FTX collapse

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ABSTRACT

This case explains the recent scandal involving the crippled cryptocurrency exchange, FTX, and its fraudulent leader, Sam Bankman-Fried (SBF). SBF's unethical and illegal behavior is shaping cryptocurrency regulations and has robbed investors of millions. This overview of the scandal provides the reader with a concise summary of recent events and poses several discussion questions.

Keywords: Cryptocurrency, scandal, Sam Bankman-Fried, FTX, exchange

INTRODUCTION

The crippled cryptocurrency exchange FTX and its fraudulent leader, Sam Bankman-Fried – or SBF for short, changed Crypto regulation and robbed millions. But what exactly happened? How did a man who was on the cover of Forbes, hailed as a cryptocurrency juggernaut, praised for his philanthropic work, was among the largest political donors in the nation - literally 2nd behind George Soros in Democratic donations (a little under $70 million) in 2022 – with donations to causes such as to the PAC named "Protect Our Future", become the face of modernized financial fraud within a matter of two weeks (Schleifer, 2021 & Seitz-Wald, 2022)? FTX was the cryptocurrency derivatives exchange that felt as if it held the pulse of the cryptocurrency market in its palm, they did massive marketing and had personalities and athletes such as Tom Brady, Shaq, Naomi Osaka, Trevor Lawrence, Steph Curry, and Larry David as paid spokesmen for FTX (Delouya, 2022).

BIOGRAPHY OF SAM-BANKMAN FRIED

SBF is a graduate of MIT that began work at Jane Street Capital, a proprietary trading firm, where he became a trader of international ETFs. His stint at Jane Street lasted 3 years from 2014-2017 where he left and soon after founded Alameda Research, a quantitative trading firm, with a 90% equity position. He began to focus on building arbitrage trades to take advantage of the price gap of Bitcoin in the Japanese and US markets. In 2018, SBF decided to move to Hong Kong. In 2019, FTX was founded by SBF as a cryptocurrency derivatives exchange and as the cryptocurrency markets exploded in response to international governmental lockdowns due to COVID-19, FTX gained prominence as the world's largest exchange in cryptocurrency. During this time, SBF became the 'white knight' of cryptocurrency and a new financial system that he often preached as altruistic and built on the idea of giving. SBF gained fame as a new kind of billionaire that was focused on building and giving rather than greed (Lang and Hals, 2022; Schleifer, 2021; Ehrlich, 2021; Q. Ai., 2022).

CRYPTOCURRENCY DERIVATIVES EXCHANGE

Derivative securities are common in the modern financial markets, some of these you may be familiar with are options and futures. Derivative asset prices are derived from an underlying asset – for instance, a Tesla Option Contract has a value that is based on the underlying Tesla common stock. These option contracts are giving the owner of said contract the right to purchase underlying shares at X price, usually the contract is for a lot of 100 shares. The derivatives market has wonderful returns to be had and gives a trader or investor the capability, if done properly, to leverage risk while also mitigating downside. A cryptocurrency derivatives exchange is a platform that gives the derivatives packages for products like Bitcoin or Ethereum; or any other cryptocurrency that an investor deems as valuable. The exchange is simply a platform that allows for people to create an account and purchase goods or products.
"Awhile ago I became convinced that our duty was to do the most we could for the long run aggregate utility of the world "– SBF (Bankman-Fried, November 4, 2022) stated SBF during a conference where he found it in his heart to sign the Giving Pledge, a public commitment started by Bill and Melinda Gates that is signed by some of the richest families and people in the world that promises to give away majority of their net worth to philanthropic efforts. SBF had amassed

a net worth of $21 billion through mainly his equity position in FTX at the time of this statement. FTX secured a round of funding that equated to $400 million in January 2022, this brought the company's valuation to roughly $32 billion. Within 10 months, FTX had filed Chapter 11 bankruptcy, SBF was being held in a Bahamian jail cell, and reports that nearly $2 billion of investor funds from FTX were 'wiped out'.

FTX COLLAPSE

To begin the explanation of the downfall of FTX it is important to highlight the relationship of SBF and FTX with regulators in the US. SBF had adamantly posted on Twitter of the need for crypto-regulation for consumer safety and the need for "the industry, regulators, and lawmakers to work collaboratively and thoughtfully together" (Bankman-Fried, October 19, 2022). As well, he often stated how the older regulatory system was too fragile and critiqued the system as unfair. Oddly enough, FTX was/is not fully available to US citizens due to the fact that the SEC and Financial Crimes Enforcement Network believing that the ability to trade on margin on such volatile derivative contracts based off of extremely volatile underlying assets on a platform that had questionable backend capabilities was not the safest for the retail investor (Bandler, 2023). FTX was based in Hong Kong, then in 2021 the company moved to the Bahamas and became stationed there. This move was seen as a strategic one on SBF's part as the non-extradition laws and ability to layer protective strategies to shelter identification is often times a perk of the small Caribbean nations. This pseudo form of protection has since shown that if one decides to steal billions of dollars from customers, the United States government has a way of dealing with this as SBF was extradited to the US in December of 2022 and made it to court in a timely manner (Bhole, 2023).

