March 20, 2023

Vanessa A. Countryman
Secretary
U.S. Securities and Exchange Commission
100 F Street NE
Washington, DC 20549-1090

RE: Petition for Rulemaking – “Proof-of-Stake” Blockchain Staking Services

Dear Ms. Countryman:

Coinbase Global, Inc. (“Coinbase”) is filing a comment in response to our July 21, 2022, petition for rulemaking on digital asset securities regulation (the “Petition”). In this letter we focus on the securities law treatment of services related to the validation of proof-of-stake protocols (“staking”).

As we recognized in the Petition and in a previous comment on issuer disclosures, the regulatory questions around practices in the digital asset ecosystem can be “complex,” but we believe that the public is best served by the U.S. Securities and Exchange Commission (the “SEC” or “Commission”) when it acknowledges such complexities and proactively seeks market participant input in developing and conveying clear policies and guidelines to address them. Indeed, the essence of the Administrative Procedure Act is to promote reasoned decision making by administrative agencies, like the SEC, by requiring agencies to follow a sound rulemaking process that is inclusive of stakeholder input.

Our comment today is in response to a recent and surprising Commission action suggesting that the Commission may now view some staking services as constituting an investment contract and therefore a security. In describing the SEC’s recent settlement with Kraken regarding its staking services, the current SEC Chair stated:

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1 See Transcript of Hearing at 24, In re Voyager Digital Holdings Inc., No. 22-10943 (Bankr. SDNY Mar. 2, 2023) (SEC Staff Attorney William Uptegrove acknowledging that the cryptocurrency-related securities laws issues at play in the Voyager bankruptcy case are “complex”).

2 Id. at 24 (Judge Wiles expressing frustration that SEC Staff Attorney William Uptegrove’s objection to the Voyager bankruptcy plan was not an official Commission position stating, among other things, “I’m sort of unaccustomed to objections to things that may be wrong,” and that the SEC being a “[d]eliberative [body] is one thing. Absent is another.”).

3 See, e.g., SEC Rel. No. 33-5325 (Oct. 27, 1972) (establishing the Advisory Committee on Investment Management Services for Individual Investors (the “Advisory Committee”)).

Today’s action should make clear to the marketplace that staking-as-a-service providers must register and provide full, fair, and truthful disclosure and investor protection.5

Until this settlement, the Commission had not conveyed that it might consider staking services to constitute an investment contract and therefore a securities offering requiring registration with the SEC.6 And the SEC had not previously made this position known despite ample opportunity to engage the crypto industry and its participants with its concerns. Indeed, Coinbase began providing detailed presentations on what staking services are and how they work as early as December 18, 2019,7 and Coinbase repeatedly explained its own staking services throughout its S-1 process when becoming a public company nearly two years ago.8

The Chair’s assertion that the Commission has expressed a new policy position and legal determination about a widespread industry practice through a single enforcement action, rather than through any formal guidance, is creating unnecessary uncertainty for market participants. The action against one company’s embodiment of a staking service provides no guidance about what aspects of that embodiment or other embodiments of staking services may be of concern to the Commission nor provides a path for remediation if needed.

Staking services are not a monolith. A number of different models exist and while some might be categorized as offering an investment contract, core staking services that we describe in this letter are not. These services do not fit the definition of a securities offering when applying the analysis laid out in the Supreme Court case, SEC v. W. J. Howey Co. and as refined over the years.9 Considering both the black letter law of the “Howey test” as well as the policy and regulatory concerns underlying that analysis we find that core staking services neither meet the test as a matter of law, nor present the risks the federal securities laws were designed to mitigate.


6 Although the Chair has previously provided his personal view that some lending services labeled “staking” might be securities offerings, those services were not core staking services. Additionally, there was no action by the Commission nor any statement or other indication from the staff expressing a view that staking services were being offered in contravention of the securities laws. The statement of one commissioner during a media interview is generally understood as reflecting only the views of that individual and not of the commission as a whole (as commissioners typically state at the start of speeches and interviews). Interview by David Ignatius with Garry Gensler (Sept. 21, 2021). https://www.washingtonpost.com/washington-post-live/2021/09/21/transcript-path-forward-cryptocurrency-with-garry-gensler/.

7 For its part in helping the SEC understand the nature of staking services, Coinbase has repeatedly discussed its own staking services with the Commission, including explanations of how those services operate and why they do not constitute securities. Specifically, on December 18, 2019, again on July 14, 2020, and again on August 20, 2020, Coinbase presented detailed information to the Commission regarding its staking services. Also on January 10, 2020, Coinbase, with the Proof of Stake Alliance, submitted a detailed White Paper to FinHub on staking generally, and the relevant securities analysis. Then one month later, on February 12, 2020, Coinbase presented to the Commission on these same topics.

8 Throughout Coinbase’s S-1 process in 2020 and 2021, Coinbase provided substantial information to the Commission regarding its retail staking services—and the relevant legal analysis—including in letters dated December 21, 2020, and February 12, 2021.

9 328 U.S. 293 (1946).
For those staking services that may constitute an investment contract, the SEC should provide a path to workable registration. Today there is no established process. As we described in our July 21, 2022, petition and explained in greater detail in our December 6, 2022, comment on our petition, there are features of investment contracts involving digital assets that do not squarely fit within existing regulation. In developing a regulatory framework for the offering of investment contracts involving digital assets, we would encourage the SEC to also consider how that framework should apply to any staking services that do constitute an offering of securities.

