

ALERTS

The Crypto Winter of Discontent Gets Colder with First of Its Kind Insider Trading Charges

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As market and regulatory uncertainty swirl around cryptocurrencies and other digital assets, the Securities and Exchange Commission (the “SEC”) and the Department of Justice (the “DOJ”) have taken divergent approaches to charging digital asset insider trading. For its part, the SEC, in a recent enforcement case, asserts jurisdiction over certain cryptocurrencies as “securities” and brought traditional insider trading charges under Section 10(b) of the Securities Exchange Act and Rule 10b-5 promulgated thereunder.[1] The DOJ, however, has avoided “securities” designations altogether by using wire fraud and other non-securities criminal charges to pursue insider trading related to a variety of digital assets including non-fungible tokens (“NFTs”) and cryptocurrencies.[2] Prior to June 1, 2022, the DOJ’s use of wire fraud to combat insider trading of digital assets may have seemed “novel.” However, the DOJ has recently adopted the approach that regardless of the underlying instrument (NFTs, debt, cryptocurrencies, insurance products or any other non-security product), it is willing to bring fraud charges where it believes it can prove trading based on fraudulently obtained confidential information. [3]

The divergent SEC and DOJ approaches played out on July 21, 2022, when the SEC and DOJ filed parallel insider trading cases against a former Coinbase Global, Inc. (“Coinbase”) employee (Ishan Wahi), his brother (Nikhil Wahi) and a friend (Sameer Ramani).[4] Both cases are based on the defendants’ trades in digital assets that were slated for listing on Coinbase before the listing announcements were made public. The DOJ Indictment—the first cryptocurrency insider trading case

brought by the DOJ —bypassed the “are they” or “aren’t they” securities question by charging the trio of defendants with conspiracy and wire fraud for allegedly insider trading in six digital assets before they were listed on Coinbase (including two that the SEC considers securities).[5] The SEC’s Complaint, however, alleges that nine of the so-called crypto assets at issue are in fact securities under *SEC v. W.J. Howey Co.*, 328 U.S. 293, 298-99 (1946) (“*Howey*”).[6]

The unspoken implication of the SEC’s Complaint is that by listing the nine digital asset “securities” on its exchange, Coinbase engaged in the offering of unregistered securities. After the filing of the DOJ and SEC insider trading charges, it was reported that Coinbase is the subject of an SEC investigation related to listing unregistered securities. Coinbase’s Chief Legal Officer, Paul Grewal declared, in response to the SEC Complaint, that “Coinbase does not list securities on its platform. Period.”[7] In a Petition for Rulemaking (the “Petition”), also filed on July 21, Coinbase criticized the lack of guidance from the SEC regarding digital assets and offered a roadmap to the SEC for crafting a regulatory framework tailored to digital assets.[8] In its Petition, Coinbase called out the SEC for failing to “constructively engage with digital asset market participants on the design of a workable regulatory framework” and asked that the SEC “propose and adopt rules to govern the regulation of securities that are offered and traded via digitally native methods, including potential rules to identify which digital assets are securities.”[9] The Petition also offers some suggestions, and invites others to do the same, in carving a regulatory path forward including: (1) a critical analysis of the challenges of applying existing rules to digital assets (for example, digital assets are not well suited for purchase and sale in a broker-intermediary model); (2) clear delineation between which digital assets are securities and which ones are not so that issuers and purchasers are not confused; (3) disclosure requirements tailored to the unique features of digital assets; and (4) real-time settlement of digital asset transactions to maintain the pace digital asset investors expect.[10]

Both the SEC’s Complaint and the DOJ’s Indictment reflect the different approaches that enforcement authorities are taking in prosecuting potentially fraudulent trading in digital assets. But neither action definitively answers the question of when securities laws might apply to digital assets and when they might not.

When Are Digital Assets Securities?

