



# **U.S. Federal Securities and Commodity Law Analysis of Liquid Staking Receipt Tokens**

By Proof of Stake Alliance

# INTRODUCTION

This white paper provides an overview of “liquid staking,” a novel technological solution to a liquidity constraint prevalent across proof-of-stake blockchain networks, and analyzes select U.S. federal legal and regulatory issues related to proof-of-stake technology. Specifically, this white paper considers whether receipt tokens (“**Receipt Tokens**”) issued by liquid staking technologies to evidence legal and beneficial ownership of staked cryptoassets should be deemed to be “investment contracts” or “notes” under the U.S. federal securities laws and/or “swaps” under U.S. federal commodity law.<sup>1</sup>

This white paper has been prepared on behalf of the Proof of Stake Alliance (“**POSA**”). POSA is a nonprofit industry alliance whose members include the leading enterprises that advance or service existing protocols that are built on proof-of-stake technology. A more energy efficient method for validating transactions, proof of stake, is not only continuing to grow as a share of the overall blockchain market, but is also the preferred method for emerging blockchain applications. For example, 19 of the 20 largest smart contract platforms are powered by blockchains utilizing the proof-of-stake method for validating transactions, including blockchain networks like Ethereum, Solana, Cardano, Tezos, Polkadot and Avalanche. POSA’s goal is to foster increased adoption of proof-of-stake blockchain networks in the United States. The continued development of liquid staking as a technological solution to liquidity constraints associated with proof-of-stake blockchain networks advances POSA’s goal of increasing the adoption of such blockchain networks.

## OVERVIEW OF LIQUID STAKING

### What Is Staking?

Blockchains are peer-to-peer networks that incorporate a mechanism design and cryptography to enable users to transact without needing to trust one another or any intermediary.<sup>2</sup> These networks require a distributed group of users to operate computers, known as “nodes,” which run all or part of the software necessary for the system to function because it has no central operator.

Each blockchain’s underlying code incorporates a method for validating transactions called a “consensus algorithm” to incentivize nodes to contribute valuable resources to the blockchain to provide transaction settlement

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\* Developed by the Proof of Stake Alliance’s Liquid Staking Working Group, composed of members from over 10 industry organizations, co-chaired by representatives from Alluvial and Lido, and legal advisers from Willkie Farr & Gallagher LLP.

<sup>1</sup> The U.S. framework for the regulation of cryptoassets is rapidly evolving and subject to change. Congress has not expressly granted general authority to any agency to regulate cryptoassets or adopted comprehensive legislation clarifying the application of U.S. laws to cryptoassets. Similarly, very few state legislatures have adopted laws that expressly apply to cryptoassets. Nevertheless, the regulatory agencies discussed in this white paper have exercised jurisdiction over certain categories of cryptoassets and cryptoasset market participants pursuant to agency and judicial interpretations of existing law. While the legal analyses and conclusions in this white paper are based on our best understanding and application of the current state of the U.S. framework for the regulation of cryptoassets, our analyses and conclusions may change based upon new legal decisions, guidance, laws, or regulations.

<sup>2</sup> Shawn Bayern, *Of Bitcoins, Independently Wealthy Software, and the Zero-Member LLC*, 108 Nw. L. Rev. 1485, 1488 (2014).

assurances to the network’s users.<sup>3</sup> The consensus algorithm ensures that each node will be rewarded with an amount of a digitally native resource – a cryptoasset – in accordance with the rules of the algorithm, for so long as the node remains online and operates in accordance with the blockchain’s technical requirements (“**Network Rewards**”). The two most common types of consensus algorithms are proof of work and proof of stake.<sup>4</sup>

Blockchains that utilize proof of work, such as Bitcoin, rely on nodes to solve computationally challenging math problems using an application-specific machine that is powered by electricity.<sup>5</sup> Each node competes to solve a math problem using trial and error until one finds a solution in what is known as a winning “nonce.”<sup>6</sup> The first node to solve the math problem and prove it by incorporating the solution into a new “block” of validated transaction information is rewarded with a predetermined amount of the blockchain’s native cryptoasset. The reward acts to incentivize node operators to invest in the most powerful machines available, in order to perform more of the calculations required to win the opportunity to post a new block of transactions – machines that typically require significant energy to power their use.<sup>7</sup>

In contrast, blockchains that utilize proof of stake<sup>8</sup> require node operators, known as “validators,” to “stake” their cryptoassets to operate a validator node and thereby secure the blockchain network.<sup>9</sup> Unlike proof-of-work mining, proof-of-stake validating does not require energy-demanding hardware that is often prohibitively expensive. Validators are generally able to run the validator node software client on a basic laptop with a minimum amount of the blockchain network’s native cryptoasset to stake.<sup>10</sup> The validator’s staked cryptoassets function as collateral that is subject to destruction or “slashing” in the event that the validator misbehaves.<sup>11</sup> For example, if a validator on the Ethereum blockchain makes an incorrect attestation by voting for the incorrect source block, target block or head block, or misses an attestation opportunity, the validator will suffer a slashing penalty that is equal to the amount of Network Rewards that the validator would have received had the validator submitted the attestation correctly.<sup>12</sup> Whereas the proof-of-work algorithm randomly selects a “miner” to annex the next block based on its calculations, or “work,” the proof-of-stake algorithm randomly selects a “validator” to create the next block based on its share of the staked tokens. The odds of selection increase linearly the more cryptoassets the validator stakes.<sup>13</sup>

<sup>3</sup> “Settlement assurances” refers to “a system’s ability to grant recipients confidence that an inbound transaction will not be reversed.” Nic Carter, *It’s the settlement assurances, stupid* (July 22, 2019), available at [https://medium.com/@nic\\_carter/its-the-settlement-assurances-stupid-5dcd1c3f4e41](https://medium.com/@nic_carter/its-the-settlement-assurances-stupid-5dcd1c3f4e41).

<sup>4</sup> Darren J. Sandler, *Citrus Groves in the Cloud: Is Cryptocurrency Cloud Mining A Security?*, 34 Santa Clara High Tech. L.J. 250, 256 (2018).

<sup>5</sup> Satoshi Nakamoto, *Bitcoin: A Peer-to-Peer Electronic Cash System* (Oct. 31, 2008), available at <https://bitcoin.org/bitcoin.pdf>.

<sup>6</sup> Kevin Hotchkiss, *With Great Power Comes Great (Eco) Responsibility – How Blockchain Is Bad for the Environment*, Geo. Envtl. L. Rev. 1 (2019).

<sup>7</sup> *Id.* at 210.

<sup>8</sup> Some blockchains incorporate a variant of the proof-of-stake consensus mechanism, called “delegated proof of stake,” which enables users to elect delegates to validate blocks on their behalf by allocating their cryptoassets to a “staking pool” associated with a particular delegate. Parma Bains, *Blockchain Consensus Mechanisms: A Primer for Supervisors*, International Monetary Fund (Jan. 2022), available at <https://www.imf.org/-/media/Files/Publications/FTN063/2022/English/FTNEA2022003.ashx>.

<sup>9</sup> Vitalik Buterin, *A Proof of Stake Design Philosophy* (Dec. 29, 2016), available at [https://vitalik.ca/general/2016/12/29/pos\\_design.html](https://vitalik.ca/general/2016/12/29/pos_design.html).

<sup>10</sup> “GPU mining and ASIC mining . . . require huge amounts of electricity consumption, expensive hardware purchases and large warehouses. PoS staking, on the other hand, can be done on an unassuming laptop . . . .” Vitalik Buterin, *Why Proof of Stake?* (Nov. 6, 2020), available at <https://vitalik.ca/general/2020/11/06/pos2020.html>.

<sup>11</sup> Validator behavior that may result in slashing includes downtime (*i.e.*, failure to sign transactions for a period of time) and double-signing (*i.e.*, signing two blocks at the same block height).

<sup>12</sup> Blocknative, *A Staker’s Guide to Ethereum Slashing & Other Penalties* (Oct. 1, 2022), available at <https://www.blocknative.com/blog/an-ethereum-stakers-guide-to-slashing-other-penalties>.

<sup>13</sup> Cong T. Nguyen et al., *Proof-of-Stake Consensus Mechanisms for Future Blockchain Networks: Fundamentals, Applications and Opportunities*, Digital Object Identifier 10.1109/ACCESS.2019.2925010 (June 26, 2019).

Whereas nodes on a proof-of-work blockchain effectively secure the blockchain by contributing scarce computing power in validating transactions, nodes on a proof-of-stake blockchain secure the blockchain by placing scarce cryptoassets at risk of slashing in connection with their validation activities. As more validators stake more cryptoassets, it becomes more difficult for a malicious actor to obtain a sufficient amount of cryptoassets to attack the network. Validators are generally free to withdraw their stake, including any Network Rewards earned by the validator, at any time following a minimum staking period, such as two weeks, but in some circumstances the cryptoassets may remain locked after withdrawal for a brief unbonding period.

As with proof-of-work, validators on proof-of-stake blockchains acquire Network Rewards, also known as “block rewards.” In the case of proof-of-stake blockchains, the probability that a validator will be selected to create a new block (and the associated reward tokens) correlates to the validator’s stake amount.<sup>14</sup> Thus, there is an incentive for validators to have an increased stake of cryptoassets insofar as the stake amount, among other factors, will affect the probability that the validator is selected to verify the transactions and earn Network Rewards when a new block is added to the blockchain.

