSUAL INSTRUMENTS: MARINE BANK V. WEAVER

There is another route aside from *Howey* through which Staking arrangements may be classified as investment contracts. The Supreme Court stated that “[c]ongress intended the securities laws to cover those instruments ordinarily and commonly considered to be securities in the commercial world.”¹⁹⁷ In *Marine Bank v. Weaver*, the Supreme Court narrowed the *Howey* Test by permitting exceptions to unusual instruments that are both unique and lack financial risk.¹⁹⁸ In *Marine Bank*, the Court considered whether the certificates of deposit (CD) sold by a federally regulated bank were securities.¹⁹⁹ The Court made two important pronouncements regarding unusual instruments. First, it determined that the greater the number of potential investors, the more likely an agreement is not unique.²⁰⁰ Second, it held that an agreement whose product contains little to no risk is not likely to constitute an investment contract.²⁰¹ The Court held a CD was not an investment contract because it was not unusual and was federally insured, it posed no financial risk to investors.²⁰²

A court would likely determine a Staking arrangement constitutes an “uncommon or irregular instrument,” as it falls outside the common understanding of an investment contract under the ‘33 Act.²⁰³ Depending on the Node Manager, however, this uniqueness may be defeated if she solicits a large number of investors to join the pool.²⁰⁴ When compared to a federally insured CD, Staking arrangements also have more financial risk due to slashing and theft.²⁰⁵ Despite the outcomes of both the *Howey* and *Marine Bank* Tests, however, Staking arrangements may still fall under a federal exemption from SEC registration.

197. *Marine Bank v. Weaver*, 455 U.S. 551, 559 (1982).

198. *Id.* at 556.

199. *Id.* at 552.

200. *Id.* at 559-60.

201. *Id.* 558.

202. *Marine Bank*, 455 U.S. at 559.

203. *Id.* at 556.

204. *Id.*

205. *See supra* Section II.B.1.

D. EXEMPTIONS TO REGISTRATION UNDER THE '33 ACT

While it may be likely a court would find Staking arrangements to constitute investment contracts under *Howey* and *Marine Bank*, Staking arrangements may still avoid such a fate by qualifying for a registration exemption to the '33 Act. Without an exemption, Node Managers will need to register with the SEC, which requires costly periodic preparation and filing of multiple complex disclosures.²⁰⁶ This section discusses the various exemptions to the 33'Act and their applicability to Staking arrangements.

1. *Private Placements Exemption*

The first exemption allows Node Managers to refrain from registration when the Staking arrangement does not involve an offering to the public, known as a "private placement."²⁰⁷ While the SEC has not provided guidance on the limits of this exception, the Supreme Court has interpreted the exemption language to "turn on whether the particular class of persons affected need the protection of the Act."²⁰⁸ Circuit courts have interpreted this protection by looking to factors that include, but are not limited to, "the number of offerees[.]" their relationship to one another and the issuer, the offerees' sophistication, the size of the offering, and "the manner of the offering."²⁰⁹

Staking arrangements may escape registration through the private placement exception if the arrangement is private or limited to a small number of sophisticated investors. It is less clear, however, whether a Staking arrangement offered by an exchange or independent Staking pool would qualify for the exemption. Exchanges and independent Staking pools generally advertise and market to the general public, offer the Staking arrangement to a large number of investors, and likely do not have

206. See Securities Act of 1933 § 5(a), 15 U.S.C. § 77e (2012). See also *Exempt Offerings*, U.S. SEC. & EXCH. COMM'N, <https://www.sec.gov/smallbusiness/exemptofferings> [<https://perma.cc/JB7S-4WGW>] (last visited Feb. 3, 2022).

