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# FTX Collapse: The Chronicle and the Implications

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In recent past, the collapse of the Leading global cryptocurrency exchange FTX has attracted huge attention. The FTX collapsed and on Novmber 11,2022 has filed for bankruptcy lacking funds to pay its creditors and honour its customer withdrawals. FTX is known in the wider cryptocurrency market for offering complex digital products with high liquidity, such as derivatives and options. The exchange platform itself was heralded as a well-developed product. During the 2020-2021 crypto bull run, FTX, led by Sam Bankman-Fried, was often perceived as one of the most profitable, reliable, and influential marketplaces in the space. A combination of several factors, such as the economic downturn during the "crypto winter", negative revelations about FTX itself and its practices in the industry, however, has lead to its downfall. In this explainer we attempt to cover the initial journey, the questionable practices and the current outlook towards FTX exchange and related entities.

## How it started?

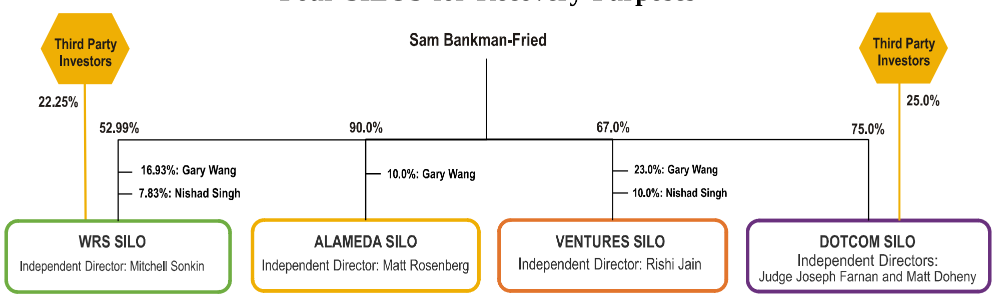
Founded in 2019, FTX quickly rose to eminence in the digital asset space, reaching the million-user mark by 2021 and reaching a valuation of over $30 billion from its last series C funding round. Group of companies under FTX empire are more than 100 in number and are incorporated across the globe while the main entity running the FTX exchange was operated out of the Bahamas. Its American partner, FTX US, had overlapping management teams but separate capital structures, allowing US residents to trade, as they were not allowed to do so on the main platform operating out of the Bahamas. FTX was established to be a cryptocurrency exchange "built by traders, for traders".

Founder of both companies involved in this debacle, Sam Bankman-Fried (SBF) is a key actor involved in this cascade of events. The 2014 MIT graduate spent his first professional years as a trader for Jane Street Capital. He then went on to launch Alameda Research in 2017, before founding FTX in 2019. He quickly became perceived as the favourite  of the crypto community, notably backing layer-1 blockchain project such as Solana. By 2022, Forbes assessed his personal net worth to be $17 billion, making him one the richest people in crypto, and placing him on the 30 Under 30 list.

Alameda Research is a quantitative cryptocurrency trading firm, founded by SBF in 2017. In addition to their trading operations headquartered in Hong Kong, the firm is heavily invested in nearly 200 crypto companies. After SBF officially left the company to focus on being FTX's CEO, he passed the torch to fellow traders Caroline Ellison and Sam Trabucco, the latter stepping down from his position of co-CEO in August 2022. Despite being established as two separate entities, FTX and Alameda Research allegedly operated very closely over the years. Funds were moving from one entity to the other without FTX customers' knowledge or approval. The close ties between FTX and Alameda also ultimately threw both companies into bankruptcy. Group of entities under the FTX empire can be broadly categorised into four group of businesses, each referred to as a silo, and the corporate shareholding / control over these silos as documented in the Chapter 11 petition filed before the Delaware court is indicated in Figure I below. Evidently, SBF is the majority shareholding for each silo.

***Figure I***

**Four SILOS for Recovery Purposes**




*Source:* https://pacer-documents.s3.amazonaws.com/33/188450/042020648197.pdf

## What happened?

On November 2nd, CoinDesk, a news website, which covers the entire digital asset space, released an article providing insights on a leaked balance sheet of Alameda Research. As of June 30th , the company's assets amounted to $14.6 billion, with nearly 40% of which comprised $FTT, FTX's invented exchange token . This ignited concerns across the crypto community that Alameda had even closer ties to FTX than expected. This leaked balance sheet ended up activating the events leading to the bankruptcy of both companies.

