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Kraken Consents to SEC Injunction and Ceases Marketing Its Staking-as-a-Service Program

SEC's cookie-cutter complaint masks significant weaknesses in its *Howey* investment contract analysis

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In a headline-grabbing action, the Securities and Exchange Commission ("SEC") announced on February 9 that it had instituted and settled an enforcement action against Kraken, a large crypto trading platform, in which it alleged that Kraken's staking-as-a-service program marketed to customers located in the United States constituted an unregistered public offering of securities in violation of Section 5 of the Securities Act of 1933, as amended (the "Securities Act").[1] While the SEC has consistently taken the position in its prior enforcement actions that the offer and sale of, and trading in, distributed ledger (or blockchain) technology-created digital assets (often denominated as "virtual currencies," "cryptocurrencies," "coins," and "tokens") are subject to federal securities laws, the Kraken enforcement action represents the first time the SEC has formally asserted jurisdiction over staking services, advancing a theory that the staking service relationship created an investment contract under the *Howey* test. The SEC's action engendered a pointed dissent from Commissioner Hester Pierce who bemoaned that "we again chose to speak through an enforcement action," conveying her view that given the lack of uniformity in staking services, "one-off enforcement actions and cookie-cutter analysis does not cut it."[2]

Taking license with the pleadings in its federal court complaint, the SEC includes numerous allegations of disclosure deficiencies in the marketing of Kraken's staking-as-a-service program,[3] seemingly unnecessary to lay the predicate for a Section 5 registration violation which requires merely proving that there was a public offer and sale of securities. Notably, the SEC did not allege violations of Section 17(a) of the Securities Act or Section 10(b) of the Securities Exchange Act of 1934, as amended (the "Exchange Act") and Rule 10b-5 thereunder which prohibit material misrepresentations or omissions of fact in connection with the offer or sale and the purchase or sale of any security, respectively. The SEC may view its concerns over disclosure deficiencies as a policy justification for its enforcement action, but in our view, the inclusion of the litany of disclosure deficiencies is a red herring which distracts from the significant weaknesses in the SEC's *Howey* investment contract analysis.

Staking

Proof of Stake ("PoS") consensus mechanisms have evolved as a more energy-efficient alternative to Proof of Work consensus mechanisms employed, for example, by the Bitcoin network.[4] In a PoS network, miners are replaced by validators that are responsible for validating transactions and adding new blocks

and, together with all nodes, for ensuring the network's security by monitoring the underlying distributed ledger for accuracy. Validators are required to "stake" tokens in order to validate blocks. "Staking" is a form of restricted digital asset ownership whereby the holders lock up their digital assets in bonded wallets and while the digital assets are staked, the holders are prevented from transacting with the staked digital assets.

The newly minted digital asset generated each time a block of transactions is validated (sometimes referred to as inflation rewards), together with any transaction fees (usually payable in fractional increments of the network's digital asset) collected by the validator from the transacting parties on the network, collectively known as rewards ("Rewards"), serve as a primary incentive mechanism to encourage participation in validating transactions on PoS networks. The probability of validating a block and receiving the associated Rewards correlates to a validator node's staked amount of the native digital asset. In general, the greater the size of the stake, the greater the probability of receiving Rewards.

Pursuant to protocols of the underlying consensus mechanism, a validator can run the risk of losing all or a portion of its bonded digital assets and/or forfeiting the opportunity to earn Rewards for a number of reasons, including, without limitation, initiating a "double-spend"[5] or failing to continuously keep a node online. The forfeiture and penalty features of PoS networks are referred to as "Slashing". There are a variety of different approaches to proof of stake protocols, and different protocols have different mechanics, technical and minimum participation requirements, and other parameters.

Staking-as-a-service ("StaaS")

With the emergence of PoS as a consensus mechanism increasingly employed by numerous networks (now including the Ethereum network), various market participants, such as Kraken, entered the market to offer customers a suite of services that enable them to "stake" their digital assets in conformance with the requirements of the underlying PoS network. Similar to the competitive environment in other markets, they compete on the basis of user experience, brand, price, and customer service. As described by the SEC, Kraken offers enhanced features within its StaaS program under which it smooths the payment of Rewards weekly or twice weekly, and through the use of a liquidity reserve of unstaked assets, commences payment of Rewards immediately and allows termination and return of staked assets without regard to, respectively, any staking bonding and unbonding periods established by the underlying consensus mechanism.