207. Securities Act of 1933 § 4(a)(2), 15 U.S.C. § 77d(a)(2) (2012).

208. Sec. & Exch. Comm'n v. Ralston Purina Co., 346 U.S. 119, 125 (1953).

209. See *United States v. Arutunoff*, 1 F.3d 1112, 1118 (10th Cir. 1993); *W. Fed. Corp. v. Erickson*, 739 F.2d 1439, 1442 (9th Cir. 1984); *Cook v. Avien, Inc.*, 573 F.2d 685, 691 (1st Cir. 1978); *Doran v. Petroleum Mgmt. Corp.*, 545 F.2d 893, 904 (5th Cir. 1977).

close relationships with investors.²¹⁰ Exchanges and independent Staking pools rely on facilitating Staking arrangements for the general public to meet the minimum Staking requirements and increase their chances of receiving the reward.²¹¹ This is evidenced by the ability to contribute any amount of crypto to the pool and their open advertising.²¹²

2. *Accredited Crowdfunding Offering Exemption*

Node Managers may generally solicit from the public and refrain from registration under Rule 506(c) under the ‘33 Act.²¹³ Rule 506(c) allows offerors to raise capital through the sale of securities without having to register if all purchasers are accredited investors, and offerors take reasonable steps to verify that investors are accredited.²¹⁴ Through this, exchanges and independent Staking pools could advertise to the general public and offer the Staking arrangement to a large number of investors, which is not possible under the private placement exemption. While exchanges that operate as brokerage firms can easily implement investor verification systems, independent Staking pools may not be as well equipped. Accordingly, large Node Managers may have the resources to comply with and utilize Rule 506(c), while smaller Node Managers likely will not.

3. *Limited Offering Exemption*

Node Managers might also find exemption under Rule 504 of the ‘33 Act, known as the “limited offering” exemption. Rule 504 allows registrants an exemption where the registrant offers and sells no greater

210. See *Buy and Sell Bitcoin, Ethereum, and More with Trust*, COINBASE, <https://www.coinbase.com/> [<https://perma.cc/25Z5-2X2Q>] (last visited Jan. 21, 2022). See generally, *Staking-as-a-Service - Best Staking Pools and Staking Service Providers*, DEF1 PRIME, <https://defiprime.com/staking> [<https://perma.cc/QJE7-QQTN>] (last visited Feb. 4, 2022).

211. Andy Rosen & Chris Davin, *5 Best Crypto Staking and Rewards Platforms of February 2022*, NERDWALLET (Jan. 18, 2022), <https://www.nerdwallet.com/best/investing/best-crypto-staking-platforms> [<https://perma.cc/F4MC-F8TG>].

212. Andy Rosen & Chris Davin, *supra* note 211.

213. 17 C.F.R. § 230.506(c) (2021).

214. *Id.*

than \$5,000,000 of securities within a 12-month period.²¹⁵ The catch is that under Rule 504, a registrant may not use “general solicitation and advertising” to promote the investment contracts offered.²¹⁶ Certain states permit solicitation to accredited investors, but if sophistication is necessary, a private placement may be a better fit.²¹⁷ Node Managers will likely not fulfill the limited offering exemption because they rely on advertising to obtain investors, the \$5,000,000 limit will prevent business growth, and accreditation is too high a bar for investors to meet and for Node Managers to verify.

4. *Interstate Offering Exemption*

The ‘33 Act also provides for a registration exemption if a business seems to raise capital within a given state, known as the “intrastate offering” exemption.²¹⁸ The SEC exempts registrants where the offering takes place in the same state the business mostly operates in and the offering is only sold to residents of that state.²¹⁹ Rule 147 provides standards for companies seeking an intrastate exemption, including whether the company verifies the residency of the purchaser of any offerings through written representation.²²⁰ Exchanges and Staking pools would likely not seek this exemption because the limitation to a singular state is too burdensome, especially for crypto that is operated on a global network and ideologically aligned with the values of decentralization.

5. *Regulation A Offering Exemption*

The final exemption, known as a “Regulation A” filing, provides for registrants to register under Tier 1 or Tier 2, capping the amount an offering can raise within a 12-month period, \$20,000,000 and \$75,000,000 respectively.²²¹ Tier 2 registrants have further limitations on the amount non-accredited investors can contribute.²²² Additionally, the

215. Securities Act of 1933 § 3(b)(1), 15 U.S.C. § 77c(b)(1) (2012); 17 C.F.R. § 230.504 (2018).

216. 17 C.F.R. § 230.502(c) (2018).

