Would Crypto Regulation Have Prevented FTX Fraud?

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FTX, a large crypto exchange, has filed for Chapter 11 bankruptcy after the crypto equivalent of a run on a bank. They ran out of money and the same guy who oversaw the **Enron Bankruptcy** took over as CEO. It turns out that not only are FTX and its subsidiaries out of money, but they were also misusing customer money for years and years. Sam Bankman-Fried, the founder and former CEO of the company has been arrested and charged with fraud. Now turn back the clock and remember that last spring President Biden issued an **executive order** telling government agencies to figure out how to efficiently regulate cryptocurrencies. Yesterday we asked would crypto regulation have prevented **FTX collapse**. The question we pose today is would crypto regulation have prevented FTX fraud?

What Would Regulation Do to and for Cryptocurrencies?

The sorts of regulations necessary for cryptocurrencies or any financial arena depend on the sorts of issues that exist in that niche. In the minds of regulators, 2022 has been a before and after watershed moment. For years, people had three types of concerns about cryptocurrencies. Crypto exchanges got hacked and people lost their money or folks lost track of their computer code and therefore lost all of the cryptocurrency in their wallets. And cryptocurrencies have not only been very volatile but also prone to manipulation or **pump and dump** schemes. Both of these risk categories fall into the category of investment risk. Thus, famous investors warned folks to stay away from this dangerous investment niche at the same time that some people were making fortunes with every Bitcoin surge.

Meanwhile, Bitcoin and others have been used for nefarious purposes and criminals have used **crypto transaction mixing** to disguise their gains, not to mention not paying **crypto taxes** on capital gains. In these cases, cryptocurrencies moved out of the investment risk arena and into the illegal activities area.

The watershed year for crypto, 2022, has shown us a prolonged **crypto winter**, a sequence of **crypto business failures**, and evidence of both poor business practices and fraudulent dealings culminating in the FTX mess. So, it turns out that crypto is the source of potentially great wealth, risky, and perhaps **rigged as well**, contrary to our previous thinking.

Now, the question is if the sorts of regulation that the stock market, commodity exchanges, banks, and insurance companies have to comply with could have helped prevent the sort of **robber baron** behavior seen in crypto and specifically fraud in the case of FTX.

Do Lessons from the Financial Crisis Help in Dealing with Crypto Today?

Going into the 2008 Financial Crisis banks were issuing home mortgages to folks that should not have gotten them. The loans were at extremely low rates but with balloons so that after a period of time, such as five years, rates would be changed to fit market conditions. The deal was that the banks and mortgage companies then sold those mortgages to other lenders. When the Financial Crisis hit people were out of work, lots of them. They could not pay on their mortgages and then lenders increased rates as balloons came due. The result was a collapse of the US housing market followed by a stock market crash and a recession. As the mess was cleaned up Bush and then Obama signed into law new regulations that were meant to prevent this from happening again. These included the **Dodd-Frank** Wall Street Reform and Consumer Protection Act. This law introduced stress tests for big insurance companies and banks and the formation of the Consumer Financial Protection Bureau. These measures have helped protect from another collapse even during the Covid crisis But, if applied to crypto would they have prevented fraud?

How Did We Find Out About Fraud at FTX?

When a company appears to be running on all eight cylinders, making huge profits, and keeping its clients and customers happy, nobody looks very closely at their books unless their stock is traded on an American stock exchange or they are a big insurance company or a bank. Despite the fact that FTX was holding people's money in the form of their own token (a *crypto* currency), they were not subject to the kind of oversight that banks experience. They were not compelled to provide yearly, independently audited, financial reports like a company listed on the New York Stock Exchange. Our opinion yesterday about regulation and the FTX collapse was that financial oversight similar to banks or stock exchange-listed companies would have help prevent the chain of events that culminated in FTX going under. It is our opinion also that if anyone had been able to take a look at the books at FTX they would have been appalled. If the evaluation of their books and (virtually nonexistent) accounting practices had had some teeth behind it the fraudulent use of customer assets would have been exposed early and stopped.

The chain of events that led to the FTX collapse and exposure of fraudulent activity started with the crypto winter and sequential business failures across the crypto realm. Because there have been no laws and precious little regulatory activity in the niche, the sequence of events progressed unimpeded as did the use of customer money (crypto tokens) to prop up failing businesses in the world of **decentralized finance**. A risk that we have previously discussed is that what worked as crypto currencies rose in value was to borrow in dollars, change them to tokens, and change now-more-valuable tokens back to dollars to repay debts. When crypto goes down, as it has for a year, this business plan is a disaster.

Regulation that prevents unduly risky behavior by crypto companies with customer money will help prevent more business disasters in this niche. Regulation that ensures accurate accounting of assets and transactions on a regular basis will be a good step towards preventing more FTX-type fraud.

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