SEC V. WAHI: AN ENFORCEMENT ACTION IMPACTING THE BROADER CRYPTO/DIGITAL ASSETS AND INVESTMENT MANAGEMENT INDUSTRIES

Date: 23 August 2022

U.S. Asset Management and Investment Funds Alert

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The U.S. Securities and Exchange Commission (SEC) has made a new crypto move—and its impact is broad.

BACKGROUND

On 21 July, the SEC filed a complaint (Wahi complaint) in the U.S. District Court for the Western District of Washington against a Coinbase Global, Inc. (Coinbase) employee and two others alleging insider trading in violation of the federal securities laws. This case is distinct from other cases involving insider trading allegations in that the SEC alleges in the complaint that nine of the crypto assets traded were "crypto asset securities": AMP, RLY, DDX, XYO, RGT, LCX, POWR, DFX, and KROM. Unlike prior SEC enforcement actions brought against Poloniex, Coburn, TokenLot, and others, in the Wahi complaint, the SEC "names names" by specifically alleging that the nine specific crypto assets are securities and therefore subject to compliance with federal securities laws and regulations. However, the SEC did not include the issuers of those nine assets, or the platform(s) upon which they are traded, as defendants, and it has not publicly announced separate actions relating to the status of the specific assets at issue as unregistered securities. Accordingly, at least for now, it will be up to the named defendants to argue that the various crypto assets are, in fact, not securities.

Notably, in a contemporaneous parallel criminal indictment, the U.S. Attorney's Office for the Southern District of New York (SDNY) charged the same three defendants with wire fraud and conspiracy to commit wire fraud in connection with an insider trading scheme.[1] Together with the Wahi complaint, and the SEC's allegations as to the status of the nine assets as "securities," the actions may have a significant impact on the investment management and digital asset industries and raise some troubling questions that may not have immediate answers. The parallel criminal complaint also demonstrates a coordinated effort on the part of U.S. governmental agencies in their focus on the digital asset industry and the broad focus of securities regulators on insider trading.

NEW ENFORCEMENT STRATEGY AND CONSEQUENTIAL INDUSTRY CONCERNS

The Wahi complaint may reflect a new, more aggressive strategy by the SEC. The SEC functionally can argue 11 cases in one: nine cases alleging that certain digital assets are improperly issued securities, one case against the

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named defendants for securities law violations, and one case impliedly against all intermediaries that offer trading in those nine digital assets to U.S. customers.[2] However, it will also be a challenge to prove that each of the nine assets are securities.

This is also the first case in which the SEC has clearly alleged that a digital asset is a security in an action that was not brought directly against the issuer of that asset. As such, the Wahi complaint raises several provocative and potentially industry-moving questions not previously presented:

- Will all U.S.-based centralized exchanges stop trading the nine assets (as was observed industry-wide with XRP after the SEC sued XRP's issuers), and if so, what recourse would investors have?
- Will any of the issuers of the nine assets in question intervene to argue against the allegations that the assets they issued are securities? If not, even though a finding in the *Wahi* case would not have a binding effect on any other court, would a finding in the *Wahi* case that the assets at issue are securities embolden the SEC and other enforcement agencies to pursue similar cases more aggressively?
- Will any exchange that lists the nine assets in question intervene to argue against the assets at issue being securities under available guidance?
- How should funds (registered investment companies, hedge funds, and private funds) holding any of the assets at issue, or assets with similar features, assess their holdings of the assets, particularly if the funds have made a reasonable determination that the assets are not securities?
- How should advisers and brokers respond to the action, including in connection with advisers' codes of ethics, disclosure obligations, portfolio holdings, and their own registration requirements?
- How should issuers, funds, and advisers modify their procedures for analyzing whether an asset is a security, if at all?

Notably, Commodity Futures Trading Commission (CFTC) Commissioner Caroline D. Pham criticized the SEC for bringing this action, stating that it is “a striking example of 'regulation by enforcement.' [since the assets] could be described as utility tokens and/or certain tokens relating to decentralized autonomous organizations (DAOs). . . .” Commissioner Pham instead suggested that these major issues should be solved “through a transparent process that engages the public to develop appropriate policy with expert input—through notice-and-comment rulemaking pursuant to the Administrative Procedure Act. Regulatory clarity comes from being out in the open, not in the dark.”

