

THE FTX CRYPTO DEBACLE: LARGEST FRAUD SINCE MADOFF?

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The crypto ecosystem has the capacity to undermine our national security, worsen the climate crisis, harm consumers and retail investors, and threaten overall economic stability—all while lining billionaires' pockets. I urge you to utilize every tool at your disposal, including . . . statutory authorities, to protect consumers and investors, our economic and national security, and our environment.

*Elizabeth Warren
U.S. Senator, Letter to Treasury
Secretary Janet Yellen
September 15, 2022¹*

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1. Letter from Elizabeth Warren, U.S. Sen., to Janet Yellen, Sec'y, U.S. Dep't of the Treasury 16 (Sept. 15, 2022) [hereinafter Elizabeth Warren Letter], <https://www.warren.senate.gov/imo/media/doc/2022.09.15%20Letter%20to%20Treasury%20re%20Crypto%20Risks.pdf>.

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I. OVERVIEW

In her letter to Treasury Secretary Janet Yellen, dated September 15, 2022, U.S. Senator Elizabeth Warren requested that the Treasury Department (“Treasury”) conduct a “comprehensive review of the risks and opportunities presented by the proliferation of the digital asset market, which ‘will highlight the economic danger of cryptocurrencies in several key areas, including the fraud risks they pose for investors.’”² Senator Warren warned, “It is crucial that Treasury ‘create the analytical basis for very strong oversight of this sector of finance’ because cryptocurrency poses grave risks to investors and to the economy as a whole.”³

2. *Id.* (quoting Jeff Stein & Tory Newmyer, *Treasury Will Warn White House That Crypto Needs Major Regulations*, WASH. POST (Sept. 8, 2022), <https://www.washingtonpost.com/us-policy/2022/09/08/treasury-crypto-warn-white-house/>).

3. Elizabeth Warren Letter, *supra* note 1, at 1.

Just weeks later, in November 2022, reports emerged that “[i]n less than a week, the cryptocurrency billionaire Sam Bankman-Fried went from industry leader to industry villain, lost most of his fortune, saw his \$32 billion company plunge into bankruptcy and became the target of investigations by the Securities and Exchange Commission and the Justice Department.”⁴ The demise of Bankman-Fried’s company FTX and its many related crypto entities created contagion and collateral damage for other participants and investors in the cryptocurrency community. The U.S. bankruptcy proceedings of many FTX-related entities, scattered across many jurisdictions worldwide, will likely take years to sort out. Shortly after the Chapter 11 filing, post-bankruptcy FTX’s new CEO John J. Ray III characterizes the collapse of FTX as the result of “the absolute concentration of control in the hands of a very small group of grossly inexperienced and unsophisticated individuals who failed to implement virtually any of the systems or controls that are necessary for a company that is entrusted with other people’s money or assets.”⁵

In just a few years, Bitcoin and other cryptocurrencies have had major societal impact, proving to be a unique payment-systems challenge for law enforcement, policymakers, and financial regulatory authorities worldwide. Rapid introduction and diffusion of technological changes, such as Bitcoin’s crypto foundation, the blockchain, thus far continue to exceed the ability of law and regulation to keep pace.⁶ By the end of November 2022, “FTX’s implosion has set off one of the worst upheavals in the history of crypto. . . . Mr. Bankman-Fried was regarded as one of the few trustworthy figures in a freewheeling, loosely regulated industry. He built a business empire, invested in smaller crypto firms and lobbied aggressively in

4. David Yaffe-Bellany, *How Sam Bankman-Fried’s Crypto Empire Collapsed*, N.Y. TIMES (Nov. 14, 2022), <https://www.nytimes.com/2022/11/14/technology/ftx-sam-bankman-fried-crypto-bankruptcy.html>.

5. *Investigating the Collapse of FTX, Part I: Hearing Before the H. Fin. Servs. Comm.*, 117th Cong. 2 (2022) [hereinafter *FTX Hearing*] (statement of John J. Ray III, CEO, FTX Debtors).

6. Lawrence J. Trautman, *Bitcoin, Virtual Currencies, and the Struggle of Law and Regulation to Keep Pace*, 102 MARQ. L. REV. 447, 449 (2018).

Washington.”⁷ This article recounts the story of FTX and highlights potential consequences for investors and the global financial system to help future lawmakers pass productive policy and regulation.

This paper proceeds as follows. Part II discusses the history and growth of cryptocurrencies. Part III examines crypto and national security risks. Part IV introduces the failure of FTX. Part V examines FTX’s bankruptcy. Part VI describes the collateral damage thus far to the crypto ecosystem. Part VII examines the FTX demise in terms of threshold questions that may help to understand what has transpired and how productive policy may be crafted for the future. Part VIII explores the role of the Securities and Exchange Commission (“SEC”). Part IX discusses the Commodity Futures Trading Commission (“CFTC”). Part X addresses crypto and the Federal Reserve. Part XI features the role of Congressional inquiries. Part XII explores regulatory implications. Part XIII focuses on the failure of corporate governance. Part XIV discusses prosecution and litigation. Part XV concludes this article.

II. HISTORY AND GROWTH OF CRYPTOCURRENCIES

During the last decade alone, rapid technological change has resulted in major challenges to corporations,⁸ regulators,⁹

7. David Yaffe-Bellany, *‘No Cooperation’: How Sam Bankman-Fried Tried to Cling to FTX*, N.Y. TIMES (Nov. 29, 2022), <https://www.nytimes.com/2022/11/29/technology/sam-bankman-fried-ftx-bankruptcy.html>.

8. See David D. Schein & Lawrence J. Trautman, *The Dark Web and Employer Liability*, 18 COLO. TECH. L.J. 49, 66 (2019); Lawrence J. Trautman et al., *Posted: No Phishing*, 8 EMORY CORP. GOVERNANCE & ACCOUNTABILITY REV. 39, 67–71 (2021); Lawrence J. Trautman & Kara Altenbaumer-Price, *The Board’s Responsibility for Information Technology Governance*, 29 JOHN MARSHALL J. COMPUT. & INFO. L. 313, 314 (2011); Lawrence J. Trautman, *Managing Cyberthreat*, 33 SANTA CLARA HIGH TECH. L.J. 230, 232–35 (2017); Lawrence J. Trautman et al., *Governance of the Internet of Things (IoT)*, 60 JURIMETRICS 315, 324–27 (2020); Lawrence J. Trautman, *E-Commerce, Cyber, and Electronic Payment System Risks: Lessons from PayPal*, 16 U.C. DAVIS BUS. L.J. 261, 264 (2016).

9. See Peter C. Ormerod & Lawrence J. Trautman, *A Descriptive Analysis of the Fourth Amendment and the Third-Party Doctrine in the Digital Age*, 28 ALB. L.J. SCI. & TECH. 73, 73–74 (2018); Lawrence J. Trautman, Assistant Professor of Bus. L. & Ethics at W. Carolina Univ., *How Law Operates in a Wired Global Society: Cyber and E-Commerce Risk*, Prepared Remarks for the Korea Legis. Res. Inst., 2017 Legal

policymakers,¹⁰ and those engaged in providing auditing¹¹ and legal services.¹² A robust body of scholarly literature¹³ discusses the

Scholars Roundtable 4–5 (Sept. 21–22, 2017); Lawrence J. Trautman, *Congressional Cybersecurity Oversight: Who's Who and How It Works*, 5 J.L. & CYBER WARFARE 147, 152–55 (2016); Lawrence J. Trautman, *Cybersecurity: What About U.S. Policy?*, 2015 U. ILL. J.L. TECH. & POL'Y 341, 346 (2015); Lawrence J. Trautman, *Virtual Currencies; Bitcoin & What Now After Liberty Reserve, Silk Road, and Mt. Gox?*, 20 RICH. J.L. & TECH. 13, 27–28 (2014) [hereinafter *Virtual Currencies*].

10. See Lawrence J. Trautman & George P. Michaely, *The SEC and the Internet: Regulating the Web of Deceit*, 68 CONSUMER FIN. L. Q. REP. 262, 262–63 (2014).

11. See generally Ifeoma Ajunwa, *An Auditing Imperative for Automated Hiring*, 34 HARV. J.L. & TECH. 1, 20 (2021); Ashley A. Austin et al., *The Data Analytics Journey: Interactions Among Auditors, Managers, Regulation, and Technology*, 38 CONTEMP. ACCT. RES. 1888, 1888 (2021); Jean C. Bedard et al., *Using Electronic Audit Workpaper Systems in Audit Practice: Task Analysis, Learning, and Resistance* 1–4 (Mar. 2006) (unpublished manuscript), <https://ssrn.com/abstract=934201>; Marc Eulerich et al., *The Impact of Audit Technology on Audit Task Outcomes: Evidence for Technology-Based Audit Techniques*, 40 CONTEMP. ACCT. RES. 981, 982–83 (2022); Margaret H. Christ et al., *Prepare for Takeoff: Improving Asset Measurement and Audit Quality with Drone-Enabled Inventory Audit Procedures*, 26 REV. ACCT. STUD. 1323 (2021); Joshua A. Kroll et al., *Accountable Algorithms*, 165 U. PA. L. REV. 633, 633 (2017); Adi Masli et al., *Examining the Potential Benefits of Internal Control Monitoring Technology*, 85 ACCT. REV. 1 (2009); Jagdish Pathak & Mary R. Lind, *Audit Risk, Complex Technology, and Auditing Processes*, 31 EDPACS 1 (2003), <https://doi.org/10.1201/1079/43853.31.5.20031101/78844.1>; George Salijeni et al., *Big Data and Changes in Audit Technology: Contemplating a Research Agenda*, 49 ACCT. & BUS. RSCH. 95 (2019).

12. See generally Luis Bergolla et al., *Kleros: A Socio-Legal Case Study of Decentralized Justice & Blockchain Arbitration*, 37 OHIO ST. J. ON DISP. RESOL. 55 (2022) (providing dispute resolution services); Trautman, *supra* note 6, at 449–50.

