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DOJ Charges Wire Fraud (Read, Insider Trading) in NFTs

By Kit Addleman, Vicki Odette, Shelley Rosensweig and Stuart Slayton

Summer associates Austria Arnold and Erin Parker contributed to this article

In a recently unsealed indictment, the Department of Justice ("***DOJ***") charged Nathaniel Chastain with wire fraud and money laundering[1] in a scheme that has been billed as "insider trading."[2] Chastain was previously a product manager tasked with selecting non-fungible tokens ("***NFTs***") to be displayed on the homepage of OpenSea, one of the largest and most popular NFT marketplaces.[3] At the time of this alleged scheme, OpenSea had a confidentiality policy in place that prohibited using OpenSea's confidential business information except to perform work for OpenSea; Chastain signed an agreement acknowledging this duty of confidence when he joined OpenSea. The DOJ alleges that from approximately June 2021 to September 2021, Chastain "misappropriated OpenSea's confidential business information" regarding which NFTs would be featured on its homepage.[4] According to the indictment, Chastain used this confidential information to purchase dozens of NFTs prior to their homepage debuts and subsequently sold them after they were featured, resulting in a return to Chastain anywhere between two to five times his purchase price.[5] To conceal the operation, the DOJ contends that Chastain used anonymous Ethereum wallets and OpenSea accounts rather than those publicly held in his name.[6] Nonetheless, a Twitter user uncovered Chastain's ownership of some of the Ethereum

1. Indictment ¶¶ 13, 15, United States v. Nathaniel Chastain, 22 CR 305 (S.D.N.Y May 31, 2022) [hereinafter Indictment].

2. *See, e.g.*, Press Release, The United States Attorney's Office for the Southern District of New York, Former Employee Of NFT Marketplace Charged In First Ever Digital Asset Insider Trading Scheme (June 1, 2022); Elise Hansen, *Feds Charge Ex-OpenSea Worker With Insider Trading Of NFTs*, Law360 (June 1, 2022), https://www.law360.com/articles/1498750/feds-charge-ex-opensea-worker-with-insider-trading-of-nfts.

3. *Indictment*, at ¶¶ 1–2.

4. *See id.*

5. *See id.*

6. *See id.*

wallets buying NFTs before they landed on OpenSea's homepage. This discovery led OpenSea to request Chastain's resignation, and ultimately, to his indictment.[7]

1. WHAT IS AN NFT?

An NFT is a digital asset that exists and lives on a blockchain, which, broadly described, is a digital, decentralized ledger that stores information and whose accuracy is verified by the combined computing power of its users rather than a single intermediary.[8] NFTs are often associated with a digital object that provides proof of the digital object's ownership and a license to use the object for all or some purposes. NFTs have recently gained prominence as an avenue for buying and selling digital artwork, among other uses, and some NFTs sell for millions of dollars.[9] An NFT's ownership and rights are automatically verified and enforced by the NFT's code on the blockchain.[10] The Ethereum blockchain is the most popular chain for creating—or "minting"—NFTs, in part because the Ethereum blockchain enables "smart contracts." Generally, a smart contract is a computer program that automatically executes certain actions according to predetermined terms. For example, a smart contract could allow an NFT creator to retain his rights to revenue or royalties with respect to future sales or uses of an NFT, for example.

2. WHAT IS "INSIDER TRADING"?

While Chastain's alleged wrongdoing is rightly called "insider trading," Chastain was not charged as most insider-trading-defendants are. As is typically prosecuted, insider trading is prohibited under the Securities Exchange Act of 1934 (the "***Exchange Act***") as a "device, scheme or artifice to defraud . . . in connection with the purchase or sale of any security."[11]

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7. *Sarah Cascone, A Former OpenSea Employee Has Been Indicted in the First-Ever Case of NFT Insider Trading*, Artnet News (June 6, 2022), https://news.artnet.com/art-world/opensea-employee-indicted-nft-insider-trading-2124729.

