

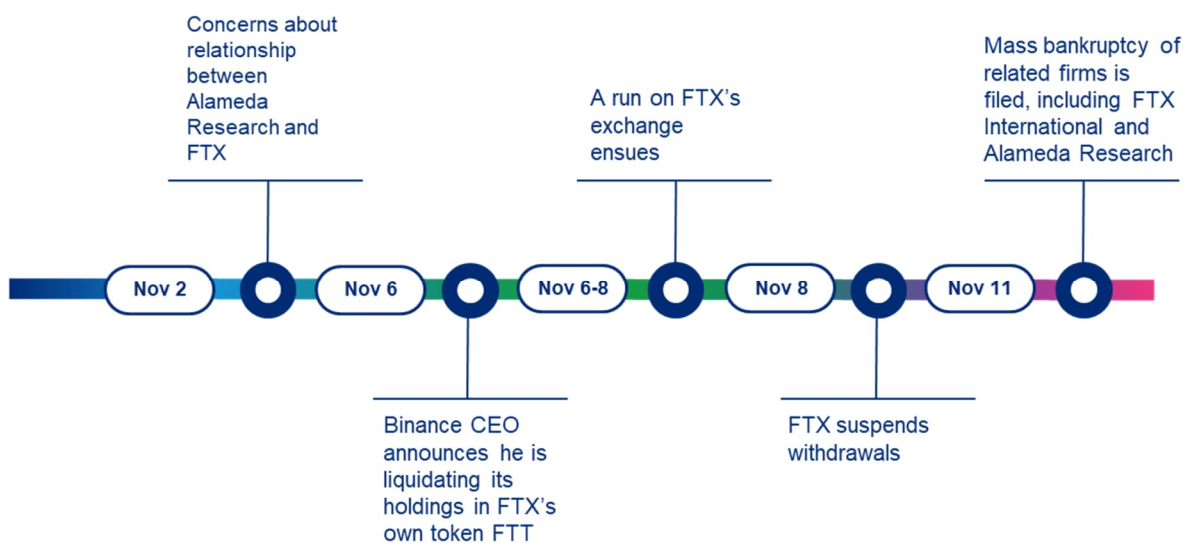
Full time for FTX

A perspective on the ongoing “Crypto Winter”

A tale of two exchanges

November saw the collapse of another crypto financial institution, FTX (we refer here to both FTX International and FTX.US). Concerns about the nature of the relationship between hedge fund Alameda Research and FTX, both founded by Sam Bankman-Fried, surfaced on November 2 in an article published by CoinDesk¹ and led to widespread solvency concerns. This was followed up by a November 6 Tweet² from a competitor, Binance CEO Changpeng Zhao, where he announced that Binance would be liquidating its holdings in FTX’s own token FTT (around half a billion dollars’ worth³). A run on FTX’s exchange followed⁴. FTX International suspended withdrawals on November 8 and, by November 11, a mass bankruptcy of related firms was filed⁵. This included FTX International and the US counterpart FTX.US, as well as Alameda Research. A balance sheet of FTX International dated November 10 was published by the Financial Times⁶, which appeared to show c. \$900 million of assets but c. \$9 billion of liabilities, indicating a severe insolvency if the records were accurate. On the same day that bankruptcy was declared (November 11), an alleged massive theft of funds (reported as equivalent to c. \$400 million) compounded a catastrophic event in the crypto-world⁷.

Figure 1. Timeline of events



Shown for illustrative purposes only

¹ <https://www.coindesk.com/business/2022/11/02/divisions-in-sam-bankman-frieds-crypto-empire-blur-on-his-trading-titan-alamedas-balance-sheet/>

² https://twitter.com/cz_binance/status/1589283421704290306

³ <https://www.forbes.com/sites/zinnialee/2022/11/07/billionaire-changpeng-zhaos-binance-to-offload-all-remaining-ftt-tokens-of-sam-bankman-frieds-ftx/?sh=5d5c46eb6711>

⁴ <https://www.coindesk.com/markets/2022/11/10/ftx-balances-tumbled-87-in-5-days-in-epic-crypto-deposit-run-data-shows/>

⁵ Official bankruptcy filing <https://s.wsj.net/public/resources/documents/alameda-filing-11112022.pdf>

⁶ <https://www.ft.com/content/0c2a55b6-d34c-4685-8a8d-3c9628f1f185>

⁷ <https://fortune.com/crypto/2022/11/14/a-hacker-stole-400m-from-ftx-this-weekend-heres-what-we-know-so-far/>

This crisis was clearly some time in the making but was seemingly catalysed by a Twitter spat between the CEOs of two of the largest cryptocurrency exchanges (FTX and Binance) about influence over US legislators and views on regulation⁸. Although this appears to be the catalyst, the problems likely had deeper roots, with allegations of what in legal terms are called “related party transactions”. One allegation among many is that FTX made improper major loans to a related party, hedge fund Alameda Research, which appears to have been largely controlled by Bankman-Fried⁹.

