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FTX: What's next?

THE INFORMED INVESTOR
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In a noteworthy work published 2007, Richard Bookstaber recounts his experience with two financial crises of the late twentieth century – the 1987 stock market crash and the Long-Term Capital Management hedge fund debacle that occurred eleven years later. *In A Demon of Our Own Design: The Perils of Financial Innovation*, Bookstaber provides readers with an insider's perspective on the evolving complexity of our financial markets, as well as his own possible contributions to that complexity.

In the introductory chapter, he states: "My actions seemed insignificant at the time, and certainly the consequences were unintended. You don't deliberately obliterate hundreds of billions of investor money. And that is the heart of this book – it is going to happen again. The financial markets that we have constructed are now so complex, and the speed of transactions so fast that apparently isolated actions and even minor events can have catastrophic consequences."

Just one year after the publication of the book, as the United States found itself in the midst of a global economic crisis, Bookstaber's prescient commentary on the complexity of the financial markets was noteworthy. Bookstaber's warning might well be resonating today with some investors as they assess the worth of their crypto wallets. The spectacular collapse of Sam Bankman-Fried's FTX crypto empire, once valued at $32B, into bankruptcy late last year has left many wondering what might be next.

THE FTX COLLAPSE

Regulators contend that FTX, based in the Bahamas, raised more than $1.8 billion from equity investors, including approximately $1.1 billion from approximately 90 U.S.-based investors. They allege that, in his representations to investors, Bankman-Fried promoted FTX as a safe, responsible crypto asset trading platform and that he specifically pointed to FTX's sophisticated, automated risk measures to protect customer assets, when, in fact, FTX lacked the most basic internal controls. They also allege that Bankman-Fried misappropriated investor funds to make undisclosed venture investments, lavish real estate purchases, and large political donations.

After his arrest in the Bahamas late last year, Bankman-Fried was extradited to face eight criminal counts in the District Court for the Southern District of New York (SDNY), including wire fraud, commodities-fraud conspiracy and securities-fraud conspiracy. He has entered "not guilty" pleas to these charges. The Securities and Exchange Commission (SEC) and the Commodities Futures Trading Commission (CFTC) have also sued Bankman-Fried, alleging that he misappropriated investor funds.

CALLS FOR REGULATION OF CRYPTO ASSETS

A Wall Street Journal columnist recently asked: "Where was the SEC sheriff when Sam Bankman-Fried was funneling FTX customer funds to his Alameda Research Trading House to finance risky bets and fund a lavish lifestyle?"

Although the SEC has taken the position that, with certain exceptions, most cryptocurrencies are subject to SEC regulation, it has become clear that regulators have not yet developed a robust regulatory regime to regulate crypto assets.

To date, most of the regulatory activities that we have observed in the crypto space have appeared in the form of enforcement actions. We are not suggesting that a regulatory framework that addresses the risks of this relatively new asset class would have prevented the FTX fraud; however, we anticipate that some type of regulation will be forthcoming. As we ponder the possibilities for regulation of crypto assets in the year ahead, we are reminded of the agency turf wars and unfortunate legislation that preceded the financial crisis of 2008.

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LESSONS FROM THE 2008 FINANCIAL CRISIS

Alan Greenspan, Chair of the Federal Reserve from 1987-2006, had oversight of the Federal Reserve during a period of unprecedented prosperity. In a speech before the American Enterprise Institute prior to the "dot-com" bubble, he asked: "How do we know when irrational exuberance has unduly escalated asset value? And how do we factor that assessment into monetary policy?"

Even so, it's fair to say that, as an avowed free market economist, Greenspan was not particularly focused on the financial innovation that fueled the extraordinary growth of the over-the-counter (OTC) derivatives market which quintupled in size from 1992 to 1997.

Enter Brooksley Born, a graduate of Stanford University and Stanford University Law School, who was appointed by President Clinton to serve as the Chair of the CFTC in 1996.

Prior to joining the Clinton administration, Born had headed the derivatives practice at Arnold & Porter, a Washington, D.C.- based firm well known for its sector-specific regulatory expertise. Concerned that the OTC derivatives market posed a danger to the financial system, Born issued a Concept Release on May 7, 1998, in which she invited public comment.

Playing in the background was an increasingly contentious turf battle between the SEC and the CFTC. Would the new derivatives be regulated as commodities (within the purview of the CFTC) or securities (within the purview of the SEC)? Within hours of the publication of the Concept Release, three high-ranking officials — Federal Reserve Chair Alan Greenspan, Treasury Secretary Robert Rubin, and SEC Chair Arthur Levitt — took the remarkable step of issuing a joint statement, expressing their "grave" concerns and warning that additional regulation of the OTC derivatives market could be catastrophic. Shortly thereafter, they submitted a letter to Congress requesting that the CFTC's authority to regulate these new financial instruments be limited. Born left the CFTC in 1999, and the precarious market segment remained unregulated.

Two years later, in final days of the Clinton Administration, companion bills were introduced in the House of Representatives and in the Senate. This legislation, which removed from federal regulation the then-$97 trillion OTC derivatives market, was signed into law by President Clinton on December 21, 2000. The Commodity Futures Modernization Act of 2000 (CFMA) was never debated on the floor or the House of Representatives or the Senate but was swept into an "eleventh hour" omnibus budget bill.

CFMA had, of course, been considered in committee meetings and supported by sponsors in Congress whose conflicts of interest are now readily acknowledged. The consequences of this unfortunate legislation are legendary. The unregulated credit default swaps had provided billions to the banks that issued them. However, because they were used as a risk transfer device to "insure" against defaults on mortgage-backed securities, it is now acknowledged that credit default swaps exacerbated the financial crisis. The official Financial Crisis Inquiry Report published in 2011 concludes that CFMA was a "key turning point in the march toward the financial crisis." It also explains the specific ways in which OTC derivatives contributed to the crisis.

While we are not suggesting that crypto assets, if unregulated, have the same potential for systemic risk that existed with OTC derivatives, we are hopeful that both Congress and our domestic regulators will take reasonable steps to develop a framework for regulation.

Patricia Foster is a securities law attorney with Harris Beach PLLC. Her experience includes representation of clients in both registered and exempt securities offerings. She also has experience in various sectors of the financial services industry, including broker-dealers, investment advisers and investment companies. This column is a collaborative work by Patricia Foster and David Peartree. David Peartree is an adviser with Brighton Securities Capital Management, Inc., a registered investment adviser offering fee-only investment and financial planning advice. The information in this column is provided for educational purposes and does not constitute legal or investment advice.