8. Robyn Conti & John Schmidt, *What is an NFT? Non-Fungible Tokens Explained*, Forbes (Apr. 8, 2022), https://www.forbes.com/advisor/investing/cryptocurrency/nft-non-fungible-token/.

9. *Id.*

10. *Id.*

11. Rule 10b-5, codified at 17 C.F.R. § 240.10b-5. The crime "is generally not prosecutable absent a violation of Rule 10b-5." *Lustbader, infra* note 13, at 1834. One commentator has suggested that insider trading should be prosecuted as embezzlement. *Lustbader, infra note*

Insider trading is more a colloquial term referenced in court decisions, and it is not *specifically* defined or prohibited by any federal law, despite several Congressional proposals to do so.[12] Instead, insider trading is "by historical accident, a creature of the securities laws."[13]

Under the Exchange Act, there are several theories of insider trading, and Chastain is accused of conduct most resembling the "misappropriation theory." Under this theory, if a person possesses "material nonpublic information" ("***MNPI***") and owes the source of the MNPI a duty of trust and confidence, then the person is generally prohibited from using that MNPI to trade securities for personal gain.[14] If a person exploits MNPI in this way, the misappropriation theory holds that the person has "defrauded" the source under the Exchange Act.[15]

A. Chastain's "Insider Trading" of Certain NFTs

In what appears to be a classic example of the misappropriation theory in action, Chastain is accused of embezzling OpenSea's confidential business information regarding which NFTs would be featured on its homepage, one of Chastain's job responsibilities. With the benefit of

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13 (discussing how prosecuting insider trading under Title 18 "is more coherent and deeply rooted in longstanding legal norms" *Id.* at 1835).

12. *See* Preet Bharara, Joon H. Kim, John C. Coffee, Jr., Katherine R. Goldstein, Joseph A. Grundfest, Melinda Haag, Joan E. McKown & Jed S. Rakoff, Report of the Bharara Task Force On Insider Trading 9–13 (Jan. 2020), https://www.bhararataskforce.com/.

13. Zachary J. Lustbader, *Title 18 Insider Trading,* 130 Yale L.J. 1828, 1832 (2021). Insider trading cases are charged under Section 10(b) of the Exchange Act as a type of "manipulative and deceptive device." *See* 15 U.S.C. § 78j; 17 C.F.R. § 240.10b5–2; *see also* Matt Levine, *Don't Insider Trade NFTs*, Bloomberg (June 2, 2022), https://www.bloomberg.com/opinion/articles/2022-06-02/don-t-insider-trade-nfts.

14. United States v. O'Hagan, 521 U.S. 642, 652 (1997) ("The 'misappropriation theory' holds that a person commits fraud "in connection with" a securities transaction, and thereby violates § 10(b) and Rule 10b–5, when he misappropriates confidential information for securities trading purposes, in breach of a duty owed to the source of the information. Under this theory, a fiduciary's undisclosed, self-serving use of a principal's information to purchase or sell securities, in breach of a duty of loyalty and confidentiality, defrauds the principal of the exclusive use of that information."); *see also* 17 C.F.R. § 240.10b5-2.

15. *O'Hagan*, 521 U.S. at 652.

the pilfered particulars, Chastain timed his trades of those NFTs for his personal gain, thereby breaching his agreement to use that information only for OpenSea's benefit. But in spite of the similarities to the misappropriation theory, the DOJ did not charge Chastain with defrauding OpenSea under the Exchange Act, leaving one to question the non-inclusion.[16] The explanation resides in the Exchange Act's requirement that the fraudulent scheme be connected to the transaction of "any *security*."

1. The SEC's Digital Asset Guidance and "Any Security"

In the Exchange Act, Congress was notoriously long-winded in defining what a security is,[17] and the Supreme Court has said that whether something is a security depends not only on the form and terms of the instrument, but also on the circumstances surrounding it.[18] Determining whether some *thing* is a security is a factually intensive question, thus it was not immediately clear whether the digital assets that began springing up over a decade ago were securities. In response, the SEC published guidance on how to determine whether a particular digital asset, like an NFT, is a security under federal law.[19] In that guidance, the

16. *See* Matt Levine, *Don't Insider Trade NFTs*, Bloomberg (June 2, 2022), https://www.bloomberg.com/opinion/ articles/2022-06-02/don-t-insider-trade-nfts.

