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FTX: How the SEC Should React

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BY DARIAN IBRAHIM, OPINION CONTRIBUTOR - 11/18/22 1:45 PM ET

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Sam Bankman-Fried, founder and former CEO of FTX, testifies during a hearing before the House Financial Services Committee.

Crypto had a fortune-wrecking week, highlighted by Sam Bankman-Fried's stunning fall from grace. Bankman-Fried personally lost about $16 billion in a matter of days and is now reportedly under the supervision of authorities in the Bahamas. Bankman-Fried was apparently using FTX client funds to prop up his failing trading firm, Alameda Research. When this came to light, a virtual bank run on FTX ensued, leading to FTX/Alameda bankruptcies and his resignation.

The Department of Justice, Securities and Exchange Commission, and Commodities Futures Trading Commission are investigating. While people may go to jail related to this case specifically, of broader interest is how the FTX fiasco will inevitably lead to calls for heavy regulation on crypto. Early government response suggests we're headed down that path. It would be a mistake to paint with too broad a brush, however. I'm looking at you, SEC.

Before we go down the well-worn path of politicized regulation, we must understand what regulation will mean. If the SEC gets its way, the FTX fiasco will lead to native blockchain coins and tokens becoming “securities” under the *Howey* test established by the United States Supreme Court. But Bankman-Fried lent out client funds and couldn’t pay them back, which is not about labeling digital assets as securities. The problem was with a centralized exchange acting like a bad bank. While details are murky at this stage, fraud of some sort seems likely.

In FTX’s case, SEC involvement would deal with a narrower issuer: restrictions on how FTX could sell its native token “FTT.” FTT is important to the story. It served as collateral for FTX client funds lent to Almeda. When the fraudulent scheme was discovered, FTT’s value plummeted, leaving FTT holders and other FTX customers with a long slog ahead. And FTT might well be a security under *Howey*. But the problem wasn’t FTT or its blockchain, but Bankman-Fried commingling client funds with a separate, centralized entity he also controlled.

Classifying FTT as a security isn’t a solution to this problem — this case involves other issues. What the SEC should not do is use this as an opportunity to treat digital assets like a corporation’s stock. An IPO for a digital asset would be an extremely costly and time-consuming process, and it is unclear how digital asset issuers could even comply. SEC disclosure rules are designed for corporations with centralized management, not decentralized blockchains. Therefore, under a heavy-handed SEC approach, digital assets will not be offered in the U.S. at all. That is going too far, chilling innovation. The blockchain has much to offer society, despite bad actors sometimes grifting on it.

The *right disclosures* to FTT buyers could have helped. In my academic work, I have proposed that the appropriate regulator (be it the SEC, CFTC, or a new digital assets regulator) require that any digital asset come with both a whitepaper explaining how the native blockchain works — which is already industry standard — and a "warning box" that discloses surprising and potentially harmful features of that asset. This warning box idea originally came from two Yale law professors attempting to protect consumers from one-sided standard form contracts, and would work well for crypto, too.

The warning box wouldn't be as burdensome to an issuer as a full-blown risk-factors section of an IPO prospectus, but would need to be updated for material changes affecting a digital asset. A warning box would have required FTX to promptly disclose the loaning of client funds to Alameda using FTT as collateral, potentially preventing the disaster that followed.

The U.S. is the world's technology leader. Crypto and blockchain will be important to this story going forward. Too much regulation, or the wrong regulation, and the story will just move somewhere else where it will be harder to control. We must balance promoting financial innovation with consumer protections. Regulators should require a whitepaper and warning box disclosure for digital asset sales, but not more. The billions lost in a single week due to FTX is eye-popping, yet we must resist the urge to let this become an opportunity for the SEC to overreach.

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