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WHITE-COLLAR CRIME

Insider Trading Unchained: Not Just Securities Anymore

No federal statute defines "insider trading." Instead, the common law crime of securities "insider trading" has evolved from a convoluted collection of fact-specific court decisions, leaving significant uncertainty regarding the line between permissible and prohibited conduct across the constantly developing contexts to which the doctrine has been applied. Insider trading generally encompasses corporate insiders, or those who receive information from corporate insiders, trading securities on material non-public information. Historically, prosecutors have most often brought insider trading cases under §10(b) of the Securities Exchange Act. Increasingly, however, insider trading also is charged under the broader, more general fraud statutes contained in Title 18. Now, prosecutors have undertaken a further evolutionary step: the application of "insider trading" theories in cases that do not necessarily involve securities.

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In two recent notable cases involving NFTs and cryptocurrency markets—*United States v. Chastain* and *United States v. Wahi*—the Department of Justice has brought insider trading charges under the wire fraud statute without claiming that any securities were involved. These cases demonstrate the substantial flexibility federal prosecutors have—or at least believe they have—in charging insider trading and underscore the oft-recognized need for a federal statute expressly addressing insider trading.

Chastain and *Wahi* are developing cases. The defense in *Chastain* recently asked the court to dismiss the charges, arguing that the prosecution's theory fails because the NFTs at issue are not securities. The prosecutors responded that wire fraud does not require proving a connection with the purchase or sale of securities. The defendant's motion to dismiss was quickly followed by a motion to strike all mentions of "insider trading" from the indictment as prejudicial and impermissible surplusage. As of the time of this article, the government had not yet answered the motion to strike. In *Wahi*, however, prosecutors already have seen some success. One of the defendants, who received tips from his brother regarding which cryptocurrency assets would be listed on a marketplace, pled guilty to conspiracy to commit wire fraud, which carries a maximum sentence of 20 years in prison. His sentencing is currently scheduled for Dec. 13, 2022. The case is ongoing as to the other two defendants, one of whom remains at large. The Securities and Exchange Commission filed a parallel complaint in *Wahi*, alleging that some of the cryptocurrency assets at issue are securities.

What Is Insider Trading?

Historically, the government typically has prosecuted insider trading under §10(b) of the Securities and Exchange Act, 15 U.S.C. §78j(b), and Securities and Exchange Commission (SEC) Rule

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10b-5, which focus on "manipulative, "deceptive," and "fraudulent" practices in connection with securities. Under Title 18, in addition to their darlings the mail and wire fraud statutes, prosecutors also turn to 18 U.S.C. §1348, adopted in 2002 as part of the Sarbanes-Oxley Act, which imposes criminal liability for schemes involving the theft and misappropriation of confidential information in connection with the purchase or sale of any security or commodity. Notably, the mail and wire fraud statutes of Title 18 do not, on their face, require a connection to the purchase or sale of securities as §1348 does.

The Supreme Court has recognized two primary theories of insider trading: (1) the "classic theory," and (2) the "misappropriation theory." In *Chiarella v. United States*, 445 U.S. 222 (1980), the Supreme Court articulated the classic theory, which is where a company insider who has a relationship of trust and confidence with the corporation's shareholders trades on non-public, material information regarding the company. In *Chiarella*, because petitioner, a financial printer who traded on the announcements of corporate takeover bids he printed, had no relationship with the sellers he sold securities to, the Supreme Court determined that he did not have a duty to disclose his knowledge and overturned his convictions for securities fraud. In *Carpenter v. United States*, 484 U.S. 19 (1987), the Supreme Court, in a split 4-4 decision, affirmed by virtue of its tie vote the Second Circuit's holding that the misappropriation of prepublication information by a reporter and news clerk employed by the Wall Street Journal was sufficient to affirm mail and wire fraud convictions. The "misappropriation theory" of insider trading continued to develop until it was adopted in *United States v. O'Hagan*, 521 U.S. 642 (1997), and applies to cases where an outsider trades on non-public, material information in breach of a duty owed to the source of the information. Since *Carpenter* and *O'Hagan*, the Supreme Court has reaffirmed that the wire fraud statute protects only property rights and requires the government to prove that "an object of the fraud was property." *Kelly v. United States*, 140 S. Ct. 1565, 1571 (2020). The Supreme Court has interpreted "property" under the wire and mail fraud statutes to include "intangible" property, such as confidential business information. *Carpenter*, 484 U.S. at 25-26.

