WEEKLY SPOTLIGHT

Headline updates: FTX and FCA

Weekly Spotlight by Joseph Edwards
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Executive Summary

- We look at recent news items on Sam Bankman-Fried's trial in New York and new FCA regulations on crypto promotion.
- FTX: first week of the trial has yielded few surprises overall
- FCA: new regulations are mostly common-sense but may present problems for re-entry

FTX

The FTX trial is now in full-swing in New York, with opening statements having taken place last Wednesday and with a litany of prosecution witnesses already having been presented to the court in its first week, including former FTX CTO Gary Wang (starting on Friday and continuing through yesterday) and former Alameda CEO Caroline Ellison (starting on Tuesday).

The case is an odd one for us to write about here from a function perspective more than anything else; on the one hand, journalists covering the case are writing about it on a minute-by-minute basis, and on the other, in terms of attempting to provide a complete overview or - heavens forbid - opinion on the case, the multi-week nature of the proceedings brings few good points to stop and write about it in detail.

However, we feel it is probably worth touching on, at least in brief, the picture that has been

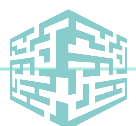
drawn in the first week of proceedings, crucially including extensive testimony from Wang and early testimony from Ellison. The key point to understand is the relationship between Alameda and FTX. We had been aware going back long preceding even the collapse of FTX that the two were essentially the same country, and that Alameda (no matter what SBF had said) enjoyed special privileges on the exchange.

One of the main things that Wang's testimony focused on is that the ability for Alameda to do, in essence, whatever they wanted was built into FTX from the very beginning. As early as August 2019 (the same month that FTX announced its seed round and launched), there was code in the account system for certain accounts to accrue negative balances and be immune to the risk systems (i.e. automatic liquidation) that FTX had in place to prevent bad debt on the exchange's side.

For the most part, everything that has come out so far in the trial has been consistent with what immediate post-mortems around FTX suggested: the problem was not that the firm was willfully attempting to steal funds (in the manner that e.g. Bernie Madoff's AM Ponzi operated), but rather that a mixture of lack of attention to detail, risk-taking behaviour, and overall operational dysfunction drove it that way.

Let us be clear here: the way that FTX operated was still, under any reasonable definition, fraud, and notably, SBF's defense has so far largely not pushed on the argument that it was otherwise, though it is part of it. Instead, their focus has been on Alameda, emphasising Ellison's operational control and attempting to make the argument that SBF was ignorant to how much trouble Alameda was in - at best a stretch of credulity, and the prosecution has already managed to note notable occasions where SBF lied publically (the point being that if he lied about e.g. Alameda's status on FTX, his pronouncements of divestment cannot particularly be trusted either).

We mentioned last week that the trial seemed like it would turn out to be less of a circus than it perhaps might have otherwise been; we tend to stand by this, at least in the early reckoning. Very few surprises have come out at this point (even things like the $100m bribe by Alameda to the Chinese government has been broadly known since well before FTX's collapse) and the picture being painted so far with respects to Alameda/FTX is not of master market manipulators, but of a company that got on a roll and kept doubling down -



a symptom of the ebbs and flows of crypto markets rather than a cause. It is possible that things get slightly more interesting over coming weeks (with particular reference to November 2021 and May 2022), but that remains to be seen.

FCA

Crypto social media was abuzz coming into the new week with reports of a FCA crackdown on crypto companies; as has tended to be the case over and over with the UK, the truth here was far less severe. As part of an ongoing push, the FCA put into place new rules on October 8th, requiring crypto companies operating in the UK to operate by a similar set of rules to most consumer-facing financial companies.

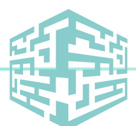
For centralised crypto companies, most of these rules are fairly common-sense. Referral bonuses and similar promotions are banned, risk warnings need to be displayed prominently, and so on. In the FCA's eyes, crypto is a high-risk investment, and to put it plainly, the historical approach of the FCA to high-risk investments is to treat them in an extremely manner to how regulators treat gambling firms - a very understandable approach in many ways.

