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# The Best-Laid Plans: Crypto Trading Plans To Limit Insider Trading Liability

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Last year, our firm published a *New York Law Journal* article predicting that regulators, including the U.S. Securities and Exchange Commission (SEC), would soon bring enforcement actions alleging insider trading in digital assets. See N. Heller and S. Enzer, "Crypto Insider Trading: What Exchanges Should Know," *New York Law Journal* (Dec. 6, 2021). That prediction has since come true. In a recent enforcement action accusing a former Coinbase employee and two associates of trading cryptocurrency tokens based on inside information that they allegedly misappropriated from Coinbase, the SEC asserted for the first time that nine of the tokens involved in the charged insider trading scheme were unregistered "securities" and that the scheme therefore constituted securities fraud in violation of SEC Rule 10b-5. See *SEC v. Wahi,* 22 Civ. 01009, Dkt. 1 (Compl.) (W.D. Wa. July 21, 2022).

> Absent a Rule 10b5-1(c) trading plan, holders of founders' tokens who sell their tokens when they possess material nonpublic information risk being accused of insider trading by the SEC, even if their token sales were not motivated by such inside information.

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Falling cryptocurrencies (bitcoins, dogecoins, shiba coins, binance coins and other)

The risk of the SEC designating cryptocurrency tokens as securities after they have been publicly traded, without prior warning to cryptocurrency market participants, can create a significant compliance challenge for many fintech companies.

To illustrate the problem, consider the following hypothetical. Suppose a fintech startup compensated the company's founders with publicly-traded cryptocurrency tokens issued by the company, subject to a lock-up period (frequently called "founders' tokens"). As the end of this period approaches, the company's success raises the market value of the founders' tokens to millions of dollars. As the founders prepare to liquidate their tokens, they learn confidential information from the company's

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general counsel that a digital asset trading exchange is considering de-listing their tokens because of the recent uptick in cryptocurrency enforcement activity by the SEC and concerns that the SEC may claim that the token sales were part of an unregistered securities offering in violation of the Securities Act of 1933. If the founders wish to avoid even the appearance of impropriety, SEC Rule 10b-5's prohibition against trading securities while in possession of material nonpublic information may deter them from selling their tokens, the market value of which may be wiped out if the exchange de-lists their tokens from public trading.

Cryptocurrency token issuers can avoid conundrums like this without having to adopt the SEC's view that founders' tokens are "securities" subject to SEC insider trading rules. SEC Rule 10b5-1(c) provides an affirmative defense to insider trading liability for certain pre-planned securities trades. To avoid difficult choices between abstaining from trading versus the risk of being accused of insider trading, token issuers can offer trading plans for digital assets that comply with Rule 10b5-1(c), while reserving all rights to argue that the assets are not "securities."

We discuss below: (1) potential insider trading penalties that holders of founders' tokens can face if they trade digital assets while they possess material nonpublic information and (2) suggestions for using prophylactic Rule 10b5-1(c) trading plans for digital assets to reduce those holders' potential exposure to such risks.

## Potential Insider Trading Liability for Sales of Founders' Tokens

Absent a Rule 10b5-1(c) trading plan, holders of founders' tokens who sell their tokens when they possess material nonpublic information risk being accused of insider trading by the SEC, even if their token sales were not motivated by such inside information.

> Until new legislation or regulations are passed providing clear guidance in this area, implementing such Rule 10b5-1(c)-complaint trading plans for digital assets can have a variety of potential benefits for cryptocurrency token issuers.

**SEC Insider Trading Rules.** Section 10(b) of the Securities Exchange Act of 1934 (Exchange Act) and SEC Rule 10b-5 thereunder prohibit fraud in connection with the purchase or sale of any "security," including the type of securities fraud known as insider trading. Rule 10b-5 bars corporate insiders and their agents from trading company-issued securities based on material nonpublic information about the company or its securities in breach of a duty of trust or confidence owed to the source of such inside information. See 17 C.F.R. §240.10b5-1(a). The SEC can sue violators of Rule 10b-5 in federal court for financial penalties and other civil remedies. See 15 U.S.C. §§78j(b), 78u(d), 78u-1(a)(2).

By regulatory fiat, the SEC has adopted a rule under which any purchase or sale of securities is deemed to be made "on the basis of" material nonpublic information if the person who caused the trade to be made knew of such inside information at the time of the purchase or sale, regardless of whether the trader actually used any inside information in making the investment decision. See 17 C.F.R. §240.10b5-1(b). The U.S. Court of Appeals for the Second Circuit has adhered to this rule, applying the "knowing possession" standard in insider trading cases. See *United States v. Royer*, 549 F.3d 886, 899 (2d Cir. 2008) (defendants can be convicted of insider trading if they "traded while in 'knowing possession' of nonpublic information material to those trades," even without "proof that the defendants 'used' such information in making the trades") (citing *United States v. Teicher*, 987 F.2d 112, 119-21 (2d Cir. 1993)).

SEC Rule 10b5-1(c) provides an exception to that rule for certain pre-planned trades. See 17 C.F.R. §§240.10b5-1(b)-(c). Specifically, Rule 10b5-1(c) provides an affirmative defense to insider trading liability for trades made pursuant to a trading plan that was established before the trader learned of material nonpublic information, even if the trader possessed inside information at the time of the trades. See id. To invoke this affirmative defense under current law, the trader must demonstrate that: (1) the trader made the trading plan before learning of material nonpublic information; (2) the plan specified the amount, price, and date of the planned trades or a written formula, algorithm, or computer program for determining them; (3) the trades were made pursuant to the plan; (4) the trader did not exercise any subsequent influence over how, when, or whether to make the trades; and (5) the trader entered the plan in good faith and not as part of a scheme to evade Rule 10b-5's prohibition against insider trading. See 17 C.F.R. §240.10b5-1(c).

