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## Compliance in decentralized finance

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By Sam Tyfield and PJ Di Giammarino

There has been a lot of discussion recently—across the globe—about how (or if) to regulate the decentralized finance (DeFi) industry. The term DeFi encompasses a broad range of activities and services, including, but not limited to:

- Minting and trading nonfungible tokens (NFTs) and other types of tokens, including derivative instruments with tokens as their underlying asset;
- Offering exchange-type facilities for NFTs and other tokens;
- New types of business structures offering more traditional products and services, such as decentralized autonomous organizations (DAOs); and
- Anti-money laundering and anti-fraud measures.

Some jurisdictions have made strides in the area. The European Union (EU) is close to launching its Markets in Cryptoassets Directive (MICA) —the DeFi equivalent of the securities and derivatives rules known as MiFID.<sup>[1]</sup> The United Kingdom (UK) has its regime for “cryptoasset businesses,” which is based on the money-laundering rules and shortly will have a MICA-equivalent.<sup>[2]</sup> And there have been regulatory advancements pursuant to which it is easier (but not simple) to categorize a token and determine whether it falls within a regulatory perimeter.<sup>[3]</sup>

DeFi has produced a large range of product and service providers with business models that bear more than a striking resemblance to those seen in traditional finance (TradFi). Some of these businesses have become household names—more infamous than famous—such as Voyager, Celsius, 3 Arrows Capital, and FTX. This article focuses on FTX and its charismatic founder, Sam Bankman-Fried.

### The breakdown of FTX

As readers may know, FTX comprised three businesses:

- The American (regulated) derivatives exchange.
- The non-United States (US) exchange.
- Alameda Research, its principal trading arm.

This article uses the term “exchange” loosely. An exchange was how FTX characterized itself, but it is important to remember that FTX was a broker–dealer operating a crossing network—not strictly an exchange. In the UK and the EU, it would be known as a “market operator,” and rules would apply to separate its activities *qua* “exchange” from its activities *qua* “broker–dealer.” In the US, one would think of it as an alternative trading system or crossing network.

While the full story has yet to emerge, the theory appears to be that FTX appropriated its customers’ deposits for its own proprietary trading activity (through Alameda Research), allowed Alameda Research to see its customers’ orders (thereby facilitating front–running), and permitted Alameda to accumulate enormous and unsustainable losses.<sup>[4]</sup> When FTX’s customers attempted to withdraw their cash, FTX was unable to source sufficient funds to permit them to do so and (on the advice of external counsel) sought bankruptcy protection. There are many more salacious details and perhaps quite a lot more to discover. However, the story, in a nutshell, is one that has been seen many times previously and one we may see again in TradFi.

Bankman–Fried was active on social and traditional media (at least prior to his extradition); his defense (for want of a better word) was that the systems and controls which would have permitted him to avoid this outcome were not in place; they were young, idealistic, foolish, etc., and had he not been bamboozled into seeking bankruptcy protection, he could have fixed it all himself in short order. It remains to be seen whether that defense survives the testimony of those who have entered into plea deals already.

Even if the defense is correct, our assertion is that this is not exculpatory or, indeed, any way acceptable.

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