Opening Statement

Steffen Kern, Head of Risk Analysis and Chief Economist, European Securities and Markets Authority (ESMA)

Economic and Monetary Affairs Committee
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Dear Chairwoman,

Dear Members of the Economic and Monetary Affairs Committee,

Thank you for inviting ESMA to address you today regarding the collapse of FTX and its implications for the EU. The collapse of FTX is a critical point in the development of crypto markets, deserves careful analysis of what it means for Europe today, and we are glad to provide whatever insight we can.

ESMA's perspective

Let me point at the outset to some key aspects about our perspective as ESMA on this case: ESMA has neither regulated nor supervised FTX. We do not have access to any information on the company beyond what is in the public domain.

As a result, the observations we can make are based solely on public information about a rapidly developing situation. The collapse is still under investigation by authorities, especially in the US and elsewhere, and ultimately, we do not know the details of what happened.

Of course, we draw upon ESMA's wider experience of monitoring and analysing developments in this area in recent years. Our risk assessments are published widely on a semi-annual basis through our Trends, Risks, and Vulnerabilities reports. Following up on our risk assessment, and growing evidence of consumer detriment and aggressive marketing, we have issued Warnings to investors on the severe risks associated with crypto-assets.

Summary of current public information

As a starting point, let me briefly summarise what we know about the case at this stage, based on the available public information. As is typical of crypto asset providers and exchanges, FTX operated digitally and across borders, with a global client base. Created in 2018 and majority-owned by a US citizen, Sam Bankman-Fried, it is headquartered in the Bahamas and until recently was one of the top-five crypto-trading exchanges globally by volume of crypto asset transactions. According to its bankruptcy filings, FTX owns or is affiliated with a complex web of over a hundred entities across five continents, one of which, FTX (EU) Ltd, is domiciled in Cyprus, supervised by the Cyprus Securities and Exchange Commission and has been suspended by the Cyprus Securities and Exchange Commission on 11 November 2022.[1] The company employed hundreds of staff and recently claimed to have over a million registered users, fewer than 10% of whom are understood to be based in the EU.

FTX is a centralised crypto trading platform. It allowed users to buy and sell crypto coins and tokens. Products available for trading on FTX also included futures, options, and leveraged tokens.

The business model of FTX has been highly complex.

- Next to crypto asset trading, it is understood to, first, involve dealer and custodian services, including margin lending to clients and safekeeping of crypto assets. On its website, FTX offered clients up to 20x leverage for various trades.

- Second, FTX is understood to have been lending to Alameda Research. Alameda has been referred to as an investment firm or proprietary trading firm founded and owned by Mr Bankman-Fried, though precise details of the business model of Alameda, its role in the conglomerate of firms around FTX and its lending arrangements with FTX remain unknown. Alameda appears to have been launched to carry out arbitrage trades, profiting from differences in crypto asset prices.

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1 On 9 November 2022, the Cyprus Securities and Exchange Commission (CySEC) called upon the Cypriot Investment Firm FTX (EU) Ltd to suspend its operations and to proceed immediately with a number of actions to protect investors. CySEC suspended the authorisation of FTX (EU) Ltd on 11 November 2022.

In 2019, FTX launched a native token, known as FTT, which gave holders the right to reduced trading fees on the platform. FTT had a total market capitalisation of EUR 3bn prior to the FTX collapse. FTT is reported to have made up over a third of the value of the assets on Alameda's books.

There are also questions around accounting practices in this regard. Alameda had stated that FTT was valued at half its USD market price on the company books, but the book value in fact reportedly exceeded the market value at the time.

FTX's collapse was rapid. On 2 November, Coindesk, a crypto news website, published an article questioning its financial soundness. On 6 November, the CEO of crypto exchange Binance announced via Twitter his intention to sell all FTX tokens held on Binance's books. Binance stated on 8 November that it intended to acquire FTX, but a day later announced that, after first due diligence, it had abandoned the rescue deal. On 11 November, FTX and dozens of its subsidiaries filed for bankruptcy.

The bankruptcy proceedings in the US are expected to take time, and many of the details of the case are yet to emerge.

First considerations on implications

At this early stage, certain features of the reported situation deserve consideration from a regulatory perspective.

First, in traditional finance, segregation of client assets is a crucial safeguard. FTX's clients – including EU-based investors – stand to lose much or all of the value of their assets deposited with the company, depending on the extent to which FTX may or may not have pooled their holdings with other capital. The governance in place at FTX has been described by observers closer to the matter as highly suspect.

The lack of safeguards in place at many entities active in crypto markets such as client asset segregation was one among many factors that prompted ESMA and the other ESAs to issue warnings to investors – in 2018, and again this year –about the severe risks involved in holding crypto-assets.[2]

Second, crypto assets carry with them extreme market risk, with huge volatility seen in prices. The price of Bitcoin, for example, is around two-thirds down from its peak around a year ago. Liquidity and operational risks – including the risk of hacks and exploits – mean that investors holding assets on crypto exchanges may find their assets are inaccessible, either temporarily or permanently. Crypto assets have long raised concerns around market manipulation and the potential for money laundering and the financing of criminal activities.

Third, despite these fundamental risks from crypto assets, we continue to see widespread and often aggressive marketing to the mass market. Consumers may be persuaded to put their money into crypto assets without being made aware of the extreme risks involved.

In addition to investor risks, we have been monitoring crypto asset markets from a financial stability perspective and have published our assessment in a dedicated report earlier this year[3]. Within the crypto asset sector, there remains potential for contagion from the FTX episode, as well as the risk that other entities in the sector have flawed business models or inadequate governance and controls. That said, at present ESMA does not see significant risks of major spill-overs into the wider financial sector, given that crypto assets represent less than one percent of total market capitalisation across traditional asset classes, and the fact that interlinkages across the crypto and traditional financial markets have remained comparatively limited.

Importance of regulatory action

The concerns we have publicly expressed on the risks around crypto assets are at the heart of the rationale for the EU's MiCA regulation. The collapse of FTX is likely to cause major detriment to retail investors, including in the EU. The specific facts of the case, as they emerge, may provide evidence relevant to policymakers in future in this area. Notably, the collapse of FTX is understood to corroborate existing evidence that corporate governance and controls in the crypto asset space at large may be very weak.

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2 See: (i) European Supervisory Authorities (2018), ESMA, EBA and EIOPA warn consumers on the risks of Virtual Currencies, 12 February; (ii) European Supervisory Authorities ESAs (2022), EU financial regulators warn consumers on the risks of crypto-assets, 17 March.

3 ESMA TRV Risk Analysis, "Crypto-assets and their risks for financial stability", 4 October 2022.

MiCA is tackling the right issues to introduce vital protections for investors and important rules for market participants through a common EU regime. Implementing and applying these protections and rules, as well as equipping regulators and supervisors with adequate resources, appears to us a matter of utmost urgency.

Service providers domiciled outside the EU play the dominant role in crypto markets. They should be expected to do so even after the implementation of a regulatory framework in the EU. EU authorities will, therefore, need to continue to cooperate closely with counterparts internationally on such matters.

ESMA stands ready to assist the EU institutions in providing technical advice and input whenever it is required.

Thank you again for the opportunity to appear before the Committee today.