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Cabinet **News and Views**

Informed analysis for the financial services industry

Business as Usual?

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So with all the speculation about a "red wave" and all of the millions and millions of advertising dollars spent on the U.S. midterm elections, we appear to have ended up right where we started: in pretty much a deadlock in the U.S. Senate and the House of Representatives, albeit with some gavels possibly switching hands.

And that, of course, suggests that all the predictions – including mine – on what a big victory by the Republicans or a hold-the-ground performance by the Democrats would mean for bank regulatory and other financial services issues have led us back to the day-to-day business of financial regulation, including crypto-assets, ESG, consumer protection and all the usual favorites on the hit parade.

Perfect case in point: the precarious position of Bahamian-based crypto exchange FTX. This is a major story, and we take a closer look at what happened to FTX, the scuttled acquisition discussions with Binance, insolvency issues and the broader implications around oversight. Be sure to read our in-depth analysis.

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The Impact of FTX's Collapse: Insights on What Comes Next


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In an unwelcome reminder of the events that unfolded in the wake of the May 2022 crypto market collapse, Bahamian-based crypto exchange FTX is reportedly on the brink of collapse following an unexpected surge in customer withdrawals and a failed deal with competitor Binance. In an effort to stave off the fate of former crypto giants Three Arrows Capital (3AC), Voyager Digital and Celsius Network, each of which entered bankruptcy protection earlier this year, FTX and Binance announced on Tuesday that they had entered into a "non-binding letter of intent" for Binance to purchase all of FTX's non-U.S. exchange business. However, within 24 hours, Binance announced that it would not proceed with the deal, citing concerns about mishandling of customer funds and U.S. regulatory investigations.

A Familiar Story

In the wake of this spring's crypto failures, FTX repeatedly made news for its high-profile purchases of distressed crypto assets. FTX's U.S.-based exchange (FTX.US) reached a deal in July to acquire crypto trading platform BlockFi as it neared bankruptcy. In September, FTX.US placed the winning bid to purchase the assets of bankrupt crypto lending platform Voyager. It was also rumored in recent weeks that FTX.US might similarly seek to purchase the assets of crypto lending platform Celsius Network in Chapter 11 proceedings.

In a dramatic turn of events, industry publications reported last week that a leaked balance sheet for Alameda Research, a leading crypto hedge fund under common control with FTX, revealed that Alameda was highly exposed to FTX's native token FTT. Citing fears that FTT might collapse like Terra LUNA in May 2022, Binance, which was a large holder of FTT, subsequently announced that it was in the process of liquidating its entire FTT holdings. The announcement sparked a surge in customer withdrawals at FTX, and rumors percolated that many FTX users were having difficulty withdrawing their crypto from the international exchange.

Like other crypto currency companies before it, FTX paused withdrawals on Tuesday, shortly before announcing the potential strategic transaction with Binance. However, with no deal currently in hand, the fates of FTX and affiliated entities such as FTX.US and Alameda are uncertain. FTX and its founder Sam Bankman-Fried also face significant backlash and increased regulatory scrutiny.

Lessons Learned from Terra, 3AC and Voyager

The news of FTX's liquidity crisis echoes the events of this spring, when the collapse of the Terra platform and its associated native token, LUNA, in May 2022 rattled consumer confidence in crypto and had a significant negative impact on the crypto industry as a whole. Many crypto hedge funds that held LUNA incurred significant losses. For instance, crypto hedge fund Three Arrows Capital (3AC), a large holder of LUNA, filed for bankruptcy protection in July. In total, roughly $40 billion in market value was lost as a result of the Terra collapse. The founder of Terra is now an international fugitive, and an Interpol Red Notice has been issued for his arrest. U.S. regulators, including the SEC and CFTC, are also reportedly investigating Terra and its founder, as well as 3AC, over allegations that it mislead investors as to the health of the hedge fund's balance sheet.

In the wake of Terra's and 3AC's collapse, two prominent crypto lending platforms, Voyager and Celsius Network, faced unprecedented demands for customer withdrawals amid industry news and social media content alleging that they were suffering liquidity issues. They both paused customer withdrawals and shortly thereafter filed for bankruptcy protection. Celsius Network recently disclosed in court filings that it faces scrutiny from state and federal regulators and has received a federal grand jury subpoena in the Southern District of New York.