217. 17 C.F.R. § 230.501(a) (2018).

218. Securities Act of 1933 § 3(a)(11), 15 U.S.C. § 77c(a)(11) (2012).

219. *Id.*; 17 C.F.R. § 230.147 (2018).

220. 17 C.F.R. § 230.147 (2018).

221. 17 C.F.R. § 230.251 (2018).

222. *Id.*

portion of the aggregate offering price attributable to secondary holders of the security may not exceed 30 percent.²²³ Within this exception, large and small exchanges and independent Staking pools are likely to meet Regulation A exemption requirements. As long as exchanges and Staking pools meet the Tier 1 offering cap of \$20,000,000 and limit a potential secondary market, they would not have to file supplemental disclosures or expend the cost of verifying and managing non-accredited investors.

IV. EVALUATING PROOF-OF-STAKE

A. STAKING ARRANGEMENTS ARE LIKELY INVESTMENT CONTRACTS

Staking arrangements are likely securities under the '33 Act. As outlined above, under *Howey*, a contract constitutes an investment contract if there is (i) an investment of money; (ii) in a common enterprise; (iii) with an expectation of profits; (iv) derived solely from the efforts of a promoter or third party.²²⁴ Explicitly, Staking arrangements involve individual investors contributing or delegating crypto to Staking pools with the expectation of receiving a reward while relying on the efforts of the pool's Node Manager.²²⁵

There is tension between whether Staking's classification as an investment contract turns on the common enterprise prong or on both the expectation of profits and the derived solely from the efforts of others prongs. Advocates of stronger regulation argue that Staking Pools satisfy the type of common enterprise considered in *Howey*, kicking Staking arrangements into SEC jurisdiction.²²⁶ They reason that unless Node Managers collect a flat fee, where Node Managers share in the profits.²²⁷ These advocates further argue that SEC required disclosure is necessary to prevent the type of fraud and deception that comes from a lack of regulation in the crypto markets.²²⁸ Proponents of free crypto markets argue Staking's classification hinges on the expectation of profits derived solely from the efforts of others prongs.²²⁹ They contend, unpersuasively,

223. *Id.*

224. *Sec. & Exch. Comm'n v. W.J. Howey Co.*, 328 U.S. 293, 298-301 (1946).

225. *See supra* Section II.B.

226. Sandler, *supra* note 11, at 280 ("[T]he prong on which the analysis turns is likely the 'common enterprise.'").

227. *Id.*

228. *Id.*

229. *Securities Law Considerations for Staking Services*, *supra* note 11.

that investors expect retention in value rather than profits, and that investors do not rely on Node Managers to obtain these profits.²³⁰ They further argue that SEC required disclosure is unnecessary to advance the intent of the securities laws because blockchain's open digital ledger already allows for access to full and accurate information.²³¹

Although the debate lives on, it is likely that advocates of stronger regulation are correct for the current and typical iteration of PoS. The investment of money prong is met because investors contribute their crypto and subject themselves to the risk of financial loss by theft or slashing.²³² Crypto, such as Ether, contributed to pools are exposed to theft and slashing if the Node Manager acts maliciously or fails to validate transactions.²³³ While investors may participate in Staking arrangements that utilize delegation and reduce the risk of slashing by not transferring ownership, the vast majority of PoS cryptos do not support delegation and are subject to theft and slashing.²³⁴

The common enterprise prong is met in jurisdictions that accept the horizontal and broad vertical commonality approach, as well as those that employ narrow vertical commonality where Node Managers collect a percentage fee.²³⁵ In jurisdictions where horizontal commonality is used, when a Node Manager aggregates all investor contributions into a single mining pool (commingles assets), the arrangement is likely an investment contract.²³⁶ Staking arrangements in jurisdictions that follow broad vertical commonality are considered investment contracts because those jurisdictions merely look for an investor-promoter relationship and some level of dependence.²³⁷ Investors in Staking arrangements are almost entirely dependent on Node Managers' skill and expertise in operating and maintaining the Node, satisfying the necessary dynamic.²³⁸ Conversely, in Staking arrangements where the Node Manager receives a percentage fee, narrow (strict) vertical commonality is likely met because the profits of the Node Manager rise and fall with the investor.²³⁹ In

230. See *supra* Sections III.B.3., III.B.4.

231. *Id.*

232. *Supra* Section III.B.1.

