

SEC Forces Kraken To Terminate Cryptocurrency Staking-as-a-Service Program

On February 9, 2023, the U.S. Securities and Exchange Commission (the “SEC”) charged cryptocurrency exchange Payward Ventures, Inc. and Payward Trading Ltd. (doing business as and hereinafter, “Kraken”) for failing to register its “staking-as-a-service” program as a securities offering, in violation of Section 5 of the Securities Act of 1933 (the “Securities Act”).¹ According to the SEC’s press release, Kraken agreed to cease operations of its staking program in the U.S. and to pay the SEC \$30 million in fines.² The SEC’s move to target staking-as-a-service (“StaaS”), which plays a critical role in the consensus protocol on many popular blockchains, represents an important development in its enforcement strategy.

Generally, the way blockchains validate and record transaction data in a decentralized manner is through the use of a consensus mechanism. One of the most popular consensus mechanisms, especially touted for its energy efficiency, is Proof-of-Stake (“PoS”). On a PoS blockchain, users that validate and record data to the blockchain’s ledger must “stake” (pledge) their cryptocurrency. If the user successfully validates or records data on the blockchain, the user receives rewards that are generally paid in kind with the cryptocurrency that is staked. If the user does not validate or record properly, the cryptocurrency that was staked is often “slashed” (*i.e.*, forfeited) as a penalty.

On many popular blockchains, any user can stake and participate in the consensus mechanism and therefore earn staking rewards. However, staking requires a level of technical expertise that can act as a barrier to entry.³ Thus, StaaS programs have emerged. In these programs, service providers offer customers a more user-friendly interface that reduces the technical expertise required to stake. Staking services generally work as follows: (i) the provider runs a validator node on the blockchain, (ii) customers permit the provider to stake their

cryptocurrency, (iii) the provider stakes this cryptocurrency on behalf of its customers to participate in the consensus mechanism and (iv) the provider returns rewards to its customers.

While staking services by and large conform to the process described above, there is some degree of variation amongst different programs. Generally speaking, StaaS providers differ the most in how they handle prongs (iii) and (iv), staking cryptocurrency on the customers’ behalf and returning rewards to customers (which often implicates whether the provider has custody or not). For example, Kraken had a specific implementation of the StaaS process in which it dictated the amount of customers’ cryptocurrency that would be staked, took custody of its customers’ crypto assets and offered customers fixed rewards at an estimated rate where Kraken would retain any earnings in excess of that rate. Under Kraken’s model, there was not a direct relation between the customer’s payout and the rewards earned by Kraken. However, not all StaaS programs follow Kraken’s model. In some StaaS programs, the staking model is less discretionary – the amount staked by the provider is equal to the amount pledged by the customer for staking, and the

rewards earned by the provider, less the amount of that provider's commission, are simply passed through to the customer.

If a SaaS program involves an offering or sale of securities, that offering or sale must be registered with the SEC under Section 5 of the Securities Act, or the offering entity must otherwise seek an applicable exemption. To date, no SaaS program has registered with the SEC, and most are not structured to qualify for an exemption. As the SEC stated in its complaint, Kraken had neither registered nor sought an applicable exemption as of the date of the SEC's action.

In its complaint, the SEC highlighted Kraken's SaaS model and characterized Kraken's services as a passive investment opportunity. The SEC noted that Kraken advertised regular, fixed returns to all customers for its services, citing Kraken's promise of "the highest fixed-rate returns in the industry." Additionally, the SEC cited the degree to which Kraken retained control over the amount of cryptocurrency staked and when it would be staked, as well as Kraken's authority to determine customers' returns (rather than the blockchain determining the rewards as featured in other models), stating that Kraken "reserve[d] the right not to pay [its] advertised return—or indeed any rewards" to customers. The SEC also took issue with Kraken's method of pooling customer assets, noting that individual customers' assets were commingled during the staking process. Applying the 1946 U.S. Supreme Court decision *SEC v. W.J. Howey Co.* to these factors, the SEC ultimately determined that through their staking program, Kraken offered and sold investment contracts (a type of security) without registering or having an applicable exemption.

