Investor Alert

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THE RAPID COLLAPSE OF CRYPTOCURRENCY PLATFORM FTX AND THE ALLEGED FRAUD ITS FOUNDER SAMUEL BANKMAN-FRIED PERPETRATED ON HIS CUSTOMERS AND INVESTORS

On December 12, 2022, accelerating an already profound and precipitous fall from grace, law enforcement authorities in The Bahamas arrested Samuel Bankman-Fried, the former cryptocurrency mogul, at the request of the United States Attorney's Office for the Southern District of New York ("SDNY"). The next day, on December 13, 2022, the SDNY unsealed a criminal indictment against Bankman-Fried charging him with eight criminal counts, including conspiracy, wire fraud, securities fraud, money laundering, and campaign finance violations.[1] That same day, the U.S. Securities Exchange Commission ("SEC") and the Commodity Futures Trading Commission ("CFTC") filed civil enforcement actions against Bankman-Fried and several of his companies, including his crypto hedge fund Alameda Research LLC ("Alameda") and his cryptocurrency exchange platform known as FTX.[2] Following a week of chaotic hearings before a Bahamian court, on December 20, 2022, news outlets reported that Bankman-Fried has consented to extradition and will return to the United States, where he faces up to 115 years in prison. The next day, Bankman-Fried departed The Bahamas.[3] On December 22, 2022, Bankman-Fried appeared in federal court in Manhattan before U.S. Magistrate Judge Gabriel W. Gorenstein, who approved an enormous $250 million bail package that allows Bankman-Fried to be released on his own personal recognizance in return for wearing an electronic monitoring bracelet and other conditions.[4] In between court dates, Bankman-Fried will be subject to home confinement at his parents' residence in Palo Alto, CA.[5]

This Investor Alert provides a summary of the facts underlying Bankman-Fried's alleged fraud and gives an overview of the three federal actions against him and his companies. Additionally, the authors offer a few

[1]Sealed Indictment, *U.S. v. Bankman-Fried*, No. 1:22-cr-00673-RA (S.D.N.Y. Dec. 13, 2022), ECF No. 1 (the "Criminal Indictment" or "CI").

[2]Complaint, *SEC v. Bankman-Fried*, No. 1:22-cv-10501-PKC (S.D.N.Y. Dec. 13, 2022), ECF No. 1 (the "SEC Complaint"); Complaint, *CFTC v. Bankman-Fried*, No. 1:22-cv-10503-PKC (S.D.N.Y. Dec. 13, 2022), ECF No. 1 (the "CFTC Complaint").

[3]Royston Jones Jr., David Yaffe-Bellany, Rob Copeland and Matthew Goldstein, "Sam Bankman-Fried Is Set for Extradition to U.S.," *N.Y. Times* (Dec. 21, 2022).

[4]Pete Brush, "Bankman-Fried Gets $250M Bail Deal In 1st SDNY Appearance," *Law360* (Dec. 22, 2022).

[5]Benjamin Weiser, Matthew Goldstein & David Yaffe-Bellany, "Sam Bankman-Fried to Be Released on $250 Million Bond With Restrictive Terms," *N.Y. Times* (Dec. 22, 2022).

takeaways for investors based on what we know so far about this rapidly evolving situation with Bankman-Fried and FTX, as well as the cryptocurrency market in general. We have researched the information contained herein from a number of sources, including the Criminal Indictment and subsequent government civil actions, and will continue to actively monitor developments in these matters.

Bankman-Fried and the Founding of Alameda Research and FTX

A 2014 graduate of the Massachusetts Institute of Technology with a bachelor's degree in physics and a minor in mathematics, Bankman-Fried began his professional career at a proprietary trading firm before moving to Berkeley, CA, where he co-founded Alameda, a privately-held crypto hedge fund, in 2017. In May 2019, Bankman-Fried and others launched FTX Trading Ltd., better known as FTX.com or simply FTX, a centralized digital asset exchange. At the time, Bankman-Fried and his associates established various subsidiaries, affiliates, and related entities, all of which did business under the FTX umbrella. Bankman-Fried's hedge fund Alameda, of which he was a 90% controlling owner at all relevant times, remained active throughout the establishment and operation of FTX.

