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Regulators and Law Enforcement are Closely Monitoring the Crypto Sector

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Triggered by the collapse of FTX, regulators and law enforcement officials have made clear that they have the crypto sector under the microscope. While their initial steps have focused on FTX, its sister company, Alameda Research, and their executives, top regulatory officials have made clear that those steps are just the beginning, and companies and executives within the crypto sector would be wise to get their houses in order to avoid investigations or actions that can drain resources, harm reputations and destroy businesses.

FTX-Related Enforcement Actions

On December 13, 2022, the US Attorney's Office for the Southern District of New York (SDNY), the Securities and Exchange Commission (SEC), and the Commodity Futures Trading Commission (CFTC) announced a series of actions related to FTX's founder Samuel Bankman-Fried's (SBF) allegedly fraudulent actions with respect to FTX and Alameda Research. More specifically, SBF is accused of allowing Alameda to use FTX customer deposits; providing Alameda with beneficial trading, including executing trades more quickly and being exempt from liquidation requirements; using FTX customer deposits for personal use; and lying about it.

The SDNY indictment charges SBF with conspiracy to commit wire fraud, wire fraud, conspiracy to commit commodities fraud, conspiracy to commit securities fraud, conspiracy to commit money laundering, and conspiracy to violate campaign-finance laws. The SEC's complaint accuses SBF of fraud in the offer or sale of securities and fraud in connection with the purchase or sale of securities. The CFTC's complaint alleges that SBF, FTX, and Alameda committed fraud and made fraudulent misstatements of material fact and material omissions.

Recent Comments From Regulatory Officials

While it would be easy to distinguish the extreme conduct related to FTX, regulators have made clear that they will be closely scrutinizing conduct throughout the crypto industry. SEC Chairman Gary Gensler has repeatedly stated that most crypto tokens are securities, the SEC recently advised public-reporting companies to ensure they are adequately disclosing to investors any potential material adverse exposure they may have as a result of bankruptcy events and financial distress involving crypto intermediaries[1], and other officials have made clear that additional scrutiny will continue long into the future. The SEC's Acting Chief Accountant, Paul Munter, for example, recently cautioned investors regarding the reliability of work done by auditing firms for crypto companies. Munter also made clear that the SEC will consider referrals to the enforcement division "[i]f we find fact patterns that we think are troublesome." Audits of FTX prior to its downfall did not identify weaknesses or improprieties, and auditing firms have recently expressed caution in how they analyze crypto companies, perhaps in part due to the increasing chances that regulators will closely scrutinize their work.

[1] https://quickreads.ext.katten.com/post/102i38j/public-companies-with-exposure-to-crypto-markets-after-ftx-collapse-to-disclose

Additionally, Deputy Attorney General Lisa Monaco recently commented that cryptocurrency companies should expect more enforcement actions, stating that the DOJ is "looking at the exploitation of this technology … however they may be used for illicit ends, whether it's ransomware, whether it's money laundering, whether it's misleading the investing public." Monaco also cautioned crypto companies to adopt a robust compliance program.

Best Practices for Staying Out of Harm's Way

Considering these recent enforcement actions and comments from DOJ and SEC officials, companies in the crypto sector should take immediate steps, including:

- ensuring the accuracy of public statements and filings, including those made by accounting firms;
- adopting a robust compliance program with detailed requirements for risk assessment and tools for avoiding commingling of funds;
- ensuring there are strict policies against, and enforcement mechanism to prevent, the use or diversion of company funds for personal use;
- disclosing to its clients or customers how their funds are used and managed; and
- implementing and maintaining internal controls for preventing certain customers from receiving preferential treatment at the expense of other customers.

CONTACTS

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