17. *See* 15 U.S.C.A. § 78 ("The term 'security' means any note, stock, treasury stock, security future, security-based swap, bond, debenture, certificate of interest or participation in any profit-sharing agreement or in any oil, gas, or other mineral royalty or lease, any collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, any put, call, straddle, option, or privilege on any security, certificate of deposit, or group or index of securities (including any interest therein or based on the value thereof), or any put, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency, or in general, any instrument commonly known as a "security"; or any certificate of interest or participation in, temporary or interim certificate for, receipt for, or warrant or right to subscribe to or purchase, any of the foregoing; but shall not include currency or any note, draft, bill of exchange, or banker's acceptance which has a maturity at the time of issuance of not exceeding nine months, exclusive of days of grace, or any renewal thereof the maturity of which is likewise limited.").

18. *See* U.S. Sec. & Exch. Comm'n v. W. J. Howey Co., 328 U.S. 293, 299 (1946).

19. U.S. Sec. & Exch. Comm'n, *Framework for "Investment Contract" Analysis of Digital Assets*, (Apr. 3, 2019) [hereinafter *SEC Guidance*], https://www.sec.gov/corpfin/framework-investment-contract-analysis-digital-assets.

SEC applies the *Howey*[20] test to determine whether a digital asset is an "investment contract," a type of security under the Exchange Act.[21] Under *Howey*, an "investment contract," and hence a security, exists when there is: (i) an investment of money; (ii) in a common enterprise; (iii) with a reasonable expectation of profits to be derived from the efforts of others. Under this test, the SEC has stated that some digital assets, like Bitcoin or Ethereum, are not securities, while other digital assets, like many coins in initial coin offerings, satisfy *Howey*'s tripartite test.[22]

According to the *Howey* test and the SEC's guidance, some NFTs may be considered an "investment contract,"—and hence a "security" under federal law. In Chastain's indictment, the DOJ entirely avoided the question of whether the NFTs Chastain traded are in fact securities under the Exchange Act. Rather than charging Chastain with violating the Exchange Act, the DOJ instead charged Chastain with wire fraud[23] and money laundering,[24] notwithstanding Chastain's purported conduct having many of the hallmarks of the misappropriation theory.

2. "Insider Trading" Outside the Exchange Act

The DOJ's use of the mail and wire fraud statutes to prosecute "insider trading" is certainly not without precedent.[25] In a strikingly similar set of circumstances, the Supreme Court in

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20. *See id.* at 293; *see also* United Housing Found., Inc. v. Forman, 421 U.S. 837 (1975); Tcherepnin v. Knight, 389 U.S. 332 (1967); U.S. Sec. & Exch. Comm'n v. C. M. Joiner Leasing Corp., 320 U.S. 344 (1943).

21. *See* 15 U.S.C.A. § 78.

22. *See* William Hinman, then-Director, Div. of Corp. Fin., U.S. Sec. & Exch. Comm'n, Remarks at the Yahoo Finance All Markets Summit: Crypto, *Digital Asset Transactions: When Howey Met Gary (Plastic)* (June 14, 2018), https://www.sec.gov/news/speech/speech-hinman-061418 ("And so, when I look at Bitcoin today, I do not see a central third party whose efforts are a key determining factor in the enterprise."); Complaint for Plaintiff at ¶ 194, U.S. Sec. & Exch. Comm'n v. Kik Interactive Inc., No. 1:2019-cv-05244 (S.D.N.Y 2019) (charging a company with the unregistered sale of securities through the company's initial coin offering).

23. *Indictment* ¶ 13; *see also* 18 U.S.C. § 1343.

24. *Indictment* ¶ 15; *see also* 18 U.S.C. § 1956(a)(1)(B)(i).