The news of Alameda's unexpectedly weak financials stimulated panic across the crypto market. Changpeng Zhao (CZ), CEO of Binance, the largest crypto exchange in the world and a direct competitor of FTX, announced via social media that Binance would sell all its $FTT tokens. In 2019, Binance had made a strategic investment in FTX, while taking a long-term position in $FTT, the exchange's invented token, to "help enable the sustainable growth of the FTX ecosystem".

On the news, combined with some stinging tweets from CZ, alarm spread across investors, both retail and institutional alike, who rushed to withdraw their funds from the FTX platform.

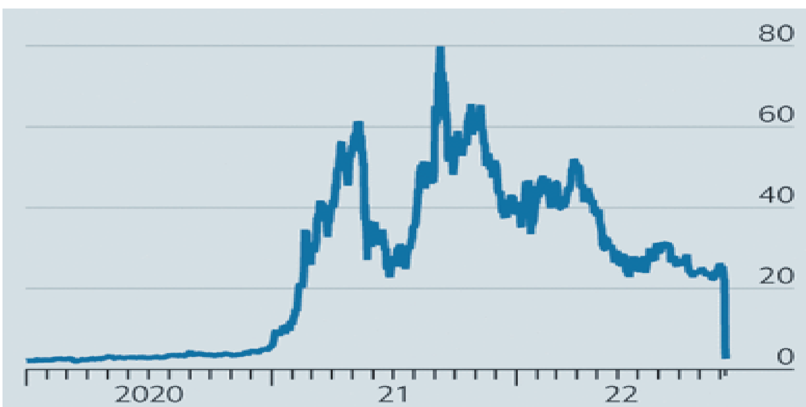
As clients withdrew their assets, it dried up the exchange's reserves. Roughly $5 billion in withdrawals were requested, which was nearly fifty times the average daily net in/out flows.

The price of $FTT collapses, bringing down the entire crypto market along with it. FTX faced a severe liquidity crisis, pushing SBF to call CZ asking for help. Both exchanges publicly proclaimed that they will sign a non-binding letter of intent, in which Binance agrees to acquire FTX, pending a due diligence procedure. After only a day, Binance announces that it will not follow through with the acquisition, citing "reports regarding mishandled customer funds and alleged US agency investigations" as reasons for the decision.

Investors were no longer able to withdraw their funds from the FTX exchange. It is disclosed that users' believably securely custodied funds (amounting up to $10 billion) are no longer with FTX. Gossips circulated that FTX had been using customers' funds to fund venture investments, marketing campaigns, and Alameda Research's trading strategies.

In a media release, the Securities Commission of the Bahamas announced that it is freezing the digital assets of FTX and related parties. They also suspended FTX's registration and appointed a provisional liquidator. The commission stated that this is a "prudent course of action" to "preserve assets and stabilize the company".

*Chart I*
**The value of an FTX Token (USD)**




*Source:* The Economist, November 9, 2022

## Why it happened?

The state of affairs at FTX entities showcase total collapse of corporate control, questionable practices of record keeping and untraceable web of lending and borrowing transactions among the relating entities and their employees. SBF resigned from the position of CEO just before filing bankruptcy petitions and Mr. John J. Ray III, famous for handling the liquidation of Enron, was appointed as the interim CEO. Ray has over 40 years of experience in legal and financial restructuring of largest corporate failures and this is how he summarised his initial findings / experience in declaration filed before the court:

> *"Never in my career have I seen such a complete failure of corporate controls and such a complete absence of trustworthy financial information as occurred here. From compromised systems integrity and faulty regulatory oversight abroad, to the concentration of control in the hands of a very small group of inexperienced, unsophisticated and potentially compromised individuals, this situation is unprecedented."*

Some of the questionable practices which have surprised the regulators and other stakeholders alike are:

1. **No record or bookkeeping:** FTX entities did not keep appropriate books of account and records of its digital assts and transactions. Almeda Research and related entities did not even maintain a record of their investment and borrowing activities.
2. **Commingling of assets of different entities and consumer funds:** There was no separation of funds of different entities of the group and SBF and Gary Wang who was the co-founder of both FTX and Alameda Research controlled access to digital assets of almost all main businesses of the group. Further, secret exemptions were granted to Alameda Research on FTX exchange on certain aspects disregarding all regulatory norms regarding related party transactions.
3. **No internal accountability or external oversight**: Financial statements of majority of the entities were not audited by any independent auditors. The veracity of the audited financial statements which are available only for few entities are also not very reliable, as per the documents filed in the court so far. SBF, sounding as a reckless, but honest entrepreneur, admitted in his tweet dated Nov 10, 2022 to have had "a poor internal labeling of bank-related accounts". As per news reports, SBF even managed to raise billions of funds from investors on the basis of spreadsheets. A report by Fortune magazine describes these spreads as "a far cry from audited financials; rather, they appear to be homespun Excel files, which are at times confusing and have inaccurate labels". Surprisingly, FTX managed to obtain funds from the likes of Sequoia and Tiger Global which raises a question on the due diligence procedure adopted by these giant investors.
4. **No record of decision making process:** SBF reportedly communicated, and also encouraged others to do so, using applications which were designed to auto-delete conversations after lapse of a certain period of time leaving no trace relating to any decision making process. There are also allegations of using software to conceal misuse of customer funds.
5. **No separation of roles and responsibilities:** FTX group of entities were discharging different roles and functions including as exchange, custodian, market maker, trader and token issuer. Many of these roles are unequivocally considered conflicting under accepted

principals of financial market. Absence of corporate governance and collapse of internal control mechanism in such delicate scenario were bound to cause fatal consequences.

6. **Role of FTT Tokens:** FTT Token arguably was the immediate cause of collapse of FTX empire. CoinDesk article highlighted that 40% of the assets of Alameda Research were in FTT Tokens and FTX also showed FTT Tokens in its balance sheet. Holding huge number of FTT Tokens within the group indicated that the trading volume only represented a small portion of the total tokens and that the then market price of the tokens may be the result of an artificial overpricing. Subsequent announcement by CZ that Binance will liquidate its FTT holding further fuelled the bank run on FTT tokens.

## What is happening now?

Bankruptcy proceedings are currently undergoing and all the assets of the relevant entities are put under the control and management of the official liquidator. Securities Exchange Commission (SEC), CFTC and Department of Justice have all initiated investigations in the case. FTX collapse will almost certainly provoke a regulatory response from various governments from across the globe, but no specific law, regulation or guidelines have been issued so far. As takeaways from this incident, upcoming regulations are likely to have specific provisions restricting use of customer's funds by any crypto exchange or custodian and may further prescribe certain governance and operational procedures to be followed by these institutions. Regulations should also prohibit a company or group of companies from discharging conflicting roles and functions.

## What will happen to Indian investors?

According to a ZeeNews report citing an industry expert, upto five lakhs Indian investors are estimated to have exposure to the FTX exchange or FTT tokens. FTX was not licenced, regulated or incorporated in India and Indian government or courts have no direct jurisdiction or control over the remaining assets of the group. There are around a million creditors, including the customers, which are involved in the case and any disbursal of funds can only take place after the conclusion of the bankruptcy proceedings. The remaining assets of the group companies will be distributed among different stakeholders as per the order of priority prescribed under the Bahamas law. The creditors and venture capitalists will get priority over customers. The possibility of a full recovery of funds for any Indian customer, or any other customer for that matter, seems highly unlikely.

## Is it better to be Safe than Sorry in the Crypto Market?

Regulators across the globe have warned retail investors about the volatility and risks associated with crypto assets. On multiple occasions, RBI Governor Mr Shaktikanta Das and Deputy Governor Mr T Rabi Shankar cautioned Indian investors in various media interactions.  RBI's foresightedness needs to be appreciated here. In absence of a global regulation on crypto, there is a significant regulatory arbitrage and unscrupulous actors like Sam Bankman Fried, Do Kwon  associated with Terra Luna algorithmic stablecoin fiasco, won't leave any avenue unexplored to exploit vulnerable investors.

It's time to eschew crypto asset speculation and focus primarily on digital asset innovation. Recent Web3 regulatory sandbox announcement by the Telangana government where RBI is a significant partner is a praiseworthy initiative to bring out the best -in-class innovative solutions to power decentralized Web3 economy.

It is important to remind ourselves what the Economist has commented on this collapse:

> *The collapse of FTX may be enough to reverse the embrace of crypto by institutions, ordinary folk and the occasional government. Institutional investors including Temasek; SoftBank…; and Ontario Teachers' Pension Plan, a Canadian fund, had all dipped their toes into the industry by buying stakes in FTX. Legislators will now eye crypto with even deeper suspicion. Whatever the precise cause of FTX's implosion, the story is already a tragedy for the industry" (The Economist, November 12, 2022).*

Does it not sound familiar? Is one not reminded about the happenings in the sub-prime toxic assets?

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