

Crypto Markets, Regulatory Environment, and the Collapse of FTX

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"I don't think FTX would freak out in the slightest anyone who understands the fundamental investment case of bitcoin," said Christopher Bendiksen, head of bitcoin research at asset manager CoinShare"



Fundamental investment case of Bitcoin?



Crypto financial system

- Distributed database: Even a traditional financial system is a series of databases held by trusted parties (banks, title company, DMV....) Replace trusted parties with a database held by everyone!
- Securing transactions: Use cryptography, blockchain
 - Ab060255af0dd5660e89e53cf06d6f4e07aec375b66249694deafb0db0440813
 - MELIORA!**
 - Stirring cream into coffee: Easy to do, hard to undo
- A great combination of game theory, incentives, cryptography and information systems, replaces trust (albeit in a costly way)
- A system of digital scarcity! An incredible coordination game!
- New (bad?) solutions to what traditional finance figured out decades ago
- Reinventing/Rediscovering what finance has been doing for centuries



Purpose of any currency



Make transactions efficient (medium of exchange)



Unit of account (measure market value of activities, "divisible", "stable")



Store of value (does not get destroyed, "own-able")



Replaces trust (cash does not need a transaction history, owned by bearer)

Cash, credit cards, deposit accounts...

Bank accounts offer benefits:

- ease of transactions (debit cards, credit cards, wiring, Zelle...)
- safety, deposit protection (FDIC)
- facilitate lending, investment, growth
- **CONVERTIBLE !**

Depository institutions are highly regulated

Provision of liquidity by Central Banks

- National currencies backed by governments
- Supply managed to ensure stability, **convertibility**, reliability, scalability, scarcity
- Managed devaluation to ensure currency is used/spent

DeFi:
DEcentralized
(DEmocratized?)
FInance

Bitcoin & Other cryptocurrencies: Is it really
Decentralized or Democratic?

- Large mining facilities with unidentified (monopoly or cartel) owners
- Convertibility, stability not ensured, deposit not insured, not scalable
- Not a great unit of account, not a great mechanism of exchange, not a great store of value
- Bitcoin appreciates mainly because supply is capped; people want to hoard it rather than use or spend it.
- What do you really own? Is your digital wallet secure?

Can you make money?

- Sure, with tons of risk....
- It's not a great inflation hedge or a great stock market hedge

FTX Trading Ltd.



Fortune Forbes Magazines

- Samuel Bankman-Fried (SBF) co-founded FTX Trading Ltd in 2019.
- At its peak, FTX was the world’s third largest cryptocurrency exchange with millions of users.
- SBF ranked as the 41st richest American on the *Forbes 400* with an estimated net worth as of 9/22 of \$17.2 billion
- Venture capital funds, institutional investors, and wealthy individuals invested nearly \$2 billion in FTX (Sequoia Capital, Softbank, Temasek, Tiger Global Management, BlackRock, and the Ontario Teacher’s Pension Fund).
- Customers deposited billions of dollars in FTX trading accounts
- FTX filed for bankruptcy on 11/17/22
- The Department of Justice indicted SBF on 8 counts of fraud, money laundering, and campaign finance offenses on December 13, 2022,
- Many investors are expected to lose their entire investments. Many of FTX’s customers are unlikely to recover the full value of their deposits.
- Prominent investors have taken a “reputational hit”



FTX – Failure in Corporate Governance

Corporate Governance: *The ways in which corporations seek to ensure that that their capital is wisely managed and to assure investors a return on their investment (Hermalin/Weisbach, 2017)*

I have over 40 years of legal and restructuring experience. I have been the Chief Restructuring Officer or Chief Executive Officer in several of the largest corporate failures in history.

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.

*John J. Ray III,
FTX's New CEO*

FTX Governance Problems

Regulatory Environment

Board of Directors

Internal Controls

- Cash controls
- Disbursement controls
- Corporate books, records and security controls
- Employee records

Corporate Structure

Financial Statements

Sophisticated Investors??



