How crypto custodians can help centralized exchanges **win back public trust**

Hex Trust Insights

January 2023

In the post-FTX world, crypto exchanges must offer stronger protection for investors' assets, writes **Colin Brooks**, chairman of the advisory board of **Hex Trust**.

Never in my career have I seen such a complete failure of corporate controls and such a complete absence of trustworthy financial information as occurred here. From compromised systems integrity … to the concentration of control in the hands of a very small group of inexperienced, unsophisticated and potentially compromised individuals, the situation is unprecedented.

These comments from John Ray III, the new CEO of FTX, are becoming watchwords for the turbulence that has engulfed the virtual asset industry. They should serve as a warning to all investors that, however successful and respectable an organization might appear, you cannot be too careful when it comes to safeguarding your and your clients' assets.

The dust has not begun to settle on the failure of FTX and its knock-on effects; it will likely be several months before all the facts come to light. What is absolutely clear, however, is that basic principles and controls were simply non-existent, enabling client assets to be used to support the operations of the exchange itself. This goes against the basic principle of asset segregation, whereby assets belonging to the client of a company are held separately and securely, away from the assets of the company itself, in this case, FTX.

What makes this more disturbing for crypto investors is that FTX was not a one-off case – there have been too many similar instances in recent months where those basic principles of client asset segregation have been overridden, client assets commingled with the assets of exchanges, used as collateral or to finance funding shortages and then ultimately lost with little or no recourse for the impacted clients. Although such practices are highly questionable and hugely damaging, they aren't necessarily actually illegal in the relatively unregulated crypto world.

The bankruptcies and asset losses in the crypto world are not a problem of blockchain technology, which by default provides full transparency. However, this is only true as long as the intermediary uses the blockchain in a proper way and discloses the wallets that hold clients' assets. The losses are reminiscent of similar problems in the past for traditional finance, and there would probably be similar risks in any unregulated and relatively immature industry that has seen incredibly rapid growth with dizzying volatility in asset valuations. But they certainly create questions of credibility and legitimacy for the virtual asset industry at this time, and we need to find ways of protecting client assets in the interests of investors themselves and the industry as a whole.

While all of this might sound rather grim, there is a silver lining. A solution to the problem of asset safety already exists. The solution is custodians. Custodians have played a key role in safeguarding TradFi assets for many years in some of the riskiest markets in the world. Their virtual asset counterparts have been taking on a growing role in the crypto world, a process that is only likely to accelerate in the wake of the recent turmoil.

A custodian's principal raison d'être is to safeguard clients' assets. A professional custodian provides a highly secure environment and ensures that any movement of assets out of the client's own wallet takes place only on the express instructions of the client. The custodian acts solely as an agent for client assets, never as a principal. Client assets do not form part of a custodian's own balance sheet.

A professional custodian provides infrastructure to ensure the safety of client assets, which includes:

- Fully regulated and audited environment
- Full segregation of client assets from its own
- Secure technology using the latest standards against unauthorized access
- Bank-grade controls (no single person can move assets)
- Independent internal governance and checks and balances
- Regular reconciliation of client positions
- Internal and external management of risk and security – continuous review and improvement

Regardless of whether it relates to TradFi or virtual assets, best practice is for assets to be held by an entity that does not itself indulge in risk-creating activities. This ensures that not only are clients' assets segregated and therefore safe, but it also makes them bankruptcy remote, i.e. minimizing the likelihood of any prolonged lock-up of assets caused by, for example, the bankruptcy of the custodian.

Regulatory jurisdictions are increasingly embracing custodians as part of their licensing regime, seeing them as a core link in the virtual asset investment chain. This is further boosting their role and some in the industry are even talking about making use of custodians mandatory for holding client assets.

Different custody models are available to clients to best suit their needs. For long-term investors with only an occasional need to trade, assets can be held in cold wallets with the custodian, being moved to the exchange's trading wallet only when a trade is to be made and with the proceeds of the trade moved back to the security of the client's wallet immediately after the trade has settled.

For more frequent traders, moving assets between wallets is not necessarily practical and other models might therefore be used. Some options being used or considered to increase asset security include:

- Escrow account model into which assets from both sides of a trade are transferred, effectively creating a single clearing counterparty between the two sides of a transaction.

- Application programming interface connectivity between exchanges and custodians that enables a custody client to make a selected part of their wallet available to an exchange for trading purposes, with the ability to return assets outside the reach of the exchange once a trade has settled. This enables clients to deal with multiple exchanges from a single wallet.
- Cross-chain services involving wrapping/unwrapping of specific products or positions where the principal assets are held in custody and a synthetic representation of the asset is traded, with settlement of the actual asset occurring on a net basis periodically during the day.

The virtual asset industry faces many challenges right now, but it should be able to emerge from the turmoil leaner and fitter while offering strong levels of asset protection for investors who, quite rightly, are now highly wary of entrusting their assets to parties with conflicting interests. As clients of exchanges increasingly demand safeguards for their assets, custodians and exchanges will need to collaborate to develop new models that provide a balance between the security of assets and simplicity of operations. Re-establishing trust and dependability is critical to the future of the industry, and custodians should play a core role in this process.

Colin Brooks

Chairman of the Advisory Board at Hex Trust

Colin Brooks is the Hong Kong-based chairman of the advisory board of Hex Trust, a digital assets custodian. Colin previously served as HSBC's Head of Custody and Clearing, a business that covered over 50 markets in six continents. In 2015 Colin was appointed as a senior advisor to Standard Chartered Bank's securities business and in 2017 as vice chairman of Securities Services. After retiring from SCB In 2020, Colin joined Hex Trust's advisory board.

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