## The Proof-of-Stake Landscape

Although the proof-of-work method for validating transactions continues to power Bitcoin, the longest-running blockchain network, proof of stake is gaining significant adoption.<sup>15</sup> The proof-of-work method has been subject to criticism for the high capital costs of the application-specific machines required to perform computations and the amount of electricity required to keep those machines online.<sup>16</sup> Recently, governments have weighed prohibitions, moratoria and other restrictions on proof-of-work mining due to environmental concerns with excess electricity usage.<sup>17</sup>

Most blockchains launched in recent years incorporate proof of stake. Recently, Ethereum transitioned from a proof-of-work blockchain to a proof-of-stake blockchain in a transition called the “Merge.”<sup>18</sup> As a result of the Merge, the Ethereum mainnet, which incorporated proof of work, “merged” with a separate proof-of-stake side-chain called the “Beacon Chain” with the result that Ethereum’s mainnet now operates solely via proof of stake.<sup>19</sup>

<sup>14</sup> Strictly speaking, the terms “proof of work” and “proof of stake” refer to Sybil-resistant methods of randomly selecting validators, and the consensus mechanism determines agreement on which new blocks become a part of the blockchain. “From an algorithmic perspective, there are two major types [of proof-of-stake mechanisms]: chain-based proof of stake and BFT-style proof of stake. In chain-based proof of stake, the algorithm pseudo-randomly selects a validator during each time slot (e.g. every period of 10 seconds might be a time slot), and assigns that validator the right to create a single block, and this block must point to some previous block (normally the block at the end of the previously longest chain), and so over time most blocks converge into a single constantly growing chain. In BFT-style proof of stake, validators are randomly assigned the right to propose blocks, but agreeing on which block is canonical is done through a multi-round process where every validator sends a ‘vote’ for some specific block during each round, and at the end of the process all (honest and online) validators permanently agree on whether or not any given block is part of the chain.” Vitalik Buterin, Proof of Stake FAQ (Dec. 31, 2017), available at [https://vitalik.ca/general/2017/12/31/pos\\_faq.html#what-about-capital-lockup-costs](https://vitalik.ca/general/2017/12/31/pos_faq.html#what-about-capital-lockup-costs).

<sup>15</sup> Felix Lutsch, *Liquid Staking Research Report*, Chorus One, p. 3 (2020).

<sup>16</sup> Environmental Working Group, Earthjustice, Greenpeace, League of Conservation Voters, Sierra Club, Friends of the Earth, Seneca Lake Guardian, Milwaukee Riverkeeper, Comment Letter on Energy and Climate Implications of Digital Assets. 87 Fed. Reg. 17,105 (Mar. 25, 2022), available at [https://static.ewg.org/upload/pdf/5.9.22\\_Final\\_EO\\_National\\_Comments2.pdf?ga=2.127981004.1313037002.1652199398-145893579.1648558628](https://static.ewg.org/upload/pdf/5.9.22_Final_EO_National_Comments2.pdf?ga=2.127981004.1313037002.1652199398-145893579.1648558628).

<sup>17</sup> See, e.g., New York S6486D (2021-2022).

<sup>18</sup> *The Merge*, Ethereum Foundation (July 25, 2022), available at <https://ethereum.org/en/upgrades/merge/>.

<sup>19</sup> *Id.*

For roughly one year prior to the Merge, Ethereum users were able to stake ether (“ETH”) via the Beacon Chain to establish an immediate level of security for the blockchain upon its full transition to proof of stake.<sup>20</sup> Consistent with other proof-of-stake blockchains, Ethereum becomes stronger and less vulnerable to attacks as more ETH is staked.<sup>21</sup> A user’s staked ETH remains locked until withdrawal capabilities are functional on Ethereum, which is estimated to occur in approximately six months.

While the Merge was highly covered and analyzed given Ethereum’s status as the second-largest blockchain, nearly all newer blockchains have been built using some form of proof-of-stake method of validation due to the inherent energy and operational efficiencies. The rise of proof-of-stake networks has fostered the growth of an entire American-based ecosystem of developers and companies involved in its development. Firms that facilitate staking, such as Figment, Blockdaemon and Coinbase Cloud, have created billions of dollars of value, employ hundreds of people and have generated significant investment in the United States.<sup>22</sup> Additionally, proof of stake democratizes participation in these blockchain networks, as anyone who holds cryptoassets native to the network may participate in staking. Network Rewards from staking are shared among stakers, whereas, in contrast to proof of work, gains flow to miners that are capable of significant capital investment in hardware and electricity. An entire ecosystem of web3 applications is also being built on proof-of-stake networks. The continued growth of this sector within the crypto ecosystem demonstrates the growing need for legal consensus on how proof-of-stake technologies are classified and regulated.

## What Is Liquid Staking?

“Liquid staking” enhances the security of proof-of-stake blockchains while providing additional functionality for stakers. When a blockchain user stakes cryptoassets directly by operating a proof-of-stake validator node, some or all of the user’s staked cryptoassets typically become locked and non-transferable for as long as the cryptoassets remain staked and until such time that the relevant blockchain’s “unbonding period” or other waiting time requirement concludes. As a result, such users immediately lose the liquidity associated with their staked cryptoassets. A solution to the liquidity constraints associated with staking has recently emerged in the form of liquid staking, whereby users who stake their cryptoassets (“**Liquid Stakers**” and each, a “**Liquid Staker**”) receive transferable Receipt Tokens that evidence ownership of (i) the staked cryptoassets, and (ii) Network Rewards that accrue in respect of such staked cryptoassets.

With liquid staking, Liquid Stakers typically stake cryptoassets through a decentralized liquid staking protocol or staking-as-a-service service provider (each as discussed below) and receive Receipt Tokens evidencing their legal and beneficial ownership of the associated staked cryptoassets. Receipt Tokens are generally transferable and usable within decentralized applications, allowing Liquid Stakers to transact with their staked cryptoassets without having to withdraw them from staking.

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<sup>20</sup> *What is staking*, Ethereum Foundation (July 14, 2022), available at <https://ethereum.org/en/staking/#what-is-staking>.

<sup>21</sup> *Id.*

<sup>22</sup> See Coindesk, “Crypto Infrastructure Firm Blockdaemon Raises \$207M at \$3.25B Valuation” (Jan. 26, 2022), available at <https://www.coindesk.com/business/2022/01/26/crypto-infrastructure-firm-blockdaemon-raises-207m-at-325b-valuation/>; and The Block, “Coinbase Cloud has \$30 billion in crypto assets staked across 25 blockchains” (Dec. 2, 2021), available at <https://www.theblock.co/linked/126104/coinbase-clients-staking-more-than-30-billion-crypto-assets>.

In a typical liquid staking protocol or service provider arrangement, Network Rewards and slashing losses accrue to (or are deducted from) staked cryptoassets in one of two constructs. In the first construct, a Liquid Staker's Receipt Tokens evidence ownership of more or fewer cryptoassets (each, a "**Static Receipt Token**") as and when Network Rewards or losses accrue. In the other construct, a Liquid Staker receives additional Receipt Tokens or loses Receipt Tokens (each, a "**Dynamic Receipt Token**") as and when Network Rewards or losses accrue. In either construct, however, a Liquid Staker may redeem the Receipt Tokens with the protocol or service provider for the associated cryptoassets at any time, subject to any waiting period imposed by the relevant blockchain. Alternatively, a Liquid Staker may transfer its Receipt Tokens to a third party.

Receipt Tokens evidence ownership of intangible commodities in the digital world in a substantially identical manner that warehouse receipts, bills of lading, dock warrants and other documents of title evidence title to tangible commodities in the physical world. For example, a person may own gold bullion or livestock but prefer to store it with a depository warehouse or syndicate for safekeeping. In return for depositing the gold bullion or livestock at the depository warehouse or syndicate, the depositor receives a document of title that evidences the depositor's ownership to the commodity that is being stored. Thereafter, the depositor can transfer the document of title to a counterparty in a commercial transaction or may use it to satisfy certain delivery obligations as it demonstrates that the person delivering it to the depository warehouse or syndicate has ownership of the actual underlying commodity. The counterparty may then take delivery of the commodity by presenting the document of title to the depository warehouse or syndicate as it represents legal and beneficial ownership of such commodity. Similarly, by redeeming Receipt Tokens, the holder may take delivery of the staked cryptoassets as the Receipt Tokens represent legal and beneficial ownership of such staked cryptoassets.

## Types of Liquid Staking Arrangements

As noted above, Liquid Stakers generally stake cryptoassets through one of two models. Under the first model, Liquid Stakers allocate cryptoassets to a decentralized smart contract protocol that stakes cryptoassets on a Liquid Staker's behalf and issues corresponding Receipt Tokens in a programmatic manner (the "**Protocol Model**").<sup>23</sup> Each Receipt Token functions as a native title document that evidences the Receipt Token holder's ownership of staked cryptoassets. The generation, issuance and redemption of the Receipt Tokens is performed automatically via smart contract code without the need for or reliance upon a third-party intermediary. For example, at the election of a Liquid Staker, the protocol will programmatically redeem the Receipt Tokens for the corresponding staked cryptoassets (taking into account any accrued Network Rewards or slashing losses). The Protocol Model is currently utilized across a number of blockchains.<sup>24</sup>

In the second model, Liquid Stakers enter into a bilateral relationship with a staking-as-a-service provider, such as a centralized exchange, governed by a services agreement (the "**Provider Model**"). Under the Provider Model, Liquid Stakers deposit cryptoassets to the service provider's digital wallet and the service provider stakes the cryptoassets on the Liquid Stakers' behalf. Upon receipt of a Liquid Staker's cryptoassets or a Liquid Staker's request

<sup>23</sup> See, e.g., Lido Finance, *Introducing Lido*, Medium (Oct. 15, 2022), <https://lidofinance.medium.com/introducing-lido-8aee079cae8e>; and David Rugendyke, *Rocket Pool – Staker's Guide*, Medium (July 30, 2021), available at <https://medium.com/rocket-pool/rocket-pool-stakers-guide-2c5c324b1749>.

<sup>24</sup> *Top 10 Non-custodial Proof of Stake Providers ranked by Staked Value*, Finrate AG (July 28, 2022), available at <https://www.stakingrewards.com/global-charts/top-10-non-custodial-proof-of-stake-providers-ranked-by-staked-value/>.

for Receipt Tokens, the service provider will generate Receipt Tokens that evidence ownership of the staked cryptoassets and will issue the Receipt Tokens to the Liquid Staker. The service provider then stands ready to redeem each Receipt Token for a corresponding amount of cryptoassets (taking into account any accrued Network Rewards or slashing losses) when the Liquid Staker tenders the Receipt Tokens to the service provider, just as warehousemen stand ready to redeem physical goods when a depositor tenders a warehouse receipt.