25. *See* William K.S. Wang, *Application of the Federal Mail and Wire Fraud Statutes to Criminal Liability for Stock Market Insider Trading and Tipping*, 70 U. Miami L. Rev. 220 (2015).

Carpenter upheld R. Foster Winans' mail fraud, wire fraud, and Exchange Act convictions.[26] There, Winans purchased securities that he recommended in his daily *Wall Street Journal* column prior to its publication, and after it was published, he sold those securities, profiting from the increased demand sparked by his column's recommendations.[27] On the mail and wire fraud counts, the Court saw Winans' use of the *Journal*'s property—its confidential business information on the column's contents prior to publication—for his own benefit as an embezzlement prohibited by the mail and wire fraud statutes. Because Winans purchased publicly traded stocks, Winans' fraud was considered "in connection with a purchase or sale of securities," and his conviction under the Exchange Act was consequently upheld.[28] With respect to Winans' conviction under the Exchange Act, the clear difference between Chastain's and Winans' schemes is the presence of a *thing* specifically enumerated as a "security" under the Exchange Act: Winans traded public stocks, definitionally a security under the Exchange Act; Chastain traded NFTs, which have not been added to the definition.[29]

B. Applying *Howey*—Could Some of the NFTs Chastain Traded be Securities?

In contrast, it is not obvious that Chastain's NFT trades were "in connection with the purchase or sale of any security." So far, the DOJ has not advanced an argument that they were. As has been demonstrated repeatedly in prior criminal cases, the DOJ can punish the alleged wrongful trading without implicating the Exchange Act, and the DOJ may wish to avoid abrogating the SEC's prerogative in evaluating whether NFTs are securities under federal securities laws.

But the more interesting question is whether Chastain's alleged conduct is *legally sufficient* to support a charge under the Exchange Act. To answer this question, one must first answer whether the NFTs in question are in fact securities. To take one of the NFTs referenced in the indictment as an example, *The Brawl 2* is digital artwork whose ownership and existence are

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26. 484 U.S. 19 (1987); *see also* Chiarella v. United States, 445 U.S. 222 (1980).

27. *Id.* at 23.