Related party transactions are a feature of the crypto world. Another major example is loans from Tether to Bitfinex, which share a parent company and were the subject of an investigation by the New York Attorney General¹⁰. We will not know for some time what exactly happened at FTX, however this is clearly a grave situation for users of the exchange and investors into the firm¹¹.

The magnitude of governance failure in the case of FTX is hard to overstate. John Ray III, who is overseeing the bankruptcy of FTX, also oversaw the bankruptcy of Enron (related party transactions were used to obfuscate a true financial picture in the Enron scandal). His words are worth reproducing:

“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.”¹²

A fall of dominoes?

Earlier in the year, we produced a commentary on the collapse of the TerraUSD stablecoin (“[An Unstablecoin Ecosystem](#)”). The TerraUSD debacle impacted various other firms, notably Three Arrows Capital (also known as “3AC”)¹³. The 3AC bankruptcy in turn caused the bankruptcy of the cryptocurrency broker Voyager, which was unable to call in its substantial loans to 3AC.

⁸ Various crypto entities and figure heads have been on a spending spree on lobbyists and Political Action Committees or PACS, and some differed in opinion on regulatory direction. <https://www.citizen.org/article/capitol-coin-cryptocurrency-lobbying-revolving-door-report/>
<https://www.cnbc.com/2022/10/21/midterm-elections-crypto-pacs-backed-by-scaramucci-bankman-fried-plan-ads.html>

⁹ <https://www.wsj.com/articles/ftx-tapped-into-customer-accounts-to-fund-risky-bets-setting-up-its-downfall-11668093732?mod=e2tw>

¹⁰ [https://www.coindesk.com/markets/2021/02/05/bitfinex-says-it-repaid-tether-for-550m-loan-at-center-of-nyag-probe/#:~:text=Crypto%20exchange%20Bitfinex%20claimed%20Friday,the%20tether%20\(USDT\)%20stablecoin](https://www.coindesk.com/markets/2021/02/05/bitfinex-says-it-repaid-tether-for-550m-loan-at-center-of-nyag-probe/#:~:text=Crypto%20exchange%20Bitfinex%20claimed%20Friday,the%20tether%20(USDT)%20stablecoin)

¹¹ Court filings indicate that there could be more than 1 million creditors.
<https://storage.courtlistener.com/recap/gov.uscourts.deb.188450/gov.uscourts.deb.188450.9.0.pdf>

¹² <https://fortune.com/2022/11/17/ftx-bankruptcy-filing-john-ray-never-seen-complete-failure-sam-bankman-fried/>

¹³ This firm was attempting to make money from yield staking on the Anchor protocol (this typically involves risky lending for a high interest rate), using TerraUSD, and also investing in LUNA (the cryptocurrency essentially collateralizing TerraUSD). When the ecosystem collapsed 3AC was hit from both sides. <https://www.bloomberg.com/news/features/2022-07-13/how-crypto-hedge-fund-three-arrows-capital-fell-apart-3ac>

There is some speculation that the FTX collapse could be a delayed response to these events, from May to July of this year. At one point during this prior crisis, FTX’s bitcoin reserves are reported to have fallen by over a half in short order¹⁴. Alameda Ventures, an investment arm of Alameda Research, another firm controlled by Bankman-Fried (there are 134 affiliated entities listed in the FTX bankruptcy filing), had loaned substantial capital to (the now bankrupt) Voyager in the shape of a \$200 million stablecoin facility and a 15,000 bitcoin credit facility¹⁵. Alameda appears to have been a lender, debtor and shareholder of Voyager, complicating a full understanding of the situation¹⁶.

Va banque!¹⁷

Exchanges are significant everyday components of the cryptocurrency ecosystem. The reason for this is that cryptocurrencies in the main are treated as pure speculative assets. In a recent 24-hour period, \$60 billion of cryptocurrency was traded, compared to a market capitalisation of \$830 billion¹⁸.

This system has much more the hallmarks of a casino than a new economy. While we believe blockchain technology has a chance to become a mainstream tool in asset custody and operational processes for real-world assets, we are concerned about the possibility that the speculative digital currency market will never amount to more than what it is currently, a tool to facilitate speculation. During the mid-year crisis, Arvind Narayanan, Professor of Computer Science at Princeton and expert on cryptocurrency opined, “...blockchain has so far proven useless. Worse, it’s proven a costly distraction to people and communities trying to solve real problems.”

In June this year, 1,500 other technologists wrote an open letter to Congress, advising: “We need to act now to protect investors and the global financial marketplace from the severe risks posed by crypto-assets and must not be distracted by technical obfuscations which mask an abject lack of technological utility”¹⁹. These interventions have dented confidence in the belief that crypto and blockchain will revolutionise finance. There is certainly a middle ground here to take, acknowledging that the thesis of blockchain as a General Purpose Technology (for example the wheel or the steam engine) appears to have significantly deteriorated, while not dismissing the promise that it has in specific areas where secure trustless record keeping is of value.

