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INSIGHT

What Happened at FTX and What Does It Mean for Crypto?

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On Friday, November 11, FTX Trading Ltd. (FTX)—one of the world's largest and most well-known cryptocurrency exchanges—announced that it had "commenced voluntary proceedings under Chapter 11 of the United States Bankruptcy Code" in Delaware. Included in the proceedings were FTX US and Alameda Research, a crypto trading company closely affiliated with FTX. The collapse of FTX is the most recent and perhaps most consequential of a spate of crypto company failures this year. This Insight examines the collapse and its implications.

What Is FTX and What Happened?

FTX was an international cryptocurrency platform that offered trading in both the spot market and derivative contracts of cryptocurrencies and allowed customers to store their cryptocurrency holdings with FTX. At its most recent valuation in fall 2022, it was believed to be worth about $32 billion—a valuation that proved to be inaccurate.

According to one news report that had seen FTX investment materials from the day before the bankruptcy announcement, the company held $900 million in "easily sellable assets" compared to $9 billion in liabilities. According to the bankruptcy filing, it had over 100,000 creditors and between $10 billion and $50 billion in liabilities.

Exactly what FTX did internally to cause its failure is unclear. However, the chain of events leading to the public loss of confidence and bankruptcy began with the publication of a report on November 2 by CoinDesk, which reported that two of Alameda Research's three largest assets (representing nearly 40% of its total assets) were the FTX-related token FTT. (FTX issued FTT tokens to provide discounts on trading fees. FTT had been worth $22 per token, fell precipitously throughout the FTX ordeal, and is currently trading at $1.29 as of the date of this Insight.) Soon after, on November 6, Changpeng Zhao, the CEO of rival exchange Binance, tweeted that his exchange would sell its roughly $2.1 billion of FTT, essentially sparking a run on FTX. According to one report, FTX experienced $5 billion of withdrawals on November 6. After FTX initially denied solvency issues, FTX and Binance tweeted days later that Binance signed a non-binding letter of intent to help FTX solve its "significant liquidity crunch." By Wednesday, November 9, the deal was off.

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For some, the vast quantity of FTT on the balance sheet of Alameda was suspect. Since CoinDesk's initial report, various media outlets have reported that an Alameda Research executive said FTX had transferred customer funds to prop up Alameda. U.S. and Bahamian regulators are reportedly investigating FTX.

Another "Crypto Winter"

The cryptocurrency market has been characterized by periods of sharp price movements from its infancy. After reaching a record high of more than $3 trillion total value in November 2021, the market experienced a sharp and near constant downturn in which the collective cryptocurrency market capitalization fell by nearly two-thirds. A host of cryptocurrency project and company failures in the summer of 2022 were caused—and exacerbated—by this broader market downturn. This has been called a "crypto winter." Recently, crypto prices had been exhibiting a closer correlation with traditional financial markets, especially tech stocks. However, the cryptocurrency market has fallen again since the FTX collapse began.

Policy Options

Calls for greater regulation of the industry preceded FTX's collapse. While it is unclear whether stricter regulations may have prevented the situation at FTX, which is a Bahamas-based entity, anti-money laundering (AML) statutes have been applied to companies in foreign jurisdictions when the proceeds of illegal activity were included in banking transactions that cleared in the United States. U.S. regulations may also apply if the company actively sought customers in the United States.

Regardless of jurisdiction, the events at FTX are relevant because they shine a light on practices by U.S.-based exchanges that may be of interest to Congress. The first is whether these firms, which face fewer regulations than traditional securities exchanges and operate as both exchanges and broker-dealers, face a conflict of interest. Moreover, unlike traditional brokers, which must segregate customer funds, crypto exchanges may have comingled funds, which could make it difficult for customers to recover funds if the exchange were hacked or went bankrupt.

Currently, there is no comprehensive regulatory framework for cryptocurrencies or other digital assets. Instead, various state and federal financial industry regulators apply existing frameworks and regulations where exchanges or digital assets resemble traditional financial products. As such, regulators may treat digital assets as securities, commodities, or currencies depending on the circumstances. For example, cryptocurrency exchanges are licensed at the state level and register with the U.S. Treasury's Financial Crimes Enforcement Network as money transmitters for AML compliance. However, application of these frameworks through formal or informal guidance by disparate regulators may make the environment murkier in the event that various overlapping regulators make competing pronouncements. For example, the chairs of both the Commodity Futures Trading Commission (CFTC) and Securities and Exchange Commission (SEC) have alluded to the fact that some digital assets are commodities and others securities under their respective jurisdictions. Where crypto actors are operating without registering with these agencies, investors do not receive the protections that regulatory compliance provides.

Beyond the practical discussion of which regulatory frameworks are applicable, the FTX incident raises more fundamental issues. Similar—albeit smaller—crypto failures in the summer of 2022 show how the lack of an overarching regulatory framework can fail to stop bad actors and how less informed participants may assume that crypto products have a regulatory "stamp of approval" when they do not.

Congress may choose to bring greater clarity and investor protection to the industry through legislation. One option would be to establish procedures for digital asset exchanges to register with one of the large market regulators and require that they segregate customer funds. On the jurisdiction issue, Congress may choose to establish some rubric that distinguishes digital asset commodities from securities and create

different procedures for registering the two types of digital assets. Where existing frameworks may be insufficient, Congress may choose to expand the authority of the CFTC or SEC or encourage them to engage in rulemaking using their existing authorities.

Author Information

Paul Tierno
Analyst in Financial Economics

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