Google.com

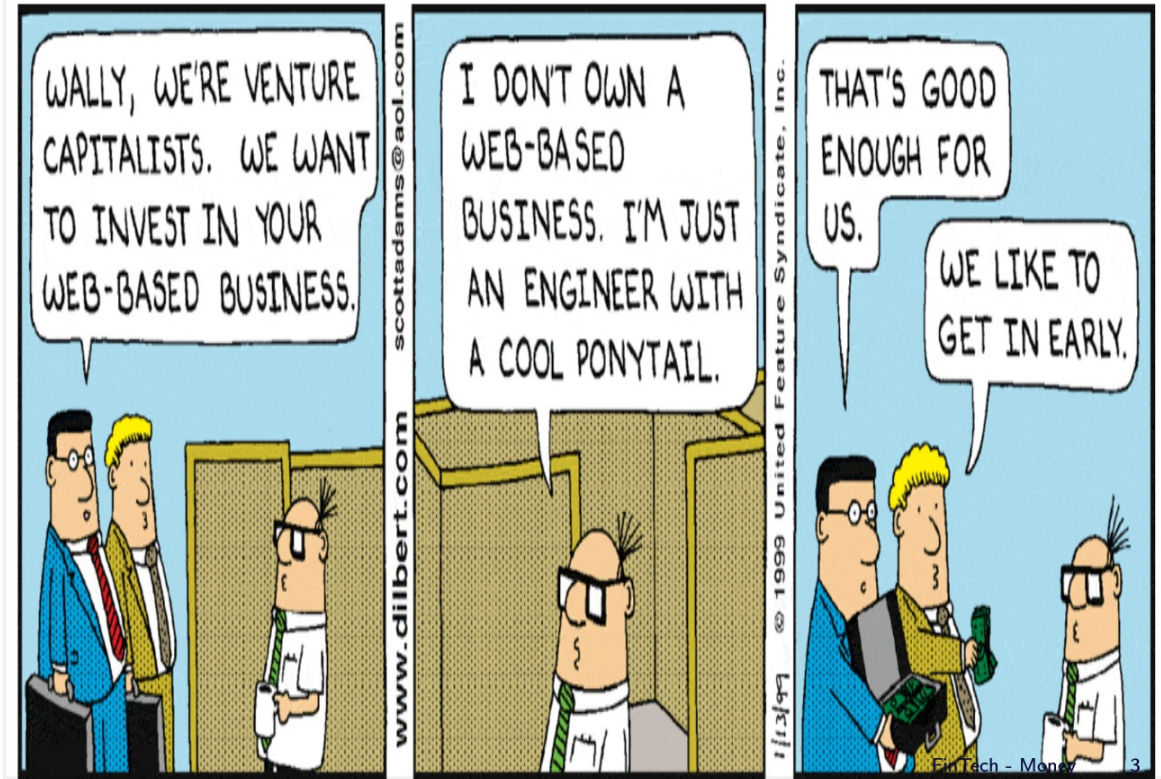
Why did sophisticated investors invest billions of dollars in FTX (as well as in WeWork, Theranos, and other companies with inexperienced management and poor corporate governance)?

Sequoia Partner Email: *I LOVED THIS FOUNDER*

1999 vs. 2023


- Not much has changed

Wednesday January 13, 1999





Venture
Capitalist
Change in
Investment
Strategy



*During the recent tech bull market, Sequoia and other Silicon Valley firms **broadened beyond the traditional venture-capital model of buying up large stakes in young startups in exchange for board seats and detailed financial information.** Instead, they raised larger funds to be able to get in on deals at higher valuations and make more daring bets.*

WSJ 11/22/22

Sequoia Capital Apologizes to Its Fund Investors

*Sequoia Capital apologized to its fund investors for the \$150 million it lost on crypto exchange FTX, said people familiar with the matter, a **rare moment of contrition** for the storied venture- capital firm.*

*Sequoia's partners told the fund investors that the **firm would improve its due-diligence process on future investments** and that it believed it was misled by FTX based on its recent bankruptcy filing, the people said.*

*A Sequoia partner said that the firm in the future will be in a position to have even early-stage startups' **financial statements audited by one of the Big Four accounting firms.***

WSJ, 11/22/22

Lessons to Learn

Investors should be careful not to invest in companies with poor governance and controls

The reputations of venture capitalists and institutional investors can be harmed by imprudent investments – proper due diligence is important

Small investors and customers should be careful not to blindly follow the lead of so-called sophisticated investors (or celebrities, such as Tom Brady, Steph Curry, and others, who promoted FTX)