Potential Impact on Crypto Market Participants

None of this is good news for FTX's investors or account holders, and those who are or may be impacted by a potential FTX – or Alameda – liquidation or bankruptcy should take care to understand their rights and potential remedies before their hands are tied.

Many large blue-chip investors including BlackRock, Ontario Teachers' Pension Plan, SoftBank, Sequoia Capital and Tiger Global reportedly took part in a $421 million Series B funding round by FTX in 2021. The round was hailed as the then-largest-ever venture capital round for a crypto company. (Celsius Network had a $750 million Series B round later that same year.) Many of these institutional investors are also said to have taken part in simultaneous Series C and Series A rounds by FTX and FTX.US. A looming question is what will happen to their investments.

As an initial matter, equity stakes in FTX are at risk if FTX is forced into liquidation. As an example of the challenges that equity holders may face in a crypto bankruptcy, in the Celsius bankruptcy proceedings, a group of Series B preferred shareholders sought appointment of an official preferred equity committee, arguing in particular that Celsius and the Official Unsecured Creditors Committee (UCC) were aligned in protecting the interests of customers at the expense of equity, which they argued could have a substantial recovery in the case. The shareholders argued that customers do not have claims against "non-customer facing entities" – including Celsius' potentially valuable Bitcoin mining business and nondebtor crypto storage business.

Celsius and the UCC objected to the requested relief and the Bankruptcy Court ultimately denied the shareholders' request for appointment of an official preferred equity committee. The decision did not address the issue of whether the customer claims can be asserted against all of the Celsius entities, leaving an open question as to whether equity actually has a viable path to recovery under its theory.

While the issues in Celsius are fact-specific, any insolvency event involving FTX or other digital asset exchanges may trigger similarly complex and novel issues. Thus, investors with a distressed crypto platform or exchange should consult with experienced counsel to consider, among other things, the following issues that may impact recoveries:

- Under what regimes the entity could file for bankruptcy or other insolvency protections, bearing in mind that some of these could be non-U.S. proceedings;
- To what degree crypto held on the platform could be found to constitute property of the bankruptcy debtors as opposed to property of the retail customers;
- Are there concerns regarding whether “corporate separateness” was maintained between and among generally related entities (such as between retail customer-facing business and any non-customer facing entities), such that claims by creditors at one entity could be asserted at other entities;
- Whether customers or other creditors may have claims against all debtors’ entities or against only certain “customer-facing entities” with which they transacted business; and
- Whether a debtors’ reorganization plan would provide customers with “in-kind” crypto recoveries (meaning payment in cryptocurrency as opposed to “dollarizing” the claims) and how this would affect any recovery by equity investors.

There is currently little indication that FTX.US, which is regulated at the federal and state level as a registered money service business (MSB), is having issues honoring customer withdrawals. However, as demonstrated in the cases of Voyager and Celsius Network, both of which operated in the U.S. with MSB licenses, fear and uncertainty over the exchange’s financial condition could drive withdrawals for a sustained period of time.

There could also be fallout in the over-the-counter (OTC) derivatives markets for positions that use as reference prices products that trade on the FTX designed contract market (DCM). These contracts will need to be evaluated for potential fallbacks if the FTX-based reference prices are no longer available or, with respect to cleared swaps, if they can no longer be cleared such that the counterparties will be facing each other’s credit (*i.e.*, not the derivative clearing organization’s (DCO’s)).

Can and Will Regulators Take Action?

At this time, it is unclear to what degree FTX.US will be implicated by recent events. Further, it is also unclear as to whether U.S. regulators will have jurisdiction over the distressed entities. However, increased regulatory scrutiny resulting from the FTX collapse remains a significant possibility. FTX-related entities in the U.S. operate a commodity derivatives exchange (DCM), a clearing house (DCO) and a swaps exchange facility (SEF), each of which is regulated by the CFTC. The CFTC may assess the solvency of these entities, their ability to discharge their regulatory duties, as well as certain representations FTX made in their spring 2022 application to conduct direct clearing for customers.