13. We will not attempt to recreate that coverage here. Rather, an adequate discussion is provided to enable a novice reader to understand the development of this technology leading to this moment. For those seeking a deeper understanding, see Chinmayi Arun, *Facebook's Faces*, 135 HARV. L. REV. F. 236 (2021); Jenna Burke et al., *Auditor Response to Negative Media Coverage of Client Environmental, Social, and Governance Practices*, 33 ACCT. HORIZONS 1 (2019); Richard L. Hasen, *Deep Fakes, Bots, and Siloed Justices: American Election Law in a "Post-Truth" World*, 64 ST. LOUIS U. L.J. 535 (2020); Kathleen Hidy & Mary Sheila McDonald, *Risky Business: The Legal Implications of Social Media's Increasing Role in Employment Decisions*, 18 J. LEGAL STUD. BUS. 69 (2013); Michael J. Jung et al., *Do Firms Strategically Disseminate? Evidence from Corporate Use of Social Media*, 93 ACCT. REV. 225 (2018); David F. Larcker et al., *Monitoring Risks Before They Go Viral: Is*

technical and rapid adoption of blockchain technology¹⁴ and its use to create a large body of cryptocurrencies.¹⁵ Trautman and Harrell provide a historical account of the development of money, barter, the United States experience, and cybercurrencies, and explain that “[t]he origin of modern virtual currencies is associated with the development of multiplayer online games, and the ‘worlds’ they create *World of Warcraft* . . . and other virtual reality environments such as *Second*

It Time for the Board to Embrace Social Media?, STAN. CLOSER LOOK SERIES, APR. 5, 2012 at 1, https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2035072; Tom C. W. Lin, *The New Market Manipulation*, 66 EMORY L.J. 1253 (2017); Seth C. Oranburg, *Securities Regulation and Social Media*, 52 LOY. U. CHI. L.J. 15 (2020).

14. See, e.g., Lawrence J. Trautman, *Virtual Art and Non-Fungible Tokens*, 50 HOFSTRA L. REV. 361, 361–72 (2022); Lawrence J. Trautman & Mason J. Molesky, *A Primer for Blockchain*, 88 UMKC L. REV. 239, 239 (2019); Lawrence J. Trautman & Alvin C. Harrell, *Bitcoin Versus Regulated Payment Systems: What Gives?*, 38 CARDOZO L. REV. 1041, 1050–55 (2017); Lawrence J. Trautman, *Is Disruptive Blockchain Technology the Future of Financial Services?*, 69 CONSUMER FIN. L. Q. REP. 232, 232–34 (2016).

15. See, e.g., Franklin Allen et al., *A Survey of Fintech Research and Policy Discussion*, 1 REV. CORP. FIN. 259 (2021); Susan Athey et al., *The Digital Privacy Paradox: Small Money, Small Costs, Small Talk* 15–16 (Nat’l Bureau Econ. Rsch. Working Paper, Paper No. 23488, 2017), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2984665; Christian Catalini et al., *Some Simple Economics of Stablecoins*, 14 ANN. REV. FIN. ECON. 117, 119–22 (2022); Joshua A.T. Fairfield, *Virtual Property*, 85 B.U. L. REV. 1047, 1058–62 (2005); Joshua A.T. Fairfield, *Bitproperty*, 88 S. CAL. L. REV. 805, 805 (2015); John M. Griffin & Amin Shams, *Is Bitcoin Really Untethered?*, 75 J. FIN. 1913, 1914–17 (2020); Larissa Lee, *New Kids on the Blockchain: How Bitcoin’s Technology Could Reinvent the Stock Market*, 12 HASTINGS BUS. L.J. 81, 81 (2016); Juliet M. Moringiello & Christopher K. Odinet, *The Property Law of Tokens*, 74 FLA. L. REV. 607, 613–14 (2022); Philipp Paech, *The Governance of Blockchain Financial Networks*, 80 MOD. L. REV. 1073, 1073 (2017); Emiliano S. Pagnotta, *Decentralizing Money: Bitcoin Prices and Blockchain Security*, 35 REV. FIN. STUD. 866, 866–71 (2022); Max Raskin & David Yermack, *Digital Currencies, Decentralized Ledgers, and the Future of Central Banking*, in RESEARCH HANDBOOK ON CENTRAL BANKING 474, 474 (Peter Conti-Brown & Rosa Lastra eds., 2017); Max Raskin et al., *How Do Private Digital Currencies Affect Government Policy?* (N.Y.U. L. & Econ. Research Paper No. 20-05, 2023), <https://ssrn.com/abstract=3437529>; Edmund Schuster, *Cloud Crypto Land*, 84 MOD. L. REV. 974, 974 (2021); Angela Walch, *The Bitcoin Blockchain as Financial Market Infrastructure: A Consideration of Operational Risk*, 18 N.Y.U. J. LEGIS. & PUB. POL’Y 837, 839–41, 844 (2015); Kevin Werbach, *Trust, But Verify: Why the Blockchain Needs the Law*, 33 BERKELEY TECH. L.J. 489, 489, 491–94 (2018).

Life, Everquest, Ultima Online, and Diablo III, all contain elements of online currencies.”¹⁶ It was only a short time before these virtual or crypto currencies gained “significant traction and became an economic reality in the real world, with Bitcoin being the most dominant.”¹⁷ The dramatic growth of this blockchain-enabled technology “present[s] particularly difficult transactional, regulatory, and law enforcement challenges because of such issues as: their anonymity due to encryption; their ability to transcend national borders in the fraction of a second; and their unique jurisdictional issues.”¹⁸ Consider that “in contrast to negotiable instruments (which, like coin and currency, are based on the reification of legal rights in a unique, possessable object), a virtual or cybercurrency is intangible and potentially ephemeral.”¹⁹

A. *The Crypto Decade*

The rapid technological developments during the last decade, “along with the recent, rapid pace in the innovation and development of new currencies and . . . mobile payment systems [has resulted in] ongoing challenges for users and regulators of the new technolog[ies].”²⁰ As shown by the numerous recent failures of crypto-space entities such as FTX, these non-regulated entities thus far have continued to exceed the ability of law and regulation to keep pace.

President Biden’s Executive Order 14067 (“EO 14067”), *Ensuring Responsible Development of Digital Assets*, observed that “[i]n November 2021, non-state issued digital assets reached a combined market capitalization of \$3 trillion, up from approximately \$14 billion in early November 2016.”²¹ EO 14067 warns that the U.S. “must take strong steps to reduce the risks that digital assets could pose to consumers, investors, and business protections; financial stability and financial system integrity; combating and preventing crime and illicit finance; national security; the ability to exercise human rights; financial inclusion and equity; and climate change and pollution.”²²

16. Trautman & Harrell, *supra* note 14, at 1042.

17. *Id.* at 1043.

18. *Id.* at 1050.

19. *Id.* (citing U.C.C. §§ 3-201, 3-301).

20. *Id.*

21. Exec. Order No. 14067, 87 Fed. Reg. 14143 (Mar. 9, 2022).

22. *Id.*

B. Warning Signs Emerge

By mid-2022 a series of fraudulent claims and crypto bankruptcies were resulting in major investor losses to many not in a comfortable position to shoulder such losses.²³ For example, crypto “bank” Voyager is reported to have made various claims “indicating that Voyager itself was FDIC-insured, that customers who invested in its cryptocurrency platform would have their funds insured, and that the FDIC would insure customers against the failure of Voyager itself.”²⁴ By the end of 2022 it was apparent that “[h]ackers have terrorized the crypto industry for years, stealing Bitcoin from online wallets and reading the exchanges where investors buy and sell digital currencies.”²⁵ Indicative of widespread harm to many crypto investors, the bankruptcy proceedings of Celsius,²⁶ a crypto lender, disclosed letters from crypto depositors. One of these letters reads:

I am a New Hampshire State resident and Celsius customer with my life savings on their platform. I am

23. See *infra* Part VI (discussing the collateral damage to the crypto ecosystem resulting from FTX’s failure).

24. Elizabeth Warren Letter, *supra* note 1, at 13 (quoting Pete Schroeder, *U.S. Regulators Order Voyager Digital to Stop ‘False and Misleading’ Deposit Insurance Claims*, REUTERS (July 28, 2022), <https://www.reuters.com/business/finance/us-regulators-order-voyager-digital-stop-false-misleading-deposit-insurance-2022-07-28/>).

25. David Yaffe-Bellany, *The Crypto World Is on Edge After a String of Hacks*, N.Y. TIMES (Sept. 28, 2022), <https://www.nytimes.com/2022/09/28/technology/crypto-hacks-defi.html>; see also Guardian Staff, *World’s Largest Crypto Exchange Hacked with Possible Losses of \$500M*, THE GUARDIAN (Oct. 7, 2022), <https://www.theguardian.com/technology/2022/oct/07/binance-crypto-hack-suspended-operations>; Lawrence J. Trautman & Peter C. Ormerod, *WannaCry, Ransomware, and the Emerging Threat to Corporations*, 86 TENN. L. REV. 503 (2019); Lawrence J. Trautman & Peter C. Ormerod, *Industrial Cyber Vulnerabilities: Lessons from Stuxnet and the Internet of Things*, 72 U. MIAMI L. REV. 761 (2018); Lawrence J. Trautman, Jason Triche & James C. Wetherbe, *Threats Escalate: Corporate Information Technology Governance Under Fire*, 8 J. STRATEGIC & INT’L STUD. 105 (2013).

26. Declaration of Robert Campagna, Managing Director of Alvarez & Marsal North America, LLC, in Support of Chapter 11 Petitions and First Day Motions, *In re Celsius Network LLC*, No. 22-10964 (Bankr. S.D.N.Y. 2022).

writing to inform you that I believe fraud has been committed by the Celsius Management Team. Upon the halt of customer's withdrawals and subsequent bankruptcy proceedings, it is now clear that Celsius's customers were repeatedly lied to in order to persuade us to deposit our money onto their platform Their front to the community of safety and security while simultaneously gambling away our life savings, retirements and pensions is a shocking and scandalous travesty.²⁷

Investor losses such as that in Celsius signaled deeper vulnerability within the crypto industry.

III. CRYPTO AND NATIONAL SECURITY RISKS

[C]rypto has ushered in a whole new dimension of fraud and threats to national security that support dangerous nation-states, embolden criminals, and finance terrorists. North Korea uses crypto stolen in hacks to finance its ballistic missile programs. Human traffickers and drug cartels and gunrunners launder their proceeds using crypto assets, and some of these laundered funds end up bankrolling terrorists bent on undermining the United States.

*Senator Sherrod Brown
Chairman,
U.S. Senate Committee on Banking, Housing, and Urban
Affairs
December 14, 2022²⁸*

27. Elizabeth Warren Letter, *supra* note 1, at 16 (citing Letter from Aaron Smith to Judge Martin Glenn, *In re Celsius Network LLC*, No. 22-10964 (Bankr. S.D.N.Y. 2022)).

28. *Crypto Crash: Why the FTX Bubble Burst and the Harm to Consumers: Hearing Before S. Comm. on Banking, Hous., and Urb. Affs.*, 117th Cong. 3 (2022) (statement by Sherrod Brown, Chairman, U.S. Senate Committee on Banking, Housing, and Urban Affairs).

