WHAT'S HOT: POTENTIAL IMPACTS OF THE UNRAVELLING OF THE FTX CRYPTO EMPIRE

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What happened with FTX:

Rumours began circulating starting on the week of 1st November that the balance sheet of Alameda Research, a quantitative trading firm, and a sister company of FTX, a Bahamas-based offshore crypto exchange, might be in trouble. They both have the same owner, a 30-year-old crypto's "golden boy", Sam-Bankman Fried. It now appears FTX might have lent out customer funds and assets (no proof of this, though) to Alameda Research which made risky bets with those assets. This is strictly prohibited in traditional finance. Both companies are private, but the market estimates that 40% of the balance sheet of Alameda Research might comprise FTT tokens, utility tokens created by FTX, and these were used as collateral at the firm.

The CEO of Binance, Changpeng Zhao, or CZ, got wind of this in the week of 1st November and said over the weekend Binance will sell all of its FTT tokens (worth over $500 million). This created the cascade of events we are witnessing and a "bank run" on FTX. On Tuesday 8th, Binance and FTX agreed on a letter of intent whereby Binance might potentially purchase FTX Global (leaving FTX US intact), but after starting due diligence, Binance concluded that the finance gap at FTX is "too big" and withdrew the offer.

From the on-chain activity, the industry has recently observed money transfers from wallets at Alameda to FTX. It appears that Alameda lost money on its trades and cannot pay back the funds and assets borrowed from FTX. FTX has been reported to have a shortfall of at least $8 billion.

Current situation:

After Binance's withdrawal of its offer to takeover FTX, the question was who would be big enough to fill the finance gap at FTX? In the traditional finance industry, it would be the government which bails out the troubled company, but there is no government back-stop in crypto. Coinbase has ruled itself out.

After Binance, there were rumours that Tron cryptocurrency network's Justin Sun was working together with FTX to put together a $9.4 billion "solution". Several investment funds and companies had access to FTX's data room and were reviewing its books. Just a short while ago on Friday (11th of Nov) FTX filed for bankruptcy.

The crypto market has been up on Thursday 10th showing some optimism for a solution by the markets.

Reputation of SBF:

Apart from the shadiness of potentially using client funds to make risky bets, there are questions about what the customers and investors of FTX actually knew or were told. Were they given full and honest information about what was going on? FTX was valued at $32 billion just in January and blue-chip VCs had completed due diligence on them. If they misled investors and clients, a court case could come for SBF. It is understood that the Securities and Exchange Commission and the Commodity Futures Trading Commission are investigating whether the FTX properly handled customer funds and its relationship with other parts of Bankman-Fried's crypto empire, including his trading house Alameda Research. It is also understood that officials from the Justice Department are working with SEC attorneys.

Impact on regulation:

Regulators are likely to come on hard on the crypto industry after this event. Incredibly, SBF spent months in Washington lobbying for crypto regulation which would have benefited his own company while at the same time potentially engaging in risky activities with client funds (no proof of this, though). SBF was the second largest donor to the democratic party (after George Soros) and the democratic party worked with him on major crypto bill proposals pending review at Congress. The crypto bill proposals are likely to be modified and could be postponed for months. This is an embarrassing turn of events for the democrats.

What changes are needed in the industry:

It is clear that transparency and cryptographic proof of reserves are necessary so clients can feel secure that their assets are not lent out or used for risky activities. Kraken has already implemented this and Binance is promising to do the same in the near future.

These events also show how important it is to keep crypto assets in cold wallets and not at centralized exchanges.

Using utility tokens as collateral, particularly utility tokens created by a firm that is also accepting them as collateral, is highly risky as they are vulnerable to short attacks. The other question is: how can you use "monopoly money" you created yourself and claim it could be used as collateral and as a replacement for real money?

There are also concerns about the increasing dominance of Binance, which, before this debacle with FTX, processed around 53% of all crypto trades on spot and derivatives markets by trade count and around 30% of the market's value.

Contagion fears:

Most cryptocurrency values are down significantly in the past five days. Bitcoin is down 20%, Ethereum 24% and Solana is down 54%. Solana is down more than others as Alameda Research was one of the early initial coin-offering investors in Solana in 2021, and Alameda is said to have held staked and unstaked Solana worth billions of USD.

We expect contagion to continue for days/weeks. Several investors have already written down the investment at FTX to zero. Most obvious companies to track are the lenders to Alameda Research, clients of FTX and other companies with direct or indirect exposures to FTX, Alameda Research or FTT tokens. At this point, we do not have enough information to judge how much, if any, might be recovered from the bankrupt FTX and its sister company Alameda Research.

Future of crypto:

We believe there is still great potential in crypto. Like with most new technologies, early stages of technological development are prone to problems, hiccups and setbacks. Some of the most troublesome business models in the crypto industry have been centralized offshore crypto exchanges (Mt Gox, BitMEX, FTX) and crypto brokers (Voyager Digital). Some fundamental changes are needed to make the industry more transparent and trustworthy with less dependence on a few players. One of the solutions could be the proof of reserves model, which we discussed earlier.

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