Insight

The Collapse of FTX

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Executive Summary

- On November 11, key cryptocurrency exchange FTX filed for bankruptcy, wiping billions of dollars of value from FTX, its billionaire founder Sam Bankman-Fried, and broader crypto markets.
- Concerns about improper use of client funds led to a run on FTX deposits, creating an estimated $8 billion liquidity shortfall.
- Lawmakers and regulators are left to deal with the fallout after the collapse of a firm and individual that had been a key presence in Washington policy debates about crypto and broader questions as to the regulation and supervision of this growing market.

Context

On November 11, cryptocurrency exchange FTX filed for bankruptcy in Delaware along with a number of other companies founded and run by crypto entrepreneur Sam Bankman-Fried. The collapse of FTX, at one point valued at $32 billion, is the most high-profile and significant casualty of crypto's wavering fortunes both on the market and in Washington. Who, then, are Bankman-Fried and FTX? What exactly happened, whose fault is it, and most pressing, what happens next?

Who Is Sam Bankman-Fried?

Born on the campus of Stanford University to two law professors, Bankman-Fried graduated from the Massachusetts Institute of Technology with a degree in physics and mathematics. Initially an intern, Bankman-Fried was eventually hired by trading firm Jane Street Capital, trading international exchange-traded funds. In 2017, Bankman-Fried noticed that the price of Bitcoin varied significantly across international jurisdictions (today it remains fairly consistent) and began to arbitrage bitcoin, particularly in and out of South Korea in what was known as the Kimchi Swap. This arbitrage was more technically complex than it sounds, as at the time significant technical maneuvers were required to connect bitcoin-trading platforms and execute trades. Bankman-Fried swiftly thereafter launched his own trading house and hedge fund, Alameda Research, that specialized in making these trades, and from this Bankman-Fried became a billionaire virtually overnight.

From this platform Bankman-Fried became one of the most recognizable faces in crypto, launching a wide range of sponsorship deals from Formula 1 race cars to Miami basketball. Bankman-Fried became something of fixture in Washington, testifying before Congress and pledging a billion dollars to Democratic races in the midterms (while he reneged on this promise, he did bankroll Democrats to the tune of at least $40 million). In Congressional testimony and elsewhere, Bankman-Fried had painted a picture of FTX as a source of stability to crypto markets and impervious to recent difficulties in tech markets.

What Is FTX?

The success of Alameda Research allowed Bankman-Fried to build a crypto empire. One of the key components of this portfolio was the creation in 2017 of FTX, a cryptocurrency exchange. Crypto exchanges allow customers to buy and sell digital assets using both digital assets and traditional money. FTX, along with its competitor Binance, dominated this space, processing the majority of all crypto trades made anywhere. FTX is incorporated in Antigua and Barbuda and headquartered in the Bahamas. Binance has no formal headquarters, and not being based in the United States allowed the two firms to engage in and permit trading that is not legal in the United States (but both have U.S.-based arms that comply with U.S. regulations). Binance itself was instrumental in the establishment of FTX as an initial investor.

In addition to its trading platform, FTX launched a "native" cryptocurrency, FTT, used among other things to pay for operating on the FTX platform. In 2021, Binance Chief Executive Changpeng Zhao sold the stake in FTX he received as an early investor and was paid partially in FTT tokens.

What Happened?

On November 2, influential crypto news publication Coindesk reported on a leaked document that appeared to show that Alameda Research had an unusually large number of FTT tokens on its balance sheet, despite the financial separation that is supposed to be in place between the two companies as distinct legal entities. Not only did this have segregation of asset implications, but FTT is not viewed as liquid enough to make it suitable to support Alameda's balance sheet.

On November 6, Zhao announced on Twitter that he had decided to liquidate its FTT holdings, in response to the Coindesk "revelations." Zhao noted that the sale would take place over time in a way that sought to minimize market impact. Despite these assurances, the move spooked the market and the price of FTT plummeted. Traders quickly tried to liquidate their own FTT exposures, and the resulting "run" on FTX led to an estimated $6 billion capital shortfall over only three days.

On November 8, Binance agreed to bail out FTX, buying its only significant competitor. Zhao noted that the sale would allow FTX to honor its commitments and pay out its withdrawals.

On November 9, Binance announced that it would no longer purchase FTX, coming to this decision "as a result of corporate due diligence" (this tweet is no longer available). Binance pointed to FTX's regulatory investigations and reports of mishandled funds.

On November 10, FTX announced that it had reached a deal with blockchain platform Tron that would allow it to use digital wallets other than FTX to swap some tokens.

On November 11, FTX, Alameda Research, and a number of other Bankman-Fried vehicles pled for bankruptcy in Delaware and Bankman-Fried stood down as CEO, with prices and market value having fallen between 80–90 percent.

