CNBC

Buyers beware: Lessons from the ethereum 'flash crash'

- The price of the digital currency ethereum briefly dropped from more than $300 to 10 cents on Wednesday on one exchange.
- The "flash crash" shows how the young infrastructure isn't yet able to handle large trades.
- Big Wall Street firms have increased their interest in digital currencies and their underlying blockchain technology.

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Thursday, 22 Jun 2017

One event this week shows why digital currency markets still have a long way to go before they're safe enough for large-scale trading.

On Wednesday afternoon, a "multimillion dollar" sell order was placed on the GDAX exchange for the digital currency ethereum. That triggered a chain of events that resulted in ethereum briefly plunging to 10 cents on the exchange, according to a blog post by the exchange's vice president, Adam White.

Stop-loss orders — baked-in directives to sell an asset once it falls to a certain price — contributed to the temporary drop. The same issue contributed to the May 2010 flash crash that sent the Dow Jones industrial average plunging nearly 1,000 points only to recover minutes later. Since then, the U.S. Securities and Exchange Commission approved a "limit up and limit down" mechanism to halt stocks after sudden moves of more than 5 percent.

"What we've been doing in the stock market to prevent flash crashes, they're nowhere near that in the cryptocurrency market," said **Joe Saluzzi**, co-founder of **Themis Trading** and co-author of "Broken Markets," a 2012 book criticizing the way regulators have allowed high-frequency traders to take unfair advantage of markets.

"You have a big market that has no confidence now," **Saluzzi** said. "How are you going to attract sizeable investors?"

Wall Street has paid increasing attention to digital currencies like bitcoin and ethereum, thanks largely to their stunning surge to record highs this year. Financial institutions also see great potential in the blockchain technology supporting the cryptocurrencies and some expect it could transform the world the way the internet did.

However, the digital currencies have shown they're still unable to support widespread demand or application.

"People are excited by what they read, but frankly there's not a lot of commercial structures out there that have really scaled," said Jim Pratt, SVP and GM of WEX Virtual Payments. "Inevitably if something can be done faster and cheaper with more transparency, governments and central banks will have to find the best way to regulate and monitor this."

High demand for ethereum this week clogged the network, while GDAX scrambled to manage the fallout from the large "multimillion dollar" sell order and ultimately restored trading.

GDAX's Adam White said the firm is investigating the price drop. "It is important to note that these trades are final in accordance with our GDAX Trading Rules (Section 3.1). Honoring properly executed orders is critical to maintaining the integrity of an exchange," he said in the blog post.

"It's part of the infrastructure as we have it right now," said Brian Kelly, a CNBC contributor and founder of Brian Kelly Capital, which runs a digital assets fund. He said if GDAX were to reverse the 10 cent ethereum trades, that would put into question the validity of other trades.

Kelly said his larger digital currency orders are primarily placed over-the-counter, outside an exchange.

The GDAX issues follow other issues in digital currency markets in the last few weeks.

Coinbase owns the GDAX exchange and is a popular way for ordinary investors to purchase digital currencies bitcoin, ethereum and litecoin. Coinbase reported a website outage Wednesday, and "degraded performance" on four days last week, amid a surge in traffic.

Bitfinex, the largest U.S. dollar-based bitcoin exchange, reported distributed denial of service attacks last week, as did another smaller exchange, BTC-e.

Cybersecurity firm Proofpoint told CNBC it has seen an "uptick" in online scams to trick consumers into sharing credentials for their digital currency holdings. "The potential losses are virtually unlimited given that scammers are attempting to gain access to both cryptocurrency wallets and exchanges," Proofpoint's research team said.

Users of another exchange called Poloniex complained on Twitter and a Reddit discussion forum that they could not withdraw funds from the exchange. Poloniex did not immediately respond to a request for comment.

That said, "no one is being forced into these purchases. If there's too much risk for the purchaser they shouldn't be buying," said Stephen Obie, partner at law firm Jones Day and representative for Overstock.com on its use of blockchain. "We're in the very early stages of a technology regulators are trying to get comfortable with."

The New York State Department of Financial Services has begun examinations of virtual currency companies, according to a June 15 release of the department's annual report. Circle, Coinbase and Ripple have received a so-called "BitLicense" as required by 2015 New York State regulation, CoinDesk said.

To be sure, the latest challenges of the cryptocurrency world aren't the worst the industry has seen. Last summer, a "DAO" hack drained more than 3.6 million of ethereum into another network, sending ethereum down more than $7 to $13, according to a CoinDesk report. In 2014, the largest bitcoin exchange at the time, Mt. Gox, filed for bankruptcy and said it lost 750,000 of its users bitcoins and 100,000 of the exchange's own.