233. *Proof-of-Stake (POS)*, *supra* note 47.

234. *Supra* Section III.B.1.

235. *Supra* Section III.B.2.

236. See Sandler, *supra* note 11, at 279-80.

237. *Id.*

238. *Supra* Section III.B.2.

239. *Id.*

contrast, Staking arrangements where the Node Manager only receives a fixed (as opposed to a percentage) fee may not be considered an investment contract in jurisdictions that accept narrow (strict) vertical commonality, because the profits of the investor and Node Manager are not tied together.²⁴⁰

The expectation of profits prong is met because both Node Managers and blockchain developers acknowledge the PoS incentive structure is explicitly designed to grant rewards.²⁴¹ Node Managers and developers regularly market investment returns available for those who participate in Staking, and investors lock up their crypto for these returns.²⁴² While a PoS incentive structure leads to crypto inflation, it does not counteract the expectations of profits awarded to those who Stake.²⁴³

The efforts of others prong is met because investors almost exclusively rely on essential managerial efforts of the Node Manager, which directly affect the failure or success of the pool.²⁴⁴ To successfully Stake crypto, a Node Manager must operate, maintain, and solicit contributions to maximize returns from rewards and minimize losses due to slashing.²⁴⁵ This entails ensuring the Node complies with the proper protocol, is continuously connected to the network, meets the minimum validator requirements, and appropriately manages contributions and distributions.²⁴⁶ While Nodes operating PoS verify and record transactions according to the protocol, Staking is not an automated endeavor, it requires Node Managers to take an active role.²⁴⁷

Under the current federal regulatory regime, Staking arrangements are likely investment contracts and thereby require SEC registration. Although registration would permit Node Managers to raise large amounts of capital through public offerings, it would come at a significant regulatory burden that many would not be able to satisfy.²⁴⁸ To comply with the SEC's aims of providing investors with the tools necessary to

240. See Sandler, *supra* note 11, at 279.

241. *Supra* Section III.B.3.

242. *Id.*

243. *Id.*

244. *Supra* Section III.B.4.

245. *Id.*

246. *Id.*

247. *Id.*

248. See generally, *Exchange Act Reporting and Registration*, SEC, <https://www.sec.gov/smallbusiness/goingpublic/exchangeact> [https://perma.cc/VF7T-YJGL] (last updated Apr. 1, 2022).

make informed decisions, Node Managers would have to file numerous burdensome and costly disclosures.²⁴⁹ Disclosures would include information relating to the essential managerial efforts that affect the success of the enterprise unless they qualify for an exemption from registration.²⁵⁰

Although Staking arrangements will likely not fall under the Private Placement, Limited Offering, or Intrastate exemptions, they could have a chance to avoid SEC filing requirements through Rule 506(c) and Regulation A. The Private Placement, Limited Offering, and Interstate exceptions generally limit the Node Manager's ability to advertise and solicit from the public at large as well as restrict contribution size and potential investors.²⁵¹ Large Node Managers may find an exemption under Rule 506(c) that authorizes them to generally solicit investment from the public if they can verify that investors are accredited.²⁵² Staking arrangements could similarly find exemption under Regulation A, which would allow Node Managers to avoid regulatory burdens or the need to supervise non-accredited investors if they are willing to limit the amount of securities offered in a 12-month period (i.e., to \$20,000,000).²⁵³ Though the Regulation A limitation is practical for small Node Managers, larger ones, like exchanges, will find the limitation to be an impediment on growth. There are, however, other actions Node Managers can take to mitigate the chance of falling under SEC jurisdiction, as discussed in the next Section.

