THE CLS BLUE SKY BLOG

COLUMBIA LAW SCHOOL'S BLOG ON CORPORATIONS AND THE CAPITAL MARKETS

Skadden Discusses Digital Asset Insider Trading Case

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Comment

On February 7, 2023, Ishan Wahi (Ishan), a former Coinbase product manager, pled guilty to wire fraud charges in an indictment in the U.S. District Court for the Southern District of New York (SDNY).

Ishan admitted that he had used material nonpublic information from his employer to tip his brother and a friend to purchase a variety of digital assets prior to announcements by Coinbase that the assets would be listed on the company's platform.

Ishan's brother previously pled guilty to one count of conspiracy to commit wire fraud.

Notably, the day before the former product manager's guilty plea and months after his brother's, the two defendants filed a motion to dismiss the Securities and Exchange Commission's (SEC's) parallel civil suit.

In its complaint, the SEC charged the same defendants with insider trading but, unlike the criminal charges, claimed the conduct violated the federal securities laws because, according to the SEC, nine of the 25 tokens traded constituted investment contracts and therefore were securities. (The SEC does not have a wire fraud statute to charge.)

The filing of the motion to dismiss in the midst of resolving the criminal case indicates that the two intend to continue challenging the SEC's civil enforcement action. Given the difference in the charges, the defendants appear to be taking a different approach than is usual in parallel proceedings like this one, where a guilty plea in the criminal case is typically accompanied by the settlement of the SEC case.

Assuming the defendants continue to press the motion in the SEC case, a decision by the court would be notable because it could offer a rare glimpse of judicial guidance regarding the applicability of U.S. securities laws to digital tokens traded on secondary markets and not in the context of a fundraising event.

Criminal Case

The SDNY indictment alleges that, from at least June 2021 through April 2022, Ishan, a product manager in Coinbase's Assets and Investing Products group, repeatedly relayed material nonpublic information (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).

According to the indictment, this information was valuable because when Coinbase publicly announced that it would list a cryptocurrency or token on its platform, that digital asset typically appreciated in value. Overall, the trio allegedly repeated this activity across 25 digital assets which, according to the indictment, allowed defendants to generate unrealized gains of at least approximately $1.5 million.

Notably, the indictment charged defendants with wire fraud and wire fraud conspiracy, which would not require the prosecution to establish that any of the digital assets are securities that are within the scope of the federal securities laws.

On September 12, 2022, Nikhil pled guilty to wire fraud conspiracy. On January 10, 2023, he was sentenced to 10 months' imprisonment and ordered to forfeit $892,500 in profits.

On February 7, 2023, Ishan pled guilty to two counts of wire fraud conspiracy and is scheduled to be sentenced in May 2023.

Ramani, who was also charged in the case, remains at large.

SEC's Civil Case

The SEC complaint, filed in the U.S. District Court for the Western District of Washington, alleges the same three defendants engaged in insider trading. The SEC's allegation that they violated Section 10(b) and Rule 10b-5 of the Securities Exchange Act of 1934 requires the tokens traded to be "securities."

Significantly, while the SEC alleges that the trio used MNPI to purchase 25 different digital assets ahead of listing announcements, the complaint alleges that only nine of the assets meet the definition of an "investment contract," and thus of a "security," under the U.S. Supreme Court's test in *SEC v. W.J. Howey Co.*, 328 U.S. 293 (1946). The other 16 assets are not identified or alleged to be securities.

Significance of Ishan's Plea

Although Ishan is not the first defendant to plead guilty to criminal charges in this case, the close succession of his filing a motion to dismiss the SEC's complaint and the guilty plea strongly suggests that the brothers intend to defend themselves against the SEC civil proceeding even though they have resolved or are about to resolve the criminal matter.

