

November 15, 2022

Initial Observations on the FTX Debacle

The dust has not yet settled from the remarkable fall to earth of cryptoasset exchange FTX, associated hedge fund Alameda, and their Icarus-like founder, as revelations and conjecture continue to be disseminated at least daily about what happened and the collateral damage. While there are sure to be many important lessons from this situation as the facts and their effects become clear, some initial observations bear mentioning:

- *Key recent failures were of centralized parties, not of blockchain technology itself.* It is ironic that the cryptoasset market, predicated on the concept of decentralization, has been brought low of late by the failure of FTX and other centralized parties, including cryptoasset lenders Celsius and Voyager as well as hedge fund Three Arrows Capital. While decentralized blockchain protocols are by no means immune from design flaws (as [witnessed](#) with the failure of the so-called stablecoin UST), and while smart contract computer code is not immune to error and hacking, the core technology of blockchain remains functional and the push to organize all blockchain technology into legacy centralized forums is proving ineffective. This is not to say that centralized blockchains are inherently problematic — many companies are employing private, “permissioned” blockchains to good avail in areas such as supply chain management, and even the Federal Reserve [is piloting](#) blockchain payments. In short, recent failures of some technology-related institutions should not prompt rejection of the technology itself. To the contrary, these failures remind us of the initial inspiration for its creation and reinforce the need for thoughtful and calibrated regulation, which may differ from the regulatory tools used in the past.
- *Well-tailored regulation can help to mitigate fraud risk.* As we [wrote](#) over a year ago, “protective features of the traditional financial system did not spring forth fully formed with the advent of markets, but evolved as a result of bitter experience which need not be relearned now at the expense of crypto investors.” Based on what is currently known about FTX’s collapse, the cryptoasset market is reminded of some painful lessons of the past, be it Madoff, Enron, or otherwise. While too many questions remain about FTX to conclude what measures might have arrested its meteoric rise and fall, we do believe that certain baseline measures warrant immediate consideration for similar entities. For instance, centralized parties (*e.g.*, centralized exchanges) receiving customer assets should be subject to robust internal controls under the purview of external auditors — of the sort mandated by Sarbanes-Oxley Sections 302 and 404 — and a specific requirement that a custodian of customer assets be duly qualified by, and subject to, state or federal regulation. Furthermore, as we have [previously remarked](#), legislative delegation of clear regulatory authority for spot cryptoasset exchanges is essential. Measures such as these should be welcomed by the industry.
- *U.S. market leadership is paramount; regulatory arbitrage is perilous.* While FTX’s U.S. arm has been swept into its bankruptcy, the preponderance of FTX’s business was

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established and operated offshore, as is the case for many companies in the cryptoasset industry. This is in no small measure attributable to continuing uncertainty with respect to U.S. regulatory treatment of cryptoassets and decentralized financial protocols, as well as regulators' [continued prioritization](#) of enforcement tools as opposed to tailoring of “traditional finance”-focused rules for cryptoassets' idiosyncratic features. Clear and more readily navigable domestic U.S. rules of the road would help both to maintain U.S. leadership in this new economic sector and to avoid regulatory arbitrage posing risk of inadequate oversight. And while the fallout from FTX's failure is sure to provide momentum for increased regulation — which is, in our view, entirely appropriate — at the same time it is important to avoid draconian responses that could tend to further drive the industry (and U.S. customers) to less safe shores.

Already polarized views on crypto are likely to be exacerbated by FTX's implosion, reinforcing both the general skepticism of crypto critics and the fervor of blockchain true-believers about the need to disintermediate financial systems by trusting in cryptography rather than centralized institutions. But these views should converge behind the goal of establishing robust systems where consumer assets are protected against third-party misuse. This objective would be well-served by balanced regulation that accounts for the novel realities of crypto and the distinctive nature of decentralized finance, as well as the unfortunately familiar realities of scandalous business conduct.

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