GROUP WORK PROJECT # 2
GROUP NUMBER: 3081

MScFE 560: FINANCIAL MARKETS

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Statement of integrity: By typing the names of all group members in the text boxes below, you confirm that the assignment submitted is original work produced by the group (excluding any non-contributing members identified with an "X" above).

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Use the box below to explain any attempts to reach out to a non-contributing member. Type (N/A) if all members contributed.
Note: You may be required to provide proof of your outreach to non-contributing members upon request.

N/A

Proposed regulation:

Crypto exchanges must disclose their related-party transactions to the public.

Interview:

Journalist: Could you please explain the proposed regulation.
Non-tech: Sure. What we propose is that crypto exchanges must disclose their related-party transactions so investors and customers can make a better evaluation.
Tech: In other words, we want to make sure that exchanges only act as exchanges and do not engage in suspicious transactions with related parties. This regulation should apply to all crypto exchanges.
Journalist: That seems a bit harsh, is that common in regulation?
Non-tech: Public companies are required to disclose their related-party transactions.
Tech: There is a whole field about it, it's called transfer pricing. Given the novelty and fuss of crypto, we want to ensure that investors are able to evaluate the business of crypto exchanges. For example, FTX is accused of having traded their coin (FTT) with Alameda in order to boost the balance sheet of the latter. Clearly, FTX had more information than their investors and customers. We consider that investors would have been more cautious if the transactions were disclosed. Customers also suffered because their money was not kept safe, but it was used in other transactions. Clearly, FTX was not acting as a exchange but was helping Alameda in their trading and funding other investments.
Journalist: I see. However, there must be some downsides.
Non-tech: Of course. Crypto exchanges are not happy about it. After all, disclosing will represent an additional cost. They will have to hire people with knowledge of corporate control and maybe update their informatic systems.
Tech: It will possibly constrain the funding of current and new exchanges. Some will argue that we are not letting entrepreneurs to fully explode their capabilities and that investors are responsible of doing proper due diligence without a regulation mandating it.
Journalist: Is the benefit worth the cost?
Non-tech: Absolutely. We want to protect investors from the possibility of frauds. In the end, we would enhance the transparency of the crypto market. It will also benefit customers because we believe that exchanges with suspicious transactions will quickly be shamed in social media and customers can decide whether they trust the exchange or not.
Tech: We want to avoid fraud. Crypto exchanges should not trade their own coins with related-parties, it is too tempting. If they do, investors must evaluate whether they are ok with it or not. We are balancing the current information asymmetry. It is a case of moral hazard.
Journalist: Could you explain what moral hazard is?
Non-tech: It occurs when the two counterparties of a contract do not have access to the same information. The party with more information can take advantage of it. For example, when a person buys health insurance, they might care less about their health because the loss is reduce due to the insurance.

Tech: Indeed, the insured person does not bear the full cost of increasing their exposure to risk. In the case of a exchange, there are standards. If the owner of the exchange uses it without being subject to those standards, problems arise. For instance, the owner could use the customers' money to invest. If the investment is good, the owner can keep the profits and the customers would never realize their money was used. However, if the investment is bad and losses are realized, the owner could either assume his mistake and pay with their own funds to the customers, or, the more likely, use other customers' money. Now, if the exchange is associated with an investment firm, we believe the incentive to lend money from the exchange to the investment firm increases rapidly.

Journalist: It seems that you are, again, using FTX as an example.

Non-tech: Why would not we? They were doing exactly what we are trying to avoid. Moreover, some of the most notable VCs were invested with them. Of course, if someone does not do their job (due diligence), they must be punished. We are trying to make that job easier.

Tech: FTX is a good example of what must not happen again. We consider that given the excitement of investors with crypto, we must make sure that the exchanges they use are safe. One step towards it is to ensure that these exchanges are legit and are not backed by a fraudulent scheme. An exchange must not work together with an investment firm, there are too many risks. We want to protect both investors and customers. This new regulation will help the whole industry. With more transparency, more institutional investors could consider funding and using crypto exchanges.

Journalist: Can we trust in the moral values of the executives of such exchanges?

Non-tech: We are not saying that all exchanges will commit fraud. We are sure that there are plenty of entrepreneurs who reject what happened inside FTX. Nonetheless, businesses are run by humans, and humans respond to incentives. If there is a chance to use customer money in other unrelated transactions under the promise of quick profit, then one should probably take it before it vanishes. Of course, problems would occur if losses are realized instead of promises. We believe that this regulation will provide the right incentives for future entrepreneurs to do the righ thing, which is not to use the money of customers in a fraudulent manner. In an ideal world, entrepreneurs should have a strong set of moral values. After all, they use money given by investors and promise to deliver innovative products and services to their customers. We do not consider that ethics training would be enough to change things, every person has their own view of life and it would be very hard to change it. The use of mechanisms tha promote certain behaviors is the way to go.

Tech: Let's not forget about investors as well. It seems that "fear of missing out" has been the mood behind crypto investments. If they stopped for a moment to make proper due diligence, then the results would have not turned the way they turned for FTX. We believe that if the relationship between FTX and Alameda had been explicit, many funds would have stepped back and the whole situation would have been stopped before collapsing and driving the market value to zero. This regulation also seeks to protect investors.

Journalist: I understand. An exchange should only be an exchange. Thank you for the explanation and we will see if it is implemented.

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