While the SEC does not distinguish Kraken's services from that of other SaaS programs, the agency differentiated the features of Kraken's services from the general process of staking and earning rewards on one's own. SaaS programs that do not follow Kraken's model and that have features substantially similar to the process of staking on one's own may thus have stronger arguments that such programs are not offerings of investment contract securities. Those SaaS providers may arguably demonstrate the ways

in which their programs cut against the common-enterprise and efforts-of-others prongs of *Howey* (e.g., showcasing how the customers' cryptocurrency is directly tied to their returns or emphasizing the provider's limited discretion and role as an "administrator" rather than as an investment promoter). SEC Commissioner Hester M. Peirce echoed this sentiment, stating that "one-off enforcement actions and cookie-cutter analysis" does not provide sufficient guidance for staking services because "staking services are not uniform[.]"⁴

However, parsing distinctions amongst SaaS programs may not be at the forefront of the SEC's concerns. "Whether it's through staking-as-a-service, lending, or other means, crypto intermediaries, when offering investment contracts in exchange for investors' tokens, need to provide the proper disclosures and safeguards required by our securities laws" said SEC Chair Gary Gensler.⁵ He further noted that the SEC's "action should make clear to the marketplace that staking-as-a-service providers must register and provide full, fair, and truthful disclosure and investor protection."⁶ Whether or not other SaaS programs would be deemed offerings of investment contract securities may therefore be determined based on the facts and circumstances surrounding each particular case.

The SEC's action against Kraken, although specific to Kraken's staking services, has the potential to influence future actions the agency may take against other blockchain-service providers. The SEC's focus on the specific facts surrounding Kraken's program provides a data point for SaaS providers to consider when analyzing their own SaaS programs.

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- 1 15 U.S.C. §§ 77e(a), (c). See *Kraken to Discontinue Unregistered Offer and Sale of Crypto Asset Staking-As-A-Service Program and Pay \$30 Million to Settle SEC Charges*, SEC (Feb. 9, 2023), accessible at [SEC.gov | Kraken to Discontinue Unregistered Offer and Sale of Crypto Asset Staking-As-A-Service Program and Pay \\$30 Million to Settle SEC Charges](#). See also *SEC v. Payward Ventures, Inc. (D/B/A Kraken) and Payward Trading, Ltd. (D/B/A Kraken)*, No. 23-cv-588 (D.N.C.A. Feb. 9, 2023), accessible at [comp-pr2023-25.pdf \(sec.gov\)](#).
 - 2 See *Kraken to Discontinue Unregistered Offer and Sale of Crypto Asset Staking-As-A-Service Program and Pay \$30 Million to Settle SEC Charges*, SEC (Feb. 9, 2023), accessible at [SEC.gov | Kraken to Discontinue Unregistered Offer and Sale of Crypto Asset Staking-As-A-Service Program and Pay \\$30 Million to Settle SEC Charges](#). Note that the settlement order has yet to be posted on the SEC's website, though it's reported that Kraken will continue to operate its staking services for international, non-U.S.-based customers.
 - 3 Other barriers to entry include minimum threshold amounts and bonding periods, but these requirements vary more significantly from blockchain to blockchain. Technical know-how is always required to operate a validator node.
 - 4 See Commissioner Hester M. Peirce, *Kraken Down: Statement on SEC v. Payward Ventures, Inc., et al.*, SEC (Feb. 9, 2023), accessible at [SEC.gov | Kraken Down: Statement on SEC v. Payward Ventures, Inc., et al.](#)
 - 5 *Kraken to Discontinue Unregistered Offer and Sale of Crypto Asset Staking-As-A-Service Program and Pay \$30 Million to Settle SEC Charges*, SEC (Feb. 9, 2023), accessible at [SEC.gov | Kraken to Discontinue Unregistered Offer and Sale of Crypto Asset Staking-As-A-Service Program and Pay \\$30 Million to Settle SEC Charges](#).
 - 6 *Id.*

NEW YORK

D. Scott Bennett
+1-212-474-1132
sbennett@cravath.com

Michael E. Mariani
+1-212-474-1007
mmariani@cravath.com

WASHINGTON, D.C.

Jennifer S. Leete
+1-202-869-7730
jleete@cravath.com

Elad L. Roisman
+1-202-869-7720
eroisman@cravath.com

CRAVATH, SWAINE & MOORE LLP**NEW YORK**

Worldwide Plaza
825 Eighth Avenue
New York, NY 10019-7475
+1-212-474-1000

LONDON

CityPoint
One Ropemaker Street
London EC2Y 9HR
+44-20-7453-1000

WASHINGTON, D.C.

1601 K Street NW
Washington, D.C. 20006-1682
+1-202-869-7700

cravath.com

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