In both models, the relationship of a Liquid Staker and the protocol or service provider, as applicable, resembles a bailment relationship. Although the requirements of a common law bailment vary from state to state, a bailment generally arises when an individual or company deposits goods in a warehouse (or an electronic equivalent) and there is an express or implied agreement that the warehouse will later return or dispose of the goods in accordance with the depositor's instructions.<sup>25</sup> In such circumstances, the individual or company is the bailor and the warehouse acts as bailee.<sup>26</sup> It is well established that a bailment relationship exists when an individual or company deposits goods (living or otherwise) such as grain, timber, lumber or livestock for the purpose of safekeeping such goods.<sup>27</sup> The bailee typically provides the bailor with a document of title memorializing that the bailor has deposited goods with the bailee but the bailor remains the legal and beneficial owner of the goods (and any offspring or byproducts thereof).<sup>28</sup> State laws generally permit documents of title to be issued in electronic format, such as in the form of a cryptoasset Receipt Token.<sup>29</sup>

# ANALYSIS OF RECEIPT TOKENS UNDER SELECT U.S. FEDERAL LAWS AND REGULATIONS

## “Investment Contract” Analysis

Section 2(a)(1) of the Securities Act of 1933 (the “**Securities Act**”) and Section 3(a)(10) of the Securities Exchange Act of 1934 (the “**Exchange Act**”) define the term “security” to include a variety of enumerated financial instruments, including, among other things, any note, stock, transferable share, warrant or right to purchase a security, as well as a catch-all category known as “investment contracts.”<sup>30</sup> In general, all offers and sales of

<sup>25</sup> See *Lionberger v. United States*, 371 F.2d 831, 840 (Ct. Cl. 1967) (“A bailment relationship is said to arise where an owner, while retaining title, delivers personally to another for some particular purpose upon an express or implied contract. The relationship includes a return of the goods to the owner or a subsequent disposition in accordance with his instructions.”).

<sup>26</sup> Practical Law Commercial Transactions, *Warehousing*, Practical Law Practice Note 0-570-3226.

<sup>27</sup> See, e.g., *Sexton v. Graham*, 53 Iowa 181, 4 N.W. 1090, 1095 (1880) (finding that “[w]here a warehouseman merely receives grain from several depositors with the understanding that it may be mixed in a common mass, and it is so mixed, the transaction is a bailment . . .” (citing *Cushing v. Breed*, 96 Mass. 376, 380 (1867))); *Chaffin v. State*, 5 Ga. App. 368, 63 S.E. 230 (1908) (timber and lumber); *Barron v. State*, 126 Ga. 92, 54 S.E. 812 (1906) (sheep).

<sup>28</sup> See *Bank of New York v. Amoco Oil Co.*, 35 F.3d 643, 652 (2d Cir. 1994) (finding a bailment relationship where a person deposits inventory with another person “in the regular course of business or financing” and the recipient provides the depositor with a document “evidencing that the person in possession of it is entitled to receive, hold and dispose of the document and the goods it covers”).

<sup>29</sup> See U.C.C. § 1-201(b)(16).

<sup>30</sup> 15 U.S.C. § 77b(a)(1); 15 U.S.C. § 78(a)(10). The definition of “security” is “virtually identical” in both statutes and, therefore, the Supreme Court has held that the definitions will be treated as identical “in our decisions dealing with the scope of the term.” *Landreth Timber Co. v. Landreth*, 471 U.S. 681, 686 n.1 (1985). For all purposes relevant to this white paper, the definition of “security” is also substantially similar under the U.S. Investment Advisers Act of 1940 and the Investment Company Act of 1940.

securities to U.S. persons or otherwise making use of U.S. jurisdictional means must be registered with the U.S. Securities and Exchange Commission (“SEC”), absent an exemption.<sup>31</sup>

Although the SEC and federal courts have deemed certain cryptoassets to be notes,<sup>32</sup> the SEC and federal courts have primarily analyzed cryptoassets to determine whether they are investment contracts within the definition of security under the federal securities laws.<sup>33</sup> Because Receipt Tokens are generated and issued in cryptoasset format, a gating issue for liquid staking protocols and staking-as-a-service providers is whether Receipt Tokens are investment contracts.

The test applied by the SEC and courts for determining whether an instrument is an investment contract originates from a 1946 Supreme Court opinion in *SEC v. W.J. Howey Co.*<sup>34</sup> The Supreme Court in *Howey* held that an investment contract is a contract, transaction or scheme through which a person (i) invests money (ii) in a common enterprise and (iii) reasonably expects profits or returns (iv) derived from the entrepreneurial or managerial efforts of others.<sup>35</sup> To be deemed an investment contract, the contract, transaction or scheme at issue must meet all four elements of the *Howey* test.<sup>36</sup> Under the prevailing legal framework for the U.S. federal securities laws and SEC and SEC staff guidance provided to date, POSA submits that Receipt Tokens, regardless of the liquid staking arrangement, do not satisfy any element of the *Howey* test. Although the analysis can rest with the determination that liquid staking does not involve an “investment of money,” we address each of the *Howey* requirements below. Accordingly, POSA submits that a Receipt Token should not be deemed to be an investment contract, and therefore, a security under the *Howey* test.

## 1. Investment of Money

To satisfy the investment of money element under the *Howey* test, an investor in a contract, transaction or scheme must give up “some tangible and definable consideration in return for an interest that [has] substantially the characteristics of a security.”<sup>37</sup> The investor must “commit his assets to the enterprise in such a manner as to subject himself to financial loss.”<sup>38</sup> The consideration need not be fiat currency – it may be cryptoassets, services or anything else of value to the seller.

POSA submits that Liquid Stakers do not make an investment of money when they allocate cryptoassets to a protocol or service provider to be staked in exchange for Receipt Tokens insofar as, in doing so, Liquid Stakers retain legal and beneficial ownership of their staked cryptoassets and any fees retained by the protocol or service provider are made in exchange for services rather than as an investment.

<sup>31</sup> 15 U.S.C. § 77e.

<sup>32</sup> See, e.g., *In the Matter of Blockchain Credit Partners d/b/a DeFi Money Market, Gregory Keough, and Derek Acree*, Securities Act Release No. 10961, Exchange Act Release No. 92588 (Aug. 6, 2021) (finding “mTokens” to be notes and therefore securities under the Securities Act).

<sup>33</sup> See, e.g., *SEC v. Kik Interactive Inc.*, 492 F. Supp. 3d 169 (S.D.N.Y. 2020) (holding that “Kin” tokens are investment contracts and therefore securities under the Securities Act).

<sup>34</sup> *SEC v. W.J. Howey Co.*, 328 U.S. 293 (1946).

<sup>35</sup> *Id.* at 298–99.

<sup>36</sup> Certain industry commentators and the SEC staff at times have collapsed the third and fourth prong of the *Howey* test. For purposes of this white paper, we analyze these prongs separately.

<sup>37</sup> *International Bhd. of Teamsters v. Daniel*, 439 U.S. 551, 560 (1979).

<sup>38</sup> 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*))).



In the context of liquid staking, Receipt Tokens operate as a title instrument to staked cryptoassets. By virtue of holding a Receipt Token, the holder possesses legal and beneficial ownership of the staked cryptoassets and any Network Rewards generated from (or slashing penalties deducted from) such cryptoassets. Liquid Stakers never transfer beneficial or legal ownership of their cryptoassets to the liquid staking protocol under the Protocol Model, the service provider under the Provider Model, or to any other third party. When a Liquid Staker allocates cryptoassets to the protocol or service provider for purposes of staking, the protocol or service provider receives the cryptoassets for safekeeping and provides Receipt Tokens to the Liquid Staker to confirm that the Liquid Staker retains legal and beneficial ownership of the staked cryptoassets. Liquid Stakers can redeem Receipt Tokens for staked cryptoassets and accrued Network Rewards with the protocol or service provider at any time, subject to any applicable blockchain restrictions.

Some liquid staking arrangements provide for the sharing of a fixed or percentage-based amount of the Network Rewards generated by a Liquid Staker's staked cryptoassets ("**Service Fees**") with the relevant protocol or service provider. Although the SEC staff has articulated a broad view that *any* consideration "designed to advance the issuer's economic interests and foster a trading market for its securities" is sufficient to satisfy the "investment of money" element,<sup>39</sup> in liquid staking arrangements, any Service Fees allocated to the protocol or service provider are paid as compensation for ministerial services rather than as an investment whereby a Liquid Staker "subject[s] himself to financial loss."<sup>40</sup> Specifically, the Liquid Staker pays a portion of the Network Rewards that the Liquid Staker acquires from staking its cryptoassets to the protocol or service provider as Service Fees in exchange for the protocol or service provider arranging for the allocation of the Liquid Staker's cryptoassets to one or more validator nodes, security and safekeeping of the allocated cryptoassets, and, in many cases, slashing coverage with respect to the allocated cryptoassets.

The protocol or service provider performs the role of a digital warehouseman. Just as a fire or flood to a physical warehouse could wipe out a bailor's physical commodities, a slashing event or cybersecurity event that impacts a digital warehouse could result in a loss of a Liquid Staker's digital commodities. However, the risk of loss present therein does not turn such a service provider relationship into an investment contract.

Liquid staking arrangements do not provide the protocol, service provider or any third party with the "full and complete right and power to assign [the staked cryptoassets] or any part thereof, and to rehypothecate for [*the third party's*] financing purposes any or all [staked cryptoassets] of [Liquid Stakers], which are indicia of an investment arrangement."<sup>41</sup> Moreover, Liquid Stakers do not consent to any separation, in whole or in part, of their staked cryptoassets insofar as the Receipt Tokens they receive evidence legal and beneficial ownership of their staked cryptoassets, which can be redeemed for the staked cryptoassets at any time, subject to applicable blockchain restrictions. This relationship is very different from a traditional securities investment where the promoter has the ability to use the funds at its discretion. In the context of liquid staking, the protocol and/or service provider do not have any discretion as to how to use the funds, but instead the cryptoassets are required to be staked until the Liquid Staker makes the decision to redeem the underlying cryptoassets.

Although a Liquid Staker, like any staker, may lose cryptoassets in the rare event of slashing, many liquid staking arrangements incorporate slashing coverage so that if slashing were to occur, the Liquid Staker arguably will be in

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<sup>39</sup> See Strategic Hub for Innovation and Financial Technology, *Framework for "Investment Contract" Analysis of Digital Assets* (Apr. 3, 2019), at FN 9, available at <https://www.sec.gov/files/dlt-framework.pdf> (the "**Finhub Framework**").

<sup>40</sup> See *Rubera*, 350 F.3d at 1090.

<sup>41</sup> *El Khadem v. Equity Sec. Corp.*, 494 F.2d 1224, 1228 (9th Cir. 1974).

a position to be “virtually guaranteed payment in full” upon redemption of Receipt Tokens.<sup>42</sup> As a result, Liquid Stakers may not subject themselves “to a risk of financial loss” that is required to establish an investment of money.

