

Inside Look: The SEC's Enforcement Action Against Cryptocurrency Exchange Kraken

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On November 20, the Securities and Exchange Commission (SEC) instituted a civil enforcement action against Kraken, a major U.S. cryptocurrency exchange. The SEC alleged Kraken operated as an unregistered broker, dealer, exchange, and clearing agency, in violation of the Securities Exchange Act. The SEC's lawsuit aims to prohibit Kraken from continuing these activities and seeks an unspecified amount of civil monetary penalties.

The SEC's complaint hinges on two main points:

Classification of Crypto Assets as Investment Contracts. According to the SEC, "Kraken is subject to the laws and regulations governing the U.S. securities markets because many of the crypto assets bought and sold through its platform are offered, bought, and sold as investment contracts." An investment contract is an instrument through which a person invests money in a common enterprise and reasonably expects profits or returns derived from the entrepreneurial or managerial efforts of others. Here, the SEC included in its complaint a non-exhaustive list of crypto assets that Kraken allegedly endorsed on its trading platform. The determination of whether a cryptocurrency token is or is not an investment contract (and hence a security subject to regulation by the SEC) is complex and depends on several factors. The issuers of the crypto assets named in the Kraken action will likely dispute the SEC's characterization of those assets as securities.

Vicarious Marketing. The crux of the SEC's "investment contract" theory of liability rests on Kraken's endorsement of public statements made by issuers of the crypto assets Kraken made available on its trading platform. For example, in 2017, Protocol Labs, Inc. (Protocol Labs), the issuer of crypto-asset Filecoin (FIL), publicly disclosed in a Q&A that ". . . [w]e plan to deploy 100s of millions of dollars over the next few years to make Filecoin the world's best storage network, not just the best decentralized storage network."

Although Kraken did not broadcast Protocol Labs' statement to its users, the SEC contends that Kraken publicly endorsed Protocol Labs' marketing of FIL by issuing the following statement on its website: "Should Filecoin be able to successfully offer decentralized storage service that can't be easily tampered with by corporations or governments, it could also gain more users, especially if centralized services begin to lose the trust of their customers. Like Bitcoin, the total amount of FIL that will ever be created is also limited, in this case, to 2 billion tokens. If the Filecoin network grows and more users trust it with their data, and more miners supply disk-space, then the amount of transactions requiring FIL should grow. The price of FIL should rise since the amount of FIL available is limited."

The SEC thus contends that although Kraken did not directly broadcast marketing materials created by Protocol Labs on its website, its public analysis of FIL reinforced investors' reasonable expectation of profits from an investment in FIL due to the managerial and entrepreneurial efforts of Protocol Labs.

Our Take. The SEC's enforcement action is predominantly focused on Kraken's alleged public promotion of marketing materials devised by issuers of crypto assets that Kraken made available on its trading platform. Given the SEC's present litigation strategy under *Howey*, cryptocurrency exchanges should consider whether the benefits of providing complimentary trading analysis to its customers outweigh the costs of navigating a possible enforcement action with the SEC.

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