FTX Rapidly Expands and Seizes the Mantle as the Responsible Lender in the Cryptocurrency Industry

As the cryptocurrency markets soared in recent years, so did FTX. At its peak, FTX was valued at $32 billion and had a daily trading volume over $20 billion. As FTX's profile grew, Bankman-Fried sought to portray himself as the most responsible leader in the crypto community, stressing the importance of regulation and accountability, engaging with lawmakers, and touting FTX's commitment to compliance, the protection of customers' assets, and comprehensive risk management. In testimony before the U.S. Senate Committee on Agriculture, Nutrition and Forestry on February 9, 2022, Bankman-Fried described FTX's treatment of customer funds as "ensur[ing] a customer without losses can redeem its assets from the platform on demand" and emphasized that "FTX segregates customer assets from its own assets across our platforms."[6] In materials provided to investors, FTX cultivated and promoted its reputation as "an industry-leading brand," with "the cleanest brand in crypto[,]" and "the only major digital asset venue to maintain positive, constructive relationships with regulators and lawmakers."[7]

The FTX Fraud

Yet, despite cultivating a public image as the

[6] CFTC Compl. ¶53.

[7] SEC Compl. ¶56-57.

responsible leader of the cryptocurrency industry, unbeknownst to FTX customers and investors, "Bankman-Fried improperly diverted customer assets to [Alameda], and then used those customer funds to make undisclosed venture investments, lavish real estate purchases, and large political donations[,]" according to the SEC Complaint.[8] Similarly, the CFTC alleges that "Bankman-Fried, his parents, and other FTX and Alameda employees used FTX customer funds for a variety of personal expenditures, including luxury real estate purposes, private jets, documented and undocumented personal loans, and personal political donations."[9] According to the CFTC, "Alameda and FTX comingled funds and freely used FTX customer funds as if they were their own, including as capital to deploy in their own trading and investment activities."[10]

Central to the Alameda and FTX insiders' diversion and misappropriation of customer and investor funds were the various categories of special treatment FTX afforded to Alameda, the hedge fund largely controlled by Bankman-Fried. According to the SEC, Bankman-Fried diverted FTX customer funds to Alameda by "(1) . . . directing FTX customers to deposit fiat currency (*e.g.*, U.S. Dollars) into bank accounts controlled by Alameda; and (2) . . . enabling Alameda to draw down from a virtually limitless 'line of credit' at FTX, which was funded by FTX customer assets."[11] A vast majority of these loans were collateralized by FTX's own "illiquid" crypto token, FTT, which was "not worth the value assigned to it" because Alameda and FTX owned a majority of the FTT tokens and "only a small portion of [which] were in circulation."[12] In sum, the SEC alleges that "there was no meaningful distinction between FTX customer funds and Alameda's own funds."[13] As for the deceptive account deposit scheme, Bankman-Fried directed FTX to have customers deposit their funds with North Dimension Inc., an Alameda subsidiary whose name obscured its connection to the hedge fund.[14] Regarding its undisclosed special treatment from FTX, Alameda enjoyed:

1) the ability to run a negative balance;
2) a line of credit worth tens of billions of dollars; and
3) a liquidation exemption that allowed Alameda's collateral to fall below the required margin levels without triggering automatic liquidation of its accounts.

[8] SEC Compl. ¶2.
[9] CFTC Compl. ¶54.
[10] *Id.*
[11] SEC Compl. ¶32.
[12] SEC Compl. ¶63.
[13] SEC Compl. ¶33.
[14] SEC Compl. ¶35.

Thus, in practice, according to the SEC, "[t]hese privileges permitted Alameda to draw on FTX customer assets to a virtually unlimited extent for its own uses."[15]

The Beginning of the End of the Fraud for Bankman-Fried, FTX, and Alameda

Unsatisfied with the amount of capital he was able to steal from FTX customers, at some point in 2021, Bankman-Fried directed Alameda to borrow billions of dollars from third-party crypto asset lending firms to fund his venture investments and for his personal use.[16] Importantly, certain of these loans permitted the lenders to demand repayment at any time.[17] When the value of crypto assets fell precipitously beginning around May 2022, some of the lenders demanded repayment from Alameda, which did not have sufficient assets of its own to cover these obligations; thus, Bankman-Fried directed Alameda to use its "line of credit" from FTX, *i.e.*, use as much FTX customer money as necessary to satisfy the third-party loan obligations.[18]

