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'Insider Trading' and NFTs: What Should Companies Be Doing?

The recent indictment of an employee of OpenSea, a prominent NFT marketplace, highlights the risk of trading digital assets based on the improper use of confidential information, even where the digital asset is not a security.

OpenSea (operated by Ozone Networks Inc.) often features or promotes specific NFTs for sale on its home page. NFTs that have been featured tend to appreciate in value due to the spotlight shone on them. Thus an individual with confidential information about which NFTs are about to be featured or promoted could purchase some of the NFTs for themselves in advance of the public announcement, turning a profit when the NFTs rise in value after they have been featured or promoted.

The recent indictment of the employee who allegedly engaged in such activity confirmed what many have long surmised; namely, that such activity constitutes wire fraud, and a form of "insider trading."

The Facts Alleged

On June 1, 2022, Nathaniel Chastain, a former product manager at OpenSea, was arrested on charges of wire fraud and money laundering. Part of Chastain's job was to select the NFTs that OpenSea would feature on its home page, information that was otherwise kept confidential until the NFTs were featured. Chastain was aware that NFTs featured by OpenSea, or other NFTs from the same creator, were likely to appreciate after they had been featured.

According to the recently unsealed indictment, from at least June 2021 to September 2021, on eleven separate occasions, Chastain used this confidential information to buy NFTs that were about to be featured by OpenSea or other NFTs from the same creator.[1] He then resold them for two to five times what he paid.

The indictment also alleges that Chastain sought to cover his tracks by purchasing the NFTs through anonymous accounts he had set up for this purpose, instead of his public OpenSea account. He also used multiple anonymous digital currency wallets to move the funds to purchase the NFTs.

[1] https://www.justice.gov/usao-sdny/press-release/file/1509701/download, *United States v. Chastain*, 22 CRIM 305 (S.D.N.Y. May 31, 2022).

The Charges

The indictment, obtained by the U.S. Attorney's Office for the Southern District of New York, alleges a count of wire fraud (18 U.S.C. 1343) and a count of money laundering (18 U.S.C. 1956), which the government in its press release and the indictment itself characterizes as "insider trading." Specifically, the government alleges that Chastain committed wire fraud by misusing OpenSea's confidential business information to "pre-purchase" NFTs that were going to be featured and then resell them at a profit. The indictment notes that Chastain had an obligation to refrain from using such information except to benefit OpenSea and had signed a confidentiality agreement with the company.

Chastain's use of devices such as the internet provides the government with the "wire" necessary to establish "wire fraud." The indictment also alleges that Chastain knowingly conducted financial transactions to conceal assets he knew to be the proceeds of illegal activity, thereby engaging in money laundering. These charges carry potential fines tens of thousands of dollars, forfeiture of the implicated property and maximum imprisonment of 20 years for each charge.

The indictment takes no position on whether the NFTs at issue were securities or commodities and therefore subject to the prohibitions against insider trading under the Securities and Exchange Act of 1934 or the Dodd-Frank Act. Indeed, the Securities and Exchange Commission did not file a parallel enforcement action, as it often does with indictments relating to insider trading of securities.

OpenSea was not alleged to have been complicit and is not otherwise implicated in the indictment. Indeed, Chastain was acting against OpenSea's interests by illegally using the company's own confidential information. In a statement, OpenSea stated that, "When we learned of [Chastain's] behavior, we initiated an investigation and ultimately asked him to leave the company. [His] behavior was in violation of our employee policies and in direct conflict with our core values and principles."[2]

How NFT Trading Policies Can Help Companies Avoid Problems

While the Chastain case involved a single employee engaged in improper activity, there are a number of important takeaways for any company engaged in the NFT market or in any digital asset endeavor. This is especially true given the comment by Damian Williams, U.S. Attorney for the Southern District of New York, that Chastain's arrest "demonstrate[s] the commitment of this Office to stamping out insider trading — whether it occurs on the stock market or the blockchain."[3] FBI Assistant Director-in-Charge Michael J. Driscoll echoed that: "With the emergence of any new investment tool, such as blockchain supported non-fungible tokens, there are those who will exploit vulnerabilities for their own gain. The FBI will continue to aggressively pursue actors who choose to manipulate the market in this way."[4]

Companies that issue NFTs or are involved in any activity that could impact the value of an NFT should strongly consider implementing NFT trading policies. Even if the liability risk to the company itself may be low — as noted, Chastain, not OpenSea, was charged — companies could face reputational harm if an employee engaged in wire fraud by trading NFTs based on company confidential information. One could also imagine a fact pattern where a company could be found liable, such as where executives knew of an employee's activity but took no action. An NFT policy can sensitize everyone to this issue.

- A comprehensive NFT trading policy should first remind employees that non-public information about an NFT launch, promotion or similar activity is confidential company information and that the employee's duty of confidentiality extends to this information. Cross-referencing any company confidentiality policy or employee confidentiality agreement is a useful approach.
- A company may want to go even further and limit the purchase of NFTs with which the company is associated for a specified period after the initial launch. This will help mitigate any risk that an employee who purchases an NFT will be perceived to have done so using company confidential information before the general public knew the NFT would be available or promoted. For example, consider if Chastain had configured a purchase order for an NFT prior to it being purchased and then executed on that order as soon as the promotion appeared, and before anyone else could reasonably react.

  Liability issues aside, a company may not want to risk the reputational harm if a large number of NFTs from an initial mint are purchased by company employees or third parties involved in the project.

[2] Zack Seward et al., US Charges Ex-OpenSea Exec With NFT Insider Trading, COINDESK (June 1, 2022).

[3] Press Release, Department of Justice, U.S. Att'y's Office, Southern District of New York, Former Employee Of NFT Marketplace Charged In First Ever Digital Asset Insider Trading Scheme (June 1, 2022).

[4] *Id.*

A company implementing such a prohibition will need to consider whether to apply it to all employees or only those who had non-public information, and also whether to impose that prohibition on third-party providers involved in the project or to family members of the covered company employees and third parties.

- Depending on the circumstances, the company may also want to extend the NFT trading policy to categories of NFTs that would likely appreciate after a particular NFT launch or promotion. As noted, Chastain often purchased NFTs of the same creator who was going to be featured, assuming that there would be a "halo effect" on those other NFTs.

The Chastain indictment is an important reminder to those in the NFT space that they may possess confidential information that affects the value of an NFT, and that trading on that information could be illegal. An NFT trading policy can be an important step by a company to mitigate this risk.