Securities Regulation Daily Wrap Up, BLOCKCHAIN—CFTC's Behnam urges legislative action on digital assets, points to regulatory 'gaps', (Dec. 1, 2022)

Securities Regulation Daily Wrap Up

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By Suzanne Cosgrove

Commission Chairman tells Senate Ag Committee the DCCPA, a bill currently before the Senate, may have averted the FTX debacle.

The lone witness in a hearing titled "Why Congress Needs to Act: Lessons Learned from the FTX Collapse," held Thursday by the U.S. Senate Committee on Agriculture, Nutrition and Forestry, CFTC Chairman Rostin Behnam lobbied for a "comprehensive regulatory regime," to prevent FTX from happening again.

"We need to move quickly on a thoughtful regulatory approach to establish guardrails in these fast-growing markets of evolving risk," he said in a prepared statement.

In particular, the CFTC must be given oversight of underlying cash digital markets that are commodities (such as Bitcoin and Ether), he said. "This is the gap," Behnam said. "Without new authority for the CFTC, there will remain gaps in a federal regulatory framework, even if other regulators act within their existing authority."

Liquidity crunch. Behnam said FTX's failure ultimately appeared to be the result of "a classic liquidity crunch" that forced a massive run on the institution. However, if the CFTC would have had a "daily lens into what was going on at FTX," it could have prevented offenses that apparently led to its collapse, including the co-mingling of funds, conflicts of interest, and a lack of records and books and corporate governance.

Without direct regulatory and surveillance authority in an underlying cash market the CFTC is limited to enforcement activity that begins with a referral or a whistleblower tip from an external source, the Chairman added.

The CFTC has brought more than 60 enforcement cases in the digital asset space since 2014, with penalties totaling just over $820 million, he said. However, "by the time the CFTC is able to exercise its fraud and manipulation authority, it is already too late for defrauded customers."

Competing bills. FTX was "emboldened by a lack of federal oversight," commented Sen. Debbie Stabenow (D-Mich.), the chair of the Ag committee and a co-sponsor of the bipartisan Digital Commodities Consumer Protection Act (DCCPA) of 2022, one of three bills related to the regulation of digital assets currently in Congress.

The Lummis-Gillibrand Responsible Financial Innovation Act also was introduced to the Senate in 2022 and the Digital Asset Market Structure and Investor Protection Act was introduced by the House of Representatives in 2021.

The DCCPA has come under fire by some industry critics in recent weeks for its link to FTX. While it was written in consultation with CFTC staff—and Benham said Thursday that the DCCPA would have prevented the actions that fueled FTX's customers' losses—former FTX CEO Sam Bankman-Fried lobbied in the bill's favor—possibly because of a perception that the CFTC is a "soft touch" regulator compared with the SEC.

"Why would FTX lobby for a bill it would have been so hard to comply with?" asked Sen. Michael Bennet (D-Colo.) at the hearing.

"They would have been so far out of compliance it would not have been possible," Behnam replied.

In a nod to perceived and real differences in market oversight, Stabenow said the DCCPA would not take authority away from other financial regulators. “No single financial regulator has the expertise or authority to regulate the entire industry,” she said.

LedgerX stands alone. Both Stabenow and Behnam noted LedgerX LLC, which is registered with and overseen by the CFTC, is the only FTX entity that did not fall into bankruptcy in November.

As a derivatives clearing organization (DCO), LedgerX is required by CFTC rules to ensure the segregation and security of customer property, including digital assets.

“The CFTC has been in near-daily contact with LedgerX, as well as the third-party custodians it uses to hold cash and digital assets,” Behnam said. “LedgerX customer property remains secure and LedgerX has the financial resources to continue operating for the foreseeable future.”

FTX’s DCO application. Behnam was quizzed by several senators about the CFTC’s meetings with FTX around an application to amend the exchange’s order of registration and offer clearing of margined products directly to market participants, rather than use a futures commission merchant as an intermediary.

FTX was “dogged in its pursuit” of the application, Behnam said. Sam Bankman-Fried was “in the (CFTC) building quite a bit,” he added. Over the course of 14 months, Behnam said he met with Bankman-Fried nine times in Washington and once at an industry conference in Florida.

The CFTC also put out a request for information to the public on the application that received 1,500 responses, Behnam said. FTX withdrew its request on November 11 and it was not approved.

But apart from FTX, the application was not the first of its kind, “and not the last we will hear about disintermediation,” Behnam said.

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