The FCA rules do have some problems and potential negative edge-case interpretations when we start talking about how they could potentially be applied to DeFi and the like, and we should not dismiss those concerns entirely, but in terms of what the FCA are actually trying to do here: the proof is in the pudding. On the first day, the FCA announced 146 warnings directed at crypto firms for deceptive advertising.

The list reveals a lot. Across the entire list, we noted just three entries that we would describe as conventional crypto firms, all exchanges - HTX (ex-Huobi), KuCoin, and Phemex. The other 143 entries seem to have overwhelmingly been scams - fake crypto mining operations, scam brokers, and a litany of similar schemes.

The UK, much to its shame, has become something of a global hub for financial fraud of this type over the last five years in particular, and it is this that the FCA rules are looking to strike against, rather than crypto businesses which we will again describe as 'conventional'.

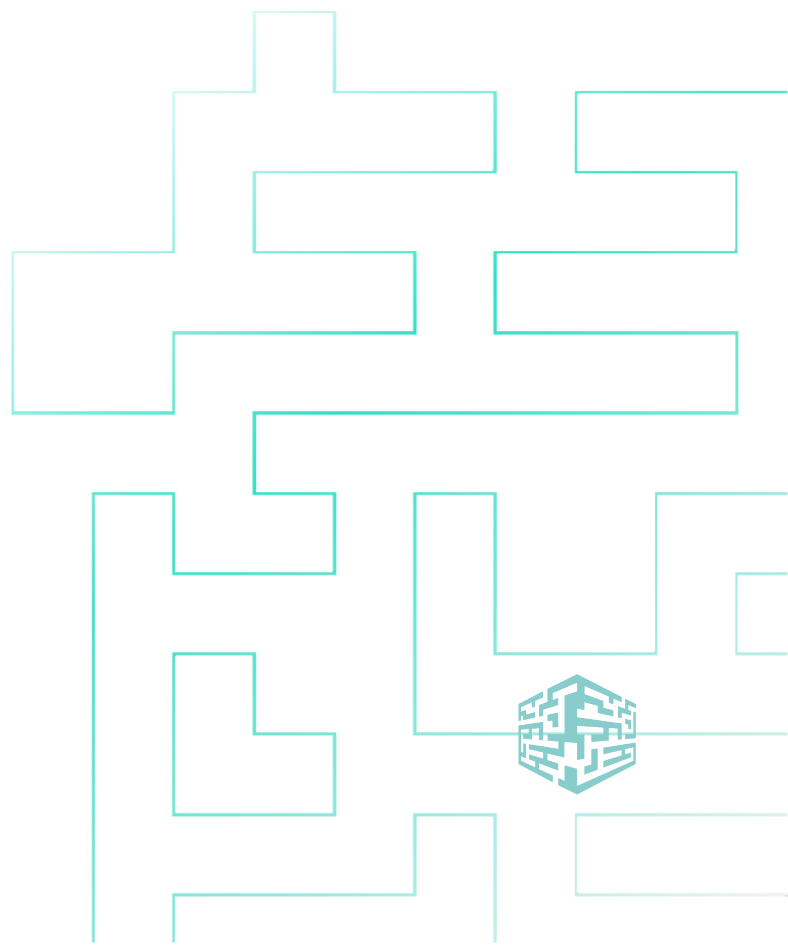
While few firms have received fresh warnings, we have already seen some odd episodes



springing out of the new rules. On Sunday, Binance announced that they were partnering with FCA-registered firm Rebuildingsociety to operate promotions. This met with action very quickly, but the crucial context here is that Binance remains unregistered in the UK and under a FCA ruling (since June 2021), while Rebuildingsociety has no FCA crypto registration and has come under severe regulatory scrutiny after the effective collapse of the original business (a peer-to-peer lending system started up in 2012) and reported attempts to farm out its existing FCA licensing for profit.

The one major firm that has reacted negatively to the new proposals is Bybit, who announced that they would be pulling out of the UK market entirely; however, Bybit is something of a long-time offender in terms of predatory marketing tactics anyway.

Overall, the FCA rules as advertised should not be a particular shock or problem for most crypto firms operating in the UK; insofar as they are a problem, it just exists in the general messaging. Non-UK firms tend to assume a level of regulatory intervention and malice that does not line up with reality de facto, and moves like this will always cause a few more questions in that regard.



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