In January 2022, the SEC proposed amendments to Rule 10b5-1(c) that would impose additional requirements to invoke this affirmative defense, including a cooling-off period, certain certification requirements, a bar on overlapping Rule 10b5-1(c) trading plans, and new corporate disclosure requirements. See Cahill Memorandum, "SEC Proposes Amendments Relating to Rule 10b5-1 Trading Plans and Related Disclosures" (Feb. 25, 2022). The SEC is currently targeting April 2023 for final adoption of the proposed amendments. See Executive Office of the President, Office of Management and Budget, Office of Information and Regulatory Affairs, "Rule 10b5-1 and Insider Trading," RIN 3235-AM86 (2022).

**SEC Jurisdiction Over Founders' Tokens.** The SEC has jurisdiction to enforce Rule 10b-5 against anyone engaged in insider trading in digital assets—including founders' tokens—if the assets qualify as "securities" under the Exchange Act. As noted above, the SEC recently brought its first enforcement action alleging violations of Rule 10b-5's insider trading prohibition based on trading in cryptocurrency tokens that the SEC alleges qualify as "securities." See *SEC v. Wahi*. While the SEC indisputably must establish that the assets were securities to establish a Rule 10b-5 violation, the SEC arguably need not prove that the violator knew or believed that the assets would qualify as securities. See, e.g., *United States v. Brown*, 578 F.2d 1280, 1284 (9th Cir. 1978) ("[T]he government is required to prove specific intent only as it relates to the action constituting the fraudulent, misleading or deceitful conduct, but not as to the knowledge that the instrument used is a security.").

In enforcement actions involving cryptocurrency assets, the SEC typically relies on allegations that the assets were part of an offering that qualifies as an "investment contract" (15 U.S.C. §78c(a)(10)), which is a type of "security" recognized by the Exchange Act (id.). See, e.g., *SEC v. Sharma*, 18 Cr. 340 (LGS), Dkt. 1 (Compl.) (S.D.N.Y. April 2, 2018). In *SEC v. W.J. Howey Co.*, 328 U.S. 293 (1946), the U.S. Supreme Court held that an "investment contract" is any contract, transaction, or scheme "whereby a person invests his money in a common enterprise and is led to expect profits solely from the efforts of a promoter or a third party." Id. at 298-99.

The SEC has offered generalized guidance on the factors it considers in determining whether a particular digital asset qualifies as an "investment contract" under *Howey* and therefore is a "security." See, e.g., SEC Corporation Finance Director William Hinman, Remarks at the Yahoo Finance All Markets Summit (June 14, 2018). A variety of stakeholders have called upon the SEC to propose new rules providing more useful ex ante guidance on which specific cryptocurrency tokens qualify as "securities." See, e.g., P. Grewal, Petition to the SEC for Rulemaking on Digital Asset Securities Regulation (July

21, 2022); Statement of CFTC Commissioner C. Pham on *SEC v. Wahi* (July 21, 2022). The SEC has thus far declined to do so, instead alleging for the first time in the context of enforcement actions—brought after particular tokens have been publicly traded—that they are unregistered securities. See, e.g., *SEC v. Ripple Labs*, 20 Civ. 10832 (ALT), Dkt. 4 (Compl.) (S.D.N.Y. Dec. 22, 2020).

### Prophylactic Trading Plans for Digital Assets To Limit Insider Trading Liability

To free recipients of founders' tokens from concerns about accusations of insider trading, token issuers can offer them trading plans for digital assets that comply with Rule 10b5-1(c), while reserving all rights to argue that the assets are not "securities." For example, token issuers can:

- inform founders of the potential benefits of adopting a Rule 10b5-1(c) trading plan for cryptocurrency assets and provide a pre-approved form plan that complies with the rule;
- include disclaimer language in the form that the plan is being entered into without prejudice to arguments that the assets covered by the plan are not securities;
- require company approval of any Rule 10b5-1(c) plans for cryptocurrency tokens and permit such plans to be established only during an open trading window in which the company does not possess material nonpublic information about the tokens;
- impose a cooling-off period between the establishment of each plan and the date of the first trade under the plan;
- require founders to provide the company with a written certification when their plans are adopted, in which they represent that they are adopting their plans in good faith and are not aware of material nonpublic information;
- prohibit founders from adopting multiple overlapping Rule 10b5-1 plans covering the same class or type of tokens;
- consider requiring all founders to use a pre-selected digital asset trading exchange to trade tokens covered by their plans, and work with that exchange to establish trading accounts that will execute trades for them in accordance with their respective plans;
- disallow any modification, termination, or suspension of plans other than during open trading windows and require a cooling-off period;
- adopt insider trading policies with clear open trading windows to ensure compliance with law and those policies and the terms of the plan; and
- consider conforming any plan to the requirements of the recently-proposed amendments to Rule 10b5-1(c) not already covered above, such as those imposing new corporate disclosure requirements.

Until new legislation or regulations are passed providing clear guidance in this area, implementing such Rule 10b5-1(c)-complaint trading plans for digital assets can have a variety of potential benefits for cryptocurrency token issuers, including (1) building the trust of token purchasers that the issuers' founders will not exploit their companies' secrets for insider trading gains, and (2) reducing the risk of founders being accused of insider trading for liquidating founders' tokens when they may possess material nonpublic information.