CARLTON FIELDS

Digital Assets: An Expanding Arena for Insider Trading and Market Manipulation

February 16, 2023

Both the SEC and DOJ are creatively and aggressively attacking the use of digital assets as a medium for insider trading or market manipulation. While the jurisdictional battle over digital assets still rages between the SEC and the CFTC, the SEC alone brought more than two dozen cases involving cryptocurrencies during its fiscal year 2022, and the SEC has formed a Special Unit within its Trial Unit in the Enforcement Division to prosecute crypto and digital asset cases.

Although this article discusses a few key cases involving insider trading and market manipulation, the digital asset arena is rife with other potential legal violations. This is amply shown, for example, by FTX, which we will address more fully in our next edition of *Expect Focus.*

Insider Trading

The SEC is bringing insider trading cases for digital assets that the SEC deems to be "crypto asset securities." The SEC defines this to include "an asset that is issued or transferred using distributed ledger or blockchain technology" such as "so-called digital assets, virtual assets, coins, and tokens that meet the definition of a security under the federal securities laws." Most digital assets arguably satisfy the familiar four-prong Howey test of what constitutes an "investment contract" (*i.e.*, an investment of money, in a common enterprise, with the expectation of profits, based on the efforts of others) and thus are "securities."

The SEC has relied on the misappropriation theory of insider trading. Unlike the classical theory which charges *inside* officers and directors with having breached their fiduciary duties to shareholders, the misappropriation theory applies to *outsiders* who may not be officers, directors, or employees of the issuer but who use or tip material non-public information (MNPI) in breach of a *duty of trust and confidence* owed to the source of the information. The misappropriation theory also has been used by the DOJ in criminal suits charging wire fraud and conspiracy to commit wire

fraud. Thus, **SEC civil and DOJ criminal concepts increasingly are being merged to bring novel prosecutions**.

Non-Fungible Tokens (NFTs)

- In *United States v. Nathaniel Chastain*, the first ever insider trading case in digital assets, the DOJ criminally charged Nathaniel Chastain with wire fraud and money laundering in violation of 18 USC §1343 and 18 USC §1956 (c)(7), respectively, for using confidential business information of Ozone Networks d/b/a OpenSea, to purchase NFTs prior to being featured on OpenSea's homepage. Each statute carries a maximum sentence of 20 years in prison, and the DOJ's indictment also alleged asset forfeiture under 18 USC §91(a)(1)(C) and 28 USC §2461(c) of all property, real or personal, traceable to the crime, as well as forfeiture of substitute assets and other property under 21 USC §853(p) and 28 USC §2461 up to the value of the forfeitable property.

NFTs are digital assets associated with a digital object, such as a piece of digital artwork (e.g., one-of-a-kind trading card, picture of soccer player, Donald Trump, or even Melania Trump's eyes), and provides proof of ownership and a license to use that object for specific purposes. An NFT has a unique identifying code and is stored and traded on a blockchain, which is a digitized and decentralized ledger of transaction information. NFTs have grown to more than a $40 billion market. OpenSea is the largest online marketplace for NFTs.

Chastain, as product manager responsible for selecting NFTs to be featured on OpenSea's homepage, had advance knowledge of which NFT would be featured. He misappropriated that confidential business information to purchase NFTs prior to their appearance on the homepage and then sold them afterwards at two to five-times higher than his initial purchase price. Chastain tried unsuccessfully to conceal his fraud by using anonymous digital currency wallets and anonymous accounts on the blockchain.

Tokens

- In *SEC v. Ishan Wahi*, the SEC charged Ishan Wahi, his brother, and a close friend with insider trading in coin-based tokens in violation of Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 thereunder. Ishan Wahi was manager at Coinbase Global, Inc (Coinbase), one of the largest crypto asset trading platforms in the United States. He was part of a "tight circle" at Coinbase that was entrusted with knowledge of which crypto asset securities would be listed and when.