A digital asset owner looking to stake its assets and act as a validator engages the StaaS provider to validate new transaction blocks for the underlying PoS network and earn Rewards on the holder's behalf. The StaaS provider uses the rights of multiple holders to improve its chance under the network's protocol of being designated to mint a block. The customer remains the legal and beneficial owner of the staked digital asset or, to the extent the digital asset is transferred to the StaaS service provider, the service provider holds the asset for the account and benefit of the customer and the digital assets so transferred are subject to transfer restrictions and may not be transferred (i.e., spent or exchanged for value) in any manner by the StaaS service provider.

Kraken's StaaS program is consistent with the foregoing. Its terms of use state the following:

> 1.2. **On-Chain Staking Services**. When you buy or hold one of the Digital Assets eligible for staking (the "**Supported Tokens**"), you are consenting to such Supported Tokens participating in the On-Chain Staking Services. You retain ownership of the Supported Tokens and such Supported Tokens shall remain property of you when staked under the terms of this Addendum. Please refer to your Kraken Account for further

> information regarding the On-Chain Staking Services. Section 6.7 of the Terms, which applies to Digital Assets, also applies to Supported Tokens addressed in this paragraph.

The SEC conveniently omits this important aspect of the terms of Kraken's StaaS program in its effort to recast the staking services relationship as an investment by the staking holder.

Kraken's StaaS customers do not make an "investment"

The SEC alleges that Kraken offered and sold investment contracts "whereby investors transfer certain crypto assets to Kraken for 'staking' in exchange for advertised annual investment returns of as much as 21% . . . ." The SEC states in this respect that "[i]nvestors lose possession and control over their crypto assets when they transfer those assets to [Kraken] and accordingly take on risks associated with the Kraken platform." The transfer and loss of possession and control over the staked digital asset in Kraken's program is entirely consistent with the prevailing operating model in the StaaS market. The StaaS service providers obtain control over multiple customers' digital assets to secure the benefits of the increased staked amount which improves the probability of earning Rewards pursuant to the underlying protocol. The SEC's results-oriented characterization of Kraken's StaaS services offering as an investment program ignores the fact that the services agreement creates no rights or obligations, except those that relate to the commercial services to be provided by Kraken and the treatment of the staked digital asset under the StaaS service arrangement.

As set forth in the analysis below, we do not believe, as alleged by the SEC, that Kraken's StaaS service agreement has the indicia of an investment contract under *Howey.* If similar allegations were leveled against another StaaS service provider that advances a vigorous defense, the SEC would confront a risk of outright dismissal of the complaint for failure to state a cause of action and otherwise would be hard-pressed to prevail in any ensuing litigation if not dismissed outright.

Analysis of Kraken's StaaS Program under *Howey*

In seminal decision interpreting what constitutes an investment contract in *SEC v. W. J. Howey Co.*, the Supreme Court held that whether something constitutes an investment contract and, therefore, a "security" depends on "whether the scheme involves [(1)] an investment of money [(2)] in a common enterprise [(3)] with profits to come [(4)] solely from the efforts of others."[6] The definition "embodies a flexible . . . principle . . . to meet the . . . schemes devised by those who seek the use of the money of others on the promise of profits."[7] In formulating its definition, Court observed "the investors provide the capital" and the "promoters manage, control and operate the enterprise."[8] The Supreme Court later stated "[t]he touchstone is the presence of an investment in a common venture premised on a reasonable expectation of profits to be derived from the entrepreneurial or managerial efforts of others."[9]

