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Why Crypto's Survival May Now Depend on Washington

By Joe Light Follow Nov. 18, 2022 4:44 pm ET

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The biggest scandal in crypto involves celebrities, sports stars, Caribbean intrigue, and a corporate mystery: How, exactly, did a company valued at $32 billion go bankrupt almost overnight? In hindsight, Sam Bankman-Fried's FTX empire displayed legions of red flags. But its fall has been striking, even to veterans of the largest blowups in corporate history.

"Never in my career have I seen such a complete failure of corporate controls," said John J. Ray, the new CEO of FTX, in a bankruptcy court filing. That's quite a comment coming from the lawyer who cleaned up Enron's bankruptcy two decades ago.

FTX has spilled blood in the streets. But far more is likely to come, and this is no time to play bargain hunter. Yes, Bitcoin and other tokens have lost more than 20%. And stocks like Coinbase Global (ticker: COIN), Silvergate Capital (SI), and Grayscale Bitcoin Trust (GBTC) have been slammed. More than $200 billion has been wiped off token market value since FTX started cracking in early November.

But nothing about this crisis indicates that it will end soon. Damage to the crypto ecosystem's credibility is unquantifiable. And more fallout is likely as other trading platforms reveal exposures to FTX and related entities, potentially pushing down token prices, crypto-related stocks, and companies even more.

Government investigations of FTX are just starting, and lawsuits are piling up. One is already targeting celebrities like Tom Brady, Larry David, and Stephen Curry for promoting FTX on its website and in a Super Bowl ad.

"We knew crypto had a highly unstable value, and now we know the platforms for trading and storing them are unreliable," says Cornell University economist Eswar Prasad, a leading digital-asset expert. "Even the basic requirement that assets can be kept securely is not met by crypto."

In Washington, calls for comprehensive crypto rules are intensifying, including a plea this past week from Treasury Secretary Janet Yellen; she said it's "vital" to address the industry's risks, protect consumers, and promote financial stability. "The dominoes aren't done falling," says Matt Hougan, chief investment officer of Bitwise Asset Management, a crypto index fund provider. "Contagion risk will keep people out of the market, and I don't know what other shoe will drop."

One might draw two conclusions. The first is that crypto has sealed its own coffin as an asset class—proving beyond a reasonable doubt that it's the "mother of all scams," in the words of New York University economist Nouriel Roubini.

The other possible conclusion is that crypto is simply proving itself irrelevant. A decade into its development, the technology has yet to make serious inroads into mainstream financial markets or commerce. The latest fiasco hasn't dented broader financial markets. The S&P 500 **SPX +0.48%** index is up 3.7% since FTX fell apart. Spreads in yields between corporate bonds and Treasuries—another sign of stress—haven't blown out like they did during the 2008-09 financial crisis.

Hougan, for one, calls both conclusions silly. "One exchange engaging in bad activity doesn't mean the end of crypto, blockchain technologies, or programmable money," he says. Bitwise hasn't seen meaningful outflows from its institutional clients, he adds, partly because they still believe in the technology and are willing to wait for this crisis to blow over.

Others in the industry say there will be a silver lining: Regulation will finally kick in, preventing other blowups. "One of the bad outcomes that could come here is conflating clear examples of human misconduct with the technology," says Dante Disparte, chief strategy officer of Circle, the company backing the $44 billion USDC stablecoin. "It's precisely because of something like this that we need to regulate the industry."

In short, crypto probably won't die, but it won't be the same in a post-FTX world. More than ever, it needs government supervision, audited financial statements, consumer protections, and transparency to survive and advance. Turning crypto into a regulated medium of exchange goes against the original libertarian ethos of Bitcoin—designed to avoid the strictures of government and corporate control. The industry may have little choice, however, if it wants to survive.

The Collapse of a $32 Billion Empire and Its Aftermath

This past week brought a flurry of revelations about potential malfeasance at Bahamas-based FTX. Corporate funds were used to buy homes in the Bahamas and other personal items for employees, Ray's filing said, with no documentation of the transactions as loans. Expenses were filed in online chats, approved with personalized emojis.

FTX didn't keep appropriate books and records, Ray noted, and its unacceptable practices included the use of software "to conceal the misuse of customer funds."

How much money has been lost isn't known. Ray noted an unauthorized transfer of $372 million of crypto and said someone had minted $300 million in unapproved tokens, diluting their value. The balance sheet has a hole of $8 billion to $10 billion, including $1 billion to $2 billion in customer assets that have gone missing, according to Reuters and other media reports. Bankman-Fried received a $1 billion loan from Alameda Research, his trading company, Ray said.

More than a million customers, creditors, and investors in FTX and related entities are now trying to recoup funds. But even the jurisdiction of FTX's remaining assets is in dispute. The Bahamas Securities Commission said on Thursday that it had directed the transfer of all FTX Digital Markets' assets to a wallet it controls "for safekeeping," a sign that jurisdictional battles over the bankruptcy could delay customer recoveries even further.