About a decade ago, cyber currency provider Liberty Reserve was successfully excluded from the U.S. financial system by the U.S. Treasury Department's application of the 2001 Patriot Act.²⁹

A. Crypto, Money Laundering, and Offshore Havens

It was the 2016 disclosures from the “Panama Papers,” consisting of 11.5 million documents derived from a years-long effort by the International Consortium of Investigative Journalists to expose a global pattern of crime and corruption where millions of documents capture heads of state, criminals and celebrities using secret hideaways in tax havens to shelter illicit gains. Focusing on hidden assets and involving the efforts of over 400 journalists worldwide, these documents reveal the offshore holdings of more than 214,000 offshore entities, connected to people in more than 200 countries.³⁰

Offshore banking services are a disproportionately important source of income for many countries, and recently the Bahamas “island nation has been encouraging crypto firms to make themselves at home, promising a copacetic regulatory touch—exactly what founder Sam Bankman-Fried was looking for when he decided to move FTX headquarters from Hong Kong last year.”³¹ *The Wall Street Journal* reported the following:

[The Bahamas'] economic anchors are tourism and offshore banking, which together make up 85% of gross domestic product, according to the U.S. Commerce Department.

29. See Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism (USA Patriot Act) Act of 2001, Pub. L. No. 107-56 § 224, 115 Stat. 272, 295 (2001); Orin S. Kerr, *Internet Surveillance Law After the USA Patriot Act: The Big Brother That Isn't*, 97 NW. U. L. REV. 607 (2003); Press Release, Dep't of Just., Co-founder of Liberty Reserve Pleads Guilty to Money Laundering in Manhattan Federal Court (Oct. 31, 2013), <http://www.justice.gov/opa/pr/2013/October/13-crm-1163.html>.

30. Lawrence J. Trautman, *Following the Money: Lessons from the Panama Papers, Part 1: Tip of the Iceberg*, 121 PENN ST. L. REV. 807, 809–10 (2017).

31. Matt Grossman & Angel Au-Yeung, *Crypto Firm FTX Landed in the Bahamas with a Bang, and Now the Bahamas Is Picking Up the Pieces*, WALL ST. J., Nov. 26, 2022, at A1.

[Prime Minister Philip] Davis, elected in September 2021, has made digital assets a centerpiece of his agenda. The island country had been hit hard by Hurricane Dorian in 2019 and the coronavirus in 2020, both of which kept tourists away. Mr. Davis's government promised that crypto would be a critical piece of the recovery. "My government's initial success in attracting significant digital-asset business is only the beginning," Mr. Davis told the Bahamas' House of Assembly in April.³²

B. Illicit Use of Crypto

In 2013 the acting Attorney General Mythili Raman warned, "Criminals are nearly always early adopters of new technologies and financial systems, and virtual currency is no exception. As virtual currency has grown, it has attracted illicit users along with legitimate ones."³³ Other reasons for illicit use include "the ability of those systems to conduct transfers quickly, securely, and often with a perceived higher level of anonymity[,] . . . [t]he irreversibility of many virtual currency transactions[,] . . . [and] their ability to send funds cross-border."³⁴

In her letter to treasury Secretary Janet Yellen dated September 15, 2022, Senator Elizabeth Warren addressed national security risks posed by crypto: "In March 2022, colleagues and I wrote to you expressing our concern that 'criminals, rogue states, and other actors may use digital assets and alternative payment platforms . . . to hide cross-border transactions for nefarious purposes.'"³⁵ Next, Senator Warren stated, "During the Senate Banking, Housing, and Urban Affairs (BHUA) Committee's hearing on Federal Reserve Chair

32. *Id.*

33. *Virtual Currencies*, *supra* note 9, at 8 (quoting Press Release, Dep't of Just., Acting Assistant Attorney General Mythili Raman Testifies Before the Senate Committee on Homeland Security and Governmental Affairs (Nov. 18, 2013)), <http://www.justice.gov/criminal/pr/speeches/2013/crm-speech-131118.html>).

34. *Virtual Currencies*, *supra* note 9, at 8.

35. Elizabeth Warren Letter, *supra* note 1, at 3 (alteration in original) (quoting Letter from Elizabeth Warren, Mark Warner, Sherrod Brown, and Jack Reed, U.S. Sens., to Janet Yellen, Sec'y, U.S. Dep't of the Treasury (Mar. 2, 2022)).

Powell’s Semiannual Monetary Policy Report to Congress in March 2022, I noted that “[c]rypto takes the sting out of sanctions.”³⁶ Senator Warren also expressed her concern about crypto national security risks:

In the past six months alone, numerous reports of crypto-facilitated illicit finance and sanctions violations have surfaced, including:

- That hacking crypto platforms has become a major source of revenue for North Korea, earning the country nearly one billion dollars through June of this year. The thefts “were aimed at funding North Korea’s nuclear weapons program.” Indeed, the United Nations reported in February that “[b]etween 2020 and mid-2021 cyber attackers stole more than \$50m of digital assets” and that the funds are an “important revenue source” for the nation’s nuclear and ballistic missile program;
- Russian Prime Minister Mikhail Mishustin signaled in August 2020 that Russia would move to accept digital assets for imports and exports, remarking that the adoption of such assets “can guarantee uninterrupted payment for the supply of goods from abroad and for export;”
- RenBridge, a cross-chain bridge that allows users to move from one blockchain to another, has been used to launder over \$540 million in cryptocurrencies, including those stolen by Russia-linked ransomware operations and hackers affiliated with North Korea;
- The virtual currency mixer Tornado Cash—which has now been sanctioned by OFAC—has

36. *Id.* at 3 (alteration in original) (quoting Press Release, Elizabeth Warren, U.S. Sen., At Hearing, Senator Warren Says “Crypto Takes the Sting Out of Sanctions” and Calls for “Cracking Down on Crypto” to Hold Russia Accountable for its Aggression” (Mar. 3, 2022), <https://www.warren.senate.gov/newsroom/press-releases/at-hearing-senator-warren-says-crypto-takes-the-sting-out-of-sanctions-and-calls-for-cracking-down-on-crypto-to-hold-russia-accountable-for-its-aggression>).

been used to launder over \$7 billion in virtual currency since 2019;

- Kraken, a crypto exchange, is “suspected of violating U.S. sanctions by allowing users in Iran and elsewhere to buy and sell digital tokens;”
- The Office of the Comptroller of the Currency (OCC) announced in April 2022 that Anchorage Digital Bank, one of the three crypto companies granted a national trust bank charter, “failed to adopt and implement a compliance program” with the Bank Secrecy Act (BSA) and other anti-money laundering rules, “including, in particular, internal controls for customer due diligence and procedures for monitoring suspicious activity, BSA officer and staff, and training.”³⁷

C. Cyber-Digital Task Force

It was the initial report of the Attorney General’s Cyber-Digital Task Force in 2018 that described how digital assets, particularly virtual currencies, are increasingly utilized by criminals “to advance their illicit activities and conceal their earnings.”³⁸ In the 2018 report, the ³⁹Attorney General also explained steps the Department was taking to trace transactions and seize ill-gotten gains and recommended that the Department continue to evaluate the threats posed by cryptocurrencies. The Cyber-Digital Task Force just two years later “published the *Cryptocurrency Enforcement Framework*, a report that chronicled categories of illicit uses of cryptocurrency by malicious actors, identified legal authorities and partnerships the Department had relied upon to combat criminal and national security threats involving

37. *Id.* at 3–4 (internal citations omitted).

38. U.S. DEP’T OF JUST., THE REPORT OF THE ATTORNEY GENERAL PURSUANT TO SECTION 5(b)(iii) OF EXECUTIVE ORDER 14067: THE ROLE OF LAW ENFORCEMENT IN DETECTING, INVESTIGATING, AND PROSECUTING CRIMINAL ACTIVITY RELATED TO DIGITAL ASSETS 1 (Sept. 6, 2022), <https://www.justice.gov/ag/page/file/1535236/download> (citing U.S. DEP’T OF JUST., REPORT OF THE ATTORNEY GENERAL’S CYBER-DIGITAL TASK FORCE (July 2, 2018), <https://www.justice.gov/archives/ag/page/file/1076696/download>).

39. *Id.*

cryptocurrency, and discussed approaches for addressing the public safety challenges related to cryptocurrency.”⁴⁰

Another significant effort to combat terrorist financing has been the Financial Crimes Enforcement Network (“FinCEN”), a bureau of the Treasury Department reporting directly to the Office of Terrorism and Financial Intelligence. It is the stated mission of FinCEN “to safeguard the financial system from illicit use and combat money laundering and promote national security through the collection, analysis, and dissemination of financial intelligence and strategic use of financial authorities.”⁴¹ More recently, it is The Anti-Money Laundering Act of 2020 (“AML Act”)⁴² that requires the Secretary of the Treasury, in consultation with the Attorney General, several federal functional regulators,⁴³ relevant state financial regulators, and relevant national security agencies, to establish and make public priorities for anti-money laundering and countering the financing of terrorism policy (AML/CFT Priorities).⁴⁴ On June 30, 2021, FinCEN stated:

As a result of the publication of the AML/CFT Priorities, FinCEN, in consultation with the staff of the U.S. Securities and Exchange Commission, Commodity Futures Trading Commission, Internal Revenue Service, and State financial regulators (collectively, “the Agencies”), is issuing this statement to provide clarity for all non-bank financial institutions (NBFIs) and other entities with regulatory AML program requirements

40. *Id.*

41. *Virtual Currencies, supra* note 9, at 38 (quoting *Beyond Silk Road: Potential Risks, Threats, and Promises of Virtual Currencies: Hearings Before the S. Comm. on Homeland Sec. & Gov’t Affairs*, 113th Cong. (2013) (statement of Jennifer Shasky Calvery, Director, Fin. Crimes Enforcement Network, United States Department of the Treasury)); *see also* Jonathan Gottfried, *The Federal Framework for Internet Gambling*, 10 RICH. J.L. & TECH. 26 (2004) (describing federal policy for online gambling).

42. The AML Act was enacted as Division F, §§ 6001-6511, of the William M. (Mac) Thornberry National Defense Authorization Act for Fiscal Year 2021. H.R. 6395, 116th Cong. (2021) (enacted).

43. 31 U.S.C. § 5318(h)(4)(A) (as amended by AML Act § 6101(b)(2)(C)).

44. *Id.*

(collectively “covered NBFIs”) on these AML/CFT Priorities.⁴⁵

Other early efforts to combat terrorist financing include the FBI’s early 2012 creation of the Virtual Currency Emerging Threats Working Group (“VCET”) to address and “mitigate the cross-programmatic threats arising from illicit actors’ use of virtual currency systems.”⁴⁶ The Digital Economy Task Force was an outgrowth of a conference held in June 2013 at the World Bank that “included officials from the European Central Bank, ICMEC, International Monetary Fund, Thomson Reuters, the U.S. Federal Reserve, U.S. Department of the Treasury’s Office on Terrorist Financing and Financial Crimes, and others.”⁴⁷ In March 2014, the Task Force issued its findings on the working group topics of: “Defining the Problem; Regulation; Law Enforcement; Human Rights/Financial Inclusion; and Interagency Cooperation and Coordination.”⁴⁸

45. FinCEN, U.S. Dep’t of the Treasury, Statement on the Issuance of the Anti-Money Laundering/Countering the Financing of Terrorism (AML/CFT) National Priorities 1 (June 30, 2021) (citing 31 C.F.R. §§ 1020.210(b) (banks without a Federal functional regulator); 1021.210 (casinos and card clubs); 1022.210 (money services businesses); 1023.210 (brokers or dealers in securities); 1024.210 (mutual funds); 1025.210 (insurance companies); 1026.210 (futures commission merchants and introducing brokers in commodities); 1027.210 (dealers in precious metals, precious stones, or jewels); 1028.210 (operators of credit card systems); 1029.210 (loan or finance companies); and 1030.210 (housing government sponsored enterprises)), [https://www.fincen.gov/sites/default/files/shared/Statement%20for%20Non-Bank%20Financial%20Institutions%20\(June%2030%2C%202021\).pdf](https://www.fincen.gov/sites/default/files/shared/Statement%20for%20Non-Bank%20Financial%20Institutions%20(June%2030%2C%202021).pdf).