In the meantime, we ask the Commission to clarify how it views various aspects of staking services, and also to solicit input from the public on those views. Engaging in a public process would require the Commission to articulate its view on how securities law applies to staking services, including which elements of the service render it an offering of securities. This would afford us and others an opportunity to respond and demonstrate which staking services do not fit within the definition of a securities offering and how those that do could best be regulated by the SEC. And where the Commission believes action might be appropriate, processes and precedents already exist that provide a template on how the Commission could address the perceived concerns in the SEC’s action.

It is important to get the regulatory treatment of staking services right. Consensus mechanisms form the backbone of the digital asset ecosystem. The inappropriate application of securities laws to the transaction validation process could unnecessarily stifle financial innovation and harm the 20 percent of American who own crypto and the three-quarters of Americans who believe that the current financial system is unfair and needs an update. This is our mission at Coinbase – to support more economic freedom by making financial products and services more accessible, faster, and cheaper. We are advancing this purpose by building the most trusted products, tools, and services, here in the US, with a commitment to help transform our current system, designed before the computer even existed, into one that is digitally native.

The risk of getting regulation wrong is that innovation moves offshore to jurisdictions that do get it right. The U.S. is competing with the EU, UK, Hong Kong, Singapore, UAE, and a host of other countries that are racing to establish crypto hubs by proposing clear regulatory frameworks. Letting critical infrastructure migrate to other jurisdictions – the validators that are paid through staking services – because rules in the U.S. are inappropriate is unnecessary. We believe it is possible for the SEC to constructively engage on these issues without compromising protections in a way that preserves U.S. innovation. This would ensure that U.S. capital markets remain the gold standard of the world.

I. Description of Blockchain Consensus Mechanisms and Staking Services

Cryptocurrencies like Bitcoin and Ethereum are powered by a technology called a blockchain. Blockchains are peer-to-peer computer networks running open-source software that records a list

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10 Morning Consult, “Cryptocurrency Perception Study,” February 24, 2023, found at https://assets.ctfassets.net/c5bd0wqjc7v0/WvuOkBwNXZsqhd6EWtkEL/7f94f8b6fbb222f3fa4d0346e473012/Morning_Consult_Cryptocurrency_Perception_Study_Feb2023_Memo__1_.pdf
of all transactions that anyone can view and verify. Its power is the people, so to speak. This database of transactions is updated across all or many computers in the network. Generally, new transactions are added to the database in sets called “blocks” and each block and its constituent transactions must adhere to the protocol rules agreed to by a majority of the network’s computers.

Blockchains are the basic underlying technology for many cryptocurrencies and other forms of digital assets that have proliferated globally over the past decade. In recent years, the rapid growth, issuance, and adoption of digital assets designed to function as media of exchange, stores of value or other units of account on blockchain-based platforms, along with the emergence of marketplaces for digital assets, has resulted in a nascent yet large industry with a market value of over $1 trillion and an estimated 420 million participants worldwide. And, while the promise of digital assets and related continued technological developments has yet to be fully realized, many believe that these emerging technologies are likely to result in, among other things, a fundamental shift away from traditional financial services businesses and intermediaries to an increasingly digitally native, peer-to-peer financial ecosystem.

The protocol rules of a blockchain are often referred to as its “consensus mechanism” and they dictate how the computers in the network reach agreement on what transactions and blocks to add to the blockchain. These consensus mechanisms prevent cryptocurrencies from being “double-spent” and protect a blockchain from attack and manipulation. The most commonly-known consensus mechanisms are based on what are called “proof-of-work” and “proof-of-stake” protocols.

a. Shift from Proof of Work to Proof of Stake Validation

In proof-of-work, participants in the network compete to add new blocks to the blockchain in a process called “mining.” The participant who is first to solve a special math puzzle that confirms a block of transactions – verifiable by all miners – is the winner and receives a small amount of newly-minted cryptocurrency as a reward and incentive. The mining process is not considered “green,” in that it entails a large number of competing miners who use specialized, expensive computer hardware that consumes a very large amount of computing power and electricity.

Proof-of-stake is generally considered to be faster and less resource-intensive. In proof-of-stake, participants must lock up, or “stake,” their cryptocurrency in order to validate transactions and add new blocks to the blockchain. These “validators” receive rewards from the protocol for their contribution to securing the blockchain. Locking up the crypto currency creates trust. If validators behave dishonestly, proof-of-stake blockchains like Ethereum incorporate penalties, which include the destruction, or “slashing,” of the validator’s stake.

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In addition to not requiring miners to engage in more energy intensive processes, proof-of-stake also offers the advantage of not requiring expensive specialized hardware. Proof-of-stake can often be run on average computers with a minimum amount of cryptocurrency to stake. Moreover, the software to operate a validator node is typically available for free and can be installed without any special expertise. This makes participating in proof-of-stake blockchain networks much more accessible to individuals who want to participate.

b. Efficiencies Derived From Staking Services

While it is generally easier to participate in proof-of-stake networks than proof-of-work networks, and this participation does not require specialized skill or efforts, operating a validator node nonetheless imposes costs. It typically requires a dedicated computer with a highly reliable Internet connection as inadvertent downtime can result in lost rewards. Additionally, running a node securely requires frequent attention to ensure software is up to date, all hardware is functioning correctly, and that signing keys have not been compromised.