Because some FTX.US market participants and intermediaries, such as brokers (futures commission merchants, or FCMs) and swap dealers, are regulated by the CFTC and the National Futures Association (NFA), the NFA may seek to ensure that FCMs' customers assets and futures positions are secure and, potentially, closed out or quickly "ported," *i.e.*, transferred to other solvent FCMs. With respect to crypto swap positions, regulatory scrutiny could also focus on the FTX SEF with respect to swap dealers' positions and, if the swaps are cleared, the FTX DCO's ability to maintain a balanced book of in-the-money and out-of-the-money positions. Volatility of the traded assets will add additional stress to the related derivatives positions, potentially resulting in significant margin calls.

FTX is already in the sights of both federal and state regulators. It was reported on Wednesday that the SEC is expanding an ongoing investigation into FTX.US to include potential misconduct at the international FTX platform. The Texas State Securities Board also recently revealed in a filing in the Voyager bankruptcy proceeding that it is investigating both FTX.US and FTX for selling unregistered securities. Both the SEC and CFTC have indicated their strong interest in assuring that crypto companies are appropriately regulated as long as U.S. investors might be harmed by their conduct, so FTX's non-U.S. location might not ward off U.S. regulatory scrutiny if U.S. persons were harmed or U.S. markets impacted in some way.

Notably, State Attorneys General and regulators have recently led the charge in holding crypto companies and their founders responsible for harm caused to investors in their respective jurisdictions. Many state regulators issued cease and desist orders against Voyager, Celsius Network and other former crypto powerhouses, and nearly all State Attorneys General agreed to a nationwide settlement earlier this year with BlockFi to resolve allegations of unlicensed sales of securities and other misconduct. If any U.S.-based investors somehow happened to sneak through FTX's geo-gating controls, it too may soon be targeted by proactive state regulators.

Crypto trading and investing remains an enticing opportunity for investors worldwide. But with that opportunity comes risk. As revelations of multi-billion dollar shortfalls continue to occur, the greater the likelihood that regulators will be forced to move quickly to bring some order and predictability to these markets.

Federal Reserve Issues Latest Financial Stability Report

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At the end of last week, the Federal Reserve Board ("FRB") issued its semi-annual Financial Stability Report.

In a statement issued with the report, FRB Vice Chair Lael Brainard stated that over the past six months, "household and business indebtedness has remained generally stable, and on aggregate households and businesses have maintained the ability to cover debt servicing, despite rising interest rates." She also noted that "[t]oday's environment of rapid synchronous global monetary policy tightening, elevated inflation, and high uncertainty associated with the pandemic and the war raises the risk that a shock could lead to the amplification of vulnerabilities, for instance due to strained liquidity in core financial markets or hidden leverage."

The Report notes that the FRB's monitoring framework "distinguishes between shocks to, and vulnerabilities of, the financial system," and "focuses primarily on assessing vulnerabilities, with an emphasis on four broad categories and how those categories might interact to amplify stress in the financial system." The four categories of vulnerabilities are (1) valuation pressures, (2) borrowing by businesses and households, (3) leverage within the financial sector, and (4) funding risks. The overview of the Report notes that since the May report was released, "the economic outlook has weakened and uncertainty about the outlook has remained elevated, noting that "[i]nflation remains unacceptably high in the United States and is also elevated in many other countries."

Related to the funding risk vulnerability (and perhaps showing some prescience to our lead story on FTX this week), the Report noted that stable coins remained vulnerable to runs. The Report included a highlighted discussion of digital assets and financial stability noting trouble and volatility in the crypto market in the spring of this year. That discussion noted that the "[t]he turmoil in the digital asset ecosystem did not have notable effects on the traditional financial system because the digital assets ecosystem does not provide significant financial services and its interconnections with the broader financial system are limited." However, the report noted that as digital assets grow, so too will the risks to financial stability, and cited the October FSOC Report on Digital Asset Financial Stability Risks and Regulation in addressing those risks and regulatory gaps.

The Report identified several near-term risks that "could be amplified" through the four financial vulnerabilities, including high inflation, geopolitical risks (noting Russia's invasion of Ukraine), market fragilities, and possible shocks caused by a cyber event.