The insider trading scheme alleged by the SEC and DOJ is straightforward. Ishan Wahi was a manager in Coinbase's Assets and Investing Products group. He allegedly tipped his co-defendants with non-public information identifying digital assets to be listed by Coinbase and when they would be listed. The two co-defendants purchased the digital assets before each were listed and sold them (at a profit) in heavy trading that followed the announcement of their listing.[11] Although the SEC's Complaint refers to 25 different crypto assets purchased as part of the alleged scheme, only nine digital assets are specifically identified as securities for the purposes of the insider trading charges:[12]

- AMP (created by Flexa Network, Inc.)
- RLY (created by Rally Network, Inc.)
- DDX (associated with the DerivaDEX protocol)
- XYO (created by XY Labs, Inc.)
- RGT (originally minted by Rari Capital)
- KROM (issued by Kromatika Finance)
- LCX (created by Liechtenstein Cryptoassets Exchange)
- POWR (issued by Power Ledger Pty. Ltd.)
- DFX (issued by DFX Finance).

These nine digital assets run the gamut of token types. For example, according to the SEC's analysis, RLY is a governance token that provides holders with voting power "over the development and structure of the business, including the right to propose changes." [13] XYO tokens function as a form of currency to pay others that operate in the XY ecosystem.[14] And POWR tokens are described as an "asset token" used on the Power Ledger platform and from which users will receive a portion of revenue.[15]

The Complaint highlights the SEC's position that the nine digital assets at the center of its case satisfy the *Howey* investment contract test because each asset at issue "constitutes an investment of money, in a common enterprise, with a reasonable expectation of profit derived from the efforts of others." [16] As to the first and second prongs of the *Howey* test – an investment of money in a common enterprise – the Complaint alleges that "each of the nine crypto assets securities were offered and

sold by an issuer to raise money that would be used for the issuer's business. In the offerings, the issuers directly sold crypto asset securities to investors in return for consideration . . ."[17]

For example, AMP token holders "stake Amp into pools that secure the network" and "[i]f the collateral pools are profitable, investors who stake Amp can share in the profits." [18] In the case of RGT, "funds raised from RGT investors were pooled to raise capital and develop the Rari protocol. . . [and] funds raised from the liquidity mining program would go towards, among other things, developing additional Rari products and the Rari protocol." [19] In another example, the LCX token was marketed as a "chance to be a part of LCX's vision to bridge the gap between traditional finance and the new monetary world powered by blockchain and cryptocurrencies." [20] Notably, the features of the nine digital assets, though not identical, include tools like staking, liquidity mining, governance and voting and ecosystem building that are common features in decentralized finance platforms.

On the third *Howey* prong – reasonable expectation of profit derived from the efforts of others – the Complaint alleges that for each of the nine digital assets, the "issuers and their management teams [addressed] the investment value of the tokens, the managerial efforts that contribute to the tokens' value, and the availability of secondary markets for trading the tokens . . . [such that] a reasonable investor in the nine crypto asset securities would continue to look to the efforts of the issuer and its promoters, including their future efforts, to increase the value of their investment." [21]

The allegations of the SEC's Complaint emphasizes that each of the nine digital assets was promoted as a "profit opportunity" to holders or that it could be traded on secondary platforms, like Coinbase. [22] For example, DDX holders could "stake" their DDX "to a DerivaDex 'insurance fund' . . . [and] contribute their DDX tokens to the fund, creating liquidity that could be used to insure parties if a transaction fails. As the insurance pool grows and earns fees, participants who staked their DDX may receive additional DDX tokens and thereby greater opportunities to profit." [23] Similarly, KROM holders were permitted to stake their tokens to the Kromatika platform and earn, "a revenue share from the fees that are charged for using the Kromatika platform." [24] Again, while the "profit" features of the nine digital assets are not identical, they cover "earnings" features associated with many digital assets currently available including, staking

rewards, waived fees for transactions in the “ecosystem,” lock up rewards and pool rewards.