## 2. Common Enterprise

To satisfy the common enterprise element, the success of the purchaser’s interest must rise and fall with others involved in an enterprise. Investments in commodities, such as ETH, by themselves, are not investment contracts.<sup>43</sup> A commodity can provide the basis for an investment contract only when the seller engages in an enterprise in which the purchaser also has an economic interest or derives an economic benefit.

In analyzing this element, courts distinguish between “horizontal commonality” and “vertical commonality.” Horizontal commonality requires the “tying of each individual investor’s fortunes to the fortunes of the other investors by the pooling of assets, usually combined with the *pro rata* distribution of profits.”<sup>44</sup> Vertical commonality requires the promoter to share risk with the investor but does not require the pooling of investor assets.<sup>45</sup> Horizontal commonality will always satisfy the common enterprise element, but courts are split as to whether vertical commonality is sufficient.<sup>46</sup> Some courts require “broad vertical commonality,” whereby the success of the investment is inextricably linked to the efforts of the promoter or other third party.<sup>47</sup> Other courts require “narrow vertical commonality,” whereby the investor’s fortunes are tied to the fortunes of the promoter or other third party.<sup>48</sup>

Based on the relationships between Liquid Stakers and the protocol or service provider, POSA submits that Liquid Stakers do not participate in a “common enterprise” with the protocol or service provider (either under a horizontal or vertical commonality theory), but instead engage in a bailor-bailee relationship with the protocol or service provider whereby the bailee safeguards and stakes the bailor’s cryptoassets for a fee.

### i. Horizontal Commonality

Liquid Stakers utilize a common servicer but do not comingle legal and beneficial ownership of their cryptoassets within a common enterprise. As discussed above, Liquid Stakers retain legal and beneficial ownership of their staked cryptoassets and the Network Rewards that result from the staking of these cryptoassets, less any Service Fees.

Similar to physical commodities maintained in a single warehouse as a fungible bulk, a protocol or service provider may maintain a Liquid Staker’s cryptoassets together with the cryptoassets of other Liquid Stakers in a single blockchain account.<sup>49</sup> Warehouse receipts that represent ownership of the physical commodities can be analogized

<sup>42</sup> *Marine Bank v. Weaver*, 455 U.S. 551, 558 (1982).

<sup>43</sup> *Noa v. Key Futures*, 638 F.2d 77 (9th Cir. 1980).

<sup>44</sup> *Revak v. SEC Realty Corp.*, 18 F.3d 81, 87 (2d Cir. 1994).

<sup>45</sup> *SEC v. SG Ltd.*, 265 F.3d 42, 49 (1st Cir. 2001).

<sup>46</sup> *See, e.g., Vale National Gas America Corp. v. Carrollton Resources 1990, Ltd.*, 795 F. Supp. 795 (E.D. La. 1992).

<sup>47</sup> *See Long v. Shultz Cattle Co.*, 881 F.2d 129, 140–41 (5th Cir. 1989).

<sup>48</sup> *See Revak*, 18 F.3d at 88.

<sup>49</sup> *See Sec. Pac. Nat'l Bank*, Fed. Sec. L. Rep. P 76,333 (S.E.C. No-Action Letter Jan. 11, 1980)

to Receipt Tokens delivered to a Liquid Staker to evidence legal and beneficial ownership of the Liquid Staker's staked cryptoassets, rather than an undivided share in a common enterprise. The protocol or service provider does not, for example, have the discretion to deploy cryptoassets from the fungible bulk to build out a business venture or to otherwise use the cryptoassets towards a common enterprise.<sup>50</sup> Instead, the protocol or service provider maintains the cryptoassets for safekeeping and stakes them on behalf of a Liquid Staker. Just as farmers' fortunes are not tied together in a common enterprise by virtue of storing their crops in a single grain silo for safekeeping, Receipt Token holders' fortunes are not tied together by virtue of allocating their cryptoassets to a single blockchain account for staking.

## ii. Vertical Commonality

A Liquid Staker and the protocol or service provider have a relationship akin to that between a bailor and bailee rather than akin to partners in a profit-seeking enterprise. When a Liquid Staker allocates cryptoassets to a protocol or service provider, the protocol or service provider stakes the cryptoassets, which become non-transferrable pursuant to smart contract code in the case of the Protocol Model, or pursuant to applicable service terms and conditions in the case of the Provider Model. In both models, the Receipt Token holder does not rely on the protocol or service provider to exercise any discretion over the staked cryptoassets or make investment decisions on its behalf. Instead, all Network Rewards accrue to the Receipt Token holder programmatically pursuant to the relevant proof-of-stake blockchain's code without any managerial efforts on the part of the protocol or service provider.

Further, a Liquid Staker is agnostic as to whether the protocol or service provider chooses to use any Service Fees earned to develop liquid staking products on additional blockchains, build out new business lines or for any other purpose since the Liquid Staker has no ability to share, directly or indirectly, in any potential profits or income earned thereby because Receipt Tokens do not provide a holder with any rights to share in an enterprise's income or profit.<sup>51</sup> The Receipt Token only entitles the Liquid Staker to receive its staked cryptoassets and corresponding Network Rewards, much like a typical bailor-bailee relationship with livestock where the document of title only entitles the bailor to the livestock and any corresponding offspring.

The fact that the protocol or service provider could become insolvent or commercially unsuccessful during the period that a Liquid Staker maintains staked cryptoassets with the protocol or service provider is not sufficient to establish a common enterprise with the Liquid Staker – insofar as the risk of a service provider's business failure or adverse business performance is a risk that every consumer takes on when engaging a service provider, or in the specific case of a bailment or similar arrangement, when the consumer “pays in advance for goods to be delivered in the future.”<sup>52</sup> If a protocol or service provider were to become insolvent or commercially unsuccessful so that it no longer provides liquid staking services, a Liquid Staker's risk is limited because the Liquid Staker has the ability to withdraw its staked cryptoassets from the protocol or service provider's platform and instead stake through another liquid staking protocol or service provider and is not “forced to rely on some particular non-replaceable

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<sup>50</sup> See *Poplar Grove Planting & Ref. Co. v. Bache Halsey Stuart Inc.*, 465 F. Supp. 585, 589 (M.D. La. 1979) (holding that a “commodity contract, particularly one involving a non-discretionary account, is not a security” because there is no common enterprise).

<sup>51</sup> See *FinHub Framework* at 6.

<sup>52</sup> See *Noa*, 638 F.2d at 80 (9th Cir. 1980) (finding no common enterprise despite the fact that silver receipt holders “bore the risk that during the thirty day period which defendants had to initiate delivery of the silver, the defendants might become insolvent.”)

expertise” native only to one particular protocol or service provider.<sup>53</sup> Therefore, the Liquid Staker does not otherwise share in the profits or risks of the protocol or service provider’s business of safeguarding and staking the Liquid Staker’s cryptoassets.<sup>54</sup>

### 3. Expectation of Profits

The expectation of profits element of the *Howey* test requires that purchasers obtain the instrument with a reasonable expectation of earning a profit. “Profits” can be through capital appreciation resulting from an initial investment (e.g., price appreciation) or a participation in earnings resulting from the use of investors’ funds (e.g., distributions to the cryptoasset holder).<sup>55</sup> Regardless of the form, profits may be a fixed or variable return on the initial investment.<sup>56</sup> The “expectations of profits” analysis is driven by the promises and offers made by the issuer to purchasers or prospective purchasers rather than the price motivation of each purchaser.<sup>57</sup>

In *United Housing Foundation, Inc. v. Forman*, the Supreme Court held that “when a purchaser is motivated by a desire to use or consume the item purchased—‘to occupy the land or to develop it themselves,’ as the *Howey* Court put it—the securities laws do not apply.”<sup>58</sup> The *Forman* Court distinguished ancillary features of consumptive instruments that might generate “speculative and insubstantial” profits, which are insufficient to bring the entire transaction within the scope of the federal securities laws, from the core features of an instrument that are designed to return profits to the investor. The latter features establish a sufficient expectation of profits.<sup>59</sup> Relatedly, the SEC staff has expressed the view that “[p]rice appreciation resulting solely from external market forces (such as general inflationary trends or the economy) impacting the supply and demand for an underlying asset generally is not considered ‘profit’ under the *Howey* test.”<sup>60</sup>

Packaging a non-security instrument with investment-like characteristics may create an expectation of profits associated with ownership of the instrument.<sup>61</sup> In considering this, courts look “outside the instrument itself” to determine “whether, in light of the economic reality and the totality of the circumstances surrounding [the instrument], the customers were making an investment.”<sup>62</sup> A cryptoasset’s functionality, pricing and manner of sale may factor into whether the purchaser has a consumptive rather than investment motive.<sup>63</sup> Even if advertising

<sup>53</sup> *Williamson v. Tucker*, 645 F.2d 404, 423 (5th Cir. 1981).

<sup>54</sup> *Noa*, 638 F.2d at 80.

<sup>55</sup> *Forman*, 421 U.S. at 852.

<sup>56</sup> *SEC v. Edwards*, 540 U.S. 389 (2004).

<sup>57</sup> *Warfield v. Alaniz*, 569 F.3d 1015, 1021 (9th Cir. 2009).

<sup>58</sup> *Forman*, 421 U.S. at 853.

<sup>59</sup> *Id.* at 857–58.

<sup>60</sup> See *FinHub Framework* at 6.

<sup>61</sup> See, e.g., *Glen-Arden Commodities Inc. v. Constantino*, 493 F.2d 1027, 1035 (2d Cir. 1974) (finding whiskey warehouse receipts sold together as a “package deal” with additional marketing services to constitute securities); *In the Matter of BlockFi Lending LLC*, Securities Act Release No. 11029, Investment Company Act Release No. 34503 (Feb. 14, 2022) (the SEC alleged that through its own public statements, BlockFi created a reasonable expectation that BIA investors would earn profits from BlockFi’s efforts).

<sup>62</sup> *Glen-Arden*, 493 F.2d at 1034.