On November 11, shortly after the bankruptcy filings, more than $600 million in digital assets were reportedly stolen from FTX in a hack.

What Happens Next?

The collapse of FTX was swift and brutal. Both Bankman-Fried and FTX were viewed as relatively safe hands, the reputable face of an industry that has struggled to dodge criticism as being an unregulated hotbed of crime and speculation. In addition to the reputational loss, the fall of FTX has had significant economic knock-on effects for crypto markets. The total market capitalization of digital assets has decreased roughly 20 percent with all major digital currencies seeing significant losses. It is, however, worth noting that the spectacular fall of its only real competition will likely have positive outcomes for Binance, provided it can avoid a similar end.

State, federal, and international financial regulators have announced their scrutiny of FTX, FTT, and Alameda Research, and specifically whether FTX funds – and by extension client funds – were used to illegally prop up Alameda Research. In the absence of congressional legislation, federal agencies will use the fallout to propose more authorities and closer supervision, most obviously Securities and Exchange Commission (SEC) Chairman Gary Gensler. The collapse of FTX puts the SEC in the very interesting position of potentially being simultaneously correct in calling for tighter crypto regulation and also as having failed in its regulatory and supervisory oversight in allowing (or at least not preventing) the collapse to happen.

D.C. lawmakers and lobbyists will be reeling from the fall of one of the loudest and most powerful voices for crypto. Those in Congress who have sought to introduce legislation that is broadly enabling to the crypto industry will now have those designs frustrated by those who see FTX's investors as victims. In a rare show of bipartisan agreement, the House Financial Services Committee has announced a December hearing to investigate FTX which Bankman-Fried is expected to attend. The House Financial Services Committee Chair Maxine Waters noted "The fall of FTX has posed tremendous harm to over one million users, many of whom were everyday people who invested their hard-earned savings into the FTX cryptocurrency exchange…" and her Republican committee counterpart, Ranking Member Patrick McHenry, likewise issued a statement saying, "It's essential that we hold bad actors accountable so responsible players can harness technology to build a more inclusive financial system." Senate Banking Committee Chair Sherrod Brown also announced the intent to hold a similar hearing.

What remains to be seen, however, is the impact that the collapse of FTX will have on cryptocurrency legislation being drafted in Congress, including both the Waters-McHenry bill and another bill in the works from Senate Agriculture Committee Chair Debbie Stabenow and Ranking Member John Boozman. The Waters-McHenry bill is viewed as overdue due to difficulties reaching agreements in the drafting process. The collapse of FTX will provide lawmakers with the impetus to get these legislative texts finalized but will do nothing to make this an easier task.

In the long term, the collapse of FTX will likely empower the traditional banking sector and other highly regulated entities in their own offerings (this is somewhat ironic given that at one point Bankman-Fried had boasted that FTX would have a balance sheet large enough to buy Goldman Sachs).

Bankman-Fried has lost an estimated 96 percent of his $26 billion personal wealth, in what can be described as one of the fastest and most significant losses of fortune of all time. In addition, Bankman-Fried will certainly be under investigation bot by both the federal financial regulators and courts in New York and the Bahamas. Bankman-Fried is viewed to have not helped matters by a series of confusing and misleading tweets over this period, despite stepping down as CEO of FTX.

Some critics have likened the collapse of FTX to other chaotic bankruptcies. While the significance of the bankruptcy is suggestive of Lehman Brothers, former Treasury Secretary Larry Summers told Bloomberg that the situation reminded him of the Enron scandal, saying: "The smartest guys in the room. Not just financial error but, certainly from the reports, whiffs of fraud. Stadium namings very early in a company's history. Vast explosion of wealth that nobody quite understands where it comes from."

Conclusions

In European history, the Schleswig-Holstein question refers to a complex set of diplomatic questions arising from the legal status of the duchies of Schleswig and Holstein to the Danish, German, and Austrian thrones. Of the question, British politician Lord Palmerston reportedly said: "Only three people have ever really understood the Schleswig-Holstein business – the Prince Consort, who is dead – a German professor, who has gone mad – and I, who have forgotten all about it."

In microcosm the collapse of FTX has all the elements of what makes crypto such an important and difficult conversation for regulators. A company operating without a federal regulatory framework, dealing in highly complex assets, enjoys a close relationship with a federal agency that did not do enough to scrutinize what it was doing with customer assets, leading to a run on deposits and a rapid liquidity crunch followed by bankruptcy. You don't have to squint too hard to see uncomfortable parallels to the 2007–2008 financial crisis.

Fortunately, however, the key differentiating factor seems to be one of contagion. While crypto remains to broader global financial stability what Schleswig-Holstein is to Europe, the impacts will mostly be felt within the industry itself and have limited spillover. But how long can this last, and will regulators and lawmakers get ahead of it before it does?