46. *Virtual Currencies*, *supra* note 9, at 41 (quoting Press Release, Dep’t of Just., Acting Assistant Attorney General Mythili Raman Testifies Before the Senate Committee on Homeland Security and Governmental Affairs (Nov. 18, 2013), <http://www.justice.gov/criminal/pr/speeches/2013/crm-speech-131118.html>).

47. *Id.* at 40.

48. *Id.* (quoting *Beyond Silk Road: Potential Risks, Threats, and Promises of Virtual Currencies: Hearings Before the S. Comm. on Homeland Security & Governmental Affairs*, 113th Cong. (2013) (statement of Ernie Allen, President & CEO, The International Centre for Missing & Exploited Children); *see also* Christopher Bronk et al., *The Dark Side of Cyber Finance*, 54 SURVIVAL: GLOB. POL. & STRATEGY 129 (2012); Fernando M. Pinguelo & Bradford W. Muller, *Virtual Crime—Real Damages: A Primer on Cybercrimes in the United States and Efforts to Combat Cybercriminals*, 16 VA. J.L. & TECH. 116, 119 (2011); Malte Möser et al., *An Inquiry into Money Laundering Tools in the Bitcoin Ecosystem*, in 2013 APWG ECRIME RESEARCHERS SUMMIT (2013); William Hett, *Digital Currencies and the*

D. Executive Order 14067 and Attorney General Report

President Biden’s Executive Order 14067, *Ensuring Responsible Development of Digital Assets*, dated March 9, 2022, warned:

[T]he growing use of digital assets in the global financial system demands strong steps to reduce the risk that digital assets are used for illicit finance or other criminal purposes—such as money laundering, cybercrime, ransomware, narcotics, theft and fraud, and human trafficking—or to undermine our national security by enabling terrorism and proliferation financing.⁴⁹

Transnational crime organizations, some acting with the blessing of nation states, prefer cryptocurrency transactions due to “the perceived anonymity of cryptocurrency to buy and sell illegal drugs, to advertise and promote human trafficking, to collect ransomware payments, to perpetrate frauds and thefts against consumers and investors, and to finance threats to national security—including terrorist fundraising and malicious rogue state activity.”⁵⁰ Cryptocurrencies are the payment method of choice for ransomware and other digital extortion schemes.⁵¹ The DOJ also reported:

Cryptocurrency is also used to raise funds for terrorist organizations and other nation state threat actors, although cases involving cryptocurrencies are less prevalent than those involving traditional financial assets. For instance, in 2020, the Department announced

Financing of Terrorism, 15 RICH. J.L. & TECH. 4 (2008); INT’L CTR. FOR MISSING & EXPLOITED CHILDREN & THOMSON REUTERS, *THE DIGITAL ECONOMY: POTENTIAL, PERILS, AND PROMISES: A REPORT OF THE DIGITAL ECONOMY TASK FORCE* (2014), <https://www.icmec.org/digital-economy-report/>

49. U.S. DEP’T OF JUST., *THE REPORT OF THE ATTORNEY GENERAL PURSUANT TO SECTION 5(b)(iii) OF EXECUTIVE ORDER 14067*, *supra* note 38, at i.

50. *Id.* at 5.

51. Lawrence J. Trautman et. al., *Understanding Cyber Risk: Unpacking and Responding to Cyber Threats Facing the Public and Private Sectors*, 78 U. MIAMI L. REV. (forthcoming 2024) (manuscript at 74–75).

the government's largest-ever seizure of cryptocurrency in the terrorism context. This action disrupted al-Qassam Brigades, al-Qaeda, and ISIS (Islamic State) fundraising campaigns, including a scheme in which ISIS attempted to exploit the COVID-19 pandemic by operating a fraudulent website purporting to sell N95 masks and other personal protective equipment. And in 2018, the Department charged twelve members of the GRU, a Russian Federation intelligence agency, with committing federal crimes intended to interfere with the 2016 U.S. presidential election. The indictment alleged that the defendants attempted to avoid detection by, among other things, funding the operation with cryptocurrency earned by mining Bitcoin.

Rogue states have also turned to cryptocurrency theft in an effort to raise funds. The United States and the United Nations have implicated the Democratic People's Republic of Korea (DPRK), for example, in a number of cryptocurrency heists and other related criminal activity. In March 2022, Lazarus Group, a hacking group sponsored by the DPRK, stole over \$600 million from a blockchain project linked to an online gaming platform.⁵²

In relevant part, it is the Executive Order 14067 language of Section 2(c) that establishes the principal U.S. digital asset policy objectives as follows:

We must mitigate the illicit finance and national security risks posed by misuse of digital assets. Digital assets may pose significant illicit finance risks, including money laundering, cybercrime and ransomware, narcotics and human trafficking, and terrorism and proliferation financing. Digital assets may also be used as a tool to circumvent United States and foreign financial sanctions regimes and other tools and

52. U.S. DEP'T OF JUST., THE REPORT OF THE ATTORNEY GENERAL PURSUANT TO SECTION 5(b)(iii) OF EXECUTIVE ORDER 14067, *supra* note 38, at 6–7.

authorities. Further, while the United States has been a leader in setting international standards for the regulation and supervision of digital assets for anti-money laundering and countering the financing of terrorism (AML/CFT), poor or nonexistent implementation of those standards in some jurisdictions abroad can present significant illicit financing risks for the United States and global financial systems. Illicit actors, including the perpetrators of ransomware incidents and other cybercrime, often launder and cash out of their illicit proceeds using digital asset service providers in jurisdictions that have not yet effectively implemented the international standards set by the inter-governmental Financial Action Task Force (FATF). The continued availability of service providers in jurisdictions where international AML/CFT standards are not effectively implemented enables financial activity without illicit finance controls. Growth in decentralized financial ecosystems, peer-to-peer payment activity, and obscured blockchain ledgers without controls to mitigate illicit finance could also present additional market and national security risks in the future. The United States must ensure appropriate controls and accountability for current and future digital assets systems to promote high standards for transparency, privacy, and security—including through regulatory, governance, and technological measures—that counter illicit activities and preserve or enhance the efficacy of our national security tools. When digital assets are abused or used in illicit ways, or undermine national security, it is in the national interest to take actions to mitigate these illicit finance and national security risks through regulation, oversight, law enforcement action, or use of other United States Government authorities.⁵³

President Biden’s National Security Strategy observed that “[t]echnology is central to today’s geopolitical competition and to the

53. Exec. Order No. 14067, 87 Fed. Reg. 14143, 14144 (Mar. 9, 2022).

future of our national security, economy and democracy. U.S. and allied leadership in technology and innovation has long underpinned our economic prosperity and military strength.”⁵⁴ On November 7, 2022, Reuters reported that “[c]rypto giant Binance has processed Iranian transactions with a value of \$8 billion since 2018 despite U.S. sanctions intended to cut Iran off from the global financial system, blockchain data show.”⁵⁵ Reuters also reported:

Almost all the funds, some \$7.8 billion, flowed between Binance and Iran’s largest crypto exchange, Nobitex, according to a review of data from leading U.S. blockchain researcher Chainalysis. Nobitex offers guidance on its website on how to skirt sanctions.

Three-quarters of the Iranian funds that passed through Binance were in a relatively low-profile cryptocurrency called Tron that gives users an option to conceal their identities. In a blog post last year, Nobitex encouraged clients to use Tron—a mid-tier token—to trade anonymously without “endangering assets due to sanctions.”

The scale of Binance’s Iranian crypto flows—and the fact that they are continuing—has not been previously reported.

The new findings come as the U.S. Justice Department is pursuing an investigation into possible violations of money-laundering rules by Binance, which dominates the \$1 trillion crypto industry, with over 120 million users. The transactions put the company at risk

54. Michael Conklin et al., *Legal Recourse for Victims of Blockchain and Cyber Breach Attacks*, 23 U.C. DAVIS BUS. L.J. 135, 166 (2022–2023) (alteration in original) (quoting OFF. OF THE PRESIDENT, NAT’L SEC. STRATEGY 32 (2022), <https://www.whitehouse.gov/wp-content/uploads/2022/10/Biden-Harris-Administrations-National-Security-Strategy-10.2022.pdf>).

55. Angus Berwick & Tom Wilson, *Crypto Exchange Binance Helped Iranian Firms Trade \$8 Billion Despite Sanctions*, REUTERS (Nov. 7, 2022, 8:08 AM), <https://www.reuters.com/business/finance/exclusive-crypto-exchange-binance-helped-iranian-firms-trade-8-billion-despite-2022-11-04/>.

of falling afoul of U.S. prohibitions on doing business with Iran, lawyers and trade-sanctions experts said.⁵⁶

IV. FTX—BIGGEST FAILURE SINCE ENRON AND MADOFF?

[W]e need to get to the bottom of what happened at FTX, but we can't let its collapse cause us to abandon the great promise and potential of crypto.

*Kevin O'Leary
Professional Investor
December 14, 2022⁵⁷*

In many ways, the FTX implosion, with estimated losses in excess of \$7 billion,⁵⁸ brings back memories of corporate failures (and estimated losses) of two decades ago such as Enron (\$74 billion),⁵⁹ WorldCom (over \$175 billion),⁶⁰ Adelphia Communications,⁶¹ Bernard Madoff securities fraud (\$18 billion),⁶² the mortgage security

56. *Id.*

57. *Crypto Crash: Why the FTX Bubble Burst and the Harm to Consumers: Hearing Before S. Comm. on Banking, Hous., and Urb. Affs.*, 117th Cong. (2022) (statement of Mr. Kevin O'Leary, Professional Investor).

58. *FTX Hearing*, *supra* note 5, at 6–7 (statement of John J. Ray III, CEO, FTX Debtors); *see also* Corinne Ramey et al., *FTX Founder Is Charged with Fraud*, WALL ST. J., Dec. 14, 2022, at A1.