Wahi repeatedly tipped MNPI about the content of Coinbase's "listing announcements" to his brother and a close friend, who, in turn, used the MNPI to trade ahead of any listing, earning more than $1.1 million in illicit profits in nine different crypto asset security tokens. As tipper, Ishan Wahi,

violated his duty of trust and confidence owed to Coinbase. His brother and friend, as the tippees, violated securities laws by trading crypto asset securities "on the bases of" MPNI that they "knew, were reckless in not knowing or consciously avoided knowing" that Wahi had provided them in breach of his duties to Coinbase. Wahi "benefited" from his tip because he "bestowed gifts" of MNPI on his brother and close friend.

Although Wahi, his brother, and friend took steps to conceal their communications through use of a web of anonymous accounts, blockchain wallets, and addresses on multiple platforms, the suspicious trading of the brother and friend was brought to the attention of Coinbase's director of security operations by a third party, who noticed several blockchain wallets linked to the brother and friend that showed trades in 25 crypto assets within 24 hours before each token was listed for trading.

Even though the DOJ could have brought criminal charges of insider trading under Section 10(b) of the Exchange Act and Rule 10b-5, it instead opted for a more expansive approach. Specifically, it criminally charged Wahi, his brother, and his friend together with participating in a *scheme* to engage in insider trading and thus *conspiracy to commit wire fraud* under 18 USC §1349, as well as charging each individually with wire fraud under 18 USC §1343, which makes it a crime to devise or participate in a scheme or artifice to defraud and to obtain money and property by false and fraudulent pretenses. Unlike Rule 10b-5, noticeably absent is the need for the DOJ to show a personal "benefit" to Wahi under the wire fraud statute.

The indictment charged all three defendants with trading in all 25 digital assets for realized and unrealized gains of $1.5 million, not just the nine tokens singled out by the SEC as crypto asset securities. As in *Chastain*, the DOJ requested asset forfeiture of all property, real or personal, traceable to the crime, as well as forfeiture of *substitute* assets, and other property up to the value of the forfeitable property.

Market Manipulation

In *SEC v. The Hydrogen Technology Corporation*, the SEC filed civil charges against The Hydrogen Technology Corporation and its former president and CEO, Michael Ross Kane, and against Tyler Ostern, president and CEO of Moonwalkers Trading Limited. Hydrogen "minted" approximately $11.1 billion "hydro tokens" to raise capital. The SEC alleged that, from January 2018 through April 2019, Hydrogen and Kane offered and sold these unregistered crypto asset securities and hired Ostern to manipulate the price and volume of the hydro tokens traded on crypto asset trading platforms. To effect the manipulation, Ostern, a self-described crypto asset "market maker," created the false appearance of robust trading and artificially propped up the price of the hydro tokens.

Ostern accomplished the manipulation by using a customized trading bot (i.e., a computer program that automates trades) and by placing and cancelling trades at random increments of price and

volume. Ostern told Kane that he would keep the sell pressure to a minimum until he could "build enough capital to really get the market moving upward" and then "pump the price and sell into the FOMO (*i.e.*, fear of missing out) guys down the road." Ostern later bragged to Kane that his trading bot and "volume shenanigans" on a popular trading platform had generated an illusion of a million hydro tokens bought and sold in a matter of three seconds, about one half of which were fake. Hydrogen reaped profits of more than $2.2 million.

The SEC sought disgorgement and civil monetary penalties from all defendants as well as an officer and director bar against Kane. Ostern entered into a consent injunction and also agreed to a bar prohibiting him from participating as a finder, promoter or agent in any offering or trading in penny stock.

Authored By

Thomas V. Sjoblom

Related Practices

SEC Enforcement
Financial Services Regulatory
Life, Annuity, and Retirement Solutions

Related Industries

Life, Annuity, and Retirement Solutions
Life, Annuity, and Retirement Solutions
Securities & Investment Companies