Investment of Money

The first prong of the *Howey* test requires that there be an investment of money into the enterprise. "[T]he investment of 'money' need not take the form of cash."[10] To be sure, a digital asset holder seeking to engage a StaaS service provider in a staking relationship holds a digital asset that it locks up (or transfers into custody) and delegates the associated validation rights. Such transfer or lockup of the digital asset does not involve an investment of money or any form of value within the common understanding of such term. In *Howey*, the Supreme Court quoted from the Minnesota Supreme Court's decision in *State v. Gopher Tire & Rubber Co.*[11] to frame the term investment contract as a contract or scheme for "'[t]he placing of capital or laying out of money in a way intended to secure income or profit from its employment.'"[12] In the part of the statement not quoted, the Minnesota Supreme Court

emphasized that the placing of capital in that manner "is an investment as that word is commonly used and understood."[13] An investment of money requires that the investor "commit his assets to the enterprise in such a manner as to subject himself to financial loss."[14]

A digital asset holder's decision to stake its assets by engaging a StaaS service provider, such as Kraken, is not a commitment of the asset to an enterprise where it is exposed to the risk of loss from its employment in the enterprise. The SEC makes a conclusory allegation that the customer's transferred assets are at risk as a result of the control obtained by Kraken in accessing the services under terms and conditions established for the program and the possibility that the staked assets may be subject to encumbrances of Kraken's creditors.[15] But as made clear in its terms of use, Kraken may not sell, transfer, loan, hypothecate, or otherwise alienate in any manner the staked digital asset while it is subject to the StaaS service relationship. At all times, the customer remains the legal and beneficial owner of the staked digital asset and is exposed to the risks associated with such ownership, which do not change by virtue of the staking relationship. A StaaS service provider such as Kraken does not risk the invested capital of staking holders to generate revenues and profits from its enterprise. In such circumstances, the transfer of the digital asset for the specific purpose of staking does not equate to the commitment of capital to be deployed by Kraken managers in its enterprise. The transfer of the digital asset with direction that it be staked under the terms and conditions of the staking agreement does expose the holder to a risk of Kraken's performance failure (including actions that lead to uncompensated Slashing),[16] a risk that is present in all service relationships. However, the existence of such risk has no bearing on whether a staking holder has made an investment in a common enterprise within the meaning of *Howey*.[17] The decision to enter into a staking relationship with a StaaS service provider simply is not a decision to invest in (or expose the holder's digital assets to the success or failure of the business of) any enterprise.[18] The digital asset holder's use of its digital asset in this manner does not constitute an investment at all and fails to satisfy this prong of the *Howey* test.

Common Enterprise

The second prong of the *Howey* test requires that the investment of money be in a "common enterprise," which the Supreme Court did not define.[19] There is a circuit court split concerning how to analyze the existence of a common enterprise. The lower courts have adopted three different judicial standards to analyze the requirement of a common enterprise: "horizontal commonality," "broad vertical commonality," and "narrow or strict vertical commonality."

Horizontal Commonality

Although not entirely clear, the SEC seems to have advanced horizontal commonality in its Kraken complaint. To that end, the SEC alleges that Kraken does not segregate nor separately manage the staked assets and asserts that the fortunes of investors are tied together because the larger the pool of assets, the higher the likelihood of obtaining rewards that inure to the benefit of all investors and Kraken.

To show the existence of a common enterprise, "[m]any courts require a showing of horizontal commonality—a type of commonality that involves the pooling of assets from multiple investors so that all share in the profits and risks of the enterprise."[20] The focus is on the connection between the individual investor and other investors in the enterprise. In the case of horizontal commonality, "each investor's interest is pooled with that of other investors, so that each has an undivided share in a pool of assets rather than an undivided share."[21] In addition, the pooling of profits for pro rata distribution to investors "is essential to horizontal commonality."[22]

A digital asset holder that enters into a staking relationship with a StaaS service provider locks up or transfers the digital assets and delegates validation rights associated with its digital assets. As is the case with Kraken's StaaS program, at all times the holder retains legal and beneficial ownership of the staked assets. Upon termination of the relationship, the staked digital assets are released from their restrictions without the payment of any interest or any financial return. The digital assets that are staked by its holder are already eligible to earn Rewards under the rules established by the consensus mechanism, which were not developed by or under the direction of the StaaS service provider. Fundamentally, the digital asset holder is entering into a bilateral contractual relationship under which it will obtain prescribed benefits from the services provided by the service provider. The benefits in the form of the consensus mechanism-generated Rewards do not represent profits of an enterprise operated by the StaaS service provider.

