State Regulators Are Not Leaving FTX To The Feds

By **Sid Mody, Daniel Suvor and Marica Wright** (March 2, 2023)

Sid Mody

Daniel Suvor

Marica Wright

Since the November collapse of FTX Trading Ltd., subsequent revelations about the crypto exchange's co-founder Samuel Bankman-Fried's gross mismanagement of the company, as well as the inappropriate ties between FTX and Alameda Research, among many other details, have overtaken the headlines.

Ever since, FTX has faced intense scrutiny from regulators, as federal authorities have brought both criminal and civil cases against FTX entities, founders and some employees, also launching investigations against related parties and individuals.

But state regulators have also gotten in on the action in the crypto space. State financial regulators in Texas, California and New York have been investigating — and even litigating against — FTX, Celsius Network, Nexo Group, BlockFi and Voyager Digital, all large crypto-lending players.

The feds have commandeered most of the headlines, but companies dealing with digital assets would be wise to keep an eye — or two — on state regulators as well.

Let's take a look at what the states have been up to.

Texas

In late November, the Texas State Securities Board filed a notice requiring Samuel Bankman-Fried to appear before an administrative law judge,[1] with the agency claiming that FTX's alleged violations of the Texas Securities Act are related to the offer and sale of digital assets that the board says should be "regulated as securities."[2]

The notice alleged that Bankman-Fried and FTX offered and sold unregistered securities in the Lone Star State without registering as a dealer or an agent, and that the FTX co-founder withheld material facts about the status of the company.

However, Administrative Law Judge Sarah Starnes has paused the proceedings, asserting that Bankman-Fried could not be sued in lieu of his former companies unless the Texas State Securities Board could establish that he had personally done business in Texas.

Though several outlets have reported Judge Starnes' ruling as a win for Bankman-Fried, Director of Enforcement for the Texas State Securities Board Joseph Rotunda has indicated that the board will likely file an amended complaint and provide additional information to support the action against Bankman-Fried.[3]

Also, within this action, Texas regulators are investigating the individuals who promoted FTX and will look into the payments received for celebrity endorsements, as well as the corresponding disclosures and their accessibility to retail investors.

Some states may be content to let the federal investigators drive, but Texas, for one, is not taking a backseat to the feds. Though the administrative hearing is on hold, Texas state officials have taken other paths in their investigation.

Notably, Texas was one of three states that filed a petition in the federal FTX bankruptcy case seeking the appointment of an independent examiner. The case includes letters of support from 16 other states' securities and banking regulators.[4]

Additionally, in January, Texas state legislators introduced H.B. 1666, which would require digital asset exchanges to verify the amounts of funds on reserve to pay customers when they ask for their money back and prohibit exchanges from commingling consumer funds with corporate assets — a clear response to the events leading to the FTX collapse.[5]

California

The California Department of Financial Protection and Innovation is also investigating FTX.

The DFPI has not disclosed any specifics of its investigation since its inception, but it previously initiated several enforcement actions against BlockFi, Nexo Group, Celsius and Voyager Digital, noting that these actions were "part of a larger DFPI effort to investigate companies that offer consumers interest-bearing crypto asset accounts."[6]

The focus of the agency's previous actions concerned keeping unregistered securities sold by unregistered securities dealers out of the market. For example, the DFPI revoked BlockFi's California Financing Law License on Dec. 19, 2022, one day after BlockFi paused all withdrawals from its platform citing "significant exposure to FTX" and affiliated entities.[7]

The DFPI, along with securities regulators from seven other states, secured a $22.5 million settlement against Nexo Group in January 2023 in connection with its EARN interest product accounts.[8] The states alleged that Nexo had offered investors interest-earning accounts without registering them as securities.

The DFPI issued a notice to Celsius Lending LLC in August 2022, stating its intention to revoke Celsius's California Financing Law lender's license and suspend its license until the revocation action was resolved.[9] The DFPI's order claimed that Celsius Network and its CEO Alex Mashinsky had made "material misrepresentations or omissions" when offering crypto interest accounts, understating the risks of depositing digital assets with Celsius.

The DFPI reached a settlement with Voyager Digital in June 2022 for violating Section 25110 of the Corporations Code, which prohibits the offer or sale of "unqualified, nonexempt securities" in California.[10] The DFPI found that the accounts offered and sold by Voyager were securities under the Corporations Code, and under the terms of the settlement, Voyager was to "desist and refrain" from selling securities in the state.

It remains to be seen whether the DFPI's investigation of FTX will follow the pattern of its prior investigations.

However, the state of California has shown that it is open to multiple approaches in order to seek accountability.

In addition to the DFPI's investigation, California is one of the previously mentioned 16 states that wrote letters expressing support for the appointment of an independent examiner in the FTX bankruptcy case.[11]

New York

Neither New York's Department of Financial Services nor state Attorney General Letitia James has commented on their plans for FTX, but both before and after the FTX collapse, James filed lawsuits against BlockFi, Nexo and Celsius for violations of New York's Martin Act.

New York's actions, like those of California, focus on curbing offerings of unregistered securities from unregistered dealers.

