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Kutak Rock Client Alert

August 3, 2022

The SEC's First Crypto Insider Trading Case

by Ken Witt

On July 21, 2022, the SEC charged three individuals with insider trading of digital assets. One of the defendants, Ishan Wahi, was a product manager for [Coinbase](#), a publicly traded crypto exchange. Wahi allegedly gave tips to his brother and a friend as to which digital assets would be listed for trading in the near future on [Coinbase](#). According to the SEC's [Complaint](#), the trio racked up illicit profits of more than \$1.1 million. The DOJ separately announced the indictment of the three individuals on charges of wire fraud and conspiracy.

This is the first time that the SEC has brought an insider trading enforcement action based on the trading of digital assets. The SEC alleges that nine of the 25 crypto assets traded by the defendants are securities because they meet the definition of an "investment contract" under the *Howey* test. *Howey* is a 1946 Supreme Court case that defines an investment contract as (i) an investment of money, (ii) in a common enterprise, (iii) with a reasonable expectation of profit derived from the efforts of others.

In an approach that some, including [CFTC Commissioner Caroline Pham](#), call "regulation by enforcement," the SEC has steadfastly refused to adopt regulations tailored to the crypto industry, but rather has brought a multitude of enforcement actions since 2017 based on the *Howey* test. Those cases have generally involved the failure to register digital assets such as tokens as securities under the Securities Act of 1933 and the failure of digital asset trading platforms to register as securities exchanges under the Securities Exchange Act of 1934.

The nine digital assets – or tokens – that are alleged to be securities by the SEC share certain features that should be a cause for widespread concern in the crypto industry.

The second element of the *Howey* test requires the existence of a common enterprise. A common enterprise is alleged to be present in the SEC's [Complaint](#) by reason of ownership of tokens by a management group or a reservation of tokens for future use by the issuer and management team. Another element of commonality is the contribution by investors to liquidity or collateral "pools." Ominously, the SEC also asserts that using investors' money to develop a network is enough to find a common enterprise: "Rally has made clear from the start that funds raised from investors would fund Rally's development . . ."¹ The use of investors' funds for development is characteristic of nearly all token offerings.

¹ [Complaint](#) at par. 114.

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According to the [Complaint](#), the *Howey* element requiring a reasonable expectation of profits derived from the efforts of others is evidenced by statements in “white papers,” blogs, social media and elsewhere touting the profit potential for purchasers of tokens. “Profit” is viewed by the SEC as including both capital appreciation and distributions of revenue or rewards in some form. According to the SEC, touting the listing of a token on one or more digital asset exchanges is an indicia of an expectation of profit due to the efforts of others (the management team) because such listings increase the liquidity and trading price of the token. Publicizing scarcity of the token due to a capped supply, “burning” tokens or vesting are also relevant to trading price and profit. In addition, the SEC identifies awards from participation in liquidity and collateral pools as profit.

The “efforts of others” element of the *Howey* test receives a lot of attention from the SEC. A completely decentralized network such as Bitcoin or Ethereum does not meet the test, but it is difficult to discern from this enforcement action where the SEC is going to draw the line. In each of the nine digital assets targeted by the SEC, the network is either not functioning at the time of investment or is further developed over time. The SEC finds either to be sufficient to show that the “efforts of others” are critical to the profitability of the investment. References in social media and elsewhere to management teams and their qualifications are especially damning, in the view of the SEC.

Moreover, the SEC does not have much difficulty looking through elaborate structures to find a security. For example, the DDX token is associated with the DerivaDEX protocol.² According to the [Complaint](#),

The DerivaDEX protocol is under development by DEX Labs, Inc. (f/k/a DerivaDEX, Inc.), a Delaware corporation purportedly providing software development services, as well as by a Panama-based foundation called the DerivaDEX Foundation and a British Virgin Islands-based operating entity called the DerivaDAO.³

The SEC ignores the subtleties of the separate U.S. development entity, offshore foundation and operating entity. The SEC knifes through that elaborate structure to the “central management team” that is using investors’ funds to develop the DerivaDEX protocol, which has yet to become operational.⁴ These complex cross-border structures are an attempt to create a semblance of decentralization and thereby defeat “efforts of others.” After the *Wahi* case, one wonders whether crypto developers will weigh the expense and trouble inherent in such structures versus the likely benefit in an SEC enforcement action.

Finally, this enforcement action has grave implications for “crypto exchanges” (digital asset trading platforms) subject to the SEC’s jurisdiction. It appears that seven of the nine securities deemed to be securities by the SEC are or were traded on [Coinbase](#). [Coinbase has objected strenuously](#) to that characterization but is not a party to the enforcement action. [Bloomberg reports](#) that the SEC is investigating [Coinbase](#) for permitting U.S. investors to trade securities on the exchange.

If you have any questions regarding this client alert, please contact Kutak Rock partner Ken Witt or your Kutak Rock attorney. For more information, please visit us at www.kutakrock.com.

² [Complaint](#) at par. 121.

³ [Complaint](#) at par. 122.

⁴ [Complaint](#) at pars. 131-133.