These operational chores, combined with the significant proliferation of proof-of-stake blockchains over the past few years, have contributed to the development of various services that facilitate participation in staking cryptocurrency on proof-of-stake blockchains. Customers choose to use core staking services for their convenience and security. The operations performed by the services are routine ministerial functions, including executing customers’ staking requests, operating all of the computer hardware and software related to a proof-of-stake blockchain, and ensuring that the underlying protocol requirements are observed. Users do not obtain more rewards through the use of a service than they would if they staked independently. The services perform a pass-through function, taking a fee from users to pay for the service provided. These services do not require managerial efforts to allow users to stake, but provide routine administrative services that are key to blockchain infrastructure because they allow more people to stake, adding more validating capabilities.

Core staking services are fundamentally a form of cloud computing services (CCS): a traditional technology concept where shared data centers are made available to users over the Internet, often with open-source preinstalled software packages. Users of CCS avoid the time, cost and complexity of running hardware and managing software updates. Instead, they obtain this functionality by paying a fee to the CCS operator who performs these IT tasks on their behalf. Moreover, CCS operators are often able to obtain economies of scale, for example by building larger data centers, sharing unused compute time across multiple customers, and batch processing certain routine tasks.

Similar to CCS, core staking service providers operate blockchain software for use by customers who hold cryptocurrency over the internet and manage the underlying security, technology and availability of the service. Staking rewards come from the underlying protocol, not the staking service provider.

II. Core Staking Services are Not a Securities Offering
In offering core staking services, these providers are not offering a security. When determining whether a scheme or set of services is a security, the SEC and the courts generally look at the catch-all category of “investment contract.” The test for determining whether a contract for services could be an “investment contract” was first set out by the Supreme Court in its 1946 case, *SEC v. W.J. Howey Co.*, and the SEC has used it as a touchstone for addressing the novel structures created by the development of crypto and blockchain technology.

Although staking involves new technology, the analysis in this case, if applying *Howey*, is fairly straightforward. As refined over the years, it involves four prongs:

- The investment of money (or value);
- In a common enterprise;
- With the reasonable expectation of profits;
- Derived from the managerial efforts of others.

In order to be an investment contract, a set of services must meet all four elements, and core staking as a service meets none. Additionally, an investigation into the economic reality of these staking services, when overlaid on the risks that the securities laws are designed to mitigate—and that underpin the *Howey* Court’s reasoning—further confirms the fact that this type of staking service is a software service, and not an investment contract.

**a. Investment of Money**

*Core staking services do not involve an investment of money*

At the heart of the “investment of money” prong is financial risk. Whether an investment of cash or of other assets, the courts have agreed that there must be risk of financial loss. The “investment of money” prong narrows the forms of financial risk that concern the securities laws. This risk, moreover, must be the sort of loss that accompanies an investment and not the risk that every party to a contract faces when depending on the other party to perform its agreed-upon role. That kind of investment risk is simply absent from the use of core staking services, and therefore there is no investment contract, just a plain contract for services.

Although staking customers use the assets they own, and give up alternative uses of those assets during the time they are staked, the opportunity cost of staking is not an investment. Unlike investors in an enterprise, stakers who use these services retain full ownership over their assets at all times, which means, by definition, there cannot be an investment of money. What these users are giving up—the temporary alternative use of their assets—is the same whether they use this type of service or stake on their own and cannot therefore be an investment in the staking service as an enterprise. While users of core staking services instruct the service to stake their assets, and may sacrifice other potential uses of those assets for the time being, this process does not involve the kind of investment of money that concerned the *Howey* court.

By contrast, in *Howey*, although the investors entered into a services contract with W. J. Howey Co., the primary risk they faced was not breach of contract, but the financial risk of a failed
enterprise. If the company failed in its agricultural efforts, or if other risks, such as poor weather or a depressed orange market, intervened, there would be insufficient oranges to sell to make up the investors’ losses. The investors were making a bet on the ability of the company to successfully grow and sell oranges at a profit; the company could perform every promised action and yet the investors could still face a loss.

This analog does not exist in this model of staking services. Users of these staking services are not making a bet on the success of the staking service provider as an enterprise. They are using existing staking protocols to reap a benefit, which they could do directly, or through the service provider as a convenience. While there is a risk that the service could fail to achieve the promised capabilities, that failure would be a breach of contract, not a failed investment. Any rewards the users receive are not investment gains. Reward payouts are simply the results of the successful performance of compliant validation services, and are dictated by the protocol, not the service provider. There is neither the risk that the service provider will fail to make good choices about staking, nor that the provider failed to accurately predict and adjust for market events. There is only the risk that the provider did or did not comply with a prescribed set of rules. That is simple contractual risk—no different than the risk a car owner faces when trusting a vehicle to a mechanic, or a homeowner in trusting the completion of renovations to a contractor—and is not a risk the securities laws were intended to address.

b. Common Enterprise

There is no common enterprise among stakers or between stakers and service providers in core staking services

Investors in a common enterprise need the protections of the federal securities laws because the fate of their investment is tied to the fate of the enterprise—either through the seller, promoter, or third party, or through one another—such that no investor can act independently to affect the outcome of the investment. This vulnerability is categorically different from the kind of routine counterparty risk that can be mitigated by ordinary commercial due diligence, and that is entirely independent of the counterparty risk faced by other customers of a provider. In the context of core staking services, while there may be a gathering together of assets, there is no joining of fortunes and therefore no “common enterprise.”