The digital asset holder retains undivided beneficial ownership over its staked asset and is merely using the asset to obtain the staking benefits through the services of the StaaS service provider. The holder transfers the digital asset for staking pursuant to the terms and conditions of the StaaS servicing agreement and in doing so does not contribute the asset into a pool of assets for use in the enterprise by the promoter where the holder has an undivided share. Whether the holder earns Rewards is determined entirely by the rules of the consensus mechanism, which the StaaS service provider cannot modify in any manner (although as a matter pricing the services, the share of the Rewards paid to the customer is established by the service provider and accepted by the holder). The StaaS service provider simply provides a service that enables the Rewards to be earned in accordance with the underlying consensus mechanism. For certain PoS networks, a service provider may operate in a manner similar to Kraken and offer to aggregate the digital assets of its customers for purposes of increasing probability of earning Rewards in accordance with the underlying consensus mechanism to be allocated pro rata to participating customers pursuant to the services agreement. Such aggregation may also enable the StaaS service provider to meet minimum staking requirements or allow staking to be offered to customers where the protocol imposes validator eligibility requirements that make staking independently unavailable to certain customers. However, such aggregation does not represent the kind of pooling of investor proceeds that gives rise to a common enterprise. These staked assets are not commingled such that the staking holder obtains an undivided share of the assets staked by it and other staking holders.

Vertical Commonality

Other courts require a showing of vertical commonality, which can be broad or strict. "Broad vertical commonality" requires that the well-being of all investors be dependent upon the promoter's expertise."[23] Broad vertical commonality focuses on the efforts of the promoter, requiring that the investor be dependent on the promoter.[24] The promoter need not benefit from the investment under this form of commonality.[25] "Strict vertical commonality," which is employed by the Ninth Circuit, requires that the "fortunes of the investor are interwoven with and dependent upon the efforts and success of those seeking the investment of third parties,"[26] meaning that the investor's profits are tied to the manager's profits or the profits of third parties.

A StaaS service relationship does not involve an investment in a "common enterprise" under either vertical commonality test. The extent to which a staking digital asset holder may earn Rewards is dependent upon the underlying consensus mechanism and the holder's decision to use its digital assets to access the benefits provided by a StaaS service provider. The transfer of digital assets pursuant to the StaaS services agreement (where the holder remains the owner) does not equate to an investment of capital to be deployed by a StaaS service provider in its enterprise. In our view, in the case of Kraken,

the benefits of the aggregation, smoothing and bonding and unbonding features, and the risks of performance failure resulting in uncompensated Slashing do not undermine such conclusion. The holder can earn the Rewards directly by operating its own validating node or hiring an alternative service provider, and therefore is not dependent upon any StaaS service provider as a matter of broad or narrow vertical commonality. When the staking relationship is terminated, the digital assets that are subject to the prescribed lockup are released from their restrictions without the payment of any interest or any financial return. Kraken's enhanced unbonding feature simply accelerates the release of the lockup. The digital asset holder is entitled to no "fortune" at all from the StaaS service provider (and certainly none "dependent upon the efforts and success" of the StaaS service provider); the digital asset holder's share of Rewards is simply passed through by the validator, a role more akin to a servicer than a promoter upon whose efforts the digital asset holder relies. As noted above, the StaaS service provider may in fact operate its platform at a loss, but such an operating loss would not have any effect on the ability to earn Rewards pursuant to the consensus mechanism.

