SheppardMullin

# NFT Insider Trading –

## Can There Be A Crime If It's Not A Security?

By: James Gatto

We have previously addressed the recent indictment against Nathaniel Chastain, a former executive of a major NFT marketplace, for insider trading involving NFTs. The indictment charges Chastain with one count of wire fraud and one count of money laundering. It does not allege that the NFT is a security. It does not allege violation of the insider trading laws under securities law. Since then, as we have reported, that SEC has been investigating lack of insider trading policies for NFT/crypto exchanges.

All of this has lead many people to ask whether these charges can stick if the NFT is not a security. It is likely Chastain will at least try to argue this. But will he prevail?

One of the cases that will be addressed in the Chastain case is the 1987 Supreme Court case *Carpenter v. United States*. While this case was based on insider trading of securities, it also contained a mail and wire fraud charge as well. The analysis of the mail and wire fraud in that case likley will be relevant in the Chastain case.

**Chastain Facts**

In the Chastain case, the charges are based on the following allegations:

- In violation of the duties of trust and confidence he owed to his employer, Chastain exploited his advanced knowledge of what NFTs would be featured on the marketplace's homepage for his personal financial gain
- As part of his employment, Chastain was responsible for selecting NFTs to be featured on the homepage and the company kept confidential the identity of featured NFTs until they appeared on its homepage. After an NFT was featured on the homepage, the price buyers were willing to pay for that NFT, and for other NFTs made by the same NFT creator, typically increased substantially
- From about June 2021 to at least in or about September 2021, Chastain used this confidential business information about what NFTs were going to be featured on its homepage to secretly purchase dozens of NFTs shortly before they were featured. After those NFTs were featured, Chastain sold them at profits of two to five times his initial purchase price. To conceal the fraud, Chastain conducted these purchases and sales using anonymous digital currency wallets and anonymous accounts

**Carpenter Facts**

In *Carpenter*, Foster Winans wrote a column for the Wall Street Journal (WSJ) entitled Heard on the Street (Heard) in which he reported on up-and-coming stocks. In 1983, Winans entered into a scheme that entailed him sending information about the stocks to be featured in Heard to two friends who worked at a brokerage firm. When Heard

featured a stock, it generally affected the actual price and quantity of the stock in the market. Over a four-month period, the brokers used Winans' information regarding stocks yet to be featured in Heard to make trades that resulted in profits of around $690,000. When the Securities and Exchange Commission (SEC) began an investigation, Winans and his co-conspirator Carpenter confessed.

**Carpenter Decisions – Lower Courts**

The district court found that Winans had breached the duty of confidentiality he owed the WSJ and found him and his co-conspirators guilty of mail and wire fraud as well as securities violations. The petitioners appealed and argued that, because the WSJ—the only alleged victim of the mail and wire fraud charges—had no interest in the stocks being traded, the conviction should be overturned. The U.S. Court of Appeals for the Second Circuit held that the petitioners' misappropriation of the upcoming publication schedule was sufficient to establish a case for mail and wire fraud. The Circuit court reasoned that the use of mail and wire services had a sufficient nexus to Winans' knowing breach of his duty of confidentiality he owed the WSJ and that this breach harmed the WSJ.

**Carpenter Supreme Court Decision**

The case made its way to the Supreme Court, which addressed two questions:

1. Can the petitioners be found guilty of securities crimes against the Wall Street Journal even though the Wall Street Journal had no interest in the securities traded?
2. Did the petitioners use mail and wire services as an essential part of their scheme to defraud the Wall Street Journal of its property?

The Supreme Court affirmed the convictions for securities crimes (albeit with a divided court) and held that Petitioners' conspiracy to trade on the Journal's confidential information is within the reach of the mail and wire fraud statutes.

According to the Court, the Journal had a "property" right in keeping confidential and making exclusive use, prior to publication, of the schedule and contents of Winans' columns which right is protected by the statutes. The Court found that Petitioners' activities constituted a scheme to defraud the Journal within the meaning of the statutes. It concluded that it was irrelevant that petitioners might not have interfered with the Journal's use of its confidential information, publicized the information, deprived the Journal of the first public use of the information, or caused the Journal monetary loss. Rather, the Court found it sufficient that the Journal had been deprived of its important right to *exclusive use* of the information prior to disclosing it to the public.