The initial phase the FTX Collapse began around August of 2022, when the FDIC served a cease-and-desist order to FTX US for misleading and lying to customers. This came from several tweets and public outings where C-Suite executives of FTX and FTX US were stating that "direct deposits into FTX are placed in individually FDIC-insured bank accounts in the user's names" and "stocks/positions are held in FDIC insured brokerage accounts", these statements were false. A response from FTX US CEO Brett Harrison of "we didn't mean to mislead anyone" did not fair well as investigators began to probe the tranches of FTX to determine what really was being done to investor money. In looking at the debt of FTX, it was found that the company borrowed from over 1 million creditors, and that nearly $6 billion of debt held by FTX consisted of FTX's own printed FTT coin. Of the FTT debt, nearly 40% of that was collateralized to borrow USD. This finding unearthed a level of thievery, deceit, lying, and ignorance that is not fully understood by the public (Ledger Insights, 2022).

Upon further investigation of the coding of FTX a "backdoor", as described by FTX attorney Andrew Dietderich, was found that allowed Bankman-Fried to funnel money without alerts or alarms tripping. This code enabled a seemingly endless line of credit that SBF used to fund his trading circus at Alameda Research (Bhole, 2023). Roughly $10 billion was moved between FTX and Alameda - $2 billion still are unaccounted for. George Wang, the head technology officer of FTX who created the fake line of credit, and Caroline Ellison, CEO of Alameda Research and girlfriend of SBF, both pleaded guilty to fraud and conspiracy in December of 2022. Attorney Andrew Dietderich also stated that the line of credit that Wang created upon request of Sam Bankman-Fried would have allowed "upwards of $65 billion to be transferred" (Bandler, 2023). As of January 3, 2023, SBF plead not guilty to various charges of

fraud and conspiracy. SBF was also able to post his $250 million dollar bail bond amount – the ruling judge has recently stated that he will make public the 2 guarantors of this bail amount – and SBF is now on house arrest until his hearing on October 3, 2023 (Marsanic, 2023).
Within 1 week of the investigations of FTX, from the 2nd to 3rd week of November 2022, FTX's public Ethereum wallet value went from $3.4 billion to $700 million. The hedge funds Sequoia, Blackrock, Ikigai held positions in FTX ranging from $350 million to $1 billion that became illiquid. And within 14 days BlockFi, a leading digital asset lender that FTX had a strong control of, declared bankruptcy. According to CNBC, BlockFi has close to $1.2 billion of assets tied into FTX as FTX seemingly bailed them out of failing business tactics (Forbes, 2022).

The debacle of FTX and the villainous behavior of SBF has dramatically impacted the entire financial markets in a way that Madoff or any of the other notorious thieves in the markets has done before (Smith, 2023; Kharpal, 2023). SBF's fraudulent behavior coupled the tactics of a Madoff level Ponzi scheme, a narcissistic belief that he and his bandit crew knew what to do with the average person's money more than they did, taking advantage of a undiscovered belief of cryptocurrencies in their present form being of any value, and then hiding the fact through self-printed FTT token. The cryptocurrency markets themselves spiraled downward in a more than typical manner as Bitcoin - the "beckon of hope" as quoted by Michael Saylor - dropped 22% in a week and the overall crypto market lost close to $1.4 trillion in value in 2022 (Reuters, 2022).

The long term impacts of the FTX collapse will consist of accelerated regulatory guidelines and laws, as the Commodity Futures Trading Commission (CFTC), the SEC, IRS, and newer bills such as the Senate's Digital Commodities Consumer Protection Act, the Infrastructure Investment and Jobs Act are coming together and presenting an increased regulatory pace to build at least some protection for the retail investor in the cryptocurrency markets (Beyer, 2023; Bandler, 2023). Additionally, it is important now more than ever that retail investors begin to self-educate on the new frontier of speculative investing that is cryptocurrency. While the extent of fraud found in FTX's case is most certainly due to bad players in the market that are lying and stealing, this financial collapse and criminal activity should inform everyone that the responsibility of an individual's financial well being needs to be controlled by the individual in a respective manner; if not, there will always be room for a toxic player such as SBF to take advantage of the layman.

DISCUSSION QUESTIONS

1. While criminal charges are being brought towards SBF and other executives of FTX, there is still a small collective heavily putting blame on investors for not doing proper due diligence. At what point does the line become crossed between improper due diligence for the investor and fraud from the company?
2. While social media aided in the swiftness of the crumble of FTX, there were previous rumblings of foul play from the company that seemed to be swept under the rug. Why and how did a scheme of this magnitude happen in this age of information?
3. Based on what is in the article, along with other news of foul play in the cryptocurrency markets, how can the argument of "a decentralized and secure currency" be kept for the current crypto space? Should more regulation be placed on the crypto markets?

4. The overall sentiment of crypto currencies in their present form being the future for currency has seemingly fallen flat. What could change to bring the crypto market from a speculative bet, to a secure asset?
5. For a financial institution such as FTX, should it be required for a 3rd party (perhaps an audit group) to critique and publicly examine the inner workings of said financial institution so that things such as not having a finance or account department are known to the investors/customers? (That is correct, FTX did not have either of those departments)
6. There will always be bad players in a market, how can individuals become more privy to it and protect themselves from instances such as the FTX debacle?

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