Users of this kind of staking service retain full authority over their assets, with the ability to unstkate them, sell, hypothecate, vote, or pledge them or otherwise dispose of them independent of the service provider and its other customers. In fact, because the assets belong to the user throughout, the failure of the entire staking service provider has little effect on the user’s property rights. The user will need only to find a new provider, or create the necessary set-up to engage in staking as an individual.

The rewards that customers of core staking services receive are the same whether the customers are using a service or staking on their own, and are unrelated to the performance of the service provider. The rewards are consideration for the performance of validation tasks, and are generated and earned based on the blockchain protocol’s rules, once a validator node successfully completes its validation task. In other words, users holding identical assets can
expect similar staking rewards because the protocol sets the rewards rates, but this is also the case if they each stake on their own. Staking through this kind of service provider only increases convenience, not rewards allocated by the blockchain protocol. Protocol-imposed reward rates do not change whether assets are pooled together or not, or whether a validator node is operated by a user or a service. Nor does the amount of assets staked by a particular node increase the reward rate per asset—*i.e.*, the protocol does not pay escalating rewards for staking more assets.\(^\text{12}\)

A brief example illustrates the difference between the kind of non-security fee-for-service arrangement that stockbrokers use (and that is analogous to the commissions received by staking service providers) and the arrangements of investment managers. Courts have repeatedly distinguished between the compensation of *investment managers* based on profits on the appreciation of value of speculative assets—which satisfy vertical commonality—and fees collected by *stockbrokers* “for every consummated transaction”—which do not. Why? Because the former makes choices that affect the fortunes of the customer, and receive compensation based on the value they create for their customers, whereas the latter only executes the actions the customer has requested. Investment managers’ fortunes rise and fall with the choices they make, as do the fortunes of their customers. Stockbrokers have no such relationship with their customers. Similarly, the fortunes of core staking service providers and those of their customers, are independent of one another and no common enterprise exists.

**c. Reasonable Expectation of Profit**

*Payment for services is not an expectation of profit*

Core staking services also fail the “expectation of profit” prong because the rewards the users receive are just payment for services rendered. As described above, the purpose of staking is to provide a validation mechanism for a network or protocol. The rewards are consideration paid for the validation services the asset owner provides by staking the assets. Those rewards are not returns on investment; instead, they are service fees, set by the blockchain protocol, and are the same whether the customer stakes on her own or through a service. However you stake, whether on your own or through this kind of service, the consideration you receive for services provided is not a reasonable expectation of a return on investment; it is just a fee paid for performing a job.

The reason that “expectation of profit” is one of the prongs of *Howey* is once again financial risk. An investor in a security needs information about the issuer and the planned enterprise to know whether that enterprise is likely to produce a profit. The investor takes a risk on the enterprise—ideally an informed one, thanks to mandated disclosures—and hopes that the risk pays off. Users of this model of staking service take no such enterprise risk. There is no need to evaluate the likely success or failure of a business plan. And there is no need for the securities

\(^\text{12}\) There is a common misperception that staking more assets earns a higher rate of reward. This is not true. While a larger stake will produce larger rewards on some protocols, on a *per token* basis the overall rate of return is typically flat or declining with size. To our knowledge, no protocol pays escalating per token rewards based on the amount staked. Such a feature would create economic incentives towards staker centralization, which could compromise the security of a Proof of Stake network.
laws. These staking rewards are not the “profits” the Howey court envisioned, and do not meet this prong of the test.

d. Efforts of Others

Core staking services entail ministerial efforts and not the managerial efforts of others

While all four prongs of the Howey test must be met for an arrangement to constitute an offering of an investment contract, it is the last prong—profits derived from the efforts of others—that has typically required the closest analysis. Satisfying this prong requires that the investor rely on the “efforts of others” and, as later courts have held, those efforts must be characterized as “undeniably significant ones, those essential managerial efforts which affect the failure or success of the enterprise.”13 Those that are merely ministerial or administrative do not rise to the level required to satisfy this prong.14

Core staking service providers exert no discretion and have no authority to deviate from the terms of the service. There is no obligation or discretion for the service provider to seek out the best opportunities and there is no need to build trust through disclosures mandated by the securities laws. There is therefore no need for the types of disclosures securities laws require for an investor to understand how discretion would be used, such as the key people making the decisions, their backgrounds, the result of their decisions thus far, and their plans for the future. This type of information, designed to help investors decide whether to trust individuals to make good use of their money and generate profit, is not relevant in the context of core staking services. Any protections consumers may need, such as clear terms of service and recourse under contract law if the terms are violated, fall outside the remit of the SEC and outside the scope of the securities laws.