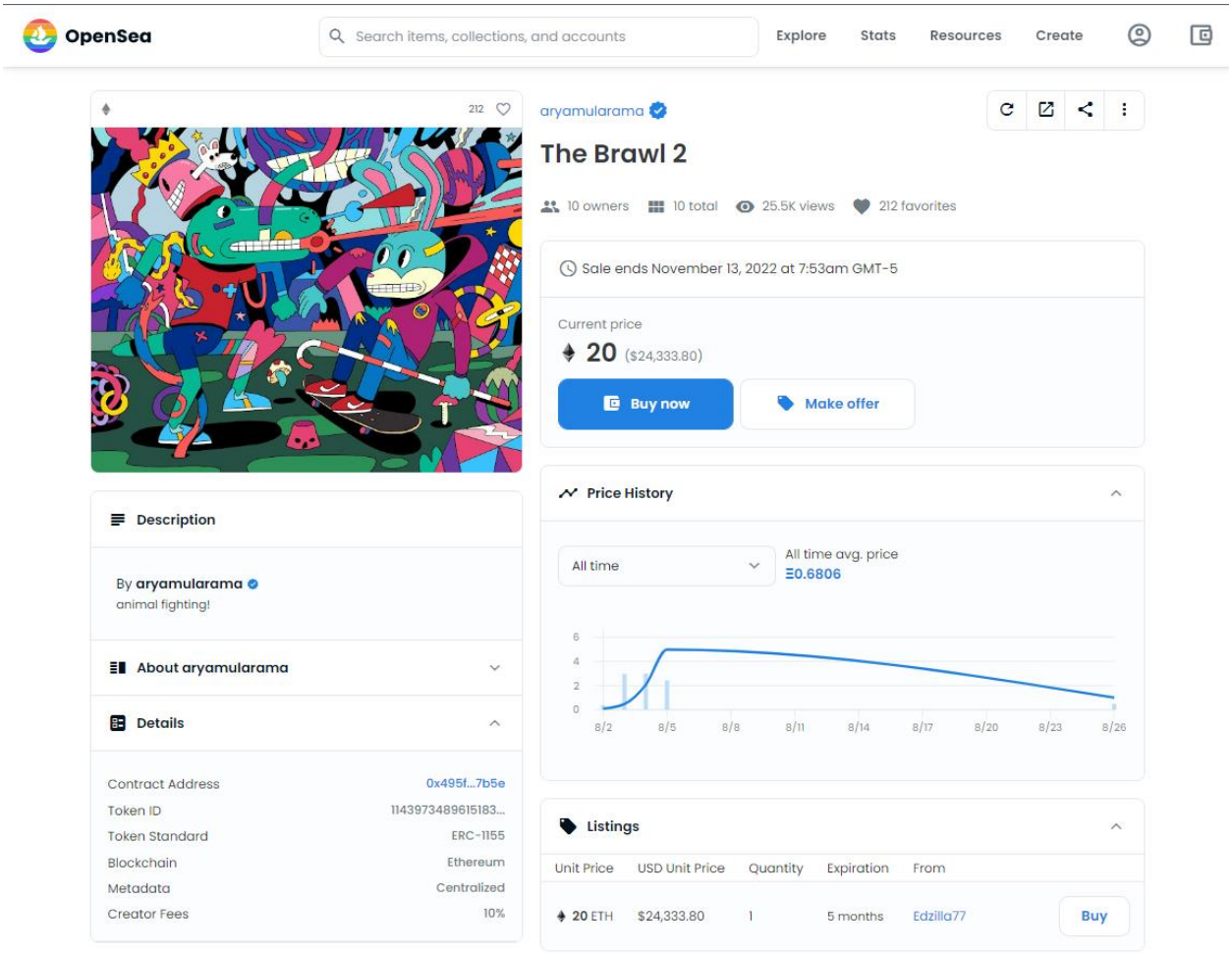
28. Controversially, Winans' conviction under the Exchange Act was upheld because the Supreme Court was evenly divided on the issue, *id.* at 24., but the question was later decided through the Court's approval of the misappropriation theory in *O'Hagan*. 521 U.S. at 654.

29. *See* 15 U.S.C. § 78c(a)(10)–(11).

found on the Ethereum blockchain.[30] At first blush, art is not often thought of as a security but that passing impression may not give the consideration due under *Howey*, with respect to NFTs or otherwise.[31] Under *Howey*, art could be considered a security if its purchase is (i) an investment of money; (ii) in a common enterprise; (iii) with a reasonable expectation of profits to be derived from the efforts of others.

30. Arya *Mularama, The Brawl* 2, (Aug. 2021), https://opensea.io/assets/ethereum/0x495f947276749ce646f68ac8c248420045cb7b5e/114397348961518322921608574946167637566822641286206938679228262868342318039050; *Indictment* ¶ 10.a.

31. *See generally* Maureen Holm, Comment, *The Art Investment Contract: Application of Securities Law to Art Purchases*, 9 Fordham Urb. L.J. 385 (1981); *see also*, e.g., Robert Frank, *Yieldstreet launches fund for smaller investors to bet on art*, CNBC (Nov. 12, 2021), https://cnb.cx/30fLfCb; Stephan Rabimov, *Creative Capital Formula: How Art & Science Are Driving Millennial Investment,* Forbes (Nov. 8, 2021), https://www.forbes.com/sites/stephanrabimov/2021/11/08/creative-capital-formula-how-art--science-are-driving-millennial-investment/?sh=15b3010b6623.