POTENTIAL IMPACT ON THE CRYPTO/DIGITAL ASSET INDUSTRY

The defendants may argue the nine assets named in the Wahi complaint are not securities, which would defeat the securities fraud allegations, but doing so might require that they win a nine-front war. Moreover, some of the digital assets at issue used novel issuance strategies compared to others that have previously been the subject of claims under the federal securities laws, and thus, those arguments may be particularly complex.

It is unclear how the various intermediaries serving U.S. persons will respond to the allegations that the nine assets at issue are securities; Coinbase so far has publicly said it does not list securities and filed its own petition

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for rulemaking by the SEC with respect to treatment of digital assets under federal securities laws and regulations.

The Wahi complaint—and future developments in the case—may have a broad impact on the digital assets space. A court decision indicating that any one of the nine assets is a security may encourage regulatory enforcement and class action claims, including actions against exchanges that fail to delist it. Even without more clarity from the SEC, despite Commissioner Pham's and Coinbase's call for such rulemaking or guidance, such actions may chill activities in the digital assets industry.

POTENTIAL IMPACT ON THE INVESTMENT MANAGEMENT INDUSTRY

As indicated above, the Wahi complaint presents important—and potentially troubling—questions for investment advisers, broker-dealers, and funds (registered and unregistered) with respect to the assets named in the Wahi complaint and similar digital products.

Whether a digital asset is considered an investment contract, and thus a "security," generally depends on the test outlined by the U.S. Supreme Court in *SEC v. W.J. Howey Co.*[3] In *Howey*, the Supreme Court found that an "investment contract" exists where (i) there is the investment of money, (ii) in a common enterprise, (iii) with a reasonable expectation of profits to be derived, and (iv) from the efforts of others (the Howey factors). The Supreme Court emphasized that the determination of whether an investment contract exists lies in the circumstances surrounding the contract and the manner in which it is offered, sold, or resold. Thus, the question of whether a digital asset is an investment contract—and therefore a security—is fact-based and has the potential to result in two reasonable but contrasting answers.

Absent regulation from the SEC or the CFTC, firms have been left to develop their own processes for determining whether a digital asset constitutes an investment contract (or other form of security) based on their own assessments of the Howey factors and relevant nonbinding regulatory guidance, including statements by SEC officials, the SEC's "Framework for 'Investment Contract' Analysis of Digital Assets" (the Framework),[4] and enforcement actions.[5] The SEC's assertion in the Wahi complaint that the nine assets are securities may result in firms having to reconsider prior reasonable judgments made, consistent with the Framework and other guidance, that the particular assets or similar assets are not securities. Such reconsideration may result in firms feeling required to revisit disclosure, sell portfolio holdings on behalf of clients, and amend or adopt codes of ethics and compliance policies and procedures, including in particular with respect to personal trading and material nonpublic information, to reflect the SEC's assertions.

Further complicating matters, if a crypto asset is determined to be a "security," then the asset is likely also to be deemed an "investment security" for purposes of the Investment Company Act of 1940 (the 1940 Act).[6] Consequently, a currently unregistered pooled investment vehicle that invests in one or more crypto assets found to be securities could be deemed an "investment company" and, absent an available exemption, be required to register as an "investment company" under the 1940 Act. A requirement to do so based merely on assertions in a complaint, rather than in response to a regulation produced by a transparent rulemaking process that adheres to the "notice and comment" requirements of the Administrative Procedure Act, creates interpretative risks and potentially difficult compliance challenges. Moreover, consistent with its approach in *BlockFi*, the SEC could charge the unregistered fund with violating Section 7(a) of the 1940 Act by engaging in interstate commerce while failing to register as an investment company.[7]

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CONCLUSION AND NEXT STEPS

While it may be too soon for firms to reassess reasonably their previous determinations respecting these matters and similar digital assets, firms should monitor the movement of the *Wahi* case closely, as it confirms the SEC's intent to police violations of the securities laws even in areas that remain unsettled as to whether the particular assets are, in fact, securities. Moreover, investment advisers, broker-dealers, and funds should consider reviewing their policies and procedures to consider whether certain modifications should be made to address the SEC's assertions with respect to these and similar digital assets.