III. How Past Commission Actions Can Inform The Treatment of Staking Services

Over the years, many market practices have emerged that raised novel questions, and led the SEC to question the orthodoxy of its established regulatory positions. As with staking services today, past Commissions have faced similar opportunities to establish preferred market practices through the courts, and instead wisely pursued more measured and careful approaches. We offer three past examples that could serve as a guide for this Commission.

a. 1973 Committee on Special Investment Advisory Services (SIAS)

Fifty years ago the Commission was faced with a similar question of how to determine whether an emerging technology-based service is, in fact, an offering of a security. At that time, the SEC

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evaluated the emerging use of computer technology in providing investment services to individual clients. Some believed the provision of such services—which, given advances in computer technology could be provided to customers at scale—might constitute an offering of an investment contract, thus resulting in violations of the Securities Act of 1933 (the “Securities Act”) and the Investment Company Act of 1940 (the “Investment Company Act”).

The genesis of this debate was the “uncertainty about the applicability of the [Securities Act and the Investment Company Act]” that had arisen as a result of the SEC’s action in *First National City Bank (Citibank) and Merrill Lynch, Pierce, Fenner and Smith, Inc.* In this action, the SEC claimed that, under Citibank’s SIAS, a customer’s limited power of attorney giving Citibank investment discretion and authorizing Merrill Lynch to accept instructions from Citibank constituted an investment contract offered and sold in violation of the registration requirements of the Securities Act. The issuance of such securities also, according to the SEC, resulted in the creation of an investment company in violation of the Investment Company Act. As in the Kraken matter, this was a settled action with no precedential value, but the SEC recognized that it could nonetheless create uncertainty that merited clarifying action by the SEC.

The SEC created an Advisory Committee to help dispel the uncertainty *First National* created for SIAS providers and to inform its regulatory process moving forward. In establishing the Advisory Committee, then-Chairman Casey highlighted the SEC’s concern that the absence of clear standards was actually inhibiting the provision of services and market activity that did not implicate the securities laws. The aim of the Advisory Committee was to assist the SEC with “developing clearer policies and guidelines” with respect to SIAS programs. Its work was a high priority for the SEC in order to help the Commission determine, among other things, how it could embrace technology in a manner that would accommodate the needs of smaller market participants.

Based on the Advisory Committee’s recommendations, the SEC eventually adopted Rule 3a-4 under the Investment Company Act, which provides investment advisory programs with a nonexclusive safe harbor exemption from the registration requirements of both the Securities Act and the Investment Company Act. In the lengthy series of SEC rulemakings leading up to the adoption of Rule 3a-4, the SEC expressly acknowledged that the law was unclear and could result in inconsistent treatment of service providers on the issue of whether discretionary SIAS

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17 See supra note 3.
19 Advisory Committee Report at 1.
20 SEC Chairman William J. Casey, “Where Are We Going?,” Address by Chairman Casey before the Economic Club of Detroit (Sept. 18, 1972), at 10-11.
21 SEC Rel. No. IC-22579 (Status of Investment Advisory Programs under the Investment Company Act of 1940) (Mar. 24, 1997), available at https://www.sec.gov/rules/final/ic-22579.txt. This release also highlighted the SEC’s Division of Corporation Finance indication that, if Rule 3a-4 were to be adopted, it would not recommend that the Commission take enforcement action if interests in an investment advisory program operated in accordance with the proposed rule's requirements were not registered under the Securities Act.
programs involved a “common enterprise” under the *Howey* test and could therefore be considered investment contracts.\(^{22}\) No such uncertainty existed for similar programs conducted on nondiscretionary basis. In the intervening time between the issuance of the Advisory Committee report and the adoption of Rule 3a-4, market participants were left to operate on the basis of what guidance they could glean from a series of SEC staff no-action letters regarding investment advisory programs.\(^{23}\)

Almost fifty years later, this example offers a just-as-relevant approach to addressing the novel legal issues around staking services. As was the case then, the SEC is facing a new technology and would benefit from public engagement to both understand the issues and evaluate the best way to consider regulation, while acknowledging where its oversight is unnecessary. Equally important, the specific conclusions of the SEC in relation to SIAS services—that a lack of discretion points to a lack of a securities offering—provide a useful analogy to the question of how to consider staking services.

b. 2000 Regulation Fair Disclosure

In the 1990s, the SEC again faced uncertainty in the market about how the securities laws should apply to a common industry practice. At that time, public companies would often share information with a select group of analysts and investors in advance of making full disclosures to the general public. The Commission was concerned that this was leading to a loss of investor confidence in the integrity of our capital markets. In response, the Commission adopted Regulation Fair Disclosure, and explained in its 2000 adopting release:

> Issuer selective disclosure bears a close resemblance in this regard to ordinary “tipping” and insider trading. In both cases, a privileged few gain an informational edge -- and the ability to use that edge to profit -- from their superior access to corporate insiders, rather than from their skill, acumen, or diligence.\(^{24}\)

Importantly, rather than pursue potentially viable enforcement actions to make policy, the SEC explicitly rejected that path and instead chose rulemaking as the more prudent course, stating:

> While we have considered this approach -- and of course we remain free to bring such cases where a selective disclosure does violate insider trading laws -- we do not agree that this is the appropriate response to the legal uncertainties posed by current insider trading law. In other contexts, we have been criticized for attempting to “make new law”

