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Insider Trading and Cryptocurrency: A Primer for Traders



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Securities regulators have increasingly prioritized enforcement of insider trading laws against high-profile securities and derivatives traders and firms in the past decade. More recently, regulators have also turned the spotlight on initial coin offerings, with the Securities and Exchange Commission and Commodity Futures Trading Commission bringing enforcement actions against ICO issuers and companies involved in virtual currency derivatives. These trends are likely to intersect in 2018, as regulators begin to eye cryptocurrency and cryptocurrency derivative products for insider trading abuses.

Every cryptocurrency trader doing business in the U.S. should be aware of relevant insider trading laws and how they affect their businesses, to avoid not only actual wrongdoing but also any appearance of impropriety that could attract unwanted attention.

A Threshold Question: Are Cryptocurrency Products Regulated?

The idea that the SEC and CFTC could investigate violations of insider trading laws assumes that the cryptocurrency product being traded is a security or commodity derivative (respectively) in the first place.

Both regulators have asserted such jurisdiction. SEC Chairman Jay Clayton has asserted that most (if not all) ICOs have sufficient hallmarks of securities, comments that came only months after the regulator released its report on the investigation into The DAO, a virtual currency issuer whose tokens were found to be securities under the Supreme Court's *Howey* test. The SEC has since brought actions against two different ICO issuers for, among other allegations, issuances of unregistered securities.

Similarly, the CFTC has asserted jurisdiction over virtual currency derivatives, from the CFTC's September 2015 settlement with Coinflip Inc., the operator of an online trading platform for virtual currency derivatives; its July 2017 order granting Ledger X registration as the first virtual currency-related derivatives clearing organization under the Commodities Exchange Act; its permission for trading of Bitcoin futures products on the Chicago Board of Exchange; and its recent enforcement actions against allegedly unlicensed cryptocurrency commodity pool operators and other alleged fraudsters.

The question of whether a given cryptocurrency product is a security, commodity, currency, smart contract, or something else entirely has not yet been settled by Congress or the courts, and will undoubtedly be hotly contested in both enforcement and private litigation. That being said, as long as regulators believe they have jurisdiction to regulate insider trading in these markets, traders and issuers must remain diligent in their compliance and regulatory obligations, including implementing appropriate controls to prevent the improper dissemination of material nonpublic information, and any improper trading based on that information.

U.S. Insider Trading Laws

The U.S. does not have one single statute that defines and bans insider trading. Instead, federal law addresses insider trading through judicial interpretations of the statutory prohibitions on fraud in connection with the purchase or sale of securities (under Section 10(b) of the Securities Exchange Act of 1934 and Rules 10-b5, 10b5-1, and 10b5-2 promulgated thereunder); commodity futures, options, or swaps (under Section 6(c)(1) of the Commodities Exchange Act and Rules 180.1 and

180.2 promulgated thereunder) and in certain instances in connection with a tender offer (Section 14(e) of the 1934 Act and Rule 14e-3 promulgated thereunder); or for short-swing profits earned by certain defined insiders, whether from the misuse of insider information or not (Section 16 of the Securities Act of 1933).

In general, these rules prohibit trading or the receipt of benefits based on material nonpublic information in violation of a duty of confidence. Under ''classic liability,'' the insider learns material nonpublic information and trades on the basis of that information. ''Tipper liability,'' in contrast, can arise when one has a duty to keep certain material nonpublic information confidential but communicates that information to someone else when it is reasonably likely they will trade on it. Similarly, ''tippee liability'' can arise when one trades on material nonpublic information obtained from someone whom they are aware has a duty to keep that information confidential.

There are many exceptions to these general rules, and exceptions to those exceptions. For instance, merely trading on material nonpublic information is not always a violation of the securities laws. A person overhearing two strangers speaking in public about an impending corporate move may lawfully trade the company's securities based on that information.

But despite a few seemingly obvious black-and-white scenarios, insider trading law exists in shades of gray. And if the regulators believe a set of circumstances might be insider trading, they may launch an expensive and invasive investigation to find out. Thus, the ever-evolving rules, and their application to murky factual scenarios, create pitfalls for the unwary.

Staying Out of Trouble

Whether trading blue-chip stocks or just-issued virtual coins, trading while in receipt of material nonpublic information is risky. Even good-faith transactions may invite regulatory scrutiny.

For example, a jury found Mark Cuban not guilty of trading on inside information after the CEO of Mamma.com gave him information about an impending transaction that would be expected to dampen the stock price. Cuban asserted — and the jury concurred — that he never agreed to keep that information confidential, and thus did not breach any duties of confidentiality. A good result for Cuban — but one that cost him millions of dollars in legal fees to achieve. Most traders (and even firms) do not have Cuban's resources.

With that warning in mind, some basic principles can help traders steer clear of unwanted regulatory attention.

First, don't trade in your own product, unless under careful and particular legal guidance. For instance, if you are a company officer, director, or insider, it is unwise to trade in your own coin offerings, or even to trade in your coins on the secondary market, without first getting legal advice about whether your trading might constitute a ''classical'' insider trading violation.

Second, don't trade on insider tips that are not generally known to the market as a whole. It's not necessarily a violation, but it's dangerous if the information was confidential. If you have heard about an impending move in a particular coin from an insider at the company, ask yourself: Did that insider have a duty to keep that information confidential? If so, why did she tell me? There may well be a duty of confidentiality attached to that information, so trading on that information may invite scrutiny.

Third, if you are involved with a coin, do not tell others about your own product's impending moves. Resist the temptation to give your friends tips about what your company is about to do with its coin; or about forks, splits, infusions to support a coin, major sellouts, or any other information. One insider, a lawyer, was recently convicted for tipping as part of a drunken brag made to a friend over dinner.

Fourth, we are seeing rumors of ''cabals'' buying or selling in unison to move market prices for coins. Even if such groups are not acting on insider information, market manipulation is barred, and engaging in such activity is asking for regulatory trouble.

Fifth and finally, anonymity will not protect you. Most coins can be purchased using cryptocurrency such as Bitcoin, Ethereum, Litecoin, etc., and many of those transactions are theoretically anonymous — tied only to a wallet address, which in turn is tied to a false name. Regulators are savvy to these tricks, and can discover the identities of even the technically savviest of bad actors. And if you intentionally misuse anonymity to violate the law, additional penalties — even criminal ones — may apply. (While nobody should break the law as a general matter, it seems particularly unwise to do so through a mechanism that is specifically designed to create an immutable public record in multiple locations.)

Conclusion

Insider trading law is quite complex, and the overlay of the law on cryptocurrency products trading, much of which is untested and unsettled, only magnifies the complexity. But insider trading enforcement in cryptocurrency product markets is coming. Traders — especially insiders — should be wary and seek counsel. Good legal advice can be pricey. But failing to get advice ahead of a trade, and defending a lawsuit from the SEC or CFTC — or a criminal prosecution by the Department of Justice — can carry a far heavier cost.

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