B. AVOIDING INVESTMENT CONTRACT CLASSIFICATION AND SEC JURISDICTION

1. *Staking as a Service*

Node Managers should consider the manner in which they charge investors, because this may impact the arrangement's classification as investment contracts. As discussed previously, the Ninth Circuit, which includes California and eight other states, accepts narrow (strict) vertical

249. Framework for "Investment Contract" Analysis of Digital Assets, U.S. Sec. & Exch. Comm'n, <https://www.sec.gov/corpfin/framework-investment-contract-analysis-digital-assets> [<https://perma.cc/8CCN-9PDX>] (last visited Feb. 4, 2022).

250. *Id.*

251. *Supra* Section III.D.

252. 17 C.F.R. § 230.506(c) (2021).

253. *See* 17 C.F.R. § 230.251 (2018).

commonality where the returns of the investor and promotor must rise and fall together to satisfy *Howey*'s common enterprise prong.²⁵⁴ Node Managers who fall within this circuit's jurisdiction may escape classification as an investment contract if they charge flat fees rather than a percentage fee. While not available on some PoS, a flat fee will disentangle a Node Manager from the investor and fail the third *Howey* prong, releasing it from investment contract status.²⁵⁵

2. Design of the Proof-of-Stake Protocol

Node Managers should also consider the design of the protocol. As discussed earlier, PoS comes in many varieties. Some adjust the reward incentives by assigning block recording rights equally among validators, while others utilize delegation. Node Managers can choose PoS outside of SEC jurisdiction by validating cryptos that reduce the need for large Staking pools, create truly randomized algorithms for assigning recording rights, and allow for delegation so that there is no contribution of crypto to begin with. These characteristics, especially delegation, could prevent Staking arrangements from satisfying the *Howey* Test. Through delegation, investors may elect Node Managers to validate transactions while retaining custody of the crypto. Delegation also allows Node Managers to perform the Staking function on behalf of individuals without commingling assets as well as incentivizes Node Managers to compete.²⁵⁶ Here, the risk of falling within SEC jurisdiction is minimized because crypto is not transferred nor commingled, potentially failing the first and second prongs of *Howey*.

3. Token Safe Harbor Proposal 2.0

In February 2020, SEC Commissioner Hester M. Peirce first proposed a safe harbor for cryptos.²⁵⁷ In April 2021, Commissioner Peirce updated her original proposal to what is now known as the "Token Safe

254. *What is the Ninth Circuit?*, U.S. CTS. FOR 9TH CIR., <https://www.ca9.uscourts.gov/judicial-council/what-is-the-ninth-circuit/> [<https://perma.cc/9PPM-SC9D>] (last visited Feb. 8, 2022).

255. *Supra* Section III.B.2.

256. See *Securities Law Considerations for Staking Services*, *supra* note 11.

257. See Hester Peirce, *Running on Empty: A Proposal to Fill the Gap Between Regulation and Decentralization* SEC (Feb. 6, 2020), <https://www.sec.gov/news/speech/peirce-remarks-blockress-2020-02-06> [<https://perma.cc/W9W6-UCHB>].

Harbor Proposal 2.0.”²⁵⁸ In it, Peirce describes the risk of federal securities laws frustrating a given blockchain network’s ability to achieve proper decentralization where tokens function as non-securities.²⁵⁹ She further states the proposed safe harbor is intended to “provide Initial Development Teams with a 3-year time period within which they can facilitate participation in, and the continued development of, a functional or decentralized network” exempt from securities registration so long as certain conditions are met.²⁶⁰

