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Five Takeaways from the FTX Cryptocurrency Exchange Fallout

December 7, 2022 | **BY CHRIS DAVS & JOSHUA SMELTZER**

Blockchain and its related cryptocurrencies were intended to upend a financial system completely reliant on trusted intermediaries. Starting in 2021 the adoption rate of cryptocurrencies skyrocketed. However, most of these new adopters are not making use of the underlying blockchain technology and instead interact with cryptocurrencies using a variety of mostly unregulated intermediaries, including exchanges like FTX.com.

Trust has, therefore, been reinserted for millions of users into a system designed to eliminate such trust. Where trust is required, trust can be abused. And the news is littered with examples of cryptocurrency investors losing money at the hands of these intermediaries.

Stablecoins appeared to be anything but stable when the Terra network and its algorithmic stablecoin (i.e. a digital asset collateralized by calculations instead of independent reserves of actual dollars) failed. Investors who didn't understand these types of "stable" coins suffered when the calculations failed.

Then the drop in cryptocurrency prices started to expose mismanagement and other risks in many other cryptocurrency companies (e.g. Celsius, Voyager and Three Arrows Capital). Sam Bankman Fried (SBF) and his FTX exchange became the latest very public example—admitting an inability to account for billions of invested capital and filing for bankruptcy. It will take time before the entire impact of the FTX failure and bankruptcy is known. However, here are five things for investors to take away from the recent events involving FTX when considering the future of digital assets.

1. Beware the cult of personality.

FTX's explosive growth was driven largely by the popularity of SBF himself and a roster of celebrity promoters—including Tom Brady, Giselle Bündchen, Steph Curry and Shaquille O'Neal. Perhaps most notably, Larry David appeared in a Super Bowl ad touting FTX as a "safe and easy way to get into crypto."

FTX also bought naming rights to the Miami Heat's basketball arena, which in the eyes of many lent additional credibility to the company. SBF himself shamelessly promoted FTX—for instance, sitting for an "exclusive" CNBC interview in which he discussed surviving the "Crypto Winter" and his purportedly unique investment strategy.

This interview aired less than a month before FTX collapsed. If this type of over-the-top promotional strategy conjures up memories of past frauds, it should. Remember Enron Field in Houston? The Stanford-St. Jude Championship and Allen Stanford's ties to many notable professional golfers? Elizabeth Holmes "firing back at doubters" on CNBC, while popular "Mad Money" host Jim Cramer described her company Theranos as "one of the most exciting privately-held companies in Silicon Valley"?

Fraudsters know that investors are wowed by TV appearances, corporate sponsorships and celebrity endorsements. But TV commentators, corporate marketing departments and celebrities are not vetting these companies. If anything, these parties are blinded by sponsorship dollars or the competition to land an interview with "the next Steve Jobs" (as Holmes was described). And while the SEC's recent wave of enforcement actions against celebrity crypto promoters like Kim Kardashian is a good message to the market, average investors continue to be fooled. The FTX fraud reinforces the need for skepticism and diligence.

2. Invest in a business, not a cause.

SBF was a major proponent of a movement called "effective altruism." This philosophy dictated that the end game of SBF's and FTX's success was not their own wealth—but rather using that wealth to do good. To wit, SBF pledged to eventually donate substantially all of his net worth to charitable causes. This messaging dovetailed perfectly with much of the philosophy behind the development of cryptocurrencies—in which proponents advocated the "democratization" of the financial world, as power would be decentralized rather than concentrated in powerful financial institutions. Consequently, money poured in from those looking to not only profit, but to do good in the process.

Unbeknownst to these investors, rather than doing good with their money, SBF was misappropriating it to buy himself, his family and his friends 19 Bahamian properties worth roughly $121 million. This reinforces the fact that someone bent on fraud is not above lying about alleged charitable intentions. The FBI, IRS and other agencies for years have warned the general public about those who tug at the heartstrings of their victims in order to get them to part with their money. SBF's version of this tactic was just more brazen and more public.

The bottom line is that investment decisions should be based first and foremost on the underlying business—not its good intentions. These purported good intentions may just be a vehicle to hide fraud.