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\(^{23}\) See, e.g., Shearson/American Express Incorporated, SEC No-Action Letter (July 13, 1983); Scudder Fund Management Service, SEC No-Action Letter (Aug. 17, 1988); Westfield Consultants Group, Inc., SEC No-Action Letter (Dec. 13, 1991). See also SEC Rel. No. 15292 (Nov. 2, 1978) (addressing reporting and filing requirements for certain institutional investment managers and the scope of “investment discretion” under the Securities Exchange Act of 1934); *In re Clarke Lanzan Skalla Investment Firm, Inc.*, SEC Rel. No. IA-7180, at n.1 (June 16, 1995) (noting that where asset holders take part in managed discretion account programs but retain the indicia of individual asset ownership, “[T]here is no common enterprise and, therefore, the programs are not issuing securities. Because they are not ‘issuers,’ these programs are also not investment companies under Section 3(a) of the Investment Company Act.”).

in an uncertain area by means of enforcement action and urged instead to seek to change the law through notice-and-comment rulemaking. We believe that this rulemaking is the more careful and considered response to the problem presented by selective disclosure.\footnote{Id. at n.16.}

The Commission went on to explain that the more careful and considered approach that rulemaking offered would prevent far greater damage to the marketplace by stating:

\textit{We note, in addition, that if we were successful in enforcement actions charging selective disclosures as a form of fraudulent insider trading, the in ter ro rem effect of that success (and the consequent chilling effect on issuers) would certainly be far greater than the impact of the more measured approach we adopt today.}\footnote{Id.}

This approach illustrates how rulemaking is a better path to market regulation, even when a series of enforcement actions may be the faster and easier choice. The SEC’s treatment of staking services similarly represents an uncertain area of securities regulation with the Commission potentially holding beliefs that are at odds with common industry practices. Rather than selective enforcement actions that require industry to infer how the Commission believes the law should apply to other market participants, the market would be better served by a public dialogue on the issues.

c. 2017 The DAO Section 21(a) Report

The Commission has more recently in the context of crypto assets followed a similarly restrained approach to deferring enforcement action over a widespread market practice. In 2017, the Commission issued a Section 21(a) Investigative report on whether “The DAO,” an unincorporated organization, had violated securities laws by conducting what is colloquially called an Initial Coin Offering (ICO).\footnote{SEC Rel. No. 81207 (Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934: The DAO) (July 25, 2017), available at https://www.sec.gov/litigation/investreport/34-81207.pdf.} The Commission made the determination that the DAO tokens were securities and could have taken enforcement action, but instead issued the report as an educational opportunity for market participants, making the marketplace aware of the types of activity that would lead to an enforcement action. In their report, Commission staff stated:

\textit{In light of the facts and circumstances, the agency has decided not to bring charges in this instance, or make findings of violations in the Report, but rather to caution the industry and market participants: the federal securities laws apply to those who offer and sell securities in the United States, regardless whether the issuing entity is a traditional company or a decentralized autonomous organization, regardless whether those securities are purchased using U.S. dollars or virtual currencies, and regardless whether they are distributed in certificated form or through distributed ledger technology.}\footnote{SEC Press Release, SEC Issues Investigative Report Concluding DAO Tokens, a Digital Asset, Were Securities, (July 25, 2017), available at https://www.sec.gov/news/press-release/2017-131.}
with the SEC on potential paths forward, including by establishing shortly thereafter a new strategic hub for innovation and financial technology ("FinHub"). Given the nascent state of the market, this was the right approach at the time, and illustrates how a regulator can begin to set guardrails while allowing innovation to proceed.

However, more than five years later, and despite the market having developed more fully, the Commission has yet to propose rules that would permit the activity addressed in the report. As we have separately advocated for, rulemaking is now the most appropriate next step to provide a more durable framework, and to incorporate the best practices that have organically developed for issuers of digital asset tokens that may implicate securities laws. Nonetheless, we believe that the SEC started on the right path and could continue with actions that would provide an appropriate registration and reporting framework for these issuers.

IV. Investment Company Act Rule 3a-4 Lessons for Staking Services

While the SEC’s process ultimately leading to the adoption of Rule 3a-4 provides a useful example of a path that could be followed again today, the SEC’s statements made in its Rule 3a-4 adopting release already provide clear and unambiguous support for the fact that core staking services do not constitute an offering of securities. In particular, as the SEC noted in its Rule 3a-4 adopting release, non-discretionary programs will not, among other things, result in the issuance of "securities that are required to be registered under Section 5 of the Securities Act, regardless of whether the program is operated in accordance with the provisions of [R]ule 3a-4." As discussed above, the staking services described herein do not involve any discretion on the part of the staking service provider and, as such, do not result in the issuance of securities.

