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Cryptocurrency Insider Trading Case Could Have Broader Ramifications for the Industry

On July 21, 2022, the Department of Justice (DOJ) and the Securities and Exchange Commission (SEC) each brought insider trading charges against a former Coinbase product manager, his brother and a close friend for using material non-public information (MNPI) to purchase a variety of crypto assets prior to announcements by Coinbase that the assets would be listed on the company's platform.

This is the first time an insider trading case has been brought by the DOJ or SEC relating to fungible tokens, and comes on the heels of the first-ever DOJ indictment for alleged insider trading related to non-fungible tokens (NFTs). (See our June 16, 2022, client alert, "'Insider Trading' and NFTs: What Should Companies Be Doing?") The case also comes only a few months after the DOJ's announcement of a National Cryptocurrency Enforcement Team.

What makes this case most noteworthy, however, is the SEC's pronouncement in the complaint that a wide variety of the tokens involved were securities. As discussed below, this approach brought an unusual and sharp response from a commissioner of the Commodities Future Trading Commission (CFTC), raising many questions about the complaint's implications for Web3.

Background

The DOJ indictment, unsealed by the U.S. Attorney's Office for the Southern District of New York, and the SEC complaint, filed in the Western District of Washington, allege that, from at least June 2021 through April 2022, Ishan Wahi (Ishan), a product manager in Coinbase's Assets and Investing Products group, repeatedly relayed MNPI about the timing and identity of which cryptocurrency assets would be made available to trade on Coinbase's trading platform to his brother, Nikhil Wahi (Nikhil), and a close friend, Sameer Ramani (Ramani). This information was valuable because, according to both the DOJ and the SEC, when Coinbase publicly announced that it would list a cryptocurrency or token on its platform, that digital asset would typically appreciate significantly in value.

In his role at Coinbase, Ishan was part of a small group of employees who had confidential information about which digital assets would be listed. Coinbase's employee policies, which were acknowledged and signed by Ishan as a condition of his employment, state that "information about a decision by Coinbase to list, not list, or add features to a Digital

Asset" constitutes MNPI. The policies further stated that such MNPI should never be disclosed to others who may use that information to make trades.

The DOJ indictment and SEC complaint allege that, ahead of multiple token listing announcements in 2021 and 2022, Ishan used phone calls and text messages to tip off Nikhil and Ramani about the upcoming listings. For example, on August 30, 2021, Ishan learned that Coinbase would be listing the XYO token. In the days thereafter, and prior to the Coinbase's public announcement, blockchain addresses associated with Ramani were allegedly used to purchase XYO tokens valued at $600,000. Following the public announcement by Coinbase that XYO tokens would be listed, those coins are alleged to have appreciated to approximately $1.5 million, representing a profit of approximately $900,000.

Overall, the trio allegedly repeated this scheme across 25 tokens which, according to the SEC, earned them at least $1.1 million, which they funneled through multiple digital wallet addresses and across various trading platforms. The DOJ indictment alleges the defendants generated unrealized gains of at least approximately $1.5 million.

Ishan and Nikhil were arrested on July 21, while Ramani remains at large and is believed to be in India. The DOJ charged the three with wire fraud conspiracy and wire fraud, while the SEC complaint alleges insider trading in securities, in each case based on the use of MNPI.

There was no allegation of any wrongdoing by Coinbase, and the company acted swiftly when it learned of Ishan's activity. Indeed, Ishan's decision to leave the country appears to have been triggered by a request from Coinbase's director of security operations that Ishan attend an in-person meeting regarding the company's asset listing process.[1]

The SEC Alleges That Some of the Tokens at Issue Were Securities

The SEC's allegation that Ishan, Nikhil and Ramani violated Section 10(b) and Rule 10b-5 of the Securities Exchange Act of 1934 requires that the tokens traded were securities. Significantly, while the SEC alleges that the trio used MPNI to purchase 25 different digital assets ahead of listing announcements, the complaint only alleges that nine of the assets were securities. The other 16 are not even identified, let alone alleged to be securities.

Despite SEC Commissioner Gensler's strong statements regarding the securities status of fungible crypto tokens, the absence of any discussion of the other 16 tokens leaves the Web3 community largely in the dark as to the SEC's approach and the rationale for treating some tokens as securities but not others. The one available data point is four tokens that the DOJ listed that are not cited by the SEC (TRIBE, ALCX, GALA and ENS). Assuming the SEC and DOJ were working from the same set of facts, the SEC decided not to allege that those four coins were securities.

For its part, Coinbase has strongly challenged the notion that any of the crypto assets on its platform are securities. In a blog post the day the charges were announced, its chief legal officer cited the exchange's "rigorous process to analyze and review each digital asset" and argued that the SEC's actions speak to the lack of regulatory clarity for digital asset securities. Coincidentally, just hours before the SEC and DOJ actions were announced, Coinbase filed a petition for rulemaking with the SEC calling for clarity in the area of crypto securities.