In June 2022, James reached a nearly $1 million settlement with BlockFi for offering unregistered securities.[12]

Working with a multistate coalition, James sued Nexo Inc. and Nexo Capital Inc. in September 2022 for operating illegally and defrauding investors, and the coalition obtained a $24 million settlement in January.[13]

Additionally, in January 2023, James sued Alex Mashinsky for making false and misleading statements about the Celsius platform to encourage investors to deposit billions of dollars in digital assets.[14]

Most recently, in February, James sued the cryptocurrency platform CoinEx for failing to register as a securities broker or dealer in the state, and for falsely representing itself as a cryptocurrency exchange.[15]

Though it is unclear how New York will move forward against FTX specifically, state regulators have sought to put companies in the virtual currency space on notice for actions that it considers inappropriate in the custody and management of customer funds.

The New York Department of Financial Services issued regulatory guidance in January on the insolvency of crypto companies, which includes provisions on the segregation of and separate accounting for customers' virtual currency, virtual currency custodians' limited interest in and use of customer virtual currency, subcustody arrangements and customer disclosure.[16]

Surely regulators in all states are assessing how the FTX collapse has harmed their residents and examining their respective securities, finance and consumer protection regulations to see which ones FTX may have violated.

Texas being Texas, it has been boldest by already summoning Bankman-Fried to appear in person and potentially continuing to pursue a case against him directly, while California and New York seem to be taking a less public approach. This is not to say that the states won't collaborate more eventually, as in the BlockFi and NexoGroup settlements, or in concerted efforts to call for the appointment of an independent bankruptcy examiner.

What Companies Should Do Now

No matter the resolution of any state or federal investigation, some things are already clear:

As state legislatures become more active in the digital assets space — in some instances imposing greater burdens on industry participants — companies must make sure they are paying close attention to state legislative proposals and keep abreast of any new state legal requirements.

Companies should constantly review their policies and practices to ensure that they are in compliance with all state and federal regulations and guidelines. That may sound obvious, but if there are regulations and guidelines that companies dismissed because they didn't think they applied, they should take another look.

Failures in transparency will be judged harshly. A likely goal of all future enforcement will be to increase companies' transparency, especially in how customers' assets are used, which includes internal processes as well as all marketing and advertising material. Companies should reevaluate their terms of service and verify that they are, in fact, doing what they say they're doing when it comes to holding and transferring altcoins in their possession.

If a business involves the custody of user funds, companies should consider ways to segregate that function from other parts of their business. Also, they must ensure that such custody services receive sufficient resources to safeguard customer assets and avoid any potential conflicts of interest that may undermine the effectiveness of such a custody function.

Businesses should design and implement effective and meaningful internal controls to accurately account for revenue and expenses and to comply with applicable laws and rules.

Finally, companies shouldn't ignore state laws and rules because they're focused on the federal authorities. State enforcement actions are a viable threat to companies' financials and operations — so they must pay attention to the gaudy settlements and operational stoppages that have occurred in recent months.

Sid Mody is a partner at O'Melveny & Myers LLP.

Daniel Suvor is a partner and co-chair of the firm's state attorneys general investigations and litigation group.

Marica Wright is a law clerk at the firm.

[1] Texas State Securities Board v. Sam Bankman-Fried, 312-23-06226 (2023)

[2] https://www.ssb.texas.gov/sites/default/files/2022-11/NOH_SOAH_312_23_06226.pdf

[3] https://www.law360.com/articles/1564795/texas-fraud-claim-against-bankman-fried-thrown-into-doubt

[4] https://decrypt.co/120437/ftx-bankruptcy-texas-california-and-new-jersey-join-call-for-independent-examiner

[5] https://capitol.texas.gov/BillLookup/Text.aspx?LegSess=88R&Bill=HB1666

[6] https://dfpi.ca.gov/2022/11/10/dfpi-announces-investigation-into-crypto-asset-platform-ftx/

[7] https://dfpi.ca.gov/2022/12/19/dfpi-moves-to-revoke-blockfis-ca-financing-law-license/

[8] https://dfpi.ca.gov/2023/01/26/california-joins-22-5-million-multistate-securities-settlement-against-crypto-platform-nexo-capital/

[9] https://dfpi.ca.gov/enf-s/celsius-network-inc/

[10] https://dfpi.ca.gov/enf-v/voyager-digital-llc/

[11] https://decrypt.co/120437/ftx-bankruptcy-texas-california-and-new-jersey-join-call-for-independent-examiner

[12] https://ag.ny.gov/uploads/blockfi-lending-llc-assurance-no-22-032-june-7-2022

[13] https://ag.ny.gov/press-release/2023/attorney-general-james-and-multistate-coalition-secure-24-million-cryptocurrency

[14] https://ag.ny.gov/press-release/2023/attorney-general-james-sues-former-ceo-celsius-cryptocurrency-platform-defrauding

[15] https://ag.ny.gov/press-release/2023/attorney-general-james-sues-cryptocurrency-platform-failing-register-new-york

[16] https://www.dfs.ny.gov/reports_and_publications/press_releases/pr202301231