Expectation of Profits

The *Howey* test considers whether a participant in an enterprise has an expectation of profit.[27] The SEC makes a conclusory allegation that investors reasonably expect to profit from Kraken efforts and simply points to Kraken's advertising of the returns that may be earned through its staking services (and enhanced smoothing and bonding features that simply affect the frequency and speed of earning Rewards). The SEC otherwise fails to describe with reference to the case law how the profit is gained. The Supreme Court has defined "profits" as "capital appreciation resulting from the development of the initial investment . . . or a participation in earnings resulting from the use of investors' funds . . . ."[28] A staking relationship does not provide for any participation in the earnings of any enterprise and the StaaS service provider may operate its business at a loss, yet perform under the service agreement and deliver the allocated share of Rewards. As discussed above, there is no common enterprise into which a holder's digital assets are invested to generate revenue and profits. The Rewards are generated pursuant to the preexisting rules of the consensus mechanism and do not represent the earnings of any enterprise managed by the StaaS service provider (although the customer's share of Rewards is a function of the pricing of the services). Consistent with this and contrary to the SEC's aversions, Kraken does not using the resources of its enterprise or otherwise promise or guarantee customers any Rewards; its terms of service clearly note that customers may not receive any Rewards[29]

A staking relationship simply allows a digital asset holder to use its digital assets that it has acquired without inducement by the StaaS service provider[30] to access the benefits associated with validating transactions as a validator node while retaining beneficial ownership of its digital assets. The "profit," if any, is derived from the Rewards which are unrelated to the earnings of the StaaS service provider's business; the generation of Rewards from the aggregation of digital assets of multiple customers is simply a feature of the service provider's services offering. As noted above, the StaaS service provider may operate unprofitably without impacting the ability of a staking holder to earn Rewards. In fact, the digital asset holder could engage a replacement StaaS service provider, or where permitted by the protocol stake its assets directly, to continue to earn Rewards. Simply stated, there is no reasonable basis for a digital asset holder to expect to participate in the profits of a StaaS service provider's enterprise as a consequence of its StaaS service relationship.

Derived Solely from the Efforts of Others

The final prong of the *Howey* test requires that there be an expectation of profits "solely from the efforts of others." As subsequently interpreted, this prong is satisfied where "the efforts made by those other than the investor are undeniably significant ones, those essential managerial efforts which affect the

failure or success of the enterprise."[31] It appears from our reading of the SEC's complaint that Kraken acquired the requisite equipment, obtained the relevant expertise, and devoted the requisite resources to compete in the market and competently provide its StaaS services. The SEC's complaint does not describe any essential managerial efforts undertaken by Kraken in operating its enterprise within the meaning of *Howey.* It simply asserts that investors are led to expect that Kraken will expend efforts to generate investment returns, and as support points to Kraken's marketing of the advantages of using Kraken's services as opposed to staking independently and the advertising of its technical expertise to decide how and when to stake the assets and manage the payouts of Rewards, which in our view merely implements the customer's direction to stake under the terms and conditions of the StaaS program.

This prong is not satisfied with a StaaS service relationship because there is no reasonable basis for a digital asset holder to expect an increase in value or returns resulting solely, or even predominantly, from the essential managerial efforts of the service provider. The StaaS service provider such as Kraken makes no managerial decisions with respect to the use or expenditure of the staked digital assets (Kraken states outright that it may not sell, transfer, loan, hypothecate, or otherwise alienate in any manner the staked digital asset). Its role is limited to providing the services for which it is engaged, i.e., aggregating the staked digital assets of its customers, operating the validating node, and transmitting (or enabling the transmission of) the customers' share of associated Rewards as a servicer consistent with the terms and conditions of the StaaS services agreement. The StaaS service provider may not spend or exchange for value in any manner the staked digital asset and thus is unable to make any kind of significant management decisions that expose the customer to the investment risks of an enterprise under its management control. A customer's risk of Kraken's performance failure (including actions that lead to uncompensated Slashing) represents the kind of performance risk that prevails with commercial services agreements generally. It is not a risk of an investment in any enterprise.