The SEC's Reasoning That Nine of the Tokens Were Securities

According to the SEC, nine of the crypto assets traded by the three men constituted securities because the assets meet the definition of an "investment contract." Under the so-called *Howey* test,[2] investment contracts are assets that are offered and sold to investors who make an investment of money in a common enterprise, with a reasonable expectation of profit derived from the efforts of others. For each of the nine tokens cited by the SEC, the complaint sets forth the purported basis for a common enterprise and why there was a reasonable expectation of profits based on the efforts of others. The complaint thus provides insights into the SEC's view of the applicability of the securities laws to these crypto assets.

First, the nine tokens represent a wide range of use cases for blockchain-based digital assets. Although unclear, it is possible the SEC may have selected these nine as a representative sample of the types of tokens that could be securities:

AMP, a staking token used to guarantee retail payments on the Flexa network.

- RLY, the governance token for the Rally social token platform.
- DDX, a token that provides governance rights, discounts and staking opportunities on the DerivaDEX derivates exchange.

[1] Skadden Arps represents Coinbase in private litigation alleging that certain digital assets traded on its platform are securities.

[2] *SEC v. W.J. Howey Co.*, 328 U.S. 293 (1946).

- XYO, a token used to query geographic data, and reward those who respond.
- RGT, a token that confers certain governance rights and discounts on Rari, a "yield-maximizing robo advisor."
- LCX, a utility token for a Lichtenstein-based cryptoasset exchange and trading terminal.
- POWR, a utility for Powerledger, a peer-to-peer energy trading platform.
- DFX, the token used to reward participants for participating in liquidity pools for DFX's currency exchange platform.
- KROM, a token used as the service fee for a platform that allows crypto asset traders to place range orders.

Second, a few key themes repeated throughout the complaint provide insight into what the SEC sees as relevant under the *Howey* factors:

- The SEC consistently homes in on the fact that, for each token, the founders or development team held a large tranche of tokens — apparently suggesting that their economic incentives were aligned with purchasers' — which may be relevant to the "common enterprise" and/or "expectation of profits" prongs of *Howey*;
- In alleging a reasonable expectation of profits, the SEC repeatedly refers to the core team promoting the availability of their token on a secondary market or promoting the token's liquidity;
- In each case, to satisfy the "efforts of others" prong under *Howey*, the SEC took a broad view of the ongoing role of the development team;
- The SEC points to cases where tokens are burned or otherwise removed from the market to support the "expectation of profits" prong; and
- Posting or promoting the price of the token on a platform's website can be evidence that the core team is suggesting an expectation of profits to potential purchasers.

It may be some time until the Web3 community has any definitive clarity on these issues, particularly since the SEC claims may be stayed until the DOJ's criminal case is concluded.

The Transparency of Blockchain Transactions Aid Law Enforcement

Law enforcement officials often highlight that the transparency of blockchain transactions is an important factor in apprehending criminals. In this case, the DOJ indictment cited as an important lead a Twitter account that published a tweet on or around April 12, 2022 that an Ethereum wallet purchased a significant volume of tokens shortly before Coinbase listed that token. Both the SEC and the DOJ were able to trace the activities of Ishan, Nikhil and Ramani through their publicly viewable wallet activities.

A Sharp Retort From the CFTC

In response to the SEC complaint, CFTC Commissioner Caroline Pham issued an unusually harsh statement criticizing the SEC's approach. Commissioner Pham, who joined the CFTC in April 2022, opened her statement by citing from a House Committee Statement on the 1976 Sunshine Act: "[I]n the words of Federalist Paper No. 49: 'The people are the only legitimate fountain of power, and it is from them that the constitutional charter … is derived.' Government is and should be the servant of the people, and it should be fully accountable to them for the actions which it supposedly takes on their behalf."[3]

Pham then called the SEC complaint a "striking example of 'regulation by enforcement'" that could have broad implications and urged regulators to work together through a transparent process that leads to the development of appropriate policy. According to Pham, "Major questions are best addressed through a transparent process that engages the public to develop appropriate policy with expert input — through notice-and-comment rulemaking pursuant to the Administrative Procedure Act. Regulatory clarity comes from being out in the open, not in the dark."

Perhaps most significantly, Commissioner Pham strongly suggested she comes to a different view than the SEC on whether utility and governance tokens are securities. Specifically, she notes that "The SEC complaint alleges that dozens of digital assets, *including those that could be described as utility tokens and/or certain tokens relating to decentralized autonomous organizations (DAOs)*, are securities." (emphasis added).

Commission Pham also urged the CFTC to take a leading role in this space, which highlights the tension between the SEC and CFTC as to who should regulate digital assets. A recent bill introduced by Senators Cynthia Lummis and Kirsten Gillibrand would give the CFTC a leading role in the regulation of this sector. See our June 9, 2022, client alert, "Senate Bill Would Create Comprehensive Regulatory Structure for Cryptocurrencies and Other Digital Assets."

[3] H.R. Rep. No. 94-880 (Pt. 1), reprinted in 1976 U.S.C.C.A.N. 2183, 2184.

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