Neither an FTX representative nor Bankman-Fried responded to requests for comment. Bankman-Fried has continued posting on Twitter, apologizing, explaining, and making sometimes bizarre comments. He "continues to make erratic and misleading public statements," Ray said, citing a Twitter chat with a reporter where Bankman-Fried said, "F____ regulators they make everything worse."

Other crypto players are struggling to contain the fallout. High-yield lender BlockFi, itself the recipient of a bailout by Bankman-Fried, has frozen customer deposits. Genesis **6221 0.00%** Global Capital, a large lender, stopped withdrawals, leading Gemini Trust, an exchange founded by the Winklevoss twins, with ties to Genesis, to do the same with its yield-paying accounts.

"Genesis has been exploring all possible options and has been having positive conversations with potential investors," a spokesperson said in a statement to *Barron's*.

Another casualty has been Grayscale Bitcoin Trust, the largest publicly traded Bitcoin fund with $10.5 billion worth of the token. The trust's publicly traded security, GBTC, fell to a 40% discount to its underlying Bitcoin assets this past week. ARK

Invest CEO Cathie Wood saw that as a bargain, buying more than 300,000 shares of GBTC for her ARK Next Generation Internet ARKW -1.92% exchange-traded fund (ARKW). But GBTC's discount reflects skepticism that Bitcoin isn't done falling, and the discount could widen further due to forced-selling as more crypto entities come under pressure.

Other exchanges are racing to reassure customers. Coinbase says it doesn't take actions with customer assets without their permission. Crypto.com says it fully backs customer assets with reserves. Binance CEO Changpeng Zhao has tried to reassure customers of his exchange, the world's largest by volume, while calling for other exchanges to publish "proof of reserves."

For now, the token market appears to be taking all of this in stride. Bitcoin's price has dropped about 20%, and Ether's price has fallen 24%. That's not remarkable in the volatile token market, says The Wharton School of the University of Pennsylvania's professor Kevin Werbach, who called for more crypto regulations in a Senate hearing last February, alongside Bankman-Fried. "If I told you to look at the trading chart of most cryptocurrencies and asked you to identify the period right after the most spectacular failure in the history of the space, you'd probably not pick this out," Werbach says.

Crypto Comes Crawling to D.C.

As bulls see it, FTX's failure will prompt Washington to pass comprehensive rules.

Indeed, the best outcome may be crypto versions of Sarbanes-Oxley and Dodd-Frank—the sweeping rule changes for Wall Street that came after Enron's collapse in 2002 and the 2008-09 financial crisis. Those rules included criminal liability for executives intentionally misstating accounting, new capital buffer requirements for banks, and far more consumer protections.

U.S. policy makers are now redoubling efforts in crypto. In December, a House panel plans to hold a hearing on FTX. Next year, Congress is likely to consider bills that would require exchanges and brokerages to register with the Commodity Futures Trading Commission and/or the Securities and Exchange Commission. Regulators will also be under pressure to ensure that the FTX model of co-mingling customer assets with proprietary trading entities never happens again. That separation of assets is now a bedrock of equity broker/dealers and exchanges, but it's often absent in crypto.

Without guardrails, deep-pocketed investors like family offices and sovereign-wealth funds will stay away, says Monsur Hussain, global head of research for financial institutions at Fitch Ratings. "Some funds and family offices have liquidated at least part of their holdings until they see the dust settle," he says.

The White House also wants rules for stablecoins, which are used extensively for crypto banking and trading. Circle and other stablecoin companies have lobbied hard for rules. But the market itself has been shrinking, falling by $25 billion since peaking last May at $186 billion. "It would be difficult here to imagine a sustained recovery in crypto prices without the shrinkage of the stablecoin universe stopping," wrote analysts at J.P. Morgan in a note.

If there are winners in the fiasco, it may be companies that are already extensively regulated. Andrei Kazantsev, global head of crypto trading for Goldman Sachs, said at a conference that he'd seen a "flight to quality" from institutions seeking safe counterparties, instead of using unregulated exchanges and trading platforms.

Yet Coinbase, a beneficiary of that flight to safety, faces new headwinds. Bank of America downgraded the stock to Neutral on Friday, citing "diminished confidence in the crypto ecosystem," especially among the exchange's core retail customer base. BofA also sees revenue risk to Coinbase if there's "sustained further deterioration" in crypto asset prices, such as Bitcoin going to $10,000 from its recent $16,600.

“How far does this go? As much I keep hoping things will get better, things keep getting worse,” says D.A. Davidson analyst Chris Brendler, who maintained a Buy on Coinbase.

Some advisors say there’s no rush to get into crypto. “There’s nothing wrong with putting this in the ‘too hard’ pile,” says Meb Faber, CEO of Cambria Investment Management.

FTX now appears likely to join Enron, Lehman, and Madoff in the pantheon of corporate failures. But the chaos it’s creating in crypto is no reason to buy the dip. “I don’t think this is a value opportunity,” says Deutsche Bank strategist Marion Laboure.

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