As a fundamental matter, digital asset holders who are seeking to stake their digital assets are not looking to a promoter to expend managerial or any other efforts to advance the success of an enterprise under its management. The opportunity to earn Rewards is established by the consensus mechanism of the related network and the service provider such as Kraken is engaged simply to provide discrete services that could be provided by any number of competing service providers. The extent to which such Rewards may be earned is dictated by the rules of the consensus mechanism which are developed independently by the network's Active Participants within the meaning of the SEC's *Digital Assets Framework*[32] and are not subject to modification by the StaaS service provider (although as is the case with Kraken, the share of the Rewards is set by the service provider and accepted by the holder as a pricing matter). The StaaS provider is engaged to provide discrete services pursuant to an arrangement that is terminable by either party. The staking holder is not relying on the StaaS service provider to enhance the digital asset or modify the consensus mechanism so that it can earn Rewards at a higher rate. A digital asset holder may seek to benefit from its holdings of digital assets by engaging a StaaS service provider, but such benefits in the form of Rewards, however remunerative, do not represent profits of or income generated by an enterprise managed by the service provider. Like any StaaS service provider competitor, Kraken does not possess any unique skill or knowledge not possessed by other market participants and can be terminated and replaced with an alternative service provider at any time. The economic realities of the relationship demonstrate that the staking holder is not only not making an investment to profit from the efforts of others, but is not making any investment at all since at all times the holder remains the legal and beneficial owner of its staked asset (which specifically in Kraken's case may not be sold, transferred, loaned, hypothecated, or otherwise alienated by Kraken).[33] Ultimately, a digital asset holder retains the actual power and authority to decide whether or not to stake its digital assets and engage a StaaS service provider, and once engaged, its retains the power to

terminate the service relationship, which is the essential managerial decision, effectively precluding dependence "—both in reality and according to their investment contracts—upon the efforts of others for their profits."[34] The digital asset holder in no way is left "no reasonable alternative to reliance on" a StaaS service provider, nor is it "forced to rely on some particular non-replaceable expertise" on the part of such service provider.[35]

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Clearly the SEC's enforcement action against Kraken presents legal liability risks for staking-as-a-service providers and thus StaaS service providers should be mindful of the SEC's views and potential scrutiny regardless of merit. But a closer examination of the allegations contained in the SEC's Kraken complaint reveals significant weaknesses in its *Howey* investment contract analysis. As a settled enforcement action, this action does not reflect an actual judicial resolution adjudicated based on the merits in an adversary proceeding. Moreover, an investment contract analysis is always a transaction-specific analysis, and the structure, details, and marketing of StaaS programs differ, and specific StaaS programs may differ in meaningful ways from the facts alleged in this enforcement action. Nevertheless a StaaS service provider employing an operating model similar to Kraken that finds itself in the crosshairs of an SEC enforcement action should take away from our analysis that if vigorously defended, the SEC would risk outright dismissal of the complaint for failure to state a cause of action and if not dismissed outright, the SEC would otherwise be hard-pressed to prevail in any ensuing litigation.

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1 SEC Press Release, *Kraken to Discontinue Unregistered Offer and Sale of Crypto Asset Staking-As-A-Service Program and Pay $30 Million to Settle SEC Charges* (February 9, 2023)

2 Commissioner Hester M. Peirce, *Kraken Down: Statement on SEC v. Payward Ventures, Inc., et al.* (February 9, 2023)

3 Among other things, the complaint alleges omissions of information concerning Kraken's business and financial condition, fees charged, detailed risks, including how tokens are staked or held in reserve, and whether tokens are put to some other use. The SEC complains that investors have no way to determine whether Kraken has the means of paying the marketed returns, yet Kraken's terms of service make clear that Kraken does not guarantee that customers will earn any Rewards.

4 *See* Bitcoin Energy Consumption Index, available at https://digiconomist.net/bitcoin-energy-consumption.

[5] The "double-spend" problem is the risk that a digital asset could be spent on more than one occasion by the holder of such digital asset. The design of stacking transaction logs in blocks on the blockchain is intended to ensure that the ledger does not permit the double spending of any assets. If a validator deviates and validates a block that allows a transacting party to double-spend its digital assets, such validator may lose its bonded tokens as a penalty.

[6] *SEC v. W. J. Howey Co.*, 328 U.S. 293, 301 (1946).

[7] *Id*. at 299.

[8] *Id.* at 300.

[9] *United Hous. Found. Inc. v. Forman*, 421 U.S. 837, 852 (1975).

