FTX collapse suggests money transmitters focus on permissible investments

November 17, 2022

Called it: State regs may shield Americans' crypto investments

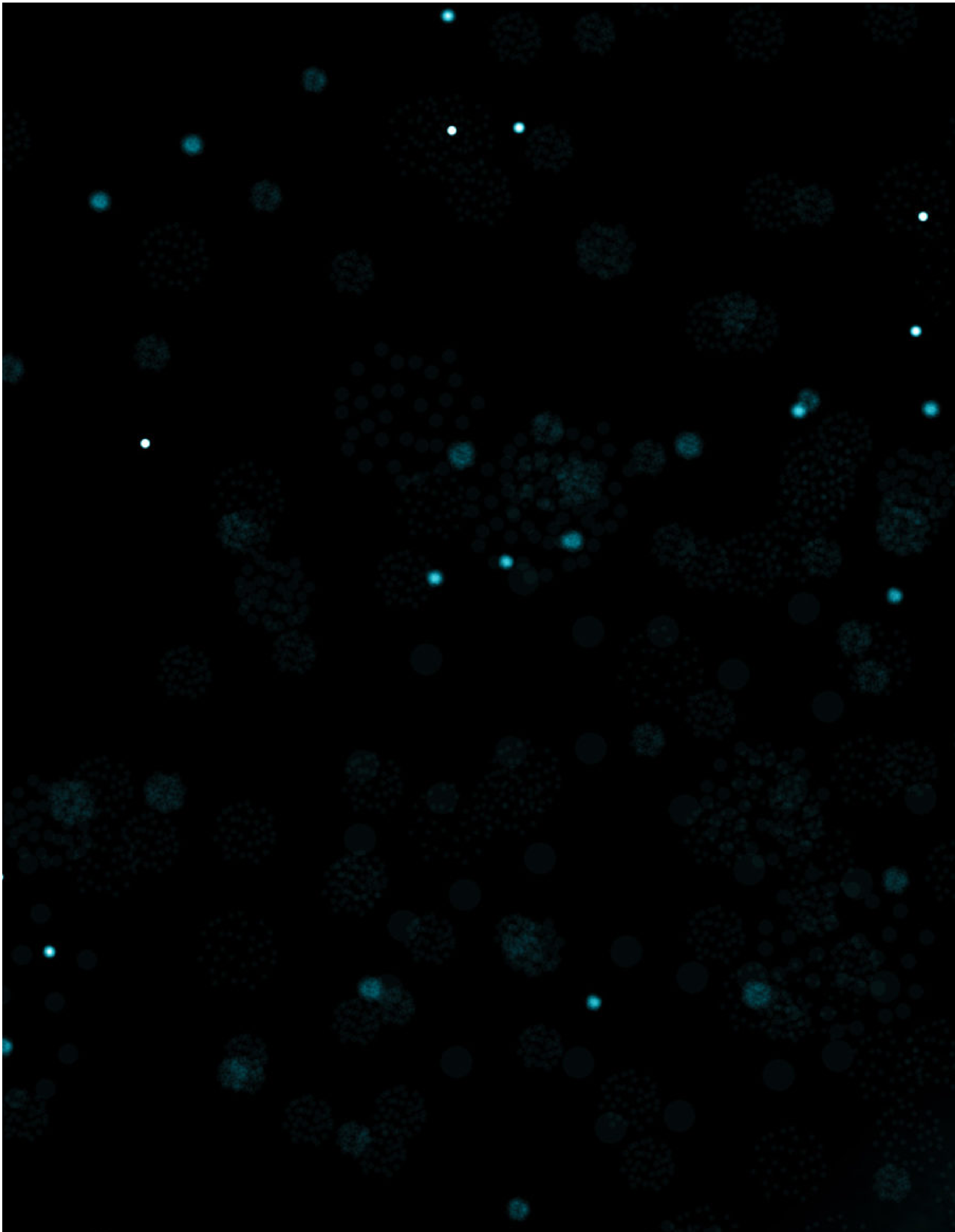
The collapse of cryptocurrency exchange FTX has been widely reported across the world. One interesting exception to the fallout appears to involve U.S. customers, according to a tweet from FTX's former CEO. We've received questions regarding whether there could be a regulatory reason for the different treatment between U.S. customers versus customers in other jurisdictions. McGlinchey does not represent FTX and does not have information regarding its operations, nor do we know whether U.S. customers will ultimately be able to recover all of their assets, particularly in light of the recent bankruptcy filing. However, the short answer is **yes; there is a regulatory basis for why this may be occurring**. This is based upon a concept we discussed in a May 2021 episode of the "More with McGlinchey" podcast, noting the detailed money transmission regulation in the United States as applied to cryptocurrency.

Reuters reported that FTX transferred customer funds from FTX to trading company Alameda Research. From publicly available information, FTX's U.S. subsidiary holds many money transmitter and money services business licenses. Many of those licenses, like those of every licensed entity, may be reviewed at the Conference of State Bank Supervisors (CSBS)'s NMLS Consumer Access website.

A common requirement of state money transmitter licensing laws, sometimes referred to as permissible investment requirements, may hold the key to a potential better outcome for U.S. customers. At a high level, money transmitters are required to maintain a level of permissible investments not less than the aggregate amount of outstanding obligations. For example, both New York and Texas have such requirements, along with many other jurisdictions. See N.Y. Banking Law § 651; Tex. Fin. Code § 151.309(a), (e). These laws typically require the calculation of those amounts to be determined according to generally accepted accounting principles (GAAP). Permissible investments are often limited to specific, highly safe, investments such as certificates of deposit or treasury securities. See N.Y. Banking Law § 640(9); Tex. Fin. Code § 151.309(b). While not every state's money transmission law applies to a cryptocurrency exchange, for those that do apply, the obligation to maintain these funds would typically relate to the equivalent value of customer deposits. Due to the nature of each licensed company having several dozen separate regulatory agencies, most companies operating on a national basis have one or more examinations (or consolidated multistate examinations) occurring on a regular basis. Within those examinations, the regulatory agencies often review the treatment of customer funds, the accounts in which those funds are held, and review detailed transactional data to ensure compliance.

In other words, state money transmitter laws and the supervision of state regulatory agencies should ensure that a licensed money services business is unable to lend out customer deposits to trading companies without ensuring that there are sufficient, safe funds available to satisfy all customer obligations. While industry and regulatory agencies do not agree about the nature, scope, and enforcement of financial services regulation (and certainly the federal approach to cryptocurrency can use some work), this incident is an opportunity to acknowledge the value of common sense regulation that protects consumers and helps ensure the ongoing safety and soundness of financial institutions.

To the extent you are a licensed money transmitter or money services business, now would be a good time to review the treatment of customer funds and the types of investments those funds are held in. In light of these events, we expect that state licensing agencies will place even greater emphasis on permissible investment requirements in future examinations.



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Robert breaks down FTX's regulatory implications and explains key takeaways for businesses and consumers.

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