<sup>63</sup> See *In the Matter of Munchee Inc.*, Securities Act Release No. 10445 (Dec. 11, 2017) (the SEC focused on certain public statements either made by Munchee or endorsed by Munchee that may indicate an investment motive on behalf of the purchaser, such statements touting an opportunity to profit); *In the Matter of Kelvin Boon, LLC and Rajesh Pavithran*, Securities Act Release No. 10817, Exchange Act Release No. 89548 (Aug. 13, 2020) (the SEC alleged that the representations in the online offering and promotional materials relating to Boon Coins created a reasonable expectation of profits derived from the efforts of others).

tactics regarding a cryptoasset were aimed at marketing the consumptive use of such cryptoasset, courts may consider the purchasers as having a profit motive if there was an offering or sale of the cryptoasset prior to it being fully functional.<sup>64</sup> Moreover, the presence of a discounted rate in an offering or sale of a cryptoasset may also be indicative of a profit motive by the purchaser.<sup>65</sup>

Proof-of-stake algorithms are designed to incentivize users to stake their cryptoassets to secure the blockchain network and in doing so potentially earn Network Rewards. While many users may choose to stake cryptoassets for entirely altruistic purposes, such as contributing to the security of the blockchain network, a staking mechanism design that does not offer Network Rewards to stakers would arguably not attract the same degree of participation. By design, many proof-of-stake blockchains also incentivize users to stake their cryptoassets to counter the inflation schedule of the blockchain's native cryptoasset. Staking temporarily removes cryptoassets from circulation and thereby acts as deflationary counterweight to the inflationary impact of minting additional cryptoassets as Network Rewards.

It follows that at least some Liquid Stakers are likely motivated by the prospect of earning Network Rewards. Many liquid staking protocols and service providers advertise the ability to earn additional income from staking cryptoassets and holding Receipt Tokens to users who have cryptoassets to stake. Holders of Static Receipt Tokens may expect their Static Receipt Tokens to increase in value as additional Network Rewards accrue from staking. Holders of Dynamic Receipt Tokens may expect to earn additional Receipt Tokens as Network Rewards accrue. These Receipt Tokens, regardless of form, may subsequently be redeemed with the issuer for the associated cryptoassets or sold on a popular trading venue. Additionally, Liquid Stakers may in some instances purchase Receipt Tokens on secondary trading venues at a discount to the price of the corresponding cryptoasset and then redeem the Receipt Tokens with the issuer for a profit.

On the other hand, POSA submits that Network Rewards are more appropriately characterized as compensation paid by the blockchain to the Liquid Staker for services provided by the Liquid Staker to the blockchain and its users rather than "profits." Each Liquid Staker provides a service to users of the blockchain by allocating cryptoassets to be staked by the liquid staking protocol or service provider to support the validation of transactions. By staking its cryptoassets, the Liquid Staker provides greater settlement assurances to users of the blockchain. Each additional cryptoasset staked by the Liquid Staker is akin to an additional brick being added to a fortress that protects commerce within the blockchain network and provides greater assurances to users that their transactions will not be reversed. The more cryptoassets staked by good actors, the harder and more expensive it becomes for a malicious actor to amass a sufficient amount of cryptoassets to scale the fortress and attack the network (*e.g.*, via a 51% attack). Liquid Stakers contribute this security service in exchange for Network Rewards, which are designed to be just material enough to encourage cryptoasset holders to stake their cryptoassets.<sup>66</sup>

The Liquid Staker's profit motivation, if any, to obtain a Receipt Token is ancillary to the consumptive utility of a document of title to the staked cryptoassets. If the Liquid Staker were interested solely in earning Network Rewards, the Liquid Staker could stake cryptoassets by operating its own validator node or via a staking-as-a-service provider. Profits earned by a Liquid Staker in excess of those that the Liquid Staker would earn by staking directly or via a

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<sup>64</sup> *Kik*, 492 F. Supp. 3d at 179–80.

<sup>65</sup> *SEC v. Telegram Grp. Inc.*, 448 F. Supp. 3d 352, 371–72 (S.D.N.Y. 2020), *appeal withdrawn sub nom. SEC v. Telegram Grp., Inc.*, No. 20-1076, 2020 WL 3467671 (2d Cir. May 22, 2020).

<sup>66</sup> See Buterin, *supra* note 9 (noting that the network purchases security by compensating the staker for the "inconvenience of not being able to move [their] coins around at will while [they] are staking").

staking-as-a-service provider, if any, are “far too speculative and insubstantial to bring the entire transaction within the Securities Acts.”<sup>67</sup> Indeed, Liquid Stakers who stake through a liquid staking protocol or service provider are likely to earn less Network Rewards than they would through an alternative staking arrangement as a result of the deduction of Service Fees.

## 4. Efforts of Others

The efforts of others element of the *Howey* test requires that the purchaser expect profits to be derived substantially from the managerial efforts of others. These efforts must be “the undeniably significant ones, those essential managerial efforts which affect the failure or success of the enterprise.”<sup>68</sup> The fact that the seller of the relevant financial instrument assigns “nominal or limited responsibilities” to the purchaser or the fact that the purchaser itself takes efforts to derive a profit from an instrument “does not negate the existence of an investment contract.”<sup>69</sup> However, in instances where the seller merely agrees to provide ancillary support to the purchaser, the purchaser’s profits will likely be deemed to depend on the skills and efforts of the purchaser rather than those of the seller.<sup>70</sup>

Courts have considered whether documents of title, such as warehouse receipts, that evidence ownership of a commodity that is under the custody of a bailor qualify as investment contracts. Courts have found, for example, that certain purchasers of whiskey warehouse receipts depended on the efforts of the issuer to achieve profits because the issuer provided its expertise in the selection of whiskey and casks, finding a market for the whiskey and arranging for warehousing and insurance for the whiskey.<sup>71</sup> The SEC applied the same reasoning in a series of interpretive releases covering whiskey warehouse receipts, explaining that an investor’s dependence “upon the seller or others to select, store and trade the whiskey” created an investment contract.<sup>72</sup> In contrast, the court in *Noa* held that certificates of ownership for silver bars warehoused by a seller for free for an initial one-year period whereby a seller advertised that it “would buy the silver back at any time at the spot price quoted by the Wall Street Journal” were not investment contracts because the future value of the instrument did not depend on the efforts

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<sup>67</sup> *Forman*, 421 U.S. at 856.

<sup>68</sup> *SEC v. Glenn W. Turner Enterprises, Inc.*, 474 F.2d 476, 482 (9th Cir. 1973); *In the Matter of Munchee Inc.*, Securities Act Release No. 10445 (Dec. 11, 2017) (the SEC alleged the investor’s profits were to be derived from Munchee and its agents who were to revise the Munchee App, create the “ecosystem” and support secondary markets); *In the Matter of Blockchain Credit Partners d/b/a DeFi Money Market, Gregory Keough, and Derek Acree*, Securities Act Release No. 10961, Exchange Act Release No. 92588 (Aug. 6, 2021) (the SEC alleged that the respondents performed essential managerial efforts by managing the DMM business and creating a trading market for DMG tokens); *In the Matter of GTV Media Group, Inc., Saraca Media Group, Inc., and Voice of Guo Media, Inc.*, Securities Act Release No. 10979 (Sept. 13, 2021) (the SEC alleged that the respondents via the G Entities discussed plans to develop the GTV online platform’s capability to process transactions using GCoins and G-Dollars and touted the “management, financial, investment, and merger and acquisition” experience of the G Entities’ management team and agents); *In the Matter of BlockFi Lending LLC*, Securities Act Release No. 11029, Investment Company Act Release No. 34503 (Feb. 14, 2022) (the SEC alleged that BlockFi had complete ownership and control over the borrowed cryptoassets, and determined how much to hold, lend and invest).

<sup>69</sup> *SEC v. Koscot Interplanetary, Inc.*, 497 F.2d 473, 483 n.14 (5th Cir. 1974).

<sup>70</sup> *See Forman*, 421 U.S. at 852-53; *Kefalas v. Bonnie Brae Farms, Inc.*, 630 F. Supp. 6, 8 (E.D. Ky. 1985).

<sup>71</sup> *See Glen-Arden*, 493 F.2d at 1034-35. *See also SEC v. Brigadoon Scotch Distrib. Co.*, 480 F.2d 1047 (2d Cir. 1973); *Sale and Distribution of Whiskey Warehouse Receipts*, Securities Act Release No. 5018, 34 Fed. Reg. 18,160 (Nov. 4, 1969) (“**Release No. 5018**”); *Investment in Interest in Whiskey*, Securities Act. Release No. 5451, 3 SEC Docket 356 (Jan. 7, 1974) (“**Release No. 5451**”).

<sup>72</sup> Release No. 5451 at 1.

of the seller.<sup>73</sup> The *Noa* court reasoned that, despite the fact that Key Futures touted the silver certificates as investments, “[t]here is a national market for silver which is not dependent upon Key Futures.”<sup>74</sup>

In a line of SEC staff no-action letters (the “**Warehouse Receipt NALs**”), the SEC staff reasoned that various warehouse receipt instruments evidencing ownership of gold bullion maintained in custody by the instruments’ issuer or a third-party custodian were not investment contracts because the arrangements did not satisfy the efforts of others element of the *Howey* test. Three such letters were published on an anonymized basis in Securities Act Release No. 5552.<sup>75</sup> The facts at issue in those letters involved sales of gold by a bank, a retail gold dealer and a registered broker-dealer.<sup>76</sup> In assessing the securities laws implications and whether registration under the Securities Act was required with respect to the receipt instruments at issue, the SEC observed that its staff focused attention on certain primary facts and considerations in determining to grant the relief in the letters. As the SEC noted:

(1) It does not appear that, in the gold investment program described in these letters, the economic benefits to the purchaser are to be derived from the managerial efforts of the seller, promoter, or a third party. (2) It does not appear that the services to be offered in connection with these offers to sell gold rise to the level of being those essential managerial efforts upon which the purchaser must rely in order to make a profit from his purchase. In this regard:

a. The purchaser will pay full value in cash for the gold purchased and purchases will not be made on margin.

b. The depository arrangement is limited to the storage of the gold with a reputable storage facility, insurance against loss or theft from the storage facility, and the issuance of a document which would evidence the right of the purchaser, or his successors and assigns to take possession of the gold; and

c. Neither X, Y, Z, nor anyone acting on their behalf has any obligation to repurchase the gold or ownership documents from the purchaser, nor to sell such gold or ownership documents for the purchaser’s account, but they may repurchase the gold at the then prevailing market price.<sup>77</sup>

Based upon the common facts in all three arrangements, the SEC staff found that the arrangements did not involve the issuance of or a transaction in securities because the sellers’ efforts were not essential efforts upon which the purchaser would rely to realize a profit.<sup>78</sup>

As explained in more detail below, liquid staking arrangements mirror the arrangements at issue in the Warehouse Receipt NALs in important respects: (i) Liquid Stakers do not acquire Receipt Tokens on margin; (ii) the depository arrangement, whether via the Protocol Model or Provider Model, is limited to safeguarding and staking the Liquid Stakers’ cryptoassets; and (iii) neither the protocol nor service provider, as applicable, has any obligation to

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<sup>73</sup> *Noa*, 638 F.2d at 79.