1. Investment of Money

Applying the SEC's guidance and the *Howey* test to *The Brawl 2*, the first question is whether "an investment of money" has occurred. When a purchaser of *The Brawl 2* exchanges anything of value, in this case Ethereum, "an investment of money" has occurred, meeting the first prong.[32]

32. Uselton v. Comm. Lovelace Motor Freight, Inc., 940 F.2d 564, 574 (10th Cir. 1991) ("[I]n spite of *Howey's* reference to an 'investment of money,' it is well established that cash is not the only form of contribution or investment that will create an investment contract."); *see also*

2. In a Common Enterprise

Turning to the second, for a common enterprise to exist under *Howey*, courts typically look for horizontal or vertical commonality, with the circuits split as to which test is appropriate.[33] In the former, investors must pool together their funds in the enterprise, and the investors' fortunes rise and fall in lock-step with the enterprise, for example through the *pro rata* distribution of the enterprise's profits.[34] To find vertical commonality, on the other hand, the investors' returns are not tied together but instead are linked to a promoter's expertise.[35] Apparently, *The Brawl 2* is not sold to multiple purchasers who each have a fractional interest in the same NFT, without which there cannot be horizontal commonality.[36]

In purchasing *The Brawl 2*, the purchaser could have vertical commonality with OpenSea or the NFT creator and reasonably expect either of them to promote the piece's value after the purchaser acquires it. OpenSea receives a percentage-based transaction fee for every NFT sold on its platform,[37] and the creator of *The Brawl 2* receives a portion of any subsequent sales of the NFT.[38] This sharing of the economics could be the hook for the purchaser to think that OpenSea *would* promote *The Brawl 2*. According to the SEC's guidance,

> Purchasers would reasonably expect [a third party] to undertake efforts to promote its own interests and enhance the value of the network or digital asset, such as where: [a third party] has the ability to realize capital appreciation from

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Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934: The DAO, Exchange Act Release No. 81,207, 2017 WL 7184670 (July 25, 2017).

33. *See* Revak v. SEC Realty Corp., 18 F.3d. 81, 87–88 (2d Cir. 1994).

34. Hart v. Pulte Homes of Michigan Corp., 735 F.2d 1001, 1004 (6th Cir. 1984).

35. Matter of Living Benefits Asset Mgmt., L.L.C., 916 F.3d 528, 536 (5th Cir. 2019).

36. There are ten copies of *The Brawl 2*, but copies are different than splitting the same NFT. *See supra* note 30.

37. OpenSea, *What are Service and Creator Fees?,* https://support.opensea.io/hc/en-us/articles/1500011590241-What-are-Service-and-Creator-fees- ("OpenSea's model is simple - we take 2.5% of every transaction involving an NFT a user chooses to list using OpenSea.").

38. *See supra* note 30 (under the "Details" section of the NFT, the "Creator Fees" are 10%). "Creator Fees" give NFT creators a share of the revenue of every sale of the NFT. *Supra* note 37.

> the value of the digital asset. This can be demonstrated, for example, if [a third party] retains a stake or interest in the digital asset. In these instances, purchasers would reasonably expect [a third party] to undertake efforts to promote its own interests and enhance the value of the network or digital asset.[39]

In other words, because OpenSea and the creator receive a financial payout that is directly linked to the value of *The Brawl 2*, the purchaser may have vertical commonality with OpenSea, the creator, or both. Moreover, courts are guided by the "economic inducements held out to the [investor]" in determining whether an asset is an investment contract,[40] and the substantial increase in value in NFTs may have driven the purchaser, expecting a return on the investment, to purchase *The Brawl 2*. Taken together, it is possible these facts could result in the finding of a common enterprise under *Howey*, which the SEC has stated "typically exists" in the context of digital assets.[41]

3. With a Reasonable Expectation of Profits to be Derived from the Efforts of Others

Regarding *Howey*'s third prong, whether a purchaser of *The Brawl 2* could have a reasonable expectation of profits to be derived from the efforts of others, the prong contains two parts, profits and the efforts of others to increase those profits. Here, "the critical inquiry is whether the efforts made by those other than the investor are the undeniably significant ones, those essential managerial efforts which affect the failure or success of the enterprise."[42] While mere price appreciation from external market forces are not "profits" under *Howey*,[43] the fact that *The Brawl 2* is freely transferable and tradable on OpenSea's platform, and the purchaser could reasonably expect OpenSea's efforts in improving its platform could affect the NFT's value seems more than enough to give rise to "profits" under *Howey*. With respect to "the efforts of others," "the second and third prongs of the Howey test may . . . overlap to a

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39. *SEC Guidance*, at ¶ II.C.1.