[10] *See* Report of Investigation Pursuant to Section 21(A) of the Securities Exchange Act of 1934: The DAO, SEC Release 34-81207 (July 25, 2017), https://www.sec.gov/litigation/investreport/34-81207.pdf; *see also, e.g.*, *Uselton v. Comm. Lovelace Motor Freight, Inc.*, 940 F.2d 564 (10th Cir. 1991) (noting that an "investment of money" for *Howey* purposes may take the form of goods or services).

[11] *State v. Gopher Tire & Rubber Co*., 146 Minn. 52 (1920).

[12] *Howey*, 328 U.S. at 298.

[13] *Gopher Tire*, 146 Minn. at 56.

[14] *See SEC v. Rubera*, 350 F.3d 1084, 1090 (9th Cir. 2003) (quoting *Hector v. Weins*, 533 F.2d 429, 432 (9th Cir. 1976) (per curiam).

[15] Kraken prudently warns customers of the potential risk of such encumbrances.

[16] Kraken commits to compensate customers for Slashing penalties resulting from erroneous operation of its services (but not for supported token maintenance, bugs, or errors, acts by a hacker or other malicious actor, or force majeure events). This indemnification-type commitment does not give rise to a common enterprise and is properly viewed as a commercial term of its service agreement.

[17] Even in the unlikely case that the StaaS service relationship is judged an investment and Slashing is viewed as a form of loss, we note that the Supreme Court provided additional context to this element of the test in *Marine Bank v. Weaver* when it stated that for an instrument to be a security, the investor must risk financial loss. *Marine Bank v. Weaver*, 455 U.S. 551, 558 (1982) ("deposits are insured by the Federal Deposit Insurance Corporation. Since its formation in 1933, nearly all depositors in failing banks insured by the FDIC have received payment in full"). Based on currently available data, there is a strong argument that there is no risk of financial loss, as the probability of a holder being Slashed is low when delegating to StaaS service providers, which have extremely high uptime rates and systems built to ensure that Slashing does not occur. In *Marine Bank*, the Supreme Court focused on the Court of Appeals' failure to provide sufficient weight to the crucial fact that the purchaser of a certificate of deposit is virtually guaranteed payment in full due to FDIC insurance. *See Marine Bank*, 455 U.S. at 558 ("The Court of Appeals failed to give appropriate weight to the important fact that the purchaser of a certificate of deposit is virtually guaranteed payment in full, whereas the holder of an ordinary long term debt obligation assumes the risk of the borrower's insolvency.")

[18] In all service relationships, there is a risk of non-performance by the service provider; however, the existence of such risk has no bearing on whether a staking holder has made an investment in a common enterprise within the meaning of *Howey*.

[19] We acknowledge that the SEC does not believe that a common enterprise is a distinct requirement under the *Howey* decision. *See In re Anthony H. Barkrate*, SEC Rel. No. 49542, 82 SEC Docket 2130, 2004 WL 762434, *3 n.13 (April 8, 2004*)*, *aff'd sub nom. Barkrate v. SEC*, 125 F. App'x 892 (9th Cir. 2005).

[20] *SEC v. SG Ltd*., 265 F.3d 42, 49 (1st Cir. 2001).

[21] *SEC v. Lauer*, 52 F.3d 667, 670 (7th Cir. 1995). *See also Walser v. Fox Hills Devel. Corp.*, 24 F.3d 1016, 1019 (7th Cir. 1994) (emphasizing "an individual interest in an enterprise, entitling the owner to a pro rata share in the enterprise's profits").

[22] *Fox Hills Devel.*, 24 F.3d at 1019.

[23] *SEC v. ETS Payphones, Inc.*, 408 F.3d 727, 732 (11th Cir. 2005).

[24] *SEC v. Koscot Interplanetary, Inc.*, 497 F.2d 473, 478 (5th Cir. 1974).

[25] *Id.* at 478-79. The SEC has previously argued that the Supreme Court's decision in *Edwards* confirms that broad vertical commonality is the correct approach to common enterprise because it supports the SEC's interpretation that a common enterprise is not a distinct requirement for an investment contract. *See Brief of the Securities and Exchange Commission, Apellee* at 13-20, *SEC v. Edwards*, 540 U.S. 389 (2004). See also *Barkrate*, 82 SEC Docket 2130, at *3 n.13. Given the tenor of its allegations in the Kraken complaint, whether this still reflects the SEC's interpretive policy position is unclear.

