MARKET UPDATE: FTX

NOVEMBER 15, 2022

ANOTHER ONE BITES THE DUST

Over twenty-one years ago, nearly to the day, Enron filed for bankruptcy—the then largest Chapter 11 bankruptcy in history (Enron boasted a peak market capitalization of $60 billion in 2000). Enron's use of special-purpose entities to mask liabilities and deceptive accounting practices also led to the demise and ultimate dissolution of its auditor, Arthur Anderson. Deceptive corporate behavior has been a fixture in corporate America for as long as one cares to look, and fraudulent investment schemes and misbehavior share similar cultural embedment. Over a century ago, Charles Ponzi, promised investors a 50% profit in 45 days or 100% in 90 days by arbitraging fluctuating currency values of postage vouchers[1]. Ponzi, of course, was not able to sustain such returns and turned to using money from new clients to pay off the promised returns of old clients. While Ponzi gets the namesake for such schemes, Sarah Howe first perpetuated this sort of scheme in the late 1800s by creating the Ladies' Deposit Company to help invest money for women—nearly forty years before Ponzi.[2] Howe promised high returns to her depositors which consisted only of women, who were by and large overlooked by the banks of the day. Irrational exuberance, excesses of capital, misalignment from executive stock compensation, and regulatory gaps are but part of the driving forces of recent fraudulent events. To this list we add one more: FTX.

		Notable Fraudulent Events[1]
2001	Enron	Deceptive and fraudulent accounting practices
2002	Worldcom	Deceptive and fraudulent accounting practices
2002	Tyco	Artifically inflating earnings, executive scandal
2003	Freddie Mac	Accounting scandal, misstatement of earnings
2003	Healthsouth	Accounting scandal, misstatement of earnings
2005	American Insurance Group	Great Financial Crisis - Credit Default Swaps (CDS), securities lending
2008	Bernie Madoff	Operator of the largest Ponzi scheme in history
2009	Satyam	Deceptive and fraudulent accounting practices
2018	Theranos	Blood-testing startup engaged in massive fraud
2022	FTX	Crypto exchange, fraud

[1] https://time.com/6125253/enron-scandal-changed-american-business-forever/, https://harbert.auburn.edu/binaries/documents/center-for-ethical-organizational-cultures/cases/tyco.pdf, https://www.nbcnews.com/id/wbna21027918, https://www.cfo.com/accounting-tax/2017/03/two-cfos-tell-tale-fraud-healthsouth/#:~:text=The%20infamous%20%242.8%20billion%20accounting,number%20of%20other%20company%20officials, https://insight.kellogg.northwestern.edu/article/what-went-wrong-at-aig, https://www.brookings.edu/research/history-credits-lehman-brothers-collapse-for-the-2008-financial-crisis-heres-why-that-narrative-is-wrong/, https://corporatefinanceinstitute.com/resources/wealth-management/bernie-madoff/, https://www.forbes.com/2009/01/07/satyam-raju-governance-oped-cx_sb_0107balachandran.html?sh=610e25f13044, https://www.businessinsider.com/theranos-founder-ceo-elizabeth-holmes-life-story-bio-2018-4

ALAMEDA RESEARCH AND FTX:

Sam Bankman-Fried (SBF), pictured right on Forbes cover next to fellow fraudster Theranos founder Elizabeth Holmes, founded Alameda Research in 2017 as a quantitative trading firm that specialized in the trading of cryptocurrencies for itself. SBF launched FTX as a cryptocurrency exchange in May 2019 and quickly became the darling venture capital (VC) crypto investment by several prominent VC funds as well as high profile individual investors. *FTX claimed a $32 billion valuation based on a series C fund raise of $400 million from several high-profile VC investors in 2021.*[3] While the news remains fluid, what seems to

[1] https://time.com/5877434/first-ponzi-scheme/
[2] https://longreads.com/2019/07/02/the-no-1-ladies-defrauding-agency/
[3] https://www.prnewswire.com/news-releases/ftx-trading-ltd-closes-400m-series-c-round-301471084.html

be clear is that the too close relationship between Alameda and FTX created an inherit conflict of interest, one that in traditional regulated markets would not exist. Alameda was able to, unbeknownst to most, borrow customer funds of FTX exchange to fund and support the trading operation of Alameda. FTX, under the control of SBF, was mixing customer funds and violating its own terms of service. It became clear that under duress, FTX would not have sufficient capital to return to its clients if they decided to withdraw their money—and so began the "run." What would unfold in a matter of days is the rapid unwind of a once valued multibillion-dollar company with investors likely losing 100% on their investments, along with crypto clients of FTX hoping to not suffer the same fate. Chronologically, what we know so far goes something like this[4]:

- **11/02/22** – CoinDesk publishes story showing Alameda's balance sheet which includes a significant stake of FTT tokens, FTX exchange's native token.
- **11/06/22** – Twitter wars: Binance CEO Changpeng Zhao tweets that Binance will liquidate its remaining holdings of FTT token. Alameda CEO Caroline Ellison tweets in response that Alameda will buy the FTT stake at $22 per token.
- **11/08/22** – Binance announces non-binding letter of intent to buy FTX pending diligence.
- **11/09/22** – Binance walks away from deal.
- **11/10/22** – SBF announced Alameda Research to wind down, FTX assets frozen by Bahamian regulators.
- **11/11/22** – FTX files for bankruptcy in the state of Delaware; SBF resigns as chief executive of FTX.
- **11/11/22** – BlockFi, crypto lender bailed out by FTX earlier this year, suspends customer withdrawals.
- **11/12/22** – FTX is reportedly hacked with $659 million in net outflows in the 24 hours after bankruptcy filing.

Much is still to be resolved and the news will likely change in coming days. Fraud is difficult to ferret out, and the shadowy and opaque nature of large parts of the crypto market make the challenge more difficult. That said, there are very basic characteristics that we believe the regulated securities markets offer in terms of investor protection and much of what is transpiring with FTX and Alameda would likely not have happened with the appropriate regulation, starting first with the clearly conflicted relationship between Alameda and FTX.

Our view in the crypto space remains unchanged in that crypto remains, by in large, speculative in nature. Client interest has been consistently correlated with the price of Bitcoin, and as a result we field fewer questions today as compared to one year ago. Where appropriate and where interest remains, we continue to focus client attention and education on those core investor protection tenets around asset custody, exchanges, and hot vs. cold wallets.

FINAL THOUGHTS

We do not believe there will be contagion in traditional capital markets (e.g., stocks, bonds, currencies) or the banking system as a result of FTX. Rather, the potential for contagion within the crypto ecosystem seems heightened, partly given the opacity, fragmentation, and lack of regulation. That said, there is likely more pain ahead as the FTX case is likely to turn up the heat in Washington on regulation—ultimately paving the way for more regulatory direction. Adding to the discomfort is what has also come to light recently: that SBF made political contributions totaling nearly $40 million, with two FTX executives contributing an additional $29 million.[5] Politicians are moving swiftly to separate themselves from SBF and FTX. Binance, meanwhile becomes the largest exchange

[4] *https://www.coindesk.com/markets/2022/11/12/the-epic-collapse-of-sam-bankman-frieds-ftx-exchange-a-crypto-markets-timeline/, https://www.cnbc.com/2022/11/13/sam-bankman-frieds-alameda-quietly-used-ftx-customer-funds-without-raising-alarm-bells-say-sources.html*

[5] *https://www.forbes.com/sites/zacheverson/2022/11/11/checks--imbalances-sam-bankman-frieds-political-donations-how-billionaires-fared-in-the-elections/?sh=5764e9703433*

operator outside of the US, and it is reasonable to expect the political winds to be at the backs of the US regulators, with discretions not seen before.

The digital asset space is likely to survive recent turmoil given the potential of the underlying technology and many cryptocurrencies have held up relatively well despite the recent FTX turmoil. We will continue to evolve our view on the investability of the digital asset space as the fact pattern changes.

Wishing you a Happy Thanksgiving.

- **Clearstead's Investment Office**

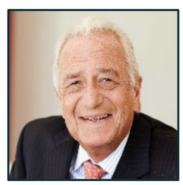
Svetlana Loshakov, CFA
Head of Investments

Aneet Deshpande, CFA
Chief Investment Strategist,
Senior Managing Director

Joe Boushelle, CFA, CAIA
Senior Managing Director,
Alternatives

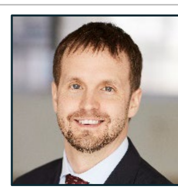
Carl Tippit, CFA
President

Tom Seay
Senior Managing Director

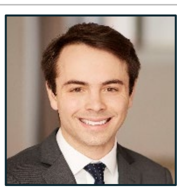


Jim Awad
Senior Managing Director

Dan Meges
Managing Director



Mike Kuebler
Analyst, Research



Mike McLelland, CFA, CAIA
Analyst, Research

Kimberly Trnavsky
Alternative Investments
Administrator