59. Kris Axtman, *How Enron Awards Do, or Don't, Trickle Down*, CHRISTIAN SCI. MONITOR (June 20, 2005), <https://web.archive.org/web/20120305064924/http://www.csmonitor.com/2005/0620/p02s01-usju.html>; *see also* Paul M. Healy & Krishna G. Palepu, *The Fall of Enron*, 17 J. ECON. PERSPECTIVES 3 (2003) (identifying market capitalization in excess of \$60 billion on December 30, 2000).

60. Daniel Kadlec, *WorldCom*, TIME (July 8, 2002), <https://content.time.com/time/subscriber/article/0,33009,1002807,00.html>.

61. Lawrence J. Trautman et al., *Corporate Directors: Who They Are, What They Do, Cyber Risk and Other Contemporary Challenges*, 70 BUFF. L. REV. 459, 474 (2022).

62. *The Madoff Scam: Meet the Liquidator*, CBS NEWS: 60 MINUTES (Sept. 25, 2009, 12:50 PM), <https://www.cbsnews.com/news/the-madoff-scam-meet-the-liquidator-25-09-2009/>.

financial meltdown of 2007-08,⁶³ GM ignition-switch safety issue,⁶⁴ and more recent financial investor frauds such as Theranos.⁶⁵ No doubt, it may take months or even years to fully understand the collateral damage caused by the failure of FTX and related entities. This section surveys the background and latest reports from the fallout of FTX.

A. Sam Bankman-Fried (SBF) and Alameda Research

Born in 1992, entrepreneur Sam Bankman-Fried's ("SBF") rapid self-made rise from obscurity to crypto multi-billionaire in just four years is one of those spectacular stories reminiscent of Mark Zuckerberg (Facebook), Sergey Brinn and Larry Page (Google), and a short list of other technology success stories. Following graduation from the Massachusetts Institute of Technology ("MIT"), Mr. Bankman-Fried took a job as "a quant at the trading firm Jane Street Capital [New York]," quit, and in January 2018, then 25-years-old "founded a trading firm in Berkeley called Alameda Research" with some friends.⁶⁶ It was during his time in New York at Jane Street Capital that SBF met recent Stanford graduate Caroline Ellison.⁶⁷ *The New York Times* reported that "[t]he pair stayed in touch, and Ms. Ellison got in contact with Mr. Bankman-Fried in February 2018, not long after he had started Alameda, which was based in an office in Berkeley."⁶⁸

63. See generally Lawrence J. Trautman, Personal Ethics & the U.S. Financial Collapse of 2007-08 (Aug. 12, 2017) (unpublished manuscript), <http://ssrn.com/abstract=2502124>.

64. See generally Marianne Jennings & Lawrence J. Trautman, *Ethical Culture and Legal Liability: The GM Switch Crisis and Lessons in Governance*, 22 B. U. J. SCI. & TECH. L. 187 (2016).

65. Lawrence J. Trautman et al., *Ethical Failure at Theranos* (Feb. 21, 2022) (unpublished manuscript), <http://ssrn.com/abstract=4040181>.

66. Benjamin Wallace, *The Mysterious Cryptocurrency Magnate Who Became One of Biden's Biggest Donors: Talking Political Bets with 28-Year-Old CEO Sam Bankman-Fried*, N.Y. MAG.: INTELLIGENCER (Feb. 2, 2021), <https://nymag.com/intelligencer/2021/02/sam-bankman-fried-biden-donor.html>.

67. David Yaffe-Bellany et al., *She Was a Little-Known Crypto Trader. Then FTX Collapsed*, N.Y. TIMES (Nov. 23, 2022), <https://www.nytimes.com/2022/11/23/business/ftx-caroline-ellison-sbf.html>.

68. *Id.*

Crypto market conditions were such that trading company “Alameda made fast profits by exploiting efficiencies in the Bitcoin market,” and “[n]ot long after its founding, Mr. Bankman-Fried moved the company to Hong Kong, where Ms. Ellison eventually joined him with a small group of traders.”⁶⁹ But after SBF co-created FTX, “the new exchange started to consume more of his time,” so he “appointed Ms. Ellison and another trader, Sam Trabucco, as joint chief executives of Alameda.”⁷⁰ However, Mr. Trabucco stepped down from this role in 2022, “leaving Ms. Ellison in sole charge.”⁷¹ The close relationship between Alameda and FTX played an important role in the later implosion of FTX.⁷²

B. History of FTX

FTX and related companies were “founded in 2019 and began as an exchange or marketplace for the trading of crypto assets. In the U.S., the company is a federally regulated exchange operator with licenses from the Department of Treasury (as a money services business) and the U.S. Commodity Futures Trading Commission (CFTC).”⁷³ SBF explained:

FTX was established by three Americans, Samuel Bankman-Fried, Gary (Zixiao) Wang and Nishad Singh, with operations commencing in May 2019. It was established in order to build a digital asset trading platform and exchange for the purpose of a better user experience, customer protection, and innovative products. FTX built the FTX.com exchange to develop a platform robust enough for professional trading firms and intuitive enough for first-time users.

69. *Id.*

70. *Id.*

71. *Id.*

72. *See infra* Section IV.D.

73. *Digital Assets and the Future of Finance: Understanding the Challenges and Benefits of Financial Innovation in the United States: Hearing Before the H. Comm. on Fin. Servs.*, 117th Cong. 1 (2021) (testimony of Sam Bankman-Fried, Co-Founder and CEO of FTX).

The core founding team had unique experience to develop an exchange given their experiences in scaling large engineering systems at Google and Facebook, combined with trading experience on Wall Street.⁷⁴

SBF has revealed that during 2021, “around \$15 billion of assets are traded daily on the [FTX] platform, which . . . represent[ed] approximately 10% of global volume for crypto trading” at that time.⁷⁵ The FTX primary base of operations and international headquarters is located “in the Bahamas, where the company is registered as a digital asset business under The Bahamas’ Digital Assets and registered Exchanges Act, 2020 (DARE).”⁷⁶ In addition:

The core product consists of the FTX.com web site that provides access to a marketplace for crypto assets and tokens. Platform users also can access the market through a mobile device with an FTX app. The core product also consists of a vertically integrated, singular technology stack that supports a matching engine for orders, an application programming interface or API, a custody service and wallet for users, and a settlement, clearing and risk-engine system. In a typical transaction, the only players involved are the buyers, sellers, and the exchange.

The FTX Group has operations in and licenses from dozens of jurisdictions around the world, including here in the U.S. At the time of this writing the FTX platforms have millions of registered users, and the FTX US platform has around one million users. For FTX.com, roughly 45 percent of users and customers come from Asia, 25 percent from the European Union (EU), with the remainder coming from other regions but for the U.S. (also excluding persons from sanctioned countries). Nearly all users of FTX.us are from the U.S.

74. *Id.*

75. *Id.*

76. *Id.* at 2.

. . . FTX services U.S. customers through the FTX US platform, which also includes FTX US Derivatives. FTX US is a separate corporate entity and company with a similar governance and capital structure to the overall corporate family, and also has its own web site, FTX.us, and mobile app. As with FTX.com, the core product is an exchange for a spot market for digital assets that, like other crypto-platforms in the U.S., is enabled through money-transmitter licenses. FTX US is headquartered in Chicago with a few other satellite offices in other U.S. cities.

FTX US Derivatives was formed through the acquisition and re-branding of LedgerX, and is now a business unit that offers derivatives products such as futures and options contracts on digital commodities to both U.S. and non-U.S. persons. FTX US Derivatives has four licenses from the U.S. Commodity Futures Trading Commission (CFTC): a Designated Contract Market (DCM) license, a Swap Execution Facility (SEF) license, a Designated Clearing Organization (DCO) license, and a Commodity Pool Operator (CPO) license. Prior to its acquisition, this business was the first crypto-native platform issued a DCO license by the CFTC in 2017, which was a milestone for the agency and the crypto industry. That license was later amended in 2019 to permit the clearing of futures contracts.⁷⁷

C. Crafting Favorable Crypto Legislation

During July 2022, reports emerged that “FTX is seeking a green light from regulators to let individual investors use derivatives to place leveraged bets on Bitcoin, a move opposed by rivals. Traditional exchanges and financial-industry groups say FTX’s proposal might endanger market stability.”⁷⁸ In 2022, *The Wall Street Journal* issued a solemn warning:

77. *Id.* at 2–3.

78. Alexander Osipovich, *FTX Asks to Offer No-Broker Crypto Trading*, WALL ST. J., July 7, 2022, at B1.

[Congressional] concerns center on a key element of the plan, under which investors could deal directly with FTX instead of going through a broker. This approach represents a change from the way derivatives markets have operated for decades.

“The FTX model would significantly increase market risk,” Terrence Duffy, chief executive of [competitor] CME Group Inc., said in a May hearing on Capitol Hill. . . .

FTX . . . says its proposal will bring 21st-century technology to U.S. markets, adding that it has safeguards to limit risk.

Consumer advocates worry that FTX’s proposal will put volatile derivatives in the hands of unsophisticated investors as crypto suffers a severe downturn. FTX says it is committed to investor protection.

. . . .

Following months of lobbying by both sides, the Commodity Futures Trading Commission is considering the proposal and could make a decision later this year.⁷⁹

By November 2022, *The Wall Street Journal* reported that “[c]rypto firms and their employees have poured \$73 million into the 2022 elections, up from \$13 million in the 2020 cycle, according to research group OpenSecrets, which tracks political donations. The industry also spent \$15 million on lobbying in the first nine months of this year.”⁸⁰ These efforts come at a time when SEC investigation efforts are focused on several “trading platforms, including Coinbase Global Inc., for operating an unregistered securities exchange, and is litigating a case against Ripple Labs Inc., the backer of a popular token. It has brought close to 100 enforcement actions against crypto entities

79. *Id.*

80. Paul Kiernan, *Crypto Firms, Executives Step Up Campaign Donations, Lobbying Ahead of Midterms*, WALL ST. J. (Nov. 5, 2022), <https://www.wsj.com/articles/crypto-firms-executives-step-up-campaign-donations-lobbying-ahead-of-midterms-11667612593>.

and recently doubled the size of its crypto-focused team.”⁸¹ Journalist Paul Kiernan reported on these developments:

The industry’s solution: Persuade Congress to change the law.

Amid the lobbying push, members of Congress from both parties have introduced bills that the crypto industry would like to see passed. One would write exemptions into securities and tax laws for cryptocurrencies. Another would assign oversight of the two largest tokens, Bitcoin and ether, to a regulator that would have to write rules from scratch.

. . . .

Wealthy investors and large companies have long used lobbyists and campaign donations to win influence in Washington. What sets the crypto industry apart, observers say, is that the stakes are existential. That has led to fast growth in political spending and unusually aggressive strategies to sway lawmakers.

Crypto’s political contributions ahead of the midterms exceed those of the defense and auto industries combined, according to OpenSecrets, although they still trail some other sectors, such as private equity. Official campaigns and outside spending groups that received the money have used it to buy television, radio and digital ads, mail pamphlets, provide yard signs, polling services and text messages.

