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SEC Approach In Wahi Presents New Challenges For Crypto

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Government scrutiny of the crypto market has been sharply increasing in recent months on the criminal and civil enforcement fronts.

In parallel proceedings that will be seen in other digital asset contexts — as in the traditional securities sphere — the U.S. Securities and Exchange Commission has initiated civil actions against individuals also facing criminal charges brought by the U.S. Department of Justice.

A recent guilty plea in U.S. v. Wahi in the U.S. District Court for the Southern District of New York, a crypto insider trading case, sets up an interesting situation where the defendants — who have already pled guilty to wire fraud — are challenging the SEC's parallel civil charges, arguing that the securities laws do not apply to the crypto-assets at issue.[1]

Among other things, they have asserted that secondary market trades involving crypto tokens are not securities transactions, regardless of whether the crypto-assets may have been considered investment contracts, and thus securities, at issuance.

For the massive secondary crypto market ecosystem, this case has the potential to broadly extend SEC jurisdiction or upend the space, depending on one's point of view.

The Wahi Criminal Charges

In a first-of-its-kind action that will by no means be the last, the Department of Justice secured two wire fraud guilty pleas against brothers who traded crypto-assets based on inside information.

The trading scheme involved three individuals: Ishan Wahi, who worked at crypto exchange Coinbase Global Inc., his brother Nikhil Wahi and a friend, Sameer Ramani.

Together, the trio allegedly earned more than a million dollars in unlawful trading profits through a scheme to engage in timely, profitable trades in certain crypto- assets that were going to be listed on Coinbase.

Ishan Wahi, a member of Coinbase's asset listing team from June 2021 to April 2022, tipped information about the listings to his brother and Ramani.

Because Ishan was involved in the process of listing crypto-assets on Coinbase's exchanges, he had advance knowledge of which crypto-assets were slated to be listed and the timing of such announcements — a sensitive piece of information since the market value of such to- be-listed crypto-assets usually increased right after Coinbase made its initial public listing announcement.

Not surprisingly, these listing decisions were confidential, and Coinbase policy expressly prohibited employees from sharing such information with outside parties or providing a "tip" to any person.

The DOJ claimed that Ishan Wahi repeatedly tipped the timing of upcoming listing announcements to Nikhil Wahi and Ramani, who then bought the assets before Coinbase made the official public announcement and sold them post-announcement at a considerable profit.

According to the indictment, the scheme involved at least 25 crypto-assets in advance of at least 14 separate Coinbase crypto-asset listing announcements.

Following the arrest of Ishan and Nikhil Wahi, the DOJ's indictment in July 2022 asserted two counts of wire fraud[2] and two counts of conspiracy to commit wire fraud.[3] Notably, neither indictment alleged insider trading under the securities laws, but instead asserted violations of the federal wire fraud statute and did not use the term "security" to describe the crypto tokens at issue.

Both Wahis have pled guilty. In September 2022, the DOJ announced that the "tippee" Nikhil Wahi pled guilty to one count of conspiracy to commit wire fraud and was later sentenced in January to 10 months in prison and ordered to pay over $800,000 in forfeiture. On Feb. 7, 2023, the DOJ announced that Ishan Wahi pled guilty to two counts of conspiracy to commit wire fraud — he has yet to be sentenced.

While insider trading claims involving securities are hardly uncommon, the convictions represent the first criminal insider trading convictions in the cryptocurrency market.

Following Nikhil Wahi's guilty plea in January, the U.S. attorney for the Southern District of New York said in a statement that the sentence "makes clear that the cryptocurrency markets are not lawless."

SEC Civil Insider Trading Charges

Meanwhile, the SEC continues to pursue a parallel civil case against the defendants based on the same scheme, a suit that has raised some controversy in the industry.[4]

On the same day that the DOJ unveiled its indictment of the Wahi brothers and Ramani in July 2022, the SEC brought a parallel enforcement action against the defendants, claiming that at least nine of the tokens involved in their insider trading scheme were unregistered securities.

