November 30, 2022

THE FAILURE OF FTX INTERNATIONAL[1]

FTX International was a leading non-US cryptocurrency exchange operated by founder and CEO Sam Bankman-Fried ("SBF") in the Bahamas. On November 11, 2022, FTX International declared bankruptcy along with over one hundred related entities in the FTX Group, including US-based sister exchange FTX US. Based on public statements and reports, FTX International appears to have failed because SBF secretly misappropriated billions of dollars in customer funds to prop up his insolvent hedge fund, Alameda Research ("Alameda"). Here's what we know so far:

- **Alameda had an improper relationship with FTX International from the very beginning.** SBF founded Alameda in 2017, and founded FTX International two years later in 2019 as an offshore exchange available only to non-US customers. Alameda was always well-known as the primary market maker for FTX International, but SBF said it was a "wholly separate" entity. We now know that Alameda had special privileges on the exchange: it was secretly exempt from liquidation, meaning it did not have to pay its debts to the exchange as other traders did, and it was given billions of dollars' worth of the exchange's pseudo-equity token, $FTT, which it later used as collateral to borrow nearly $10 billion from the exchange. The inappropriate ties between Alameda and FTX International appear responsible for the exchange's failure.

- **FTX International gave customers' assets to Alameda without their knowledge or consent.** In early 2022, bad investments left Alameda insolvent. SBF tried to salvage the hedge fund by letting it borrow nearly $10 billion from FTX International using $FTT as collateral. On November 7, he claimed that the exchange "has enough to cover all client holdings" and "[doesn't] invest client assets (even in treasuries)." We now know that FTX International used customers' assets to fund the loan, even though doing so was explicitly prohibited by the exchange's terms of service. To avoid compliance and accounting red flags, SBF built a "backdoor" into the exchange, allowing him to transfer funds without others noticing. When customers tried to withdraw their assets, a "run on the bank" caused the exchange to fail.

- **FTX US appears to have stayed solvent despite its inclusion in the FTX Group bankruptcy.** FTX International paused customer withdrawals on November 8, one week after Alameda's exposure to $FTT was revealed on November 2. FTX US, however, continued to process withdrawals until the FTX Group declared bankruptcy on November 11. Public reports and the declaration of FTX Group CEO John Ray indicate that FTX US did not engage in transactions with Alameda or transfer customers' assets out of custody. This would mean US customers — who could only access FTX US and were blocked from trading on FTX International — will likely recover most or all of their funds. SBF now claims that FTX US customers will receive "a dollar on the dollar" while FTX International customers will get "20 or 25 cents on the dollar."

[1] This document reflects our best understanding of the facts and policy implications of FTX International's failure as of the time of this writing, but we expect that many important details have yet to be uncovered. Significant investigation and thoughtful consideration are needed to develop a full view of the situation.

Although new information is still coming to light and much is unknown, some early takeaways from FTX International's failure are already clear. Here are five lessons we've learned so far:

1. **FTX International's failure was one of traditional finance, not of blockchain technology.** Although FTX International was a crypto exchange, its failure had virtually nothing to do with crypto. Rather, it was caused by garden-variety mismanagement and malfeasance: according to John Ray, "a complete failure of corporate controls," "compromised systems integrity," "faulty regulatory oversight abroad," and "the concentration of control in the hands of a very small group of inexperienced, unsophisticated, and potentially compromised individuals."

2. **The very purpose of crypto is to eliminate the risks posed by firms like FTX International.** The vision of decentralized finance ("DeFi") is to enable a broad range of financial activities without the need to rely on gatekeepers and middlemen like FTX International. Unlike opaque financial institutions, transparent DeFi protocols are inherently resistant to covert fraud and abuse. The failure of FTX International reinforces the importance of DeFi's vision.

3. **Current legislative proposals like the DCCPA would not prevent FTX International's failure.** FTX International was a Bahamian exchange that sought to avoid US jurisdiction by screening out US customers. There is no US law or regulation that can prevent the failure of an offshore entity. The best way to address non-US exchanges is to develop a regulatory framework that attracts them to the US market, but the DCCPA would not achieve that goal. Notably, SBF — the bill's chief supporter — never expressed an intent to onshore FTX International.

4. **Current US regulations already address the risk of similar failures among US exchanges.** If FTX International had been subject to US jurisdiction, then existing US laws would have been sufficient to prohibit and enable detection of the transactions that led to its failure. For example, state money transmission laws are expressly designed to prevent custodians from losing or stealing customer funds by requiring them to provide audited financial statements, submit to regular examinations, and abide by restrictions regarding investment of assets.

5. **FTX International's failure shows that crypto does not pose broader systemic risk.** Although FTX International's failure has had a substantial impact on the crypto industry, it has not affected the US economy or financial system more broadly. As Secretary Yellen explained on November 12, crypto "doesn't pose broader threats to financial stability" at this point.

FTX International's failure demands careful action. Here's what we think policymakers should do:

- **Conduct thorough investigation —** through congressional hearings, bankruptcy proceedings, and agency investigations, uncover all of the details needed to inform future policy decisions.

- **Consider tailored legislation —** in the next Congress, consider legislation focused on further mitigating risks posed by custodial intermediaries, such as centralized stablecoin regulation.