The safe harbor provision protects crypto investors by requiring semi-annual disclosures and preserving the anti-fraud provisions of the federal securities laws throughout the 3-year grace period.²⁶¹ At the end of the 3-year period, the development team must determine and represent that the network is sufficiently decentralized and that those transactions do not constitute investment contracts transactions.²⁶² Sufficient decentralization is achieved when the network is either (i) not economically or operationally controlled by a single person, entity or group under common control, and the Initial Development Team owns 20 percent or less of the crypto or 20 percent or less of determining network consensus, or (ii) functional.²⁶³

While the Token Safe Harbor Proposal 2.0 does not explicitly cover pools, Staking arrangements may fall within its scope if it is shown to be a critical component of achieving decentralization. If the Token Safe Harbor Proposal is accepted by the SEC, blockchain developers can utilize the 3-year safe harbor to develop PoS that either (i) satisfies the securities laws exceptions, (ii) properly delegates Staking rights, or (iii) reduces the incentive to create Staking pools, either by reducing the minimum to Stake or by designing recording rights to be random. Developers and Node Managers should advocate for the Token Safe Harbor Proposal 2.0 to be accepted and utilize its generous safe harbor to build networks that implement any of these characteristics.

258. See Hester Peirce, *Token Safe Harbor Proposal 2.0*, U.S. SEC. & EXCH. COMM’N (Apr. 13, 2021), <https://www.sec.gov/news/public-statement/peirce-statement-token-safe-harbor-proposal-2.0> [<https://perma.cc/6725-S9V9>].

259. See *id.*

260. *Id.*

261. *Id.*

262. *Id.*

263. *Id.*

V. CONCLUSION

An analysis under the '33 Act demonstrates that Staking arrangements are likely investment contracts. A federal court may find that a Staking arrangement 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."²⁶⁴ Further, Staking arrangements will not likely find exemption under *Marine Bank*, because they are not unique and are often characterized by a large amount of risk offset by a large return.²⁶⁵ Despite the likelihood that Staking arrangements will be deemed investment contracts, Node Managers may utilize registration exemptions under Rule 506(c) or Regulation A.²⁶⁶

Node Managers also have the opportunity to choose the crypto or fee structure to escape SEC jurisdiction. A Staking arrangement where the Node Manager receives a fixed fee that is not tied to the profits of the investor will likely fail the *Howey* Test in jurisdictions that require narrow (strict) vertical commonality. Participating in Staking alongside their investors might classify their arrangement as an investment contract. Blockchain developers and Node Managers should also consider PoS that allows investors to delegate Staking rights to avoid SEC reporting requirements.

Though the SEC and other regulatory agencies have not yet ruled on Staking arrangements, Node Managers should be on alert. The sale of unregistered investment contracts or engagement in fraud in violation of the '33 Act may subject Node Managers to liabilities and other investor remedies under state and federal securities laws, including private rights of action and rescission.²⁶⁷ The SEC has already imposed fines on cryptos deemed to be an offering of unregistered investment contracts.²⁶⁸ It is in the best interest of Node Managers and blockchain developers alike to

264. Sec. & Exch. Comm'n v. W.J. Howey Co., 328 U.S. 293, 298-99 (1946).

265. See *Marine Bank v. Weaver*, 455 U.S. 551, 558-60 (1982).

266. See Securities Act of 1933 § 4(a)(2), 15 U.S.C. § 77d(a)(2) (2012); 17 C.F.R. § 230.506(c) (2021). See also 17 C.F.R. § 230.251 (2018).

267. 15 U.S.C. § 77n; 15 U.S.C. § 78cc(a). See generally Darren J. Sandler, *Rescission in the Age of Cryptocurrency*, LAW360 (Sept. 25, 2017, 10:48 AM), <https://www.law360.com/articles/967108/rescission-in-the-age-of-cryptocurrency> [<https://perma.cc/L53L-BW52>].

268. *Telegram to Return \$1.2 Billion to Investors and Pay \$18.5 Million Penalty to Settle SEC Charges*, U.S. SEC. & EXCH. COMM'N (June 26, 2020), <https://www.sec.gov/news/press-release/2020-146> [<https://perma.cc/H5AW-N4BC>].

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innovate out of SEC jurisdiction or comply with the reporting requirements.