Unbowed by this episode, which dramatically increased the liabilities that Alameda owed to FTX, Bankman-Fried continued to direct Alameda to draw on the "line of credit" throughout the summer of 2022.[19] At the same time, however, he boldly maintained the ruse that he and FTX valued the safety of customer assets, saying on June 27, 2022 that "[b]ackstopping customer assets should always be primary[,]"[20] and continued to conceal Alameda's preferential treatment from FTX, averring to the *Wall Street Journal* in July 2022 that "[t]here are no parties that have privileged access" and claiming in a September 2022 *Bloomberg* article that "Alameda is a wholly separate entity [from FTX]."[21]

As the summer of 2022 progressed, Bankman-Fried continued to draw on customer assets to maintain FTX's patina of legitimacy and cryptocurrency leadership role, including giving a $250 million line of credit to BlockFi in late June 2022, as that company struggled through a liquidity crisis.[22] He also continued pillaging customer funds for his own personal use, including a loan to himself for $136 million.[23] Yet, the same market forces that were causing the devaluation of cryptocurrencies at large were also buffeting Alameda and FTX, though Bankman-Fried continued to conceal this fact from investors.[24] According to the

[15]SEC Compl. ¶42.
[16]SEC Compl. ¶43.
[17]*Id*.
[18]SEC Compl. ¶44.
[19]SEC Compl. ¶¶45-46.
[20]SEC Compl. ¶52.
[21]SEC Compl. ¶53. *See also id.* (Alameda CEO Caroline Ellison: "We're at arm's length and don't get any different treatment from other market makers.").
[22]SEC Compl. ¶70.
[23]SEC Compl. ¶72.
[24]SEC Compl. ¶71.

SEC, "FTX's exposure to crypto, including its own FTT token, increased substantially as Alameda increased its borrowing, backed by FTT as collateral, in the second quarter of 2022."[25]

Bankman-Fried's Fraud Comes to Light

Bankman-Fried's deceit came to light beginning in early November 2022. On November 2, 2022, *CoinDesk*, a crypto industry news website, published an article revealing that Alameda held a large position in FTT and other FTX-associated tokens.[26] Four days later, on November 6, 2022, Binance, a crypto asset trading platform, announced it would liquidate its FTT holdings worth more than $500 million, which in turn prompted many FTX customers to withdraw their funds from FTX.[27] Against this backdrop, Bankman-Fried continued to lie about FTX and Alameda as he tweeted on November 7, 2022, "FTX is fine. Assets are fine . . . FTX has enough to cover all client holdings. We don't invest client assets (even in treasuries)."[28]

The very next day, on November 8, 2022, FTX paused all customer withdrawals and the price of its token, FTT, plunged by 80%.[29] Consequently, Alameda's collateral on deposit with FTX was worth substantially less than what it had borrowed, leaving FTX with billions of dollars in unrecoverable loans.[30] Bankman-Fried reached out to Binance for help during this "liquidity crunch," but after only a single day of due diligence, Binance announced that it would not acquire FTX "[a]s a result of corporate due diligence, as well as the latest news reports regarding mishandled customer funds and alleged US agency investigations[.]"[31] In response to this news, on November 9, 2022, FTX customers withdrew approximately $5 billion.[32]

On November 10, 2022, Bankman-Fried issued a *mea culpa* on Twitter that was likely no comfort to customers, whose assets Alameda raided were worth an estimated $8 billion,[33] as he claimed, "1) I'm sorry. That's the biggest thing. I f*cked up, and should have done better."[34] Yet, alongside this apology, he claimed that he was trying to "raise liquidity" and that "[t]here are a number of players who we are in talks with, LOIs [letters of intent], term sheets, etc."[35]

But, on November 11, 2022, Bankman-Fried resigned from FTX; and that same day, FTX and around 100 affiliated entities filed for Chapter 11 bankruptcy protection.[36] On November 16, 2022, the newly

[25]SEC Compl. ¶73.
[26]SEC Compl. ¶75.
[27]SEC Compl. ¶¶76-77.
[28]SEC Compl. ¶78.
[29]SEC Compl. ¶79.
[30]*Id.*
[31]SEC Compl. ¶¶80-81.
[32]SEC Compl. ¶82.
[33]SEC Compl. ¶83.
[34]SEC Compl. ¶85.
[35]*Id.*
[36]SEC Compl. ¶86.

installed CEO of FTX, John Ray III, who navigated Enron through its bankruptcy, submitted a filing to the U.S. Bankruptcy Court in which he stated, "I have over 40 years of legal and restructuring experience. . . . Never in my career have I seen such a complete failure of corporate controls and such a complete absence of trustworthy financial information."[37] Ray continued, "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."[38]

