

## Fintech Client Alert | July 26, 2022

# SEC Brings First Crypto Insider Trading Case: Alleges That Nine Digital Assets Trading on Coinbase Are Securities



The Securities and Exchange Commission (SEC or Commission) has brought its first crypto<sup>1</sup> insider trading enforcement action<sup>2</sup> involving nine digital coins available for trading on the Coinbase Global, Inc. (Coinbase) trading platform.<sup>3</sup> Integral to the SEC's insider trading allegation are its assertions that the nine digital coins trading on Coinbase are investment contracts that are securities. Below we provide a brief review of the case and discuss potential industry responses.

### Case Overview

The SEC filed its civil action against Ishan Wahi (Ishan), a Coinbase employee, his brother, Nikhil Wahi (Nikhil) and a close friend, Sameer Ramani (Ramani), in the United States District Court for the Western District of Washington and charged the defendants with violating Section 10b and Rule 10b-5 of the Securities Exchange Act of 1934 (Exchange Act).

The complaint charges Ishan with misappropriating material, non-public information concerning the future listing of nine digital coins on the exchange in violation of his duty of trust and confidence to Coinbase and Nikhil and Ramani with purchasing those coins while in possession of information obtained in breach of Ishan's duty to Coinbase.

Simultaneously, the United States Department of Justice criminally indicted all three defendants in the United States District Court for the Southern District of New York for insider trading in violation of the federal wire fraud statute, but not the Exchange Act.

### The SEC's Charges Can Only be Sustained if the Digital Coins are Securities

The SEC alleges that Nikhil and Ramani traded in 25 digital coins listed on the Coinbase trading platform and that at least nine of them are investment contracts pursuant to *SEC v. W.J. Howey Co.*, 328 US 293, 298-299 (1946) and, therefore, securities subject to the insider trading prohibitions of the federal securities laws. None of the nine coins are registered as securities with the SEC.

The SEC alleges that these nine coins are securities because they are investments in a common enterprise in which the promotor promised to use the proceeds generated from the purchase of the coins to develop and maintain the networks that would give the coins value. According to the SEC's theory, the initial coin value of each of the nine coins was the result of the managerial efforts of the coin issuers in developing and maintaining each individual network. Further, the coin issuers represented to investors that the coins would ultimately be available to trade on the secondary market, which would increase their liquidity and allow the value to appreciate.

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## Potential Industry Responses

As is often the case with “first in kind” enforcement actions, industry participants often find themselves asking, how does this action affect my business and should I be doing anything different?

Industry participants who are concerned about the merits of the SEC's enforcement efforts could seek to structure and disclose their way around existing Commission and SEC Staff statements and actions. However, such efforts in the area of digital assets have left most industry participants frustrated, given the perceived overreaching and lack of clarity by the Commission and its Staff in applying that guidance. For example, the SEC's Coinbase complaint does not clarify how the nine coins the SEC deems securities differ from the remaining 16 coins that the defendants traded on Coinbase, much less how they differ from the 150 coins in total that are traded on Coinbase.

Alternatively, industry participants can view the SEC's enforcement efforts as incorrect readings of the law and follow the statutes and the Supreme Court's case law interpreting those statutes as written. A recent example of this type of response is the response to the SEC's enforcement action against Ripple Labs and two of its principals, alleging a violation of the registration provisions of the Securities Act of 1933 in connection with its digital coin XRP. That matter has neither resulted in a rush to the Commission to register digital coins as securities nor has it halted the trading of XRP or other digital assets.

Industry participants can also continue with their current efforts to push for better guidance – not necessarily with the SEC – but with Congress and the courts. If, for example, the Coinbase civil action goes forward, there is an opportunity for court guidance on when a digital asset is a security.

## Will the Coinbase Civil Action Result in Useful Guidance?

With respect to the SEC's pending case, as a result of the parallel criminal proceeding, it is possible that the SEC's case will be stayed pending the outcome of the criminal case. However, there are factors present here that mitigate against a stay: 1) the criminal case does not charge violations of the securities laws; 2) the matters are filed in different courts on opposite coasts and 3) the legal issue as to whether the nine coins are securities is significant, but does not impact the criminal case. These factors could cause a motivated trial judge to force the SEC's case forward, potentially leading to case law on the security status of the nine coins at issue, with implications for the security status of digital assets in general.

<sup>1</sup> We refer to digital assets in this alert as crypto, digital assets, digital coins or coins.

<sup>2</sup> SEC v. Ishan Wahi, Nikhil Wahi and Sameer Ramani, Case 2:22-cv-01009 (Filed July 21, 2022).

<sup>3</sup> Coinbase, headquartered in San Francisco, CA, is one of the largest crypto trading platforms in the United States. Its stock is registered with the Commission, and its shares are publicly traded on the NASDAQ. Coinbase's trading platform is not registered with the SEC as a securities exchange, and neither Coinbase nor the trading platform are otherwise registered with the SEC.

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