The SEC has historically agreed to settle civil suits against individuals who have pled guilty in parallel criminal cases on the theory that an individual who has been convicted and sentenced need not incur further penalties. In this case, the timing of the defendants' motion to dismiss the SEC action indicates that they are willing to press forward with challenging the SEC's lawsuit notwithstanding the likely availability of a no-penalty settlement with the SEC.

Defendants' Motion To Dismiss

The defendants filed a motion to dismiss the complaint in the SEC's civil suit on February 6, 2023.

Notwithstanding a brief discussion of the defendants' state of mind, the defendants focused their arguments on the issue that is central to the SEC's case and irrelevant to the criminal case — that is, whether the nine digital assets at issue are investment contracts and therefore securities.[1]

While the SEC has notched various wins in U.S. district courts alleging that certain tokens issued in initial coin offerings (ICOs) were investment contracts, here the defendants relied heavily on the fact that none of the nine digital assets were distributed as part of an ICO at the time of the relevant trading by the defendants. Rather, they were all bought and sold on the secondary market.

This, the defendants argued, was a crucial distinction impacting the *Howey* analysis, because the developer that issued the tokens was not a party to the secondary transactions and had made no promises to the buyers on the secondary market.

This distinction plays out across the second and third prong of the *Howey* test, which examines whether there was (i) an investment of money (ii) in a common enterprise (iii) with a reasonable expectation of profit derived from the efforts of others.

Common enterprise. The defendants argued the SEC could establish neither vertical nor horizontal commonality for any of the nine digital assets.[2] There was no horizontal commonality among purchasers because:

- the money purchasers paid was not pooled in an enterprise managed by the developers but instead paid to others on the secondary market; and
- each holder of the digital assets could individually decide whether and when to sell.

As to vertical commonality between the purchasers and developers, the defendants contended there was little connecting the two groups for any of the nine digital assets because each of their values depended on market forces rather than the success of the underlying platform, as was evidenced by the tokens' price fluctuations on the secondary market.

Reasonable expectation of profits from the efforts of others. The defendants asserted that, because the tokens were meant to be used on their respective platforms and, in turn, sold on secondary markets, they were utilitarian in nature and not sold as a profit-making investment. Finally, the defendants contended that the value of each token is driven by market forces, not the continuing managerial efforts of the developers.

The defendants also took aim at the SEC's interpretation of the *Howey* test by arguing that the agency's arguments ignored long-standing requirements. Drawing on similar arguments made during summary judgment briefing in *SEC v. Ripple Labs*,[3] the brothers argued that the term "investment contract" was an established term by the time it was incorporated into the federal securities laws that required (1) a written or implicit contract or promise and (2) post-offering obligations, and that included (3) providing the investor with a legal entitlement to a share of the venture's profits.

The defendants claimed there were no agreements between the developers and purchasers on the secondary market, none of the developers made any promises to those purchasers and the developers did not offer secondary market purchasers a share of any profits.

The defendants also argued that the "major questions" doctrine precluded the SEC from revisiting the traditional meaning of the term "investment contract" absent congressional authorization. Under this doctrine, an administrative agency must have clear statutory authorization "when it seeks to regulate 'a significant portion of the American economy.'" *West Virginia v. EPA*, 142 S. Ct. 2587, 2621 (2022) (Gorsuch, J., concurring) (citation omitted).

The defendants argued that the SEC lacks independent authority to regulate the cryptocurrency industry — worth an estimated $1 trillion, according to the defendants — for several reasons.

First, the defendants argued that the major questions doctrine precluded the SEC from using the term "investment contract," the scope of which has traditionally been more limited, to expand its regulatory authority to a substantial and new industry.

Second, the defendants argued that Congress is already actively debating how cryptocurrency should be regulated, suggesting that the SEC lacks jurisdiction to regulate the industry.

Possible Impact on the Digital Asset Industry

If the court issues a decision on the motion to dismiss, its ruling may provide some clarity to areas where critics of the SEC have been clamoring for more guidance. While the SEC has long claimed that fairly applying the *Howey* test will always yield a clear result,[4] there are myriad digital assets, with a wide range of uses and tokenomic structures, and an analysis under *Howey* does not always yield a straightforward answer.