The Court found untenable Winans' argument that his conduct merely violated workplace rules and did not amount to proscribed fraudulent activity, noting that the mail and wire fraud statutes reach any scheme to deprive another of property by means of fraud, including the fraudulent appropriation to one's own use of property entrusted to one's care by another. The Court found that Winans violated his fiduciary obligation to protect his employer's confidential information by exploiting that information for his personal benefit, while pretending to perform his duty of safeguarding it. The Court also found that each of the petitioners acted with the required specific intent to defraud.

With respect to wire fraud, the Court rejected Petitioners' contention that the use of the wires and the mail to print and send the Journal to its customers is insufficient to satisfy the statutory requirement that the mails be used to execute the scheme. It noted that circulation of the column to Journal customers was not only anticipated but was an essential part of the scheme, since there would have been no effect on stock prices and no likelihood of profiting from the leaked information without such circulation.

**Relevance of Carpenter to Chastain Case**

So what does this mean for Nathaniel Chastain? Certainly there are some parallels between the facts of his case and those of the *Carpenter* case. But there are differences as well. *Carpenter* was an insider trading case based on the purchase and sale of securities. Chastain bought NFTs, which have not been alleged to be securities. He has not been charged with insider trading of securities. However, the Courts finding on the wire fraud charge in *Carpenter* will likely have a bearing on the Chastain case.

A finding of wire fraud requires that four elements be satisfied:

- The defendant created or participated in a scheme to defraud another out of money or property
- The defendant did so with the intent to defraud
- It was reasonably foreseeable that the defendant would use wire communications
- The defendant did, in fact, use interstate wire communications

One of the most interesting questions, which relates to the first element, is whether Chastain defrauded his employer out of money or property by buying NFTs from others?

In *Carpenter*, the petitioners alleged that their activities were not a scheme to defraud the Journal within the meaning of the wire fraud statutes because they did not obtain any "money or property" from the Journal. The *Court* rejected this argument, stating that the object of the scheme was to take the Journal's confidential business information - the publication schedule and contents of the "Heard" column - and its intangible nature does not make it any less "property" protected by the wire fraud statutes. "Confidential information acquired or compiled by a corporation in the course and conduct of its business is a species of property to which the corporation has the exclusive right and benefit, and which a court of equity will protect through the injunctive process or other appropriate remedy." The Journal had a property right in keeping confidential and making exclusive use, prior to publication, of the schedule and contents of the "Heard" column. It further noted that the concept of "fraud" includes the act of embezzlement, which is "`the fraudulent appropriation to one's own use of the money or goods entrusted to one's care by another.'"

Whether Chastain had the requisite intent to defraud is a fact question to be addressed.

With respect to the use of wire communications, Carpenter was unsuccessful in arguing that the use of the wires and the mail to print and send the Journal to its customers is insufficient to satisfy the statutory requirement that the mails be used to execute the scheme. It noted that circulation of the column to Journal customers was not only anticipated but was an essential part of the scheme, since there would have been no effect on stock prices and no likelihood of profiting from the leaked information without such circulation.

With Chastain, a question will be whether this rationale will apply to his use of blockchain and digital currency wallets (e.g., was it an essential part of the scheme).

**Conclusion**

We have only seen the tip of the iceberg in the Chastain case. We have not heard his side of the story yet. This will be a closely watched case. Regardless of how the facts unfold for him, the bigger picture is that suspect behavior, whether illegal or not, can lead to a variety of problems. We continue to encourage NFT marketplaces and other players in the NFT ecosystem to consider developing insider trading policies to minimize the likelihood of these or other issues. See our post on NFT Insider Trading Compliance Policies – What They Cover and Why You Need One for more information.

## For further details, please contact:

**James Gatto** | Washington, D.C.
*Leader, Blockchain and Fintech Team*
202.747.1945
jgatto@sheppardmullin.com

Sheppard Mullin's Blockchain Technology and Fintech team helps clients develop innovative and comprehensive legal strategies to take advantage of what may be the most disruptive and transformative technology since the Internet. We focus on advising clients on how to meet their business objectives, without incurring unnecessary legal risk. Our team includes attorneys with diverse legal backgrounds who collectively understand the vast array of legal issues with and ramifications of blockchain technology, NFTs and metaverses.

*This alert is provided for information purposes only and does not constitute legal advice and is not intended to form an attorney client relationship. Please contact your Sheppard Mullin attorney contact for additional information.*