<sup>74</sup> *Id.* at 80.

<sup>75</sup> SEC Releases, *No-Action Position Relating to Certain Offerings of Gold*, Securities and Exchange Commission, (Dec. 26, 1974) (“**Release No. 5552**”).

<sup>76</sup> Release No. 5552 at 1–4.

<sup>77</sup> *Id.* at 5.

<sup>78</sup> *Id.*



purchase the Liquid Stakers' staked cryptoassets or Receipt Tokens – instead each Liquid Staker has complete discretion over whether or not to redeem the Receipt Tokens.

Other no-action letters addressing warehouse receipts outline similar principles. For example, in *Security Pacific National Bank*, the SEC staff determined that registration under the Securities Act was not required when an issuer of gold arranged for the storage of purchased gold on behalf of the purchasers and issued a gold certificate evidencing each purchaser's ownership of the gold.<sup>79</sup> The seller of the gold did not offer investment advice and did not perform services to enhance the resale value of the gold that was purchased.<sup>80</sup> As a result, the SEC staff reasoned that the seller's efforts in issuing the gold certificates and arranging for the safekeeping of the gold did not rise to essential efforts that affected the purchasers' ability to realize a profit and thereby the scheme did not result in the issuance of or a transaction in securities subject to registration under the Securities Act.<sup>81</sup>

Relatedly, in *Republic National Bank of New York*, the SEC staff observed that the issuance of documents of title representing ownership to underlying goods did not subject the issuer to registration under the Securities Act even when the issuer was engaged in the public advertising of the gold sales program.<sup>82</sup> The sales of gold at issue in the letter were made on a cash basis and the documents of title were fully assignable.<sup>83</sup> Furthermore, the issuer engaged in providing storage of and insurance for a purchaser's gold bullion.<sup>84</sup> The SEC staff found that Republic's gold bullion program did not require compliance with the registration requirements of the Securities Act because Republic's activities did not rise to essential efforts whereby purchasers were relying on Republic to make a profit.<sup>85</sup>

To the extent that the protocol, under the Protocol Model, utilizes a decentralized autonomous organization (a "DAO") to maintain governance over the protocol, POSA submits that there is no "other" for purposes of a *Howey* review, as any ministerial tasks are performed by an unaffiliated, dispersed community of blockchain users.<sup>86</sup>

Assuming, however, for purposes of this white paper, that there is in fact an "other" in both the Protocol Model and the Provider Model, Receipt Tokens are substantially identical to warehouse receipts and bills of lading that evidence ownership of physical commodities maintained by a custodian for safekeeping while in storage or transit. In these types of arrangements, the bailor relies upon the bailee to engage in certain ministerial activities to prevent harm to and loss of the bailor's commodities and in many cases, such as with live crops and livestock, to tend to the commodity and safeguard its naturally occurring fruits or offspring on the bailor's behalf. The bailee must water, feed and tend to the live crops and livestock of the bailor, but the bailor does not select the best commodities for breeding,<sup>87</sup> or when or where the bailee should sell its commodities. Similarly, Receipt Tokens evidence ownership of digital commodities allocated by a Liquid Staker to the possession and care of a protocol or service provider. The protocol or service provider stakes the Liquid Staker's cryptoassets on the Liquid Staker's behalf, including any organically occurring Network Rewards that result from staking the Liquid Staker's cryptoassets. The protocol or

<sup>79</sup> *Sec. Pac. Nat'l Bank*, Fed. Sec. L. Rep. P 76,333 (S.E.C. No-Action Letter Jan. 11, 1980).

<sup>80</sup> *Id.* at 8.

<sup>81</sup> *Id.* at 9.

<sup>82</sup> *Republic Nat'l Bank of New York*, Fed. Sec. L. Rep. P 80,037 (S.E.C. No-Action Letter Dec. 26, 1974).

<sup>83</sup> *Id.* at 3.

<sup>84</sup> *Id.* at 2.

<sup>85</sup> Since 1980, the SEC staff has declined to respond to any further no-action requests regarding gold offerings. *See, e.g., MBT Banking Corp.*, SEC Staff No-Action Letter, 1991 WL 176754 (May 1, 1991). The SEC included "[e]soteric commodity offerings (e.g., gems, rare books, gold, silver, and master recordings)" in a list of "situations in which the staff will decline to state a [no-action] position."

<sup>86</sup> *See FinHub Framework* at 4.

<sup>87</sup> In contrast, courts have found an investment contract where cattle breeders used their expertise to purchase and select the best cattle embryos for breeding on behalf of investors. *See Bailey v. J.W.K. Properties, Inc.*, 904 F.2d 918 (4th Cir. 1990).



service provider has no discretion as to the blockchain network on which to stake the cryptoassets, for how long the cryptoassets remain staked or the resale value of the cryptoassets.

Similar to *Noa* and the Warehouse Receipt NALs, under liquid staking arrangements, the protocol or service provider's role "is limited to the storage of the [staked cryptoassets] with a reputable storage facility, insurance against loss or theft from the storage facility, and the issuance of a document which would evidence the right of the purchaser, or his successors and assigns to take possession of the [cryptoassets]."<sup>88</sup> Although the protocol or service provider may select certain validators to stake the cryptoassets, such activity is ministerial and akin to selecting the reputable gold storage facility. And unlike the facts at hand in the whiskey warehouse receipt cases and interpretive releases, the protocol or service provider does not use its expertise to select the cryptoassets to be staked, choose the appropriate blockchain network to stake the Liquid Staker's cryptoassets or find a market for the cryptoassets or Receipt Tokens.<sup>89</sup> Just as with livestock maintained by a syndicate and the offspring thereof, the responsibility for selling the cryptoassets associated with Receipt Tokens, including any Network Rewards generated therefrom, "would be the job of the [Liquid Staker], and any profits derived would necessarily depend on the skills and efforts of the [Liquid Staker] rather than those of the [protocol or service provider]."<sup>90</sup>

A possible counterargument is that the idle nature of the goods entrusted to a bailee in a typical bailor-bailee relationship is a key differentiator when examining the efforts of others prong of the *Howey* test. However, it is common in the commodity industry for bailments to involve livestock, such as sheep and plants, and for evidence of ownership of such commodities to be documented by a warehouse receipt, bill of lading or dock warrant. For example, a rancher located in California might need to transport cattle to Mexico via freight. When the rancher tenders possession of its cattle to a freight operator, the freight operator would provide the rancher with a bill of lading evidencing the rancher's legal and beneficial ownership of the cattle during transport. Once the cattle arrive in Mexico, the rancher might arrange for the cattle to be maintained by a pasture owner pursuant to a warehouse receipt. In the event that the cattle produce offspring during transport or while maintained by the pasture owner, the bill of lading or warehouse receipt, as applicable, would entitle the rancher to such offspring rather than the freight operator or warehouseman. The same is true of liquid staking arrangements, where the protocol or service provider, as applicable, safeguards the Liquid Staker's cryptoassets, including any Network Rewards produced by such cryptoassets.

Whether the staking technology is deployed by computer code, as is the case under the Protocol Model, or by humans, as under the Provider Model, the technology is ministerial at its core and not "undeniably significant." Indeed, any Liquid Staker can operate a validator node independent of a liquid staking protocol or a service provider and collect Network Rewards pursuant to the relevant blockchain's proof-of-stake method for validating transactions. Furthermore, virtually all protocols and service providers offering access to liquid staking use substantially identical and fully functional staking technologies, which, under SEC staff guidance, is a favorable characteristic in determining that a purchaser is not relying on the efforts of others.<sup>91</sup>

To satisfy the efforts of others element of *Howey*, the efforts made by "others" must be "the undeniably significant ones, those essential managerial efforts which affect the failure or success of the enterprise."<sup>92</sup> Liquid Stakers

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<sup>88</sup> Release No. 5552 at 1.

<sup>89</sup> See *Glen-Arden*, 493 F.2d at 1032.

<sup>90</sup> See *Kefalas*, 630 F. Supp. at 8.

<sup>91</sup> See *FinHub Framework* at 9.

<sup>92</sup> *Glenn W. Turner Enterprises* 474 F.2d at 482.

arguably have no reasonable basis to expect an increase in value or returns resulting solely, or even predominantly, from the managerial efforts of the protocol or service provider, as applicable, because the protocol or service provider does not make any managerial decisions with respect to the use or expenditure of the staked cryptoassets. Instead, the protocol or service provider is merely responsible for issuing a Receipt Token and allocating the underlying cryptoasset to a validator. The protocol or service provider may not spend or exchange for value in any manner the underlying staked cryptoassets and thus is unable to make any significant management decisions that would expose the Liquid Staker to the investment risks of an enterprise under its management control.

Liquid Stakers utilizing a liquid staking protocol or service provider are not looking to an “other” or a collective group of “others” to expend managerial or any other efforts to advance the success of an enterprise under its management. Rather, the opportunity to earn Network Rewards is established by the method of validating transactions of the related blockchain and the liquid staking protocol or service provider is engaged to provide discrete services that could be provided by any number of competing protocols or service providers. The extent to which such Network Rewards may be earned is dictated by the rules of the method for validating transactions, which are developed independently by the developers of each specific blockchain network and are not subject to modification by *any* liquid staking protocol or service provider. The protocol or service provider is merely engaged by a Liquid Staker to provide discrete services pursuant to an arrangement that is terminable by the Liquid Staker at any time by redeeming the Receipt Token for the underlying staked cryptoasset. Alternatively, the Liquid Staker may trade its Receipt Token on the secondary market. Thus, the Liquid Staker is not relying on the protocol or service provider to enhance the resale value of the underlying cryptoasset or modify the method for validating transactions so that it can earn Network Rewards at a significantly higher rate.