December 2022; Bahamian Authorities Arrest Bankman-Fried and U.S. Authorities File a Trio of Actions Against Him and FTX

On December 12, 2022, just one month after FTX filed for bankruptcy protection, the Bahamian authorities arrested Bankman-Fried. On December 13, 2022, the SDNY unveiled an eight-count criminal indictment against Bankman-Fried. The Indictment includes the following charges:

1. Conspiracy to Commit Wire Fraud on Customers (18 U.S.C. § 1349)
2. Wire Fraud on Customers (18 U.S.C. §§ 1343 and 2);
3. Conspiracy to Commit Wire Fraud on Lenders (18 U.S.C. § 1349);
4. Wire Fraud on Lenders (18 U.S.C. §§ 1343 and 2);
5. Conspiracy to Commit Commodities Fraud (18 U.S.C. § 371);
6. Conspiracy to Commit Securities Fraud (18 U.S.C. § 371);
7. Conspiracy to Commit Money Laundering (18 U.S.C. § 1956(h)); and
8. Conspiracy to Defraud the United States and Violate the Campaign Finance Law (18 U.S.C. § 371).

During a news conference discussing the Criminal Indictment, U.S. Attorney Damian Williams deemed Bankman-Fried and FTX's gambit as "one of the biggest financial frauds in American history."[39] Williams also

[37] Declaration of John J. Ray III in Support of Chapter 11 Petitions and First Day Pleadings, *In re FTX Trading Ltd.*, No. 22-bk-11068-JTD (Bankr. D. Del. Nov. 17, 2022), ECF No. 24 ("Ray Decl."), ¶¶4-5.

[38] Ray Decl. ¶5

[39] David Yaffe-Bellany, Matthew Goldstein & Emily Flitter, "Prosecutors Say FTX Was Engaged in a 'Massive, Yearslong Fraud'," *N.Y. Times* (Dec. 13,

stated that the investigation is "very much ongoing" and "moving very quickly."[40]

Also on December 13, 2022, the SEC and CFTC filed civil enforcement actions against Bankman-Fried, FTX, and related entities. The SEC Complaint alleges two claims for relief: (1) Fraud in the Offer or Sale of Securities in violation of Section 17(a) of the Securities Act of 1933 (15 U.S.C. § 77q(a)); and (2) Fraud in Connection with the Purchase or Sale of Securities in violation of Section 10(b) of the Exchange Act of 1934 and Rule 10b-5 promulgated thereunder (15 U.S.C. § 78j(b) and 17 C.F.R. § 240.10b-5).[41] The SEC is seeking, among other penalties, "disgorgement plus prejudgment interest of all ill-gotten gains" and civil penalties.[42]

Relatedly, the CFTC Complaint includes two counts for violations of the Commodity Exchange Act ("CEA"): (1) Fraud in violation of Section 6c(1) of the CEA (7 U.S.C. § 9(1)) and Regulation 180.1(a)(1),(3) (17 C.F.R. 180.1(a)(1),(3)); and (2) Fraudulent Misstatements of Material Fact and Material Omissions in violation of Section 6c(1) of the CEA (7 U.S.C. § 9(1)) and Regulation 180.1(a)(2) (17 C.F.R. 180.1(a)(2)).[43] The CFTC seeks, among other penalties, to enjoin Bankman-Fried, FTX, and Alameda from participating in trading activities in the future and to pay civil monetary penalties and restitution.[44] On December 21, 2022, the CFTC amended its Complaint to add as Defendants FTX Co-Founder Zixiao "Gary" Wang and Alameda CEO Caroline Ellison.[45] Contemporaneous with the filing of the CFTC Amended Complaint, the CFTC submitted letters to SDNY regarding Wang and Ellison's agreement to Consent Orders of Judgement on Liability against them,[46] which revealed, among other information, that Wang and Ellison had pled guilty to fraud charges in criminal cases against them.[47]

Lastly, on December 21, 2022, the SEC filed a civil lawsuit against Wang and Ellison while, like the CFTC, also filing agreed-to proposed judgments against the former close associates of Bankman-Fried.[48] In the proposed judgments, Wang and Ellison pled guilty to numerous counts of securities fraud, including violations of Section 10(b) of the Exchange Act and Rule 10b-5.[49] According to various news reports, both