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Although these theories are "the two generally accepted theories of insider trading," they are certainly not the only principles the government has used in pursuing securities insider trading charges. In *SEC v. Dorozhko*, for example, a case involving a computer hacker who unlawfully accessed a computer system and traded on the information he obtained, the Second Circuit held that, where an affirmative misrepresentation is made in connection with a securities transaction, that misrepresentation can qualify as a deceptive device even in the absence of the breach of duty that is required in the classical and misappropriation theories. 574 F.3d 42, 45 (2d Cir. 2009). Moreover, judicial interpretation of the ever-flexible mail and wire fraud statutes has produced other potentially applicable theories, including the right-to-control and right to honest services, that the Supreme court will review in its October 2022 term. See generally R. Anello and R. Albert, "SCOTUS To Assess 'Right-to-Control' and Honest Services Fraud," New York Law Journal (Aug. 11, 2022). Although active debate is still brewing about what constitutes "property," the government's burden is arguably easier under the wire and mail fraud statutes as it need only show (1) a scheme to defraud another of money or property, and (2) use of mail or wires to execute the scheme. The involvement of securities or commodities is not an element as it is in §10(b) or §1348 cases.

'Insider Trading' of Assets Other Than Securities

Cryptocurrency has been touted as a more transparent form of investing, as the information needed to price digital assets is generally available to the public, and in theory no "inside" information is available to exploit before public releases of information, such as earnings announcements and SEC filings. Whether cryptocurrency and

digital assets qualify as securities remains a controversial open question beyond the scope of this article. While the SEC has taken the approach that certain digital assets may be securities, in some recent cases, the U.S. Attorney's Office has taken the road of least resistance—the question is not whether something is a security, but instead, whether the scheme smells of insider trading. If it does, prosecutors have begun taking the position that criminal liability can be premised on laws and theories traditionally used to prosecute insider trading.

This past June, the U.S. Attorney's Office for the Southern District of New York unsealed a grand jury indictment against Nathaniel Chastain, a former product manager at an online Non-Fungible Tokens (NFTs) marketplace called OpenSea. NFTs are digital assets stored on a blockchain, which is a digital, decentralized ledger that stores information regarding creation, transfers, purchases, and proof of ownership. Multiple times per week, OpenSea featured different NFTs on its homepage. In the aftermath, the price of the featured NFT, and of other NFTs made by the same creator, typically increased substantially. According to the indictment, Chastain, who was responsible for selecting which NFTs would be featured on OpenSea's homepage, exploited his advanced knowledge for personal gain by buying dozens of NFTs right before they were featured. Chastain then allegedly sold the NFTs for a profit shortly after they were featured and the price had risen. To conceal the fraud, the indictment alleges that Chastain used various digital wallets and accounts on the Ethereum blockchain.

In other words, according to the indictment, Chastain, a la the reporter in *Carpenter*, is alleged to have engaged in "insider trading" of the NFTs—he used his knowledge of material, non-public information to misappropriate his employer's confidential business information for personal financial gain. Chastain, however, was not charged with a violation of the securities law. Instead, the alleged scheme was charged as a violation of the wire fraud statute, as well as money laundering based on the alleged wire fraud violations.

Although the indictment against Chastain alleges "insider trading," the government does not actually argue that the NFTs at issue are securities, and apparently seeks to steer clear of that controversy. During a pretrial conference, the Court asked the prosecutor to clarify whether the items at issue were securities. The prosecutor responded, "[w]e're not alleging securities fraud," explaining that the government's theory is premised on the Supreme Court's decision in *Carpenter* to describe insider trading conduct in the context of wire fraud.

The defense in Chastain has taken the government to task for its purportedly prejudicial use of the "insider trading" label and recently moved to strike as surplusage all references to "insider trading" from the indictment. This, as the U.S. Attorney's Office has touted its indictment as the "first ever digital asset insider trading scheme." In its response to Chastain's motion to dismiss, however, the government characterized Chastain's objection to the use of the "descriptor" "insider trading" as "just a quibble regarding the nomenclature of this case[.]"

