LEGAL UPDATES

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SEC Sends Clear Message to Crypto Industry that Registration is Necessary

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The Securities and Exchange Commission (SEC) has again flexed its regulatory might in its latest and clearest message to the cryptocurrency market that SEC registration is necessary for most decentralized financial activities, this time taking aim at "staking services"—a means of earning rewards on crypto assets. In this novel case filed on February 9, 2023, the SEC argued that Kraken's crypto staking service should have been registered with the SEC. Kraken agreed to a settlement with the SEC that requires it to stop offering their crypto staking services in the U.S. and pay a $30 million penalty. A federal judge must approve this settlement before it becomes effective.

Cryptocurrency staking is one way in which crypto transactions are verified using a proof of stake consensus mechanism, which is a means of verifying transactions on proof-of-stake blockchains by using validators who hold a certain amount of a cryptocurrency and who receive rewards in exchange for validating blockchain transactions. The other consensus mechanism is proof of work, which is used in Bitcoin transactions. Staking is a process in which cryptocurrency holders volunteer their crypto to take part in validating transactions on the blockchain—in other words, checking that the ledger all "adds up" and that all transactions on the blockchain are valid. In return, validators, who cannot use their cryptocurrencies involved in the validating process for a period of time, receive a share of the transaction fees or newly created cryptocurrencies. That reward is then passed on to customers at centralized exchanges who agreed to stake their assets. From a customer's perspective, it's a way to receive returns on cryptocurrencies, by agreeing for them to be "put to work," or "locked up," for a certain period of time. Staking is only possible on proof-of-stake blockchains, such as Ethereum.

Kraken offered these staking services. According to Kraken's website, users needed less than a penny's worth of Ethereum to earn a staking yield of 4% to 7% a year. In contrast, to earn staking rewards directly from a crypto network, holders may have to lock up roughly 32 of their Ether, valued at approximately $50,000 as of today's date. This difference in capital requirements led some to question how Kraken can guarantee the four to seven percent returns on such small stakes. "Kraken not only offered [holders] outsized returns untethered to any economic realities, but also retained the right to pay them no returns at all," SEC Enforcement Director Gurbir Grewal said.

In its enforcement action, the SEC stated that Kraken has failed to provide customers proper disclosures about how their cryptocurrency will be used and should have to register their staking services with the agency. "Are they lending, borrowing, or trading with them? Are they commingling them with their other businesses? Where do the rewards come from? Are you getting your fair share?" SEC Chair Gary Gensler asked, adding, "There's currently no reliable way as an investor to know the answers to these important investment questions." In its settlement with the SEC, Kraken neither admitted nor denied the SEC's claim that its staking service should have been registered.

Gensler says the action should put other crypto exchanges on notice and that those platforms should come into compliance with securities laws. Kraken said it would continue to offer staking to customers based outside of the United States. In a statement, Coinbase, one of the largest cryptocurrency platforms, said its staking program was not affected by Kraken's settlement with the SEC because its own service is "fundamentally different" than Kraken's.

SEC Commissioner Hester Peirce, who has advocated for leniency and accommodation in the SEC's stance toward crypto firms, criticized the enforcement action against Kraken. "A paternalistic and lazy regulator settles on a solution like the one in this settlement: do not initiate a public process to develop a workable registration process that provides valuable information to investors, just shut it down," Ms. Peirce said in a statement.

It is important to note that the Kraken settlement does not create new law but could serve as a push for Congress to pass legislation that places tighter restrictions on the cryptocurrency marketplace.

Contact us

Husch Blackwell LLP's blockchain and digital asset team will continue to keep its clients abreast of the latest SEC enforcement actions and assist its clients in complying with SEC requirements. If you have questions, please contact our team or your Husch Blackwell attorney.