Securities Regulation Daily Wrap Up, COMMODITY FUTURES—Binance rescue of FTX called off, but lawmaker, consumer group concerns may persist, (Nov. 9, 2022)

Securities Regulation Daily Wrap Up

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The now defunct Binance-FTX acquisition raised questions about the future direction of U.S. blockchain regulation along with questions about the potential consequences of FTX's CFTC proposal to further open markets to retail investors.

It has been widely reported that the Binance-FTX rescue has been called off. Earlier in the day, Binance appeared to be ready to acquire the faltering FTX and save it from collapse. Regardless of whether the deal falls through, lawmakers and consumer groups are likely to continue to raise questions about the future direction of U.S. blockchain regulation and about an FTX application pending with the CFTC in which FTX could open more speculative markets to retail investors.

Calls for government oversight. "The recent events that have transpired between FTX and Binance are the clearest example yet of why we need clear rules of the road for digital asset exchanges in the United States," according to Senator Cynthia Lummis (R-Wyo). The Binance-FTX affair, Lummis stated, shows the need for Congress to adopt the Responsible Financial Innovation Act (S. 4356), which she introduced with Senator Kirsten Gillibrand (D-NY). The bill would direct the Securities and Exchange Commission (SEC) and Commodity Futures Trading Commission (CFTC) to issue cryptocurrency regulations.

Her concerns were echoed by Representative Patrick McHenry (R-NC), the top Republican on the House Financial Services Committee. "For years, I have advocated for Congress to develop a clear regulatory framework for the digital asset ecosystem, including trading platforms," McHenry stated.

Public Citizen, a consumer rights advocacy group, stated that the potential acquisition of FTX by Binance should be "celebrated" if it signaled "that the cryptocurrency Ponzi fad is fading away." According to the group's president, Robert Weissman, "It's time, once and for all, to silence the utopian-libertarian gibberish, recognize that crypto has provided no social utility while worsening the climate crisis, and acknowledge that the crypto industry's investment scams have cost retail investors billions. On the other hand, crypto has proven great for money launderers and tax dodgers." Weissman added, "Regulators, including the Commodities Futures Trading Commission and Securities and Exchange Commission, must carefully scrutinize this merger and its aftermath, to ensure as little additional damage is inflicted on real people as possible."

Americans for Financial Reform (AFR), which advocates for stricter regulation of financial markets, cautioned against policymakers reacting to the crypto turmoil by embracing "half-baked solutions." It called out the proposed Digital Commodities Consumer Protection Act (S. 4760), which would empower CFTC to regulate digital assets, as inadequate. The provisions of S. 4760 were "heavily influenced by crypto industry lobbying," according to Mark Hays, a senior policy analyst at AFR, and "could actually usher in a weak regulatory framework for digital assets that would fail to adequately protect consumers and investors and might instead legitimize questionable crypto business practices and models not unlike what we've seen today."

Better Markets calls on FTX to withdraw proposal. In a press release following news that Binance would acquire FTX, industry watchdog Better Markets said FTX should withdraw a proposal it had submitted to the CFTC under which it planned to clear non-intermediated, margined retail trades. Absent a withdrawal by FTX, Better Markets urged the CFTC to deny the application. As of publication, Better Markets had not issued any public statement following news that Binance would no longer acquire FTX.

Better Markets President and CEO Dennis M. Kelleher remarked on how FTX's proposal, if it were approved, could lessen the financial backstops for clearing houses. Said Kelleher: "FTX's application was always flawed because it's novel, untested, and high-risk proposal to dramatically change the structure and operations of the clearing house model, which has proved itself through multiple crises, depended upon FTX's representations of its financial strength."

Kelleher also suggested that the Binance-FTX arrangement was further evidence of the manifestation of the problems raised by Better Markets in its comment letters about FTX's proposal. "The crypto carnage, volatility, and wealth destruction over the last twelve months were red flags of the threats posed to customer protection and systemic stability by cryptocurrency investments generally," added Kelleher. "While events are still unfolding rapidly, recent events have once again proved that those risks are real and systemic, this time as specifically applicable to FTX itself."

FTX's application to the CFTC sought to clear non-intermediated, margined products to be traded by retail investors who would have to comply with required initial margin (to open a position) and maintenance margin (minimum percentage of the notional value of the portfolio that margin must exceed). Under the proposal, margin levels would be recalculated every 30 seconds and an automated process would liquidate 10 percent of a portfolio at a time on a 24-7 basis until collateral on deposit exceeds the required amount of maintenance margin. FTX also would establish a full liquidation threshold and it would establish a $250 million guarantee fund to backstop certain losses.

The CFTC sought public comment on 15 questions, most with numerous subparts, regarding FTX's proposal. The resulting public comments totaled 1,500 with most of them submitted by individuals and only about a dozen submitted by trading firms or other large entities or market interest groups.

Better Markets submitted two comments on FTX's proposal, including a lengthy comment in May 2022 that focused on the potential market upheaval that could occur from FTX's proposed auto-liquidation feature. Said Better Markets: "...while immediate auto-liquidation of customer margin may protect the clearing house and FTX, it could result is [in] massive customer losses, not that different from the losses retail customers sustained from risky trading in 2021, including the GameStop trading frenzy in January 2021 and a boom in retail trading in risky options, both facilitated by Robinhood, which made the same claims about choice and access."

Binance, FTX's one-time rescuer, through BAM Trading Services Inc. d.b.a. Binance.US, which claims to be the world's largest crypto platform by volume, also submitted a comment on FTX's CFTC application and said that it saw economic efficiencies in FTX's proposal. For example, in a footnote, Binance observed that: "We are as an isolated matter impressed by the fact that FTX has the ability to calculate a customer's margin level every thirty (30) seconds as positions are marked to market. This is the kind of technological process that allows financial institutions to better identify and mitigate risks than traditional methods."

However, Binance also expressed concerns that FTX's proposal could undermine customer protection and increase systemic risk. For one, Binance said that retail investors would suffer most losses instead of losses being shared equally by all customers without notice or opportunity to post additional margin. Conflicts of interest and self-dealing are possible, Binance said, if sophisticated traders manipulate the auto-liquidation model. Binance added that it was worried that FTX's proposal could "exacerbate procyclical- and cascade- prompted market moves," including the potential for a "flash crash." Lastly, Binance said that FTX's proposed guarantee fund was an acknowledgment of risk but nevertheless an inadequate solution.

Companies: Binance

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