FOOTNOTES

[*] Josh Durham, a summer associate at K&L Gates, contributed to this client alert.

[1] *See* Complaint, United States v. Wahi, No. 22 Crim. 392 (S.D.N.Y. filed Jul. 21, 2022), https://www.justice.gov/usao-sdny/press-release/file/1521186/download. The criminal indictment does not specifically allege the crypto assets are securities, but it alleges insider trading of crypto assets in violation of a general wire fraud statute. Nevertheless, the indictment, along with the SEC's allegations, demonstrate an increasing governmental focus on crypto and digital assets. In fact, this action by the U.S. Attorney's Office of the SDNY comes on the heels of the same office bringing wire fraud and anti-money laundering charges against an individual in connection with non-fungible tokens. (See Complaint, United States v. Chastain, No. 22 Crim. 305 (S.D.N.Y. filed Jun. 1, 2022), https://www.justice.gov/usao-sdny/press-release/file/1509701/download.) In announcing the indictment in that matter, U.S. Attorney Damian Williams stated that the charges "demonstrate the commitment of this Office to stamping out insider trading—whether it occurs on the stock market or the blockchain." Press release, U.S. Dep't of Just., Former Employee Of NFT Marketplace Charged In First Ever Digital Asset Insider Trading Scheme (June 1, 2022), https://www.justice.gov/usao-sdny/pr/former-employee-nft-marketplace-charged-first-ever-digital-asset-insider-trading-scheme.

[2] This may be one demonstration of the SEC following through on its previously stated commitment to focus on crypto and digital assets in connection with enforcement and examination activities.

[3] *See* SEC v. W.J. Howey Co., 328 U.S. 293 (1946).

[4] SEC Div. of Corp. Fin., Framework for "Investment Contract" Analysis of Digital Assets (Apr. 3, 2019), https://www.sec.gov/files/dlt-framework.pdf.

[5] *See* Complaint, SEC v. Ripple Labs, Inc., No. 20 Civ. 10832 (S.D.N.Y. filed Dec. 22, 2020), https://www.sec.gov/litigation/complaints/2020/comp-pr2020-338.pdf; Order Instituting Cease-and-Desist Proceedings, *In re* BlockFi Lending LLC, Securities Act Release No. 11029 (Feb. 14, 2022), https://www.sec.gov/litigation/admin/2022/33-11029.pdf; Order Instituting Cease-and-Desist Proceedings, In re BlockFi Lending LLC, Securities Act Release No. 11029 (Feb. 14, 2022), https://www.sec.gov/litigation/admin/2022/33-11029.pdf [hereinafter, *BlockFi*].

[6] The term "investment securities" is defined by the 1940 Act to mean all securities except (A) government

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securities, (B) securities issued by employees' securities companies, and (C) securities issued by majority-owned subsidiaries of the owner that (i) are not investment companies, and (ii) are not relying on either the Section 3(c)(1) exception or Section 3(c)(7) exception from the definition of “investment company.”

[7] In BlockFi, the SEC determined that, in addition to offering unregistered securities and acting as an unregistered broker, BlockFi Lending LLC's activities and holdings deemed it to be an “investment company” under Section 3(a)(1)(C) of the 1940 Act because it was an issuer engaged or proposed to be engaged in the business of investing, reinvesting, owning, holding, or trading in securities, and it owned or proposed to acquire investment securities having a value of more than 40% of the value of the company's total assets on an unconsolidated basis. In the SEC's view, BlockFi Lending LLC's investment activity, and its substantial holdings of investment securities (representing more than 40% of the value of the company's total assets on an unconsolidated basis) caused BlockFi Lending LLC to be an unregistered investment company. As a result, the SEC claimed BlockFi Lending LLC violated Section 7(a) of the 1940 Act. In settling with the SEC, BlockFi Lending LLC agreed to, among other things, pay a US$50 million penalty and cease the offering and sale of its lending products.

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