In search of a use case

We have highlighted the demise of various cryptocurrency use cases over time (for example the “digital gold” use case of bitcoin, [here](#)), and feel that the point may have passed for this system to prove itself. Most of the use cases we come across are in system / self-serving; another common use case is play-to-earn gaming, which may continue for some time, but feels niche, dystopian and unsustainable. Worse, it feels like an avalanche of “motivated

¹⁴ <https://insights.glassnode.com/the-week-onchain-week-46-2022/>

¹⁵ <https://www.coindesk.com/business/2022/06/17/voyager-digital-secures-loans-from-alameda-to-safeguard-its-assets/>

¹⁶ <https://www.proactiveinvestors.co.uk/companies/news/987016/in-voyager-digital-s-messy-bankruptcy-sam-bankman-fried-holds-considerable-sway-987016.html> and <https://www.bloomberg.com/news/articles/2022-09-20/alameda-to-repay-200-million-in-crypto-to-bankrupt-voyager> ,

¹⁷ Etymology, “From French (je) va (la) banque, a call used in the 18th century in games like Rouge et Noir and Faro to announce that one was betting as much money as the bank had, to either win or lose that amount.” Source: [Wiktionary](#)

¹⁸ <https://coinmarketcap.com/> 15 November 2022

¹⁹ Available at <https://concerned.tech/>

reasoning”²⁰, where blockchain and crypto-assets have been proffered as the solution to almost any real-life problem by crypto-enthusiasts, while noticeably people trying to solve problems rarely if ever seem to hit on crypto-assets and blockchain.

“Black Swan” author Nicholas Nassim Taleb, hit on one of the reasons why now is a critical time for the world of digital assets: *“At zero interest rates... for long periods of time, you are hurting the economy. You're creating bubbles, creating tumors like bitcoin...”*. Just as the hunt for yield contributed to crypto-asset uptake, rising interest rates in the traditional monetary sphere could now impair it.

The last bout of private currency explosion happened in 19th Century America (1837 – 1866), known as the Free Banking Era, or more informally as the time of wildcat banking, when thousands of currencies were issued²¹. There is every possibility that if the current set of currencies proves no more useful than the last, they will disappear over a similar time period²².

What’s next?

It’s possible, even likely, for the current crisis to spread further either quickly, or in the more delayed way that happened with FTX itself (related party Alameda was reportedly due to repay a c. \$200 million loan to Voyager in September²³). Large withdrawals from the exchange ecosystem have been reported in the week following the FTX blow-up²⁴. The system is hyper-visible, as blockchains are public, but also very complicated, and can be compared to a bowl of spaghetti. Users of exchanges can often be unaware of the relative lack of protection that the space is afforded, there exists a potential reality of exchange assets being frozen and users ending up as unsecured creditors²⁵. In the wake of FTX’s bankruptcy, bitcoin maximalist and overtly crypto-evangelical figurehead Michael Saylor²⁶ is now advising self-custody of crypto (as opposed to using exchanges). If a large part of the crypto community removes its assets into its own wallets, this might expose other exchanges in the midst of financial difficulty, and we could see more deposit runs.

²⁰ “Motivated reasoning is the phenomenon in cognitive science and social psychology in which emotional biases lead to justifications or decisions based on their desirability rather than an accurate reflection of the evidence.” Source: [Wikipedia](#)

²¹ <https://www.jstor.org/stable/25473238?mag=banks-own-private-currencies-in-19th-century-america> "On Bank Notes", Mark Fiege and Stephen Mihm. *Environmental History*. Vol. 13, No. 2 (Apr., 2008), pp. 350-359

²² The Richmond Federal Reserve’s Economic Brief of June 2022 provides a detailed evaluation of the two periods and what this might mean for digital currencies https://www.richmondfed.org/publications/research/economic_brief/2022/eb_22-21

²³ <https://markets.businessinsider.com/news/currencies/sam-bankman-fried-alameda-repay-voyager-200-million-loan-2022-9>

²⁴ <https://news.bitcoin.com/crypto-trading-platforms-deal-with-massive-withdrawal-requests-over-5-billion-in-btc-eth-removed-from-exchanges/>

²⁵ Coinbase’s Q1 10-Q filing was the subject of much discussion this year as it warned investors of precisely that eventuality <https://www.businessinsider.com/coinbase-warning-users-could-lose-crypto-bankruptcy-earnings-2022-5?r=US&IR=T>

²⁶ Founder of the firm Microstrategy, and initiator of its policy to hold large amounts of treasury money in Bitcoin. View on self-custody expressed in November interview with CoinTelegraph, source: <https://cointelegraph.com/news/exchange-outflows-hit-historic-highs-as-bitcoin-investors-self-custody>

Closing words

The recent Crypto Winter has been unpleasant for investors in cryptocurrencies, after a run of failures of tokens, lenders and exchanges. The exact circumstances of the disaster at FTX will not be known until the dust settles. We caution investors to not view this as an isolated incident but as a pattern of linked failures. Due to a lack of regulation, protections, poor segregation of customer assets on centralized exchanges, paucity of use cases and a rise of digital asset fraud related to decentralized finance, among many other worrying developments, we continue to advise investors to avoid holding strategic positions in digital assets.



Matt Scott
Senior Strategic Research Consultant

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November, 2022