[26] *Brodt v. Bache & Co.*, 595 F.2d 459, 460 (9th Cir. 1978) (citing *SEC v. Turner Enters., Inc.*, 474 F.2d 476, 482 n.7 (9th Cir. 1973)).

[27] *Howey*, 328 U.S. at 299.

[28] *United Hous. Found. Inc. v. Forman*, 421 U.S. 837, 852 (1975).

[29] Kraken's terms of service state: "[y]ou agree and understand that neither Payward Trading nor Kraken guarantees that you will receive Staking Rewards and that the applicable percentage (i) is an estimate only and not guaranteed, (ii) may change at any time in Payward Trading's sole discretion, and (iii) may be more or less than the actual staking rewards Payward Trading receives from the Supported Token protocol."

[30] *See SEC v. C. M. Joiner Leasing Corp.*, 320 U.S. 344 (1943) ("The test, rather, is 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."). The SEC does not allege that Kraken solicited customers to purchase the underlying staked digital assets.

[31] *SEC v. Glenn W. Turner Enters.*, 474 F.2d 476, 482 (9th Cir. 1973). The Ninth Circuit wrote, "We hold . . . the word solely should not be read as a strict or literal limitation . . . but rather must be construed realistically . . . to include those schemes which involve in substance, if not form, securities." *Id*. The Supreme Court has declined to rule on this point. In *United Housing Foundation, Inc. v. Forman*, the Court stated, "This test speaks in terms of 'profits to come *solely* from the efforts of others.' (*Emphasis supplied*.) Although the issue is not presented in this case, we note that the Court of Appeals for the Ninth Circuit has held that "the word 'solely' should not be read as a strict or literal limitation of the definition of an investment contract, but rather must be construed realistically, so as to include within the definition those schemes which involve in substance, if not form, securities." *SEC v. Glenn Turner Enters., Inc.*, 474 F. 2d 476, 482, *cert. denied*, 414 U.S. 821 (1973). We express no view, however, as to the holding of this case." 421 U.S. 837, 847 n.16 (1975). In the DAO Report, the SEC applied the standard articulated by the Ninth Circuit in *Turner*. *See* Report of Investigation Pursuant to Section 21(A) of the Securities Exchange Act of 1934: The DAO, SEC Release 34-81207 (July 25, 2017), https://www.sec.gov/litigation/investreport/34-81207.pdf.

[32] *Framework for "Investment Contract" Analysis of Digital Assets*, available at https://www.sec.gov/files/dltframework.pdf (defining an Active Participant as a promoter, sponsor, or third party that provides essential managerial efforts that affect the success of the enterprise.)

[33] *See Landreth Timber Co. v. Landreth*, 471 U.S. 681, 689 (1985) ("Applying the *Howey* test, we concluded that the instruments likewise were not 'securities' by virtue of being 'investment contracts' because the economic realities of the transaction showed that the purchasers had parted with their money not for the purpose of reaping profits from the efforts of others, but for the purpose of purchasing a commodity for personal consumption.")

[34] *See Affco Invs. 2001 LLC v. Proskauer Rose L.L.P.*, 625 F.3d 185, 191 (5th Cir. 2010). *See also Williamson v. Tucker,* 645 F.2d 404, 421 (5th Cir. 1981) ("So long as the investor has the right to control the asset he has purchased, he is not dependent on the promoter or on a third party for 'those essential managerial efforts which affect the failure or success of the enterprise.'"); *Fargo Partners v. Dain Corp.*, 540 F.2d 912, 916 (8th Cir. 1976) ("Fargo retained ultimate control of the operation of the apartment complex by reserving the right to fire Candletree as its manager on thirty days' notice. Whether it chose to exercise that right or was content to give Candletree a free hand is irrelevant; the power to control the business was in Fargo's hands.")

[35] *Williamson v. Tucker*, 645 F.2d at 423.