The SEC alleged in its complaint that this subset of crypto-assets satisfies the Howey test by "including continuing representations by issuers and their management teams regarding the investment value of the tokens, the managerial efforts that contribute to the tokens' value, and the availability of secondary markets for trading the tokens."

The Wahi brothers moved to dismiss the SEC's complaint, arguing that the commission is engaging in a regulatory power grab.

According to the Wahi brothers, the tokens were not investment contracts because, even if at issuance there was an investment in a common enterprise, once the underlying assets were sold on secondary markets, those trades break the connection between an investor and an issuer.

Because "there are … no binding promises running from the developers to the tokenholders, … [p]ublic declarations by token developers about the software they hope to create do not create post-sale legal obligations, and cannot convert tokens sold on secondary markets into investment contracts," counsel for the defendants wrote in a Feb. 6 motion to dismiss.

In other words, the token has become a simple asset, negating ongoing obligations that may have otherwise existed under securities laws, including the antifraud provisions of the Exchange Act, which underpins insider trading liability.

Counsel for the defendants have argued that the crypto tokens are no longer like a participation interest in an orange grove — which was held to be a security in the U.S. Supreme Court's 1946 decision in U.S. Securities and Exchange Commission v. W. J. Howey Co. — but now more resemble a simple orange, an asset generated by the enterprise.

Unsurprisingly, crypto industry participants have blanched at the SEC's expansive view that secondary trades in crypto tokens should generally be considered regulated transactions involving investment contracts.

The Blockchain Association, an industry group, has filed an amicus brief challenging the SEC's approach of seeking to apply the securities laws to tokens in the Wahi case absent any formal commission action or court ruling, also asserting that the commission is attempting to assert jurisdiction on the secondary market by leaning on secondary traders, not the token issuers themselves.

As such, the SEC is trying to invent new regulations via a singular enforcement action without allowing market participants who would have otherwise been able to participate in a notice-and-comment process, according to the group, which added that such a move would be "devastating" and "cause great damage" to crypto market participants.

What's Next

The court in the Wahi case is expected to consider whether the crypto-assets at issue can be considered securities, even when they lose a direct connection to an issuer. How the SEC fares in this case could determine how regulation may affect the thousands of tokens traded in the crypto markets.

But the SEC — and potentially other governmental and regulatory authorities — do not view the application of insider trading laws as the only tool that the government has to regulate the crypto industry.

Although criminal prosecutions have recently made big headlines — such as in the infamous FTX case — civil regulators have been asking for more crypto enforcement authority as well.

Last summer, the chairman of the U.S. Commodity Futures Trading Commission urged congressional action on crypto regulation. SEC Chair Gary Gensler has been even more assertive by making clear that he plans to use the SEC's powers to increase oversight of the crypto industry, including in enforcing conflict of interest laws.

Amid multiple actions in the post-FTX regulatory crackdown on crypto, a recently proposed SEC rule is designed to revise the Advisers Act's custody rule as it applies to crypto when a registered adviser has custody.

The rest of 2023 could see developments for the crypto industry on many fronts.

The industry will be watching how the SEC flexes its enforcement authority in the crypto markets, what other rulemaking could be promulgated in the absence of crypto-related federal legislation and how the agency fares in court in the Wahi case.

While the recent actions of the DOJ and the SEC in connection with the Wahi brothers' case may seem aggressive, they are hardly surprising.

Future rulemaking, along with favorable outcomes for the SEC in pending litigation, could further increase market scrutiny. But regardless of the outcome of the Wahi civil action, the SEC has made clear that it intends to play a dramatically increased role in crypto oversight, and market participants need to be ready.

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[1] U.S. v. Wahi, No. 22-cr-00392 (S.D.N.Y.)

[2] 18 U.S.C. § 1343

[3] 18 U.S.C. § 1349

[4] SEC v. Wahi, No. 22-1009 (W.D. Wash. Amended Complaint Dec. 22, 2022).

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