Implications for the Digital Asset Marketplace and Beyond

As a practical matter, any determination (and therefore, clarity) by a court whether the nine digital assets in the SEC’s Complaint are securities under federal securities laws will require patience that may never be rewarded. With pending criminal charges against three defendants, the SEC proceedings could be temporarily stayed while the DOJ and defendants focus resources on addressing the criminal charges. And beyond the allegations of the Complaint, the SEC offers no broader guidance as to the designation of these specific nine assets — or any other digital assets — as securities. Commissioner Caroline D. Pham of the Commodities Future Trading Commission observed that the Complaint is “a striking example of regulation by enforcement . . . [with] broad implications beyond this single case, underscoring how critical and urgent it is that regulators work together.”[25] In short, there is unlikely to be any near term resolution of the SEC’s Complaint that would quell the uncertainty surrounding regulatory treatment of digital assets, making requests for guidance from regulators increasingly urgent.

In the interim, issuers of digital assets, particularly digital assets bearing any resemblance to the nine now characterized by the SEC as “securities” are left to grapple with an uncertain regulatory landscape. Coinbase and other exchanges likely must decide whether to delist similar digital assets. And issuers and exchanges alike are potentially weighing options to defend against allegations of unregistered securities offerings.

The implications of both the SEC’s case and the DOJ’s case should prompt everyone who engages with digital assets to pause. For example, other similarly situated issuers of digital assets should consider whether the SEC could make the same securities case against their digital assets. Exchanges, lending platforms and broker-dealers might want to assess whether they need to re-categorize the digital assets that they are listing. As the SEC ramps up enforcement activity in this area, investment advisers should reassess their existing analyses regarding the impact on their clients and operations of treating cryptocurrencies as securities – particularly with respect to insider trading, personal trading and Custody

Rule compliance. Treatment of certain digital assets as securities could materially impact liquidity in the U.S. and elsewhere, and advisers should consider the potential impacts on portfolio management and whether existing risk disclosures are adequate.

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If you have any questions concerning this *Alert*, please contact your attorney at Schulte Roth & Zabel or one of the authors.

[1] *SEC v. Ishan Wahi, et al.*, No. 22-cv-1009 (W.D.W.A. July 21, 2022), available here (the “Complaint”).

[2] *United States v. Ishan Wahi, et al.*, No. 22-cr-392 (S.D.N.Y. July 21, 2022), available here (the “Indictment”); *United States v. Chastain*, No. 22-cr-305 (S.D.N.Y. June 1, 2022), available here (the “Chastain Indictment”).

Charging insider trading of digital assets as wire fraud relieves prosecutors from having to demonstrate that the digital asset at issue is a “security” – a showing that would be required for Section 10(b) and Rule 10b-5 liability.

[3] For further discussion, see *SRZ Securities Enforcement Quarterly*, August 2022, available here.

[4] *SEC Charges Former Coinbase Manager, Two Others in Crypto Asset Insider Trading Action*, SEC Press Release 22-127, July 21, 2022, available here. *Three Charged in First Ever Cryptocurrency Insider Trading Tipping Scheme*, DOJ Press Release 22-232, July 21, 2022, available here.

[5] See *supra* 2, the Indictment.

[6] See *supra* 1. The Complaint refers to “crypto asset security” as “an asset that is issued and/or transferred using distributed ledger or blockchain technology – including, but not limited to, so-called “digital assets,” “virtual currencies,” “coins,” and “tokens” – and that meets the definition of “security” under federal securities laws.” *Id.* at 2.

[7] Paul Grewal, Coinbase Chief Legal Officer, *Coinbase does not list securities. End of story.*, July 21, 2022, available here.

[8] *Petition for Rulemaking- Digital Asset Securities Regulation*, July 21, 2022, available here.

[9] *Id.* at 1-2.

[10] Petition at 5-7.

[11] *See generally* the Complaint and Indictment.

[12] Complaint at 3, 22-59.

[13] *Id.* at 28-30.

[14] *Id.* at 35-39.

[15] *Id.* at 48-52.

[16] *Id.* at 8.

[17] *Id.* at 22.

[18] *Id.* at 25.

[19] *Id.* at 40.

[20] *Id.* at 45.

[21] *Id.* at 23.

[22] *Id.* at 22-59.

[23] *Id.* at 34-35.

[24] *Id.* at 57-59.

[25] Statement of CFTC Commissioner Caroline D. Pham on *SEC v. Wahi*, July 21, 2022, available [here](#).

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