40. *Joiner Leasing Corp*., 320 U.S at 352–53.

41. *SEC Guidance*, at ¶ II.B.

42. U.S. Sec. & Exch. Comm'n v. Koscot Interplanetary, Inc., 497 F.2d 473, 483 (5th Cir. 1974).

43. *SEC Guidance*, at ¶ II.C.2. ("Price appreciation resulting solely from external market forces . . . impacting the supply and demand for an underlying asset generally is not considered 'profit' under the Howey test.").

significant degree" in cases where a common enterprise is found on the basis of vertical commonality.[44] If a common enterprise is found in the case of *The Brawl 2*, then the purchaser may reasonably expect his profits to be derived from the efforts of OpenSea.

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It would then seem that there is an argument that *The Brawl 2* could be a security, depending on the circuit in which the case is heard, but the analysis is far from certain. To date, no court has issued a final ruling deciding whether NFTs like *The Brawl 2* are securities under federal law. A pending class action in the Southern District of New York may issue one of the first rulings applying the above analysis to NFTs.[45] The DOJ most likely saw the risk of trudging through this analysis and distracting the jurors from the import of Chastain's alleged actions as too great. As a result, further guidance on how NFTs fit within federal securities laws may come another day.

Until then, the *Howey* analysis for some NFTs is clearer, even if only comparatively. NFTs are a new technological form of an old concept—the verified ownership of property and the rights associated to that property. Because NFTs are often minted on blockchains supporting "smart contracts," those chains allow NFTs to be minted with various financial structures that are more directly tied to the definition of "security" under federal law. For example, some NFTs are "fractionalized," where slivers of a single asset are available for purchase, such that many people collectively own the asset. As SEC Commissioner Hester Peirce has suggested, these NFTs are closer to being securities.[46] In other cases, an NFT creator could receive a percentage of subsequent sales of the created NFT in perpetuity, and the artist could then sell her rights to that revenue stream (with such rights being digitally represented in the minted block, and thus, part of that NFT). In each of these examples, the fractionalized NFTs or the rights to revenue, the splitting of the economic interests is more similar to a security than straightforward purchase of the entire NFT, as in the Chastain case.

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44. Long v. Shultz Cattle Co., 881 F.2d 129, 141 (5th Cir. 1989)

45. Friel v. Dapper Labs, Inc., 1:21-CV-05837 (S.D.N.Y 2021).

46. Will Gottsegen, *Some NFT Sales Could Be Illegal: SEC Commissioner Hester Peirce*, Decrypt (Mar. 26, 2021), https://decrypt.co/62989/sec-hester-peirce-nfts.

3. CONCLUSION

With the burgeoning NFT market volume increasing from $106 million in 2020 to $44 billion in 2021, the SEC is increasing its scrutiny of the NFT industry.[47] Yet as the Chastain indictment demonstrates, those in the NFT and crypto industry more broadly should be aware that just because a particular digital asset may not technically be a security, conduct surrounding the crypto industry has been, and always will be, subject to the full panoply of federal law.

Contacts:

Kit Addleman, Kellie Bobo, Robert Bruner, Madelyn Calabrese, Ricardo Davidovich, Daren Domina, Evan Hall, Vicki Odette, Shelley Rosensweig, Stuart Slayton and Taylor Wilson

47. Matt Robinson, *SEC Scrutinizes NFT Market Over Illegal Crypto Token Offerings*, Bloomberg Law (Mar. 2, 2022), https://www.bloomberg.com/news/articles/2022-03-02/sec-scrutinizes-nft-market-over-illegal-crypto-token-offerings.