In a similar fact pattern, the SEC and U.S. Attorney's Office for the Southern District of New York brought parallel cases against three people involved in a scheme to misappropriate confidential information about tokens to be listed on Coinbase, a major online cryptocurrency exchange platform, who are alleged to have traded on that information in advance of listing announcements. A parallel SEC complaint is noticeably lacking from *Chastain*; perhaps as a testament to the difficulties of discerning whether NFTs are securities. In *Wahi*, the SEC brought its case under §10(b) of the Exchange Act and Rule 10b-5, arguing that at least some of the assets at issue are securities. The U.S. Attorney's Office for the Southern District of New York, however, charged only wire fraud and conspiracy to commit wire fraud.

One of the individuals allegedly involved in the charged scheme, Ishan Wahi, was a Coinbase employee and former product manager with responsibility for determing which digital assets would be listed on Coinbase's exchange. He is alleged to have breached the duty of trust and confidence owed to his employer by using his knowledge to trade ahead of the listings and to tip off the other two defendants. His conduct is claimed to have been prohibited by Coinbase's internal trading policy, which specifically prohibited using token listings for personal economic gain. FBI

Assistant Director Michael J. Driscoll stated in a press release: "Although the allegations in this case relate to transactions made in a crypto exchange—rather than a more traditional financial market—they still constitute insider trading … . Today's action should demonstrate the FBI's commitment to protecting the integrity of all financial markets—both 'old' and 'new.'" The government's approach has met with some success so far; Nikhil Wahi, who received tips from his brother, Ishan Wahi, pled guilty to one count of conspiracy to commit wire fraud in connection with a scheme to commit insider trading in cryptocurrency assets on Sept. 12, 2022.

'Fraud is fraud is fraud,' but where does it end?

Over 10 years ago, one of the authors co-authored an article lamenting the "evolving mystery" of fraudulent insider trading. See R. Morvillo and R. Anello, "The Evolving Mystery of Illegal Insider Trading," New York Law Journal (Aug. 3, 2010). Since then, Congress has tried a number of times to pass a law defining insider trading. In 2015, three bills were introduced in Congress; none were enacted. In 2020, a task force convened by former Southern District of New York U.S. Attorney Preet Bharara and former SEC Commissioner Robert L. Jackson Jr. to propose insider trading reform issued a report focusing on the "wrongfulness" of insider trading as a way to capture the variety of scenarios in which material nonpublic information can be obtained and communicated. The report proposed that "wrongfulness" be defined to include concepts of deception, misrepresentation, misappropriation, theft, and embezzlement as a result of breaches of duties of trust and confidence. In doing so, "wrongfulness" would capture conduct from traditional insider trading scenarios, as well as evolving prosecutions in the cryptocurrency markets, hacks and other unauthorized means of accessing corporate secrets—thereby crafting an insider trading statute as broad as the most aggressive government proponents assert the common law of insider trading already is.

Last year, the House of Representatives passed the most recent iteration of the "Insider Trading Prohibition Act." The bill would amend the Securities Exchange Act of 1934 "to prohibit certain securities trading and related communications by those who possess material, nonpublic information, and for other purposes." At a hearing discussing the bill earlier this year, Prof. John C. Coffee Jr., a professor of law at Columbia Law School, noted that because insider trading is effectively a common law crime, it can "expand in irregular and sometimes spasmodic movements," excluding the public from these deliberations.

At its core, insider trading involves taking advantage of confidential, material information that is unavailable to the general public for personal gain in violation of a duty of confidence. Many perceive something fundamentally unfair—or fraudulent—about someone taking advantage of their position of superior information and using that knowledge to make a profit on information that is not available to the public. Simply because a situation is unbalanced, however, does not mean it is, or should be, a crime. Across the vast and varied array of financial and commercial transactions that occur every day across our economy, quite commonly one party believes that she or he has a superior understanding of the value of the item being transacted than her or his counterparty, and so is making a great deal. The line between when a party's informational superiority is deemed legitimate or not can be elusive. According to Southern District of New York U.S. Attorney Damian Williams, "fraud is fraud is fraud, whether it occurs on the blockchain or on Wall Street," but the question, particularly in the arena of new cutting-edge technologies, is precisely what varieties of information disparities constitute fraud? Prosecutors' aggressive expansion of the concept of "insider trading" into new contexts holds the same dangers of overcriminalization, federal overreach, and vagueness as other controversial and imprecisely defined theories of federal fraud liability. These dangers underscore the need for Congress to provide legislative direction through a properly tailored insider trading statute.