Trading platform FTX Trading Ltd. has become the third-largest source of 2022 campaign contributions after Democratic megadonor George Soros’s firm and cardboard-box manufacturer Uline.

A boom in token prices last year enabled the crypto industry to set aside large amounts of cash for political activities. In a little more than a decade, cryptocurrencies rose from a concept to a \$3 trillion dollar market in November 2021, before crashing below \$1 trillion this year.

81. *Id.*

By helping to get enough crypto-friendly lawmakers elected in November, the industry is hoping to push favorable legislation across the finish line quickly.

....

Some sitting lawmakers also have received crypto-tied donations.⁸²

The crypto industry publications relations effort to create favorable public opinion during 2022 was significant. John Reed Stark, former chief of the SEC's Office of Internet Enforcement from 1998 to 2009 wrote, "There was little precedent for the scale and the star power that characterized the deluge of high-profile celebrity endorsements promoting cryptocurrencies."⁸³

D. FTX Implodes

The Wall Street Journal reported, "[o]ne FTX executive vomited when he learned that the crypto exchange was missing billions of dollars of customer money. A company lawyer quit via a harsh text message A top salesman who had bet big on FTX equity saw most of his wealth evaporate overnight."⁸⁴ The nightmare for stunned FTX employees came just four days after entrepreneur SBF "tweeted that FTX was fine despite a flood of customer withdrawals. He now faces questions about why FTX lent some \$10 billion in customer funds to an affiliated trading firm, Alameda Research."⁸⁵ As former FTX marketing specialist Nathaniel Whittemore recalled, "You have to understand just how devastated the average FTX employee was Not only did it seem they might be out of a job, but they were

82. *Id.*

83. John Reed Stark, *Celebrity Crypto-Hawkers Should Get a Close Look*, N.Y. TIMES (Dec. 17, 2022), <https://www.nytimes.com/2022/12/17/opinion/crypto-ftx-crash-celebrity.html>.

84. Alexander Osipovich et al., *FTX's Collapse Leaves Staff Stunned, Shaken with Anger*, WALL ST. J., Nov. 17, 2022, at A1.

85. *Id.*

potentially facing the total loss of their savings. All I could think of was rage and white-hot anger.”⁸⁶

Weeks after the collapse, reports emerged providing additional insight and describing concerns about SBF “orchestrating crypto trades that could send the industry into a meltdown.”⁸⁷ Just hours before the FTX bankruptcy filing, Binance CEO Changpeng Zhao, texted SBF warning “[s]top now, don’t cause more damage.”⁸⁸ Mr. Zhao also posted “[t]he more damage you do now, the more jail time” in a group chat with SBF and other crypto executives.⁸⁹ *The New York Times* reported:

The series of about a dozen group texts between Mr. Zhao and Mr. Bankman-Fried on [November] 10, which were obtained by *The New York Times*, show that key crypto leaders feared that the situation could get even worse. And their frantic communications offer a rare glimpse into the unusual way business is conducted behind the scenes in the industry, with at least three top officials from rival companies exchanging messages in a group chat on the encrypted messaging app Signal.

The texts also show that industry leaders were acutely aware that the actions of a single firm or fluctuations in the value of one virtual currency could destabilize the whole industry. The exchanges became increasingly tense as Mr. Bankman-Fried and Mr. Zhao traded barbs.

Earlier that week, Mr. Zhao had agreed to buy FTX and save the exchange, before backing out of the deal. In the [November] 10 texts, he appeared certain that

86. *Id.* at A1–2; see also Thomas Conlon et al., *The Collapse of FTX: The End of Cryptocurrency’s Age of Innocence*, BRITISH ACCT. REV. (2023), <https://doi.org/10.1016/j.bar.2023.101277>.

87. David Yaffe-Bellany & Emily Flitter, *Executives Traded Frantic Texts as Crypto Collapsed*, N.Y. TIMES (Dec. 9, 2022), <https://www.nytimes.com/2022/12/09/technology/ftx-text-messages.html>

88. *Id.*

89. *Id.*

FTX would not survive, and concerned that it could bring the rest of the industry down with it.⁹⁰

E. Entrepreneur in Denial

As the crisis increasingly came into focus, “a group of FTX lawyers and executives moved to strip authority from Mr. Bankman-Fried and urged the company’s top leaders to prepare for bankruptcy. For days, Mr. Bankman-Fried ignored their warnings and clung to power, seemingly convinced that he could save the firm, despite mounting evidence to the contrary.”⁹¹ *The New York Times* provided a detailed report of these changes:

“The exchanges must be halted immediately,” Ryne Miller, a top FTX lawyer, wrote in an email to Mr. Bankman-Fried and other staff on [November] 10. “The founding team is not currently in a cooperative posture.”

Mr. Bankman-Fried eventually relented, stepping down as FTX’s chief executive and authorizing the company to file for bankruptcy. Dozens of pages of internal company emails and texts obtained by *The New York Times* offer a detailed look at those chaotic final days, as messages flew back and forth among FTX officials who seemed to be growing increasingly irritated with the 30-year-old founder.

Throughout, Mr. Bankman-Fried appeared deluded about FTX’s prospects, insisting that he could find a way to keep the company running, the documents show. A day before the bankruptcy filing, he told employees that he was trying to raise new funding, and as recently as last week he said he regretted authorizing the bankruptcy.

The messages reviewed by *The Times* and interviews with insiders show how a small group of lawyers and executives struggled to get through to Mr. Bankman-Fried, even appealing to his father as they

90. *Id.*

91. Yaffe-Ballany, *supra* note 7.

pressed their case. While Mr. Bankman-Fried was scrambling to line up investors, Mr. Miller sent a text to top staff describing the prospect of a fund-raise as “0% likelihood.”

The push and pull continued into the early hours of [November] 11, when Mr. Miller sent a series of messages urging Mr. Bankman-Fried to sign papers so the company could file for bankruptcy.

“Please can you sign the document,” he wrote at 2:29 a.m.⁹²

Among the first day’s bankruptcy declarations are those of newly appointed FTX CEO John J. Ray III in Support of Chapter 11 Petitions and First Day Pleadings, which provide insight into the events leading to the Chapter 11 filing.⁹³ Accordingly, Mr. Ray stated:

The Debtors faced a severe liquidity crisis that necessitated the filing of these Chapter 11 Cases on an emergency basis on November 11, 2022, and in the case of Debtor West Realm Shires Inc., on November 14, 2022 (collectively, the “Petition Date”). In the days leading up to the Petition Date, certain of the circumstances . . . became known to a broader set of executives of the FTX Group beyond Mr. Bankman-Fried and members of his inner circle. Questions arose about Mr. Bankman-Fried’s leadership and the handling of the Debtors’ complex array of assets and businesses.

As the situation became increasingly dire, Sullivan & Cromwell and Alvarez & Marsal were engaged to provide restructuring advice and services to the Debtors.

On November 10, 2022, the Securities Commission of the Bahamas (the “SCB”) took action to freeze assets of non-Debtor FTX Digital Markets Ltd., a service provider to FTX Trading Ltd. and the employer

92. *Id.*

93. Declaration of John J. Ray III in Support of Chapter 11 Petitions and First Day Pleadings, *In re* FTX Trading Ltd., No. 22-11068 (JTD) (Bankr. D. Del. 2022).

of certain current and former executives and staff in the Bahamas. Mr. Brian Simms, K.C. was appointed as provisional liquidator of FTX Digital Markets Ltd. on a sealed record. The provisional liquidator for this Bahamas subsidiary has filed a chapter 15 petition seeking recognition of the provisional liquidation proceeding in the Bankruptcy Court for the Southern District of New York.

In addition, in the first hours of November 11, 2022 EST, the directors of non-Debtors FTX Express Pty Ltd and FTX Australia Pty Ltd., both Australian entities, appointed Messrs. Scott Langdon, John Mouawad and Rahul Goyal of KordaMentha Restructuring as voluntary administrators.

At the same time, negotiations were being held between certain senior individuals of the FTX Group and Mr. Bankman-Fried concerning the resignation of Mr. Bankman-Fried and the commencement of these Chapter 11 Cases. Mr. Bankman-Fried consulted with numerous lawyers, including lawyers at Paul, Weiss, Rifkind, Wharton & Garrison LLP, [and] other legal counsel A document effecting a relinquishment of control was prepared and comments from Mr. Bankman-Fried's team incorporated. At approximately 4:30 a.m. EST on Friday, November 11, 2022, after further consultation with his legal counsel, Mr. Bankman-Fried ultimately agreed to resign, resulting in my appointment as the Debtors' CEO. I was delegated all corporate powers and authority under applicable law, including the power to appoint independent directors and commence these Chapter 11 Cases on an emergency basis.

Other than the proceedings in the Bahamas and Australia, to my knowledge, no other Debtor or non-Debtor subsidiary is subject to other insolvency proceedings at this time.⁹⁴

94. *Id.* ¶¶ 40–45.

Just days following the bankruptcy filing, reports emerged that SBF “still thinks that he can raise enough money to make users whole, according to people familiar with the matter. . . . [A]longside a few remaining employees, [SBF] spent the past weekend calling around in search of commitments from investors to plug a shortfall of as much as \$8 billion”⁹⁵ As the immediate post-bankruptcy starts to come into focus, the founder’s unlikely success in crafting a rescue became evident as “Mr. Bankman-Fried told investors [just days earlier] he needed emergency funding to cover a shortfall of as much as \$8 billion due to withdrawal requests.”⁹⁶ *The Wall Street Journal* reported, “FTX’s bankruptcy could involve more than one million creditors, its lawyers said in court filings Before the chapter 11 filing, Mr. Bankman-Fried had spoken to companies including [rival crypto exchanges] Coinbase and Kraken, plus hedge funds and venture-capital investors in the hope of a bailout”⁹⁷ How did this happen? Here is an account of what is known about FTX and related entities thus far.

F. The Alameda Related-Party Problem & FTT

Looking back, “[t]he relationship between Alameda and FTX was the original sin that led to the implosion of Mr. Bankman-Fried’s empire. Alameda traded heavily on the FTX platform, meaning it sometimes benefited when FTX’s other customers lost money, a conflict of interest that Mr. Bankman-Fried sometimes seemed uncomfortable discussing in interviews.”⁹⁸

It has not been unusual for a crypto exchange such as FTX to issue its own currency, here “FTT.” These issuances “allow founders and early investors to profit if the value rises and to motivate traders to use the exchange. FTT was different though because of the tight connection between FTX and Mr. Bankman-Fried’s trading firm,

95. Caitlin Ostroff et al., *FTX Founder Sam Bankman-Fried Attempts to Raise Fresh Cash Despite Bankruptcy*, WALL ST. J. (Nov. 15, 2022, 8:56 AM), <https://www.wsj.com/articles/ftx-founder-sam-bankman-fried-attempts-to-raise-fresh-cash-despite-bankruptcy-11668520573>.

