**FTX: An Illustration of the Difficulties in Structuring Crypto-Asset Regulation and Incentives**

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The financial woes of cryptocurrency exchange FTX and hedge fund Alameda Research have dominated the recent financial news cycle. On November 2, 2022, CoinDesk reported that Alameda Research held a substantial amount of the FTT token issued by FTX. Both FTX and Alameda Research were founded by Sam Bankman-Fried. Following this revelation, rival cryptocurrency exchange Binance announced that it would sell their its FTT tokens, resulting in a mad rush for other investors to pull out of the token. Subsequent negotiations between FTX and Binance failed, and the former has since filed for bankruptcy.[1] A securities regulation exam hypothetical in the making, this affair has further highlighted the volatility in the much-discussed but little-understood crypto-asset sector. This blog post will explore some areas of the regulatory canvas on which FTX's odyssey is painted.

Some have argued that, even with cryptocurrencies, such bank runs are not inevitable and may be preventable through regulation. Issued in March of 2022, the SEC Staff Accounting Bulletin asks banks and broker-dealers to include custodied crypto-assets in their balance sheets. Specifically, "as long as Entity A is responsible for safeguarding the crypto-assets held for its platform users, including maintaining the cryptographic key information necessary to access the crypto-assets, the staff believes that Entity A should present a liability on its balance sheet to reflect its obligation to safeguard the crypto-assets held for its platform users."[2] With the crypto-assets on their balance sheets, "banks and affiliated broker-dealers . . . would [be] subject . . . to higher capital and liquidity requirements. As a result, these financial institutions have largely stayed out of the crypto-custody business."[3] So, according to critics, the SEC has made it more expensive for banks and affiliated broker dealers to protect crypto-assets. While prices may still fluctuate regardless of the custody of crypto-assets, sophisticated banks and broker-dealers could give customers of cryptocurrency exchange customers a high degree of assurance that their assets would not simply disappear. According to the critics, SAB 121 drastically increases the price of such protection.

In addition to raising the issue of whether to increase regulation of cryptocurrency exchanges, this saga also raises the question of how such regulations could reach the exchanges. According to the CEO of Coinbase, Brian Armstrong, the FTX fiasco was partially caused by their ability to evade regulations.[4] FTX operates out of the Bahamas, a small country with little regulatory oversight of sophisticated financial institutions. Armstrong also alleges that in regulating cryptocurrency, the SEC has regulated through enforcement instead of putting clear guidance into place. Armstrong contends that "smarter" regulation is preferable to heavy-handed regulation as it incentivizes cryptocurrency exchanges to maintain operations in the US. In a world where cryptocurrency exchanges can be set up anywhere, policymakers need tools to either incentivize exchanges to set up regulatable operations in the US or to reach those who are not in the US. In other words, policymakers ought to incentivize cryptocurrency exchanges to operate within the reach of US financial regulations. This means that regulation must strike a balance between protecting consumers and incentivizing exchanges to operate within its reach.

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[1] Kalley Huiang, What Happened to FTX? Here's What to Know., N.Y. TIMES, NOV. 10, 2022.
[2] Staff Accounting Bulletin No. 121, 87 FR 21015-01
[3] Hal Scott & John Gulliver, An SEC Rule May Cost FTX Crypto Customers Billions, WALL ST. J., Nov. 14, 2022.
[4] Brian Armstrong, Op-ed: Crypto markets need regulation to avoid more washouts like FTX, CNBC, NOV 11, 2022 HTTPS://WWW.CNBC.COM/2022/11/11/OP-ED-CRYPTO-MARKETS-NEED-REGULATION-TO-AVOID-FTX-TYPE-SITUATIONS.HTML

Rescinding or modifying SAB 121 may be such a way to regulate without deterring cryptocurrency exchanges from establishing regulable operations in the US. If the rule were to require US operations as a necessary condition for crypto-asset custody at banks and associated broker-dealers, there would be a strong incentive for cryptocurrency exchanges to base their operations in the US. Such an arrangement with banks and affiliated broker-dealers, the most sophisticated custodians, protects both customers and legitimate exchanges from malicious actors. Such protection may also entice sophisticated consumers into using US-based exchanges. The potential downside to this proposal is it allows banks and affiliated broker-dealers to take on increased risk, but as Scott and Gulliver point out, these institutions are already highly regulated and possess immense operational capabilities. A compelling argument can be made that there would be a net decrease in the risk borne by investors and the financial system at large if the rule were to be rescinded or modified as described above.

Of course, custody is not the only solution to the risk of theft and bank runs. Exchange Binance claims to have a self-insurance fund of over one billion dollars.[5] Another exchange, Bitstamp, has a crime insurance policy underwritten by Lloyd's.[6] These practices may somewhat counter the incentive provided by the above-proposed modification of SAB 121. If an exchange can get the same degree of assurance from an insurer or self-insurance as they could through custody, there would be no incentive to establish operations in the US. It would be interesting to examine the marginal incentive value of allowing broker-dealer or bank custody as opposed to the insurance alternative.

In conclusion, cryptocurrency exchanges present a nuanced regulatory problem to which there is no clear, one size fits all solution. While some have criticized the SEC for increasing the cost of crypto-asset custody by banks and affiliated broker dealers, it is unclear whether this presents an incentive problem in the first place given the alternative means of protection against loss that exchanges can employ. This serves as an illustration of the emerging challenges in regulating cryptocurrency exchanges and the potential consequences of their widespread adoption. Going forward, it will be interesting to observe the ways that the FTX collapse impacts regulatory approaches toward cryptocurrency.

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[5] Shaurya Malwa, Binance Tops Up Emergency Insurance Fund 'SAFU' to $1B After BNB Volatility, CoinDesk (NOV 9, 2022) HTTPS://WWW.COINDESK.COM/BUSINESS/2022/11/09/BINANCE-TOPS-UP-EMERGENCY-INSURANCE-FUND-SAFU-TO-1B-AFTER-BNB-VOLATILITY/

[6] Cryptocurrency Exchange Bitstamp Adds Lloyd's-Backed Crime Insurance Policy, Insurance Journal (Oct 10, 2020) https://www.insurancejournal.com/news/national/2020/10/22/587487.htm