It is well established that if the owner of property has the right to terminate a relationship with a service provider, then the owner is not reliant upon the managerial efforts of the service provider.<sup>93</sup> Liquid Stakers retain the actual power and authority to decide whether or not to stake their cryptoassets and engage a liquid staking protocol or service provider, and once engaged, each Liquid Staker retains the power to terminate the liquid staking relationship, which is the essential managerial decision, effectively precluding dependency upon the efforts of others for their profits. Liquid Stakers have full control over their ability to either redeem their Receipt Tokens for their staked cryptoassets or exchange their Receipt Tokens for another cryptoasset.

Accordingly, POSA submits that Liquid Stakers do not rely on the essential efforts of any “other” to realize economic benefits from liquid staking activities.<sup>94</sup>

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<sup>93</sup> 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 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.”).

<sup>94</sup> Moreover, to the extent that liquid staking arrangements could be viewed as eliminating barriers to entry for stakers – insofar as Liquid Stakers need not operate and manage the hardware required to be a validator – we note that Liquid Stakers can select from a broad swath of liquid staking arrangements providing substantially identical technological solutions. Any efforts by a liquid staking protocol or service provider in making staking more accessible should not be viewed as “essential” efforts.

## A. “Note” Analysis

An instrument that is not an “investment contract” under *Howey* may still be deemed to be a “note” within the scope of the “security” definition under the federal securities laws. The test applied by the SEC and courts for determining if an instrument is a “note” was outlined in the Supreme Court’s opinion in the case of *Reves v. Ernst & Young*.<sup>95</sup> Although POSA submits that Receipt Tokens do not constitute notes, we nonetheless outline the legal analysis that the SEC and courts would likely exercise in considering whether Receipt Tokens fall under the definition of a “note” in accordance with the test set forth in *Reves v. Ernst & Young*.

Under *Reves*, a note is presumed to be a security unless it falls into certain judicially created categories of financial instruments that are not securities, or if the note in question bears a “family resemblance” to other notes, as determined by a four-part balancing test, known as the “*Reves* test.”<sup>96</sup> The *Reves* test involves an assessment of: (i) the reasonable motivations of the seller and buyer; (ii) the plan of distribution of the instrument; (iii) the reasonable expectation of the investing public; and (iv) the presence of other risk-reducing factors. Based on an application of the *Reves* test, POSA submits that Receipt Tokens are not “notes.”

### I. Motivations of the Seller and Buyer

The *Reves* test requires an assessment of the reasonable motivation of the seller in issuing the instrument and the buyer in choosing to acquire the instrument. “If the seller’s purpose is to raise money for the general use of a business enterprise or to finance substantial investments and the buyer is interested primarily in the profit the note is expected to generate, the instrument is likely to be a ‘security.’ If the note is exchanged . . . to advance some other commercial or consumer purpose, on the other hand, the note is less sensibly described as a ‘security.’”<sup>97</sup>

As a threshold matter, the process of staking cryptoassets, and minting and delivering Receipt Tokens, does not involve a “buyer” or a “seller” of a financial instrument representing indebtedness or otherwise. Liquid staking protocols and service providers do not “sell” Receipt Tokens to raise money for the general use of a business enterprise, and Liquid Stakers do not “purchase” Receipt Tokens to gain economic exposure to such a business. Instead, protocols and service providers issue Receipt Tokens to Liquid Stakers as commercial instruments to evidence the Liquid Staker’s legal and beneficial ownership of staked cryptoassets. As outlined previously, Receipt Tokens are substantially identical to warehouse receipts, bills of lading and dock warrants, which allow holders to engage in commercial transactions and transfer legal and beneficial ownership of the associated commodity while the commodity is maintained in storage or is in transit. Without a warehouse receipt or bill of lading, a commodity owner would have no way to transfer legal and beneficial ownership to a third party without withdrawing the commodity from storage or transit. Similarly, without a Receipt Token, Liquid Stakers have no ability to transfer legal and beneficial ownership of their staked cryptoassets without withdrawing the cryptoassets from staking. Owners of Receipt Tokens may of course profit from the increase in value of the associated commodity and any resulting naturally occurring rewards or ancillary benefits associated with holding the Receipt Tokens, but the core motivation of both the seller and buyer of the Receipt Token is non-investment-related.

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<sup>95</sup> *Reves v. Ernst & Young*, 494 U.S. 56, 61 (1990).

<sup>96</sup> *Id.* at 67.

<sup>97</sup> *Id.* at 66.

## 2. Plan of Distribution

The *Reves* test requires consideration of the plan of distribution for the instrument. If the instrument is offered to a broad segment of the general public or “an instrument in which there is ‘common trading for speculation or investment’,” it is more likely to be a security.<sup>98</sup>

Liquid staking protocols and service providers offer Receipt Tokens to persons who have cryptoassets to stake. Persons who do not have the requisite cryptoassets for staking are not able to generate Receipt Tokens. The protocol or service provider therefore does not target a broad segment of the general public by offering an instrument for common trading but rather a narrow class of cryptoasset users that seek to stake their cryptoassets. Moreover, liquid staking protocols and service providers issue Receipt Tokens to provide an electronic document of title, not to raise proceeds that are subsequently pooled for capital appreciation or business development purposes.

## 3. Expectations of the Public

The *Reves* test requires an assessment of the reasonable expectations of the investing public. If the investing public is likely to view the instrument as a security, then it is more likely to be a security.<sup>99</sup>

While an analysis of the specific market materials and statements made by any specific liquid staking protocol and service provider is beyond the scope of this white paper, liquid staking protocols and service providers generally market the functionality of Receipt Tokens as electronic documents that evidence ownership of staked cryptoassets rather than as an investment or as an opportunity to obtain an economic benefit or profit. Liquid Stakers are generally referred to in liquid staking arrangement marketing materials as “stakers” rather than “investors” or “clients.” Additionally, liquid staking protocols and service providers generally take great care to avoid marketing or advertising Receipt Tokens as interests in any “business enterprise” or otherwise insinuating that holding Receipt Tokens involves an investment.<sup>100</sup>

## 4. Risk-Reducing Factors

The *Reves* test requires consideration of whether there is a risk-reducing factor or an alternative regulatory regime that significantly reduces the risk of the instrument and makes the application of the federal securities laws unnecessary.<sup>101</sup> As a general matter, Receipt Tokens are subject to the general anti-fraud and anti-manipulation regulatory framework of the U.S. Commodity Futures Trading Commission (“CFTC”).

The CFTC has general anti-fraud and anti-manipulation jurisdiction over any transaction involving a commodity.<sup>102</sup> The Commodity Exchange Act, as amended (the “CEA”), defines the term “commodity” to include an enumerated list of agricultural products and “all other goods and articles, . . . and all services, rights, and interests . . . in which

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<sup>98</sup> *Id.* at 57.

<sup>99</sup> *Id.* at 66.

<sup>100</sup> *Id.*

<sup>101</sup> *Id.* at 67.

<sup>102</sup> See 7 U.S.C. § 9(1) (prohibiting, *inter alia*, the use of “any manipulative or deceptive device or contrivance” “in connection with any . . . contract of sale of any commodity in interstate commerce”); 17 C.F.R. § 180.1(a) (prohibiting, *inter alia*, the use of “any manipulative device, scheme, or artifice to defraud” “in connection with any . . . contract of sale of any commodity in interstate commerce”).

contracts for future delivery are presently or in the future dealt in.”<sup>103</sup> The CFTC and federal courts have deemed certain “digital assets,” including bitcoin, ether, litecoin and tether, to be statutory commodities regardless of whether futures contracts may not presently or in the future be dealt in any particular type of cryptoasset (*e.g.*, tether).<sup>104</sup>

Receipt Tokens evidence ownership of staked cryptoassets, many of which the CFTC and bipartisan lawmakers have recognized as commodities subject to the CFTC’s jurisdiction.<sup>105</sup> Owners of proof-of-stake blockchain cryptoassets are able to stake their cryptoassets and earn Network Rewards by virtue of owning the cryptoassets. Receipt Tokens simply evidence ownership of those cryptoassets and allow a Liquid Staker to transfer such ownership without having to unstake its cryptoassets.

In considering the existence of other risk-reducing factors, the Supreme Court in *Reves* relied on the fact that “[t]he notes are [. . .] uninsured.”<sup>106</sup> Unlike in *Reves*, liquid staking arrangements may incorporate slashing coverage, which covers and protects against rare slashing events, which could otherwise result in lost cryptoassets. The Supreme Court in *Reves* also considered the uncollateralized nature of the notes to be an unfavorable fact when searching for risk-reducing factors to suggest the instruments were not securities.<sup>107</sup> Receipt Tokens, unlike the notes in *Reves*, are effectively one hundred percent collateralized with the underlying staked cryptoassets, which is in stark contrast to a traditional “note” offering that may indeed be entirely unsecured. Moreover, the Uniform Commercial Code and state bailment laws may also apply to certain liquid staking arrangements, affording holders of Receipt Tokens certain statutory rights.

As a result, applying the securities regulatory framework to Receipt Tokens—commercial instruments designed to make the transfer of ownership of a staked commodity more seamless, which also affords holders the benefit of some form of insurance—would arguably be unnecessary, contradictory to precedent, and likely to interfere with commerce.

## B. “Swap” Analysis

POSA submits that Receipt Tokens do not meet the definition of a “swap” because Receipt Tokens do not satisfy any prong of the swap definition set forth in the CEA Section 1a(47) and CFTC Rule 1.3.

Section 1a(47) of the CEA defines a swap to include, among other things, any agreement, contract or transaction that: (i) is an “option of any kind”; (ii) “provides for any purchase, sale, payment, or delivery (other than a dividend on an equity security) that is dependent on the occurrence, nonoccurrence, or the extent of the occurrence of an

<sup>103</sup> 7 U.S.C. § 1a(9).

<sup>104</sup> See *CFTC v. My Big Coin Pay, Inc.*, 334 F. Supp. 3d 492, 496-98 (D. Mass. Sept. 26, 2018) (“Congress’ approach to defining ‘commodity’ signals an intent that courts focus on categories—not specific items—when determining whether the ‘dealt in’ requirement is met. . . . My Big Coin is a virtual currency and it is undisputed that there is futures trading in virtual currencies (specifically involving Bitcoin). That is sufficient . . . to allege that My Big Coin is a ‘commodity.’”); *CFTC v. McDonnell*, 287 F. Supp. 3d 213, 228 (E.D.N.Y. 2018) (“[v]irtual currencies can be regulated by CFTC as a commodity.”); *In the Matter of: Tether Holdings Limited, Tether Operations Limited, Tether Limited, and Tether International Limited*, CFTC Docket No. 22-04, at 8 (Oct. 15, 2021) (“[d]igital assets such as bitcoin, ether, litecoin, and tether tokens are commodities.”); *In the Matter of: BFXNA INC. d/b/a BITFINEX*, CFTC Docket 16-19, at 5–6 (June 2, 2016) (“virtual currencies are encompassed in the [CEA] definition and properly defined as commodities.”).