96. *Id.*

97. *Id.*

98. Yaffe-Bellany et al., *supra* note 67.

Alameda Research, which also collapsed”⁹⁹ According to *The Wall Street Journal*:

Alameda played an unusual dual role by holding most of the FTT outstanding and being the main trading partner for the currency, according to people familiar with the transactions.

Alameda then used FTT as collateral to get hundreds of millions in loans, people familiar with the matter said. *The Wall Street Journal* also reported FTX lent cryptocurrencies from its own customers to Alameda. It couldn’t be determined if FTT was used as collateral for the customer loans.

. . . .

The arrangement also proved to be Mr. Bankman-Fried’s undoing. A CoinDesk report that a chunk of Alameda’s assets was made up of FTT, and that it may have overvalued those holdings, set off a run on FTX.¹⁰⁰

G. Lack of Audit

Reports emerged that “[e]ven before the crisis . . . there were signs that Alameda was in big trouble. According to a recent bankruptcy filing, the company’s quarterly financial statements were never audited.”¹⁰¹ Of particular importance, “[o]ne business partner . . . ended work with Alameda after a call with its executives raised red flags late last year. . . . [When] asked about a line representing \$2 billion of investments on Alameda’s balance sheet[,] . . . the Alameda representatives couldn’t explain what it was.”¹⁰² This pervasive failure of risk management and fundamental corporate governance is a theme that permeates the post-mortem analysis of FTX.¹⁰³

99. Patricia Kowsmann et al., *FTX’s Digital Coin Was at Heart of Crypto Exchange’s Fall*, WALL ST. J., (Nov. 14, 2022), <https://www.wsj.com/articles/ftxs-digital-coin-was-at-heart-of-crypto-exchanges-fall-11668416718>.

100. *Id.*

101. Yaffe-Bellany et al., *supra* note 67.

102. *Id.*

103. See *infra* Part XIII for additional discussion about this important topic.

H. Accounting Treatment of Digital Currencies

As shown by the financial disclosures of Marathon Digital Holdings, Inc., a cryptocurrency mining enterprise, the rapid creation and growth in the market for digital currencies has resulted in “uncertainty regarding the reporting and proper asset classification of digital currency holdings.”¹⁰⁴ Accordingly, Marathon states:

Management intends to exercise its business judgment in determining appropriate accounting treatment for the recognition of revenue from mining of digital currencies. Management, in conjunction with its outside public accountants and its auditors, has examined various factors surrounding the substance of the Company’s operations and the available guidance published for public company accounting practices in Accounting Standards Codification.

The Company intends to account for its digital currency assets as indefinite life intangible assets. An intangible asset with an indefinite useful life is not amortized, but rather is assessed for impairment annually, or more frequently, when events or changes in circumstances occur which indicate that it is more likely than not that the indefinite-lived asset is impaired.¹⁰⁵

I. Binance Announced Sale of FTT

Attributed to a CoinDesk website article, *The New York Times* reported:

[The] Alameda balance sheet . . . appeared to show that a large portion of the company’s assets consisted of FTT, the cryptocurrency that FTX invented.

The disclosure raised concerns about the financial stability of Mr. Bankman-Fried’s empire. On [November] 6, Mr. Zhao announced plans to sell an

104. Marathon Digit. Holdings, Inc., Annual Report (Form 10-K) 22 (Mar. 9, 2022).

105. *Id.*

enormous supply of FTT. At the time, the token was worth about \$22; if its price dropped too much, FTX would be in trouble.

Ms. Ellison confronted Mr. Zhao on Twitter: “Alameda will happily buy it all from you today at \$22,” she said. Behind the scenes, she gave orders to her small team of traders to keep the token’s price at \$22 by placing bids at roughly that level, according to a person familiar with the matter.

But Mr. Zhao’s tweets set off the crypto equivalent of a bank run, and customers rushed to withdraw their holdings from FTX.

As the crisis unfolded, Ms. Ellison was visiting the Alameda office in Hong Kong, where she worked in a private meeting room, taking phone calls, according to a person familiar with the matter. Two days after Mr. Zhao’s tweets, Mr. Bankman-Fried announced what had seemed unthinkable: The exchange was facing “liquidity crunches,” unable to meet withdrawals.¹⁰⁶

In retrospect, the run by depositors at FTX was caused at least partly by Binance chief executive Mr. Changpeng Zhao’s comments expressing doubts about FTX and Alameda. *The New York Times* summarized that “Mr. Zhao’s comments . . . left the company owing \$8 billion. Within less than a week, FTX and Alameda had filed for bankruptcy.”¹⁰⁷

V. THE BANKRUPTCY

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. 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.

106. Yaffe-Bellany et al., *supra* note 67.

107. *Id.*

John J. Ray
CEO (Post Bankruptcy Filing)
FTX Entities
*November 17, 2022*¹⁰⁸

Following the swift collapse of FTX and over 130 of its affiliate entities, including FTX US, FTX filed on November 11, 2022, for protection under provisions of Chapter 11 bankruptcy.¹⁰⁹ Just a few days following the complex FTX Chapter 11 filing, *The Wall Street Journal* observed that “[t]he U.S. bankruptcy system will hash out the largest-ever collapse of a cryptocurrency exchange through a legal process that has barely begun to answer how holders of digital currencies will fare in an insolvency.”¹¹⁰ Although a well-established process, Chapter 11 proceedings have “never successfully reorganized a major U.S. crypto firm. Celsius Network LLC and Voyager Digital Inc. tumbled into bankruptcy earlier this year and have yet to unfreeze their customers’ money or secure a restructuring that would unlock users’ assets.”¹¹¹ These two cases have only been in the courts since July 2022—“not enough time to clarify crypto customers’ legal rights in an insolvency. Many of the same questions are expected to be put forth in FTX’s [C]hapter 11 case, still in its infancy.”¹¹² Among the threshold issues:

Celsius, a crypto lender, has argued in court papers that most of the customer assets deposited into its flagship yield-earning program are property of the firm, rather than of the customers. If so, customer assets could be pooled into a bankruptcy estate and distributed to satisfy all company debts in a [C]hapter 11 plan. Those

108. Declaration of John J. Ray III in Support of Chapter 11 Petitions and First Day Pleadings ¶ 5, *In re FTX Trading Ltd.*, No. 22-11068 (JTD) (Bankr. D. Del. 2022).

109. Voluntary Petition for Non-Individuals Filing for Bankruptcy, *In re FTX Trading Ltd.*, No. 22-11068 (Bankr. D. Del. 2022).

110. Andrew Scurria & Soma Biswas, *FTX Collapses into Bankruptcy System That Still Hasn’t Figured Out Crypto*, WALL ST. J., Nov. 16, 2022, at B10.

111. *Id.*

112. *Id.*

could include the sizable bankruptcy legal fees and administrative expenses, followed by other secured or priority debts, leaving a potentially bleak recovery for these depositors.

A bankruptcy judge is expected to decide whether Celsius or its customers own the cryptocurrencies deposited into its flagship Earn program. Also up for debate are the rights of Voyager and Celsius preferred stockholders.

Celsius also has asked for a ruling on whether crypto posted by customers as collateral for loans now belongs to the [C]hapter 11 estate. Another key question is whether Celsius could claw back customer withdrawals or loan liquidations completed in the 90 days before it filed for bankruptcy.

Terms of service for Celsius told users that if it went bankrupt, crypto deposited into its flagship yield-earning program “may not be recoverable, and you may not have any legal remedies or rights in connection with Celsius’ obligations to you” other than as an unsecured creditor. Voyager returned \$270 million in cash held in custody accounts to depositors, but the company said most of customers’ \$1.3 billion of digital coins belong to the [C]hapter 11 estate.

FTX’s terms of service appear to go further than other crypto exchanges in clarifying that it doesn’t acquire title to customer assets in its user accounts and doesn’t treat customer property as its own. The Wall Street Journal has reported that FTX lent billions of dollars worth of customer assets to its affiliated trading firm, Alameda Research LLC, and that senior FTX officers were aware of it.¹¹³

With more than four decades of legal and restructuring experience, John J. Ray III assumed his new role as Chief Executive

113. *Id.*

Officer of FTX and related entities on November 11, 2022.¹¹⁴ Mr. Ray’s considerable experience includes having served as the “Chief Restructuring Officer or Chief Executive Officer in several of the largest corporate failures in history[,] . . . hav[ing] supervised situations involving allegations of criminal activity and malfeasance (Enron)[,] . . . novel financial structures (Enron and Residential Capital), and cross-border asset recovery and maximization (Nortel and Overseas Shipholding).”¹¹⁵

Mr. Ray observed that “[n]early every situation in which I have been involved has been characterized by defects of some sort in internal controls, regulatory compliance, human resources and systems integrity.”¹¹⁶

A. Complete Lack of Corporate Controls

A theme that runs prominently throughout this account of the FTX saga is the critical importance of risk management in the form of internal controls and related systems—and the failure of FTX management to understand this need. Shortly after entering into bankruptcy, Mr. Ray famously commented on the “complete failure of corporate controls[,] . . . 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.”¹¹⁷

Within weeks of the bankruptcy petition, it was reported that the demise of “FTX and Celsius Network LLC exposed hidden risks that might have raised red flags for investors, including related-party transactions, commingled customer funds, sketchy record-keeping and questionable accounting. Some of these problems often appear in

114. Declaration of John J. Ray III in Support of Chapter 11 Petitions and First Day Pleadings ¶ 1, *In re FTX Trading Ltd.*, No. 22-11068 (JTD) (Bankr. D. Del. 2022).

115. *Id.* ¶ 4.

116. *Id.*

117. *Id.* ¶ 5.

disclosures by public crypto companies, including weak systems used to keep numbers accurate.”¹¹⁸

On November 30, 2022, much to the amazement of many, FTX founder and entrepreneur Mr. Bankman-Fried participated via Zoom in an interview with journalist Andrew Ross-Sorkin and candidly discussed the unraveling of FTX and related positions. Among the most remarkable of Mr. Bankman-Fried’s comments included his statement that the company’s demise was the result of “a massive failure of oversight on my part.”¹¹⁹

VI. COLLATERAL DAMAGE TO CRYPTO ECOSYSTEM

The demise of FTX and related entities resulted in contagion among many other participants in the crypto economy. In discussing contagion of the recent crypto collapse, financial journalist Greg Ip examines “the bankruptcy filings of Voyager Digital Holdings Inc., Celsius Network LLC and FTX Trading Ltd. and hedge fund Three Arrows Capital, and [does not] find any banks listed among their largest creditors.”¹²⁰ Mr. Ip writes:

While bankruptcy filings aren’t entirely clear, they describe many of the largest creditors as customers or other crypto-related companies. Crypto companies, in other words, operate in a closed loop, . . . with few apparent connections of significance to traditional finance. This explains how an asset class once worth roughly \$3 trillion could lose 72% of its value, and prominent intermediaries could go bust, with no discernable spillovers to the financial system.