3. Garbage in = garbage out.

The FTX exchange, and many other cryptocurrency exchanges, are not really decentralized. For most of the recently failed or bankrupt companies, there is a centralized group of managers interacting on behalf of investors with the actually decentralized networks. Therefore, it is the quality of these managers and their companies, and reserves on hand to protect investors, that must succeed and not the blockchain network used or the associated cryptocurrencies unconnected to the company.

Multiple commentators have indicated that FTX was horribly mismanaged and its books were beyond inaccurate. Including, as mentioned above, misplacing billions of dollars. The amounts invested don't matter if the exchange, as FTX claims, can't find and return the money invested when asked. There were advisors and accountants involved, but it didn't appear to matter. There were little to no internal controls, the apparent outside controls of auditors also failed, and there were no regulatory reporting or other compliance requirements that might have signaled a problem. If the investment is going into a faulty company with a faulty system, it has very little, if any, chance of success.

Customers and legislators are almost guaranteed to demand more of the digital asset companies and exchanges going forward. This will likely require proof of adequate reserves and more public disclosure and reporting to both oversight government agencies and investors.

4. Compliance is a good investment.

The collapse of FTX has ushered in a significant change in dialog within the cryptocurrency community. After years of antagonism towards regulators (a two-way street, to be sure, as many regulatory agencies have been likewise antagonistic towards the industry and unfairly painted it with a broad brush), many within the community are now acknowledging that regulation could be a good thing. And whether it's a good thing or not, it's coming. FTX's collapse has, predictably, led to calls for tighter regulation.

This reinforces that compliance is a good investment and a potential competitive differentiator. For instance, Coinbase stands out as a cryptocurrency exchange that has taken a markedly different compliance approach from FTX. Coinbase is a U.S.-based, publicly traded company. This requires it to comply with SEC and NASDAQ rules and regulations, to provide audited financials to the public, etc. This is not to say, of course, that every cryptocurrency or blockchain company can or should go public. These companies should, however, ensure that they have made the investment needed to both understand and meet certain compliance obligations demanded by the government and/or their investors. This will not only keep them out of trouble but also set them apart from their competitors.

5. Blockchain and digital assets will survive.

Bitcoin has a history of being discounted as a fad and has been pronounced dead multiple times. However, it always seems to survive, and the failure of specific digital asset companies are unlikely to be the demise of Bitcoin and other digital assets.

The blockchain technology, the networks employing that technology and the associated cryptocurrencies are built to be trustless, and they remain trustless. The blockchain technology and its underlying cryptocurrencies provide something that millions of new users flocked to in 2021 and are still adopting, albeit at a slower rate. There is clearly a demand. The intermediaries failed, not the blockchain networks.

In an ironic twist, the failure of centralized cryptocurrency intermediaries further supports the need for the actual decentralized financial exchange system. What users need is an easier way to access the actual blockchain network without the need for intermediaries acting on their behalf. Access to the actual blockchain system remains remarkably difficult for an average user, and that's how intermediaries flourished and recruited customers by offering a user-friendly way to invest.

However, as a new innovation, it will hopefully become easier to access and use as the technology develops. Then users will not need to rely as heavily on outsiders to act on their behalf.

FTX, mostly because of its penchant for publicity, is a very public failure, but it is not the entire blockchain and digital asset ecosystem—it's just one piece. Investors must be careful but shouldn't necessarily give up entirely on blockchain and digital assets because of recent events. Instead, they should demand more business and compliance formalities common in other industries to ensure that the risks involved are adequately disclosed and considered. Investors should also demand more protections, accountability, and punishment for companies acting on their behalf.

There will always be risks, but risks can be managed if the company and the investor deal in good faith with knowledge and understanding of all the facts. That should be the goal going forward.

Chris Davis *is a former SEC litigator and partner at Gray Reed and co-lead of the firm's blockchain and digital asset practice. Chris can be contacted at cdavis@grayreed.com.*

Joshua Smeltzer *is a former Department of Justice litigator and partner-elect at Gray Reed and co-lead of the firm's blockchain and digital asset practice. Joshua can be contacted at jsmeltzer@grayreed.com.*