Nevertheless, and despite the fact that core staking services are not investment related and do not involve the provision of investment advice, it is worth noting that the staking services described in this letter are otherwise consistent with the provisions of the safe harbor. In particular, every core staking service customer “has the ability to impose reasonable restrictions on the management of their respective accounts,” including the designation of particular assets that the staking service provider should deploy. The staking service provider has no power, ability, discretion or authority to unilaterally deploy customer assets into staking on behalf of its customers. Further, each staking service customer receives real-time account information containing a description of all relevant account activity, and retains, with respect to all assets in

30 See Coinbase Global, Inc. Comment on SEC Rulemaking Petition No. 4-789 (requesting that the Commission propose and adopt rules to govern the regulation of securities that are offered and traded via digitally native methods, including potential rules to identify which digital assets are securities) (Dec. 6, 2022) available at https://www.sec.gov/comments/4-789/4789-20152418-320297.pdf.
32 Notably, IC Act Rule 3a-4 is available for any “sponsor” of an investment advisory program, regardless of their status as an investment advisor. See id. at n.25; see also SEC, Division of Examinations, Risk Alert, Observations from Examinations of Advisers that Provide Electronic Investment Advice, at n.2 (Nov. 9, 2021), available at https://www.sec.gov/exams/announcement/risk-alert-electronic-investment-advice.
33 Investment Company Act Rule 3a-4(a)(3). Note that the rule is drafted to apply to the provision of investment advisory services related to securities, which are not applicable to the staking programs described herein.
34 See id. at (a)(4).
their respective account, to the same extent as if the client held the assets outside the program, the right to:

- Withdraw his/her assets;
- Vote his/her assets, or delegate the authority to vote assets to another person;
- Be provided in a timely manner with a written confirmation or other notification of each asset transaction, and all other documents required by law to be provided to asset holders; and
- Proceed directly as an asset holder against the issuer of such asset in the client's account and not be obligated to join any person involved in the operation of the program, or any other client of the program, as a condition precedent to initiating such proceeding.\(^\text{35}\)

While this rule may not be directly applicable to staking services that may constitute investment contracts, the underlying principles provide a valuable precedent for the SEC in considering how to address staking services. Additionally, we refer the SEC back to our December 6, 2022, comment in which we provided detailed recommendations for how the SEC might approach a workable registration process for investment contracts involving digital assets.

V. Unintended Consequences of the Improper Application of Securities Laws

As markets become digitally native, it is critical that we get the relevant regulation right. This is especially true for the proof-of-stake consensus mechanisms that enable Layer 1 blockchains to record transactions and maintain the public ledgers in the digital asset ecosystem. The validation process underlying the proof-of-stake consensus mechanism relies on the community of blockchain users to ensure that network operations run efficiently and securely, and for their participation they earn rewards. The computing services that support staking introduce efficiency gains that enable broader participation by the user community.

As we explain throughout this letter, users of core staking services enter into contractual arrangements and the investor protection concerns underlying securities laws do not exist in the context of these services. Applying securities laws to these services does not improve the operation, performance, security, or safety of the proof-of-stake validation process or distribution of rewards. To the extent that a staking service model does constitute an investment contract, there is currently no established path to registration or other means of ensuring the offering complies with federal securities laws.

The SEC’s recent enforcement action against a staking provider could have significant economic consequences to the digital asset ecosystem. In particular, the assertion by the SEC Chair that its enforcement action “should make clear to the marketplace that staking-as-a-service providers must register” creates strong economic incentive to leave the U.S. because (1) the SEC has not offered a workable remediation path for registration, and, more importantly, (2) there is widespread belief that there is no basis for registration for core staking service providers, as we have articulated throughout this letter. Leaving or avoiding the U.S. as a domicile for economic

\(^{35}\) See id. at (a)(5).
activity is a rational response to potential injunctions and financial penalties from unclear and inappropriate regulatory responsibilities.

Pushing legitimate business activity offshore undermines the mandate set forth by President Biden in his executive order, which stated:

*We must reinforce United States leadership in the global financial system and in technological and economic competitiveness, including through the responsible development of payment innovations and digital assets. The United States has an interest in ensuring that it remains at the forefront of responsible development and design of digital assets and the technology that underpins new forms of payments and capital flows in the international financial system.*

The costs of offshoring the critical infrastructure of a nascent industry that already exceeds $1 trillion in value with an estimated 420 million participants far outweighs any perceived benefit that can be achieved by applying securities laws to the proof-of-stake consensus mechanism for blockchains. Yet, this is the path we are on given the lack of industry recourse to the recent SEC action.

The federal rulemaking process is designed to protect individuals and businesses against bad customs such as these. Rulemaking requirements under the Administrative Procedure Act entail public notice and comment, while other legislative requirements and executive orders stipulate the cost benefit analysis of proposed rules. Of course, the public cannot compel the SEC to write rules subject to these requirements, such as in response to our petition for rulemaking, but the Commission should nonetheless adhere—in all of its actions—to the underlying responsibility articulated by Congress and the President to ensure that its actions entail benefits to society that outweigh the costs.