The nine digital assets alleged to be securities illustrate this point because many of them lack features the SEC has relied on for the *Howey* analysis in other enforcement actions to date. In this case, the SEC put forth new arguments for the court to decide, including whether a purchaser could have a reasonable expectation of profits to be derived from the efforts of others when:

- he is not in privity with the developers;
- the developers have not clearly committed to develop and launch a project that will result in financial benefits to token holders; and
- the expected profits are derived from prices on the secondary market, which may be more interwoven with market forces than the efforts of the developers.

As to the major questions doctrine, the defendants raised an important argument for the district court and beyond. Several Supreme Court justices have demonstrated that they are sensitive to possible administrative overreach and may be willing to stem it even in the face of significant consequences.[5] (See our September 2022 *Insights* article "*West Virginia v. EPA*: Implications for Climate Change and Beyond.")

Regardless of the outcome on this motion, the major questions doctrine has become more of a live issue in light of other judicial developments and is sure to be argued in other digital asset-focused SEC enforcement actions.

Conclusion

As the SEC continues to bring enforcement actions in which it asserts jurisdiction over digital assets — and in which defendants are not willing to settle — it takes on increasing litigation risk. In the *Wahi* enforcement action, the agency's most aggressive efforts to date have been met with defendants who are intent to press their case.

For that reason, a ruling here may offer a rare judicial perspective on the *Howey* test's requirements and application in the context of digital assets traded on a secondary market and not in connection with a fundraising event.

ENDNOTES

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

2 In the U.S. Court of Appeals for the Ninth Circuit, horizontal commonality requires that investors group their assets into a common pool, such that they share in any increases or decreases in the value of the asset. *See Hocking v. Dubois*, 839 F.2d 560, 566 (9th Cir. 1988), *aff'd in relevant part*, 885 F.2d 1449 (9th Cir. 1989) (*en banc*). Vertical commonality requires "that the investor and the promoter be engaged in a common enterprise." *Mordaunt v. Incomco*, 686 F.2d 815, 817 (9th Cir. 1982) (citing *Brodt v. Bache & Co*., 595 F.2d 459, 460-61 (9th Cir. 1978)) (citations omitted).

3 *See* Defendants' Memorandum of Law in Support of Their Motion for Summary Judgment, *SEC v. Ripple Labs, Inc*., No. 20 Civ. 10832 (S.D.N.Y. Sept. 17, 2022), and Plaintiff Securities and Exchange Commission's Memorandum of Law in Opposition to Defendants' Motion for Summary Judgment, *SEC v. Ripple Labs, Inc*., No. 20 Civ. 10832 (S.D.N.Y. Oct. 21, 2022).

4 For example, on September 9, 2022, Gurbir Grewal, director of the SEC's Division of Enforcement, reiterated his belief that the "*Howey* and *Reves* tests remain vital and accurate means of identifying instruments that fall within the jurisdiction of the securities laws." Remarks at SEC Speaks 2022 (Sept. 9, 2022).

5 *See West Virginia v. EPA*, 142 S. Ct. 2587 (2022). Justice Brett Kavanaugh began voicing his opposition to what he views as growing administrative overreach long before becoming a Supreme Court justice. *See, e.g., SeaWorld of Fla., LLC v. Perez*, 748 F.3d 1202, 1218 (D.C. Cir. 2014) (Kavanaugh, J. dissenting) (stating that the Department of Labor's assertion of authority over SeaWorld's whale show was an improper assertion of its regulatory authority).

This post comes to us from Skadden, Arps, Slate, Meagher & Flom LLP. It is based on the firm's memorandum, "Digital Asset Insider Trading Case Could Provide Sought-After Guidance to Industry," dated February 14, 2023, and available here.