<sup>105</sup> See, *e.g.*, Debbie Stabenow, John Boozeman, David Scott and Glenn ‘GT’ Thompson, Final Digital Assets Letter, Congress of the United States (Jan. 12, 2022) (“The CFTC has long considered certain digital assets to be commodities and courts have agreed.”); Lummis-Gillibrand Responsible Financial Innovation Act, S.4356, 117th Cong. (2021-2022); see also a bill to amend the Commodity Exchange Act to provide the Commodity Futures Trading Commission jurisdiction to oversee the spot digital commodity market, and for other purposes, S.4760, 117th Cong. (2021-2022).

<sup>106</sup> *Reves*, 494 U.S. at 69.

<sup>107</sup> *Id.*

event or contingency associated with a potential financial, economic, or commercial consequence”; or (iii) “provides on an executory basis for the exchange . . . of 1 or more payments based on the value or level of 1 or more . . . financial or economic interests or property of any kind, or any interest therein or based on the value thereof, and that transfers . . . the financial risk associated with a future change in any such value or level without also conveying a current or future direct or indirect ownership interest in an asset.”<sup>108</sup>

The first prong of the swap definition includes an option contract,<sup>109</sup> which is defined as “an agreement, contract, or transaction that is of the character of, or is commonly known to the trade as, an ‘option’, ‘privilege’, ‘indemnity’, ‘bid’, ‘offer’, ‘put’, ‘call’, ‘advance guaranty’, or ‘decline guaranty’.”<sup>110</sup> In considering the applicability of the definition, courts have identified three key characteristics of an option: (i) the seller charges a nonrefundable premium at the outset to cover the seller’s commission and costs; (ii) the option gives the purchaser the right to take physical possession of the commodity but does not obligate him to do so; and (iii) a profit in an option accrues only if the price of the commodity rises enough to cover the initial premium (but losses are limited to the premium).<sup>111</sup> Furthermore, the CFTC, the federal agency that administers and implements the CEA, relies upon “pre-existing contract law, commercial practice and the economic nature of the contract.”<sup>112</sup> Applying this framework, the CFTC previously explained that “an option is necessarily a unilateral contract which binds the optionee to do nothing but grants him the right to accept or reject the offer in accordance with its terms within the time and manner specified in the option. The outstanding factor is that the optionee is not bound until he acts on the option one way or another. At the same time, during the period when the optionee is free to accept or reject, the optionor cannot act in derogation of the terms of the option.”<sup>113</sup>

POSA submits that Receipt Tokens do not have the characteristics of an option. Liquid staking protocols and service providers do not charge a premium to generate a Receipt Token and therefore Liquid Stakers need not consider any premium price against the price of the associated cryptoassets. Additionally, Receipt Tokens evidence ownership of cryptoassets rather than the right to purchase or sell cryptoassets. Receipt Tokens also do not expire upon a set date and time like an option. As a result, POSA submits that Receipt Tokens should not be deemed to satisfy the first prong of the swap definition.

The second prong of the swap definition includes any agreement, contract or transaction that “provides for any purchase, sale, payment, or delivery . . . that is dependent on the occurrence, nonoccurrence, or the extent of the occurrence of an event or contingency associated with a potential financial, economic, or commercial consequence.”<sup>114</sup>

Receipt Tokens do not provide for any purchase, sale, payment or delivery that is dependent upon the occurrence of an event or contingency because Network Rewards are programmatically generated and automatically accrue to the staked cryptoassets without regard to any occurrence or nonoccurrence. Therefore, POSA submits that Receipt Tokens should also not be deemed to satisfy the second prong of the swap definition.

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<sup>108</sup> 7 U.S.C. § 1a(47).

<sup>109</sup> 7 U.S.C. § 1a(47)(A)(i).

<sup>110</sup> 7 U.S.C. § 1a(36).

<sup>111</sup> See *Commodity Futures Trading Comm’n v. U.S. Metals Depository Co.*, 468 F. Supp. 1149., 1155 (S.D.N.Y. 1979).

<sup>112</sup> See *Characteristics Distinguishing Cash and Forward Contracts and “Trade” Options*, 50 Fed. Reg. 39656, 39658 (Sept. 30, 1985).

<sup>113</sup> *Id.*

<sup>114</sup> 7 U.S.C. § 1a(47)(A)(ii).

The third prong of the swap definition includes contracts, agreements and transactions that: (i) provide on an executory basis (*i.e.*, to be performed in the future by a party) for the exchange, on a fixed or contingent basis, of one or more payments based on the value or level of one or more commodities or other financial or economic interests or property of any kind; (ii) transfers, as between the parties, in whole or in part, the financial risk associated with a future exchange in any such value or level; and (iii) does not convey a current or future direct or indirect ownership interest in an asset or liability that incorporates the financial risk so transferred.<sup>115</sup>

Receipt Tokens do not provide for the “exchange” of one or more payments “based on the value of one or more commodities or other financial or economic interests.” Rather, Receipt Tokens represent actual and direct ownership of staked cryptoassets that can be redeemed for those cryptoassets on demand. When a Liquid Staker redeems its Receipt Tokens for cryptoassets, the Liquid Staker receives the same quantity of cryptoassets initially staked by the Liquid Staker, plus any Network Rewards accrued from the staking of such cryptoassets, and minus any losses from slashing of the cryptoassets, as applicable.

Documents of title, such as warehouse receipts, have historically been considered by the CFTC to be commercial arrangements rather than swaps, as demonstrated by the fact that these instruments are governed by state law and, in a limited context, regulated by the Department of Agriculture, despite the CFTC’s exclusive jurisdiction over commodity derivatives. Receipt Tokens do not materially differ from other document of title-like instruments. Receipt Tokens are thereby distinguishable from the enumerated types of instruments that this prong is intended to capture, including interest rate swaps and credit default swaps, whereby there is an exchange of an unspecified sum in the future, the direction of which depends on the value or level of the underlying measure, such as an interest rate.

Additionally, Receipt Tokens demonstrate the ownership interest in an asset, but do not transfer the financial risk associated with a future change in the value of the associated staked cryptoassets. The Liquid Staker retains ownership of its staked cryptoassets after allocating them to a liquid staking protocol or service provider. To the extent a Liquid Staker transfers Receipt Tokens to a downstream party, the downstream party receives ownership of the staked cryptoassets by virtue of owning the Receipt Tokens. POSA submits that Receipt Tokens fit within the exclusion from the definition of swaps under CEA Section 1a(47)(A)(iii) for instruments that convey a current or future direct or indirect ownership interest in an asset because Receipt Tokens perform the function of conveying ownership of staked cryptoassets rather than solely the price risk associated with cryptoassets.<sup>116</sup>

Receipt Tokens arguably fit within an exclusion from the swap definition for commercial agreements, contracts and transactions “that historically have not been considered to involve swaps.”<sup>117</sup> The CFTC has articulated the following characteristics and factors that are common to commercial agreements, contracts and transactions: (i) they do not contain payment obligations, whether or not contingent, that are severable from the agreement, contract, or transaction; (ii) they are not traded on an organized market or over-the-counter; and (iii) they are entered into by commercial or non-profit entities as principals (or by their agents) to serve an independent commercial, business, or non-profit purpose, and other than for speculative, hedging, or investment purposes.<sup>118</sup> Furthermore, the SEC and CFTC previously identified an agreement that involves “[t]he purchase, sale, lease, or transfer of real property,

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<sup>115</sup> 7 U.S.C. § 1a(47)(A)(iii).

<sup>116</sup> *Id.*

<sup>117</sup> Further Definition of “Swap,” “Security-Based Swap,” and “Security-Based Swap Agreement”; Mixed Swaps; Security-Based Swap Agreement Recordkeeping, 77 Fed. Reg. 48207, 48247 (Aug. 13, 2012).

<sup>118</sup> *Id.* at 48247–48.



intellectual property, equipment or inventory” as an example of commercial contracts excluded from the swap definition.<sup>119</sup>

POSA submits that Receipt Tokens have each of the foregoing features of a commercial arrangement. Receipt Tokens do not contain payment obligations that are severable from the instrument. Although Receipt Tokens trade on cryptoasset trading venues and over-the-counter, CFTC guidance clarifies that the second feature is descriptive of products that do “not involve risk-shifting arrangements with financial entities, as would be the case for swaps,” rather than a bright line intended to distinguish all tradable products as swaps. Receipt Tokens resemble warehouse receipts, which are routinely used to transfer ownership of physical commodities to satisfy delivery obligations under exchange-traded futures contracts, rather than “risk-shifting arrangement[s].”

Finally, the instrument serves the commercial purpose of evidencing the Liquid Staker’s ownership of purchased staked cryptoassets rather than a speculative, hedging or investment purpose. As explained in Section III.A.3, stakers contribute an essential security service to the blockchain network by placing their cryptoassets at risk of slashing. Liquid Stakers, like other stakers, seek to provide better settlement assurances to users of a network and to earn Network Rewards, but choose to utilize a liquid staking protocol or service provider rather than stake by other means because they require documentation evidencing ownership of their staked cryptoassets for commercial purposes. Without a Receipt Token, stakers have no ability to transfer legal and beneficial ownership of their staked cryptoassets absent withdrawing the cryptoassets from staking, which may be impossible due to certain blockchain unbonding periods and other technological constraints. This presents a significant challenge for stakers. For example, a staker might need to transfer ownership of the staked cryptoassets from one digital wallet address to another digital wallet address due to a compromised private key or to comply with cybersecurity requirements imposed by a regulator. Additionally, stakers are not able to use their staked cryptoassets as collateral for a loan or to transfer ownership of their staked cryptoassets to a counterparty in a commercial transaction. Therefore, Receipt Tokens are designed to serve the same commercial purpose as warehouse receipts by allowing the instrument holder to more easily transfer legal and beneficial ownership of its commodities in commerce.

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<sup>119</sup> *Id.* at 48247.





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