*What problem is being solved?*

The SEC could look to its own guidance on how to conduct an appropriate economic analysis in pursuit of an appropriate regulatory outcome. The SEC published this guidance in 2012 to improve its internal processes after losing in the courts for failing to adequately address the economic effects of a new rule. The guidance recognizes the SEC’s statutory requirements and directs staff to the following best practices in assessing the merit of a regulatory action:

*It is widely recognized that the basic elements of a good regulatory economic analysis are: (1) a statement of the need for the proposed action; (2) the definition of a baseline against which to measure the likely economic consequences of the proposed regulation; (3) the identification of alternative regulatory approaches; and (4) an evaluation of the*  

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benefits and costs—both quantitative and qualitative—of the proposed action and the main alternatives identified by the analysis.\textsuperscript{38}

These best practices are based on the long adhered-to executive order issued in 1993 by President Clinton and updated by subsequent administrations that directs federal agencies to enact a regulatory system that:

...improves the performance of the economy without imposing unacceptable or unreasonable costs on society; regulatory policies that recognize that the private sector and private markets are the best engine for economic growth; regulatory approaches that respect the role of State, local, and tribal governments; and regulations that are effective, consistent, sensible, and understandable. \textsuperscript{39}

Implementation of these principles was formally adopted in the Office of Management and Budget’s Circular A-4, which, among other key elements highlighted for federal agencies, included the recommendation to solicit expert opinion, particularly early in the deliberative process, stating:

\textit{As you design, execute, and write your regulatory analysis, you should seek out the opinions of those who will be affected by the regulation as well as the views of those individuals and organizations who may not be affected but have special knowledge or insight into the regulatory issues. Consultation can be useful in ensuring that your analysis addresses all of the relevant issues and that you have access to all pertinent data. Early consultation can be especially helpful. You should not limit consultation to the final stages of your analytical efforts.}\textsuperscript{40}

Finally, the National Markets Securities Improvement Act expressly directs the SEC to ensure that an action is solving a problem in the public’s interest. Importantly, the Commission must do this by including factors that go beyond just investor protection, such as whether the actions will promote efficient and competitive markets.

\textit{Whenever pursuant to this title the Commission is engaged in rulemaking and is required to consider or determine whether an action is necessary or appropriate in the public interest, the Commission shall also consider, in addition to the protection of investors, whether the action will promote efficiency, competition, and capital formation.}\textsuperscript{41}

The Commission’s recent action fails to address any of these recommendations. The Commission has not (1) identified a problem that securities laws can solve, (2) engaged the public, (3)

\textsuperscript{40} MB Circular A-4, Regulatory Analysis (Sept. 17, 2003) available at https://obamawhitehouse.archives.gov/omb/circulars_a004_a-4/.
solicited experts, (4) described the economic impact from its action, or (5) explained the societal benefits that will result from it. Most importantly, the Commission has entirely failed to explain how these actions, in addition to the protection of investors, will promote efficiency, competition, and capital formation in the U.S. economy.

In promulgating an enforcement action that serves to enact policy on a widespread market practice, the SEC has circumvented a rulemaking process that has served the American public well for decades. And by circumventing the reasoned decision making process promoted by the Administrative Procedure Act and other enacting statutes, the SEC is endangering America’s competitiveness on the global stage. As digital asset markets develop, participants are increasingly steering clear of the U.S. in favor of jurisdictions that are seeking to establish themselves as crypto hubs by engaging with them through public consultations and viable registration paths.

The consequence of offshoring digital asset activity will be felt most heavily by small businesses and entrepreneurs who represent the backbone of the emerging digital asset ecosystem. The initial innovation wave started with them, with today’s large companies like Coinbase having their origins with humble beginnings and small development teams. Many of the small development teams launching today are choosing to launch in jurisdictions with a more favorable regulatory climate. As history has shown, innovation hubs are sticky and hard to displace once they land, and persistent regulatory uncertainty in the U.S. could help to ensure that the next innovation wave lands outside of its shores.

VI. Path Forward

We urge the Commission to take a different approach on the treatment of staking services. We recognize that new technologies and practices can cause agencies like the SEC to feel a sense of urgency in finding a way to fit them into existing regulatory frameworks, but pursuing public engagement instead of using enforcement actions to impose regulatory requirements across a new industry is the more prudent approach.

Enforcement actions that target one market participant but otherwise implicate all market participants put industry in an untenable position. The Commission has previously recognized the importance of not “making new law” in this way, and instead pursued notice and comment rulemaking as the more careful and considered response to new technologies and market practices. As we discussed in this letter, the Commission has also previously treated analogous developments by engaging the public through Advisory Committees and by issuing an investigative report, both which can be important precursors to rulemaking.

To learn more about staking and other digital asset technologies, the Commission could engage with the public through its two standing SEC Committees—the Investor Advisory Committee and Small Business Capital Formation Advisory Committee. The Commission could alternatively host an industry roundtable, a tool commonly used by past Commissions when interested in learning from industry about market practices. Commission staff could more
generally make themselves available in public forums, by speaking at industry, academic, and government events, to share views and solicit feedback.

Collaborative engagements such as these would put the SEC and its staff in a position to better understand digital asset technology and its potential implication on securities laws. This would in turn help the Commission and SEC better assess an appropriate path to addressing any residual market concerns, which for staking services we believe would have been better addressed, if at all, through notice and comment rulemaking.

The SEC’s role in protecting investors, ensuring fair, orderly and efficient markets, and facilitating capital formation is key to preserving our exemplary capital markets. We encourage the Commission to consider how our recommendations can help it to continue its work while also identifying those areas over which its supervision is not needed, the better to conserve its resources for its vital mission.

Sincerely,

Paul Grewal
Chief Legal Officer
Coinbase Global, Inc.