2022).
[40] *Id.*
[41] SEC Compl. ¶¶87-92.
[42] SEC Compl. at 26-27.
[43] CFTC Compl. ¶¶118-31.
[44] CFTC Compl. at 36-38.
[45] Amended Complaint, *CFTC v. Bankman-Fried*, No. 1:22-cv-10503-PKC (S.D.N.Y. Dec. 21, 2022), ECF No. 13 (the "CFTC Amended Complaint")
[46] Letters to Hon. P. Kevin Castel, *CFTC v. Bankman-Fried*, No. 1:22-cv-10503-PKC (S.D.N.Y. Dec. 21, 2022) ("CFTC Letters"), ECF Nos. 14, 15.
[47] CFTC Letters, ECF Nos. 14-1, 15-1.
[48] Complaint, *SEC v. Ellison et al.*, No. 1:22-cv-10794 (S.D.N.Y. Dec. 21, 2022), ECF No. 1; Proposed Judgments, *SEC v. Ellison et al.*, No. 1:22-cv-10794 (S.D.N.Y. Dec. 21, 2022) ("Proposed SEC Judgments"), ECF Nos. 3, 4.
[49] Proposed SEC Judgments, ECF Nos. 3, 4.

Wang and Ellison are cooperating with federal investigators.[50]

Takeaways

Bankman-Fried and FTX's downfall underscores the urgent need for policymakers and regulators to establish meaningful oversight of the cryptocurrency market. Speaking at the Aspen Security Forum on August 3, 2021, SEC Chair Gary Gensler warned, "[W]e just don't have enough investor protection in crypto. Frankly, at this time, it's more like the Wild West."[51] In the same speech, Gensler described how cryptocurrencies should be brought within the ambit of the United States' federal securities, commodities, and banking laws.[52] While aspects of the cryptocurrency market easily fit into our regulatory regimes, Gensler noted that "[t]here are some gaps in this space" and Congress will need to enact new laws "to prevent transactions, products, and platforms from falling between regulatory cracks."[53]

Sixteen months later, as the spectacular and rapid unraveling of FTX shows, crypto investors are still vulnerable as Gensler's "regulatory cracks" remain unfilled because Congress has still not empowered any regulator to seize control of monitoring the crypto market. According to reports, FTX had woefully inadequate internal controls and operated nowhere near the compliance standards it should have had it been subject to traditional federal reporting requirements. Indeed, embodying the "Wild West" status of crypto, Bankman-Fried and FTX created their own cryptocurrency token out of whole cloth whose purpose, in part, was to serve as purported collateral for the loans Alameda was taking from FTX's customer accounts. With one of the largest (and formerly most respected) entities in the cryptocurrency space exposed as a fraudulent house of cards, the need for regulation of firms in the crypto market is more urgent than ever.

While the situation and fallout from the FTX collapse will continue to play out in the months and years ahead as authorities untangle the web of Bankman-Fried's alleged crimes, the cautionary lessons for investors and regulators are not complicated. First, the demise of FTX and the relatively unsophisticated fraud Bankman-Fried, Alameda, and other FTX-insiders perpetrated underscore the need for investors to refrain from jumping too quickly into novel, loosely regulated companies, securities, and other investment

[50] *See* Andrew Ross Sorkin, Bernhard Warner, Michael J. de la Merced & Lauren Hirsch, "Sam Bankman-Fried, FTX's Co-Founder, Is Increasingly Alone," *N.Y. Times* (Dec. 22, 2022).
[51] Gary Gensler, Chair, SEC, *Remarks Before the Aspen Security Forum*, (Aug. 3, 2022).
[52] *Id.*
[53] *Id.*

vehicles without a thorough understanding of what the risks of their investment are. Second, as referenced above, the scale of the Bankman-Fried fraud – $8 billion and counting – highlights the need for U.S. financial regulators to act faster in establishing legal frameworks for nascent industries, especially those that seek funds and investments from the general public. Relatedly, in establishing these frameworks, regulators must not rely too heavily on participants and stakeholders in the industries they seek to regulate, as was done in the case of Bankman-Fried and the cryptocurrency market he used to defraud customers and investors of billions of dollars in fewer than five years.

Labaton Sucharow will continue to monitor developments related to these cases and the FTX collapse.

Labaton Sucharow's lawyers are available to address any questions you may have regarding these developments. Please contact the Labaton Sucharow lawyer with whom you usually work or the contacts below.

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