118. Ben Foldy & Jean Eaglesham, *Accounting Red Flags Are Common Among Public Crypto Companies*, WALL ST. J. (Dec. 7, 2022, 5:30 AM), <https://www.wsj.com/articles/accounting-red-flags-are-common-among-public-crypto-companies-11670395681>.

119. Adam Pasick, *Sam Bankman-Fried Blames ‘Massive Failure of Oversight’ for Collapse of FTX*, N.Y. TIMES: DEALBOOK SUMMIT (Nov. 30, 2022), <https://www.nytimes.com/live/2022/11/30/business/dealbook-summit-conference>.

120. Greg Ip, *How Crypto’s Collapse May Have Done the Economy a Favor*, WALL ST. J. (Nov. 23, 2022, 10:42 AM), <https://www.wsj.com/articles/how-cryptos-collapse-may-have-done-the-economy-a-favor-11669215926>.

. . . .

Crypto has long been marketed as an unregulated, anonymous, frictionless, more accessible alternative to traditional banks and currencies. Yet its mushrooming ecosystem looks a lot like the banking system, accepting deposits and making loans. . . .

And just like the banking system, crypto is leveraged and interconnected, and thus vulnerable to debilitating runs and contagion. This year's crisis began in May when TerraUSD, a purported stablecoin—i.e., a cryptocurrency that aimed to sustain a constant value against the dollar—collapsed as investors lost faith in its backing asset, a token called Luna. Rumors that Celsius had lost money on Terra and Luna led to a run on its deposits and in July Celsius filed for bankruptcy protection.

Three Arrows, a crypto hedge fund that had invested in Luna, had to liquidate. Losses on a loan to Three Arrows and contagion from Celsius forced Voyager into bankruptcy protection.¹²¹

Other crypto lenders were impacted by the FTX failure. *The Wall Street Journal* reported, “SALT, a smaller crypto lender, paused withdrawals[,] . . . [stating] in an email to customers that the ‘collapse of FTX has impacted our business.’”¹²² Already reeling from bankruptcy filings by Celsius Network LLC and Voyager Digital Inc., discussed previously,¹²³ highlighted below are adverse developments from the FTX collapse encountered by Binance, BlockFi, Coinbase, Core Scientific, Inc., Genesis, Marathon Digital Holdings Inc., Silvergate Capital Corp., and others.

121. *Id.*

122. Caitlin Ostroff & Vicky Ge Huang, *Crypto Lender Genesis Suspends Withdrawals*, WALL ST. J., (Nov. 16, 2022, 12:44 PM), <https://www.wsj.com/articles/crypto-lender-genesis-suspends-withdrawals-after-ftx-collapse-11668607332>.

123. Scurria & Biswas, *supra* note 110, at B10.

A. Binance

Privately held Binance, the world's largest cryptocurrency exchange, is not publicly traded, and therefore, is not required to file financial statements and other disclosure items with either the U.S. Securities and Exchange Commission or similar regulatory agencies in other countries. As a result, significant investor information has not been available to investors or customers. *The Wall Street Journal* reported disclosure by Binance:

[The disclosure by Binance] is a five-page letter from a partner at the South African affiliate of the global accounting firm Mazars. It contained three numbers. The letter wasn't an audit report, didn't address the effectiveness of the company's internal financial-reporting controls, and said Mazars did "not express an opinion or an assurance conclusion," meaning it wasn't vouching for the numbers.

Mazars said it performed its work using "agreed-upon procedures" requested by Binance and that "we make no representation regarding the appropriateness" of the procedures.

The letter was addressed to a Binance entity called Binance Capital Management Co. Ltd., which is based in the British Virgin Islands, though it wasn't clear if the assets it counted were held by that unit. The report didn't show total assets or total liabilities. Rather, its scope was limited only to Bitcoin assets and Bitcoin liabilities. Binance said it would begin releasing information about other crypto tokens in the coming weeks.

In an interview, Binance's Mr. Hillmann said the Mazars letter covered all the Bitcoin assets and Bitcoin liabilities for the company's Binance.com exchange—although the Mazars letter itself didn't say this. Mr. Hillmann also said the Mazars letter didn't cover any assets or liabilities at Binance's U.S. operations. "This is

the first step in what's going to be a much longer process”¹²⁴

On February 9, 2023, Binance financial chief Jasmine Lee is reported to have reaffirmed that customer funds are safe.¹²⁵ However, on February 13, 2023, reports emerged that the SEC has issued a Wells Notice to crypto firm Paxos Trust Co. “which the agency uses to inform companies and individuals of a possible enforcement action The notice alleges that Binance USD . . . is an unregistered security”¹²⁶ Less than ten months later, Changpeng Zhao “and his company, Binance, agreed to plead guilty to resolve a Justice Department criminal investigation that has dogged the world’s largest cryptocurrency exchange almost since its launch.”¹²⁷ Enabling Binance to continue to operate, “[a]s part of its plea, Binance will pay a \$4.3 billion fine, and Zhao stepped down as CEO. He faces a prison sentence as long as [eighteen] months.”¹²⁸

B. BlockFi

On November 28, 2022, BlockFi, Inc., a major cryptocurrency lender, filed for Chapter 11 bankruptcy and further highlighted the contagion effect that the FTX failure unleashed on the crypto exchange.¹²⁹ *The Wall Street Journal* reported:

124. Jonathan Weil, *Binance Is Trying to Calm Investors, but Its Finances Remain a Mystery*, WALL ST. J. (Dec. 10, 2022, 12:30 PM), <https://www.wsj.com/articles/binance-is-trying-to-calm-investors-but-its-finances-remain-a-mystery-11670679351>.

125. Patricia Kowsmann, *Binance.US CFO Says Customer Funds Are Safe*, WALL ST. J., Feb. 9, 2023, at B10.

126. Vicky Ge Huang et al., *SEC Plans to Sue Paxos Over Binance USD Asset*, WALL ST. J., Feb. 13, 2023, at B9.

127. Patricia Kowsmann et al., *Inside Binance’s Guilty Plea, Biggest Fine in Crypto History*, WALL ST. J., Nov. 24, 2023, at B1.

128. *Id.*

129. Alexander Gladstone, *Crypto Lender BlockFi Follows FTX into Bankruptcy*, WALL ST. J. (Nov. 28, 2022, 5:47 PM), <https://www.wsj.com/articles/blockfi-files-for-bankruptcy-as-latest-crypto-casualty-11669649545>.

BlockFi blamed its chapter 11 filing on the downturn in cryptocurrency prices this summer and this month's failure of FTX FTX's affiliated trading firm, Alameda Research, defaulted on \$680 million owed to BlockFi earlier this month, the firm disclosed in court papers.

. . . .

BlockFi's top [ten] creditors alone are owed close to \$1.2 billion, according to its filings with the U.S. Bankruptcy Court in Trenton, N.J., with the total amount of its liabilities to customers far larger. The firm's liabilities include about \$730 million outstanding to Ankura Trust Company LLC, trustee for BlockFi's interest-bearing customer accounts in the U.S.¹³⁰

C. Celsius Network LLC

Celsius Network LLC is a Limited Liability Company organized under the laws of the State of Delaware.¹³¹ Celsius announced on June 12, 2022, that it was pausing all withdrawals, swaps, and transfers between customer accounts. A Form D (Notice of Exempt Offering of Securities) filing with the Securities and Exchange Commission on April 12, 2022, listing a principal place of business in Hoboken, New Jersey, represents some of the scarce information available.¹³² Unfortunately, very little information was available about this entity or its financials until its Chapter 11 Bankruptcy Filing with the U.S. Bankruptcy Court for the Southern District of New York on July 13, 2022.¹³³ The Debtor's first day motion states, in relevant part:

The Debtors, together with their non-Debtor affiliates (collectively, "Celsius"), are one of the largest and most sophisticated cryptocurrency-based finance platforms in the world and provide financial services to institutional, corporate, and retail clients across more

130. *Id.*

131. Celsius Network LLC., Notice of Exempt Offering of Securities (Form D) (Apr. 12, 2022).

132. *Id.*

133. *See In re Celsius Network LLC*, No. 22-10964 (Bankr. S.D.N.Y. 2022).

than 100 countries. Celsius was created in 2017 to be the first cryptocurrency platform to which users could transfer their crypto assets and (a) earn rewards on crypto assets and/or (b) take loans using those transferred crypto assets as collateral. Headquartered in Hoboken, New Jersey, Celsius employs a global workforce of 648 employees and has an active user base with over 1.7 million users worldwide.¹³⁴

D. Coinbase Exchange

Coinbase Global “started in 2012 with the radical idea that anyone, anywhere, should be able to easily and securely send and receive Bitcoin. Today, we offer a trusted and easy-to-use platform for accessing the broader cryptoeconomy.”¹³⁵ During late 2022, the Coinbase website claims about 108 million verified users, \$159 billion in quarterly trading volume, \$101 billion of assets on the platform, and “245,000 ecosystem partners in over 100 countries trust Coinbase to easily and securely invest, spend, save, earn, and use crypto.”¹³⁶ Coinbase describes its business as “offer[ing] a safe, trusted, easy-to-use platform that serves as a gateway to the cryptoeconomy for our three customer groups via both custodial and self-custodial solutions: consumers, institutions, and developers.”¹³⁷ In addition, “[w]e serve as the consumers’ primary crypto account, offering both a custodial solution with the Coinbase application and self-custodied solution with Coinbase Wallet.”¹³⁸

134. Debtor’s Motion Seeking Entry of an Order (I) Directing Joint Administration of the Chapter 11 Cases and (II) Granting Related Relief ¶ 8, *In re Celsius Network LLC*, No. 22-10964 (Bankr. S.D.N.Y. 2022).

135. *Security: The Most Trusted Crypto Exchange*, COINBASE, <https://www.coinbase.com/security#:~:text=Our%20Commitment%20to%20Security%20by%20Philip%20Martin&text=The%20company%20started%20in%202012,for%20accessing%20the%20broader%20cryptoeconomy>. (last visited Mar. 5, 2024).

136. *About Coinbase*, COINBASE, <https://www.coinbase.com/about> (last viewed Dec. 11, 2022).

137. Coinbase Global, Inc., Annual Report (Form 10-K) 7 (Feb. 21, 2023).

138. *Id.* at 8.

E. Core Scientific, Inc.

In late December 2022, Austin-Texas-based cryptocurrency miner Core Scientific, Inc. filed for protection under Chapter 11 of the bankruptcy code.¹³⁹ *The Wall Street Journal* reported that Core Scientific “went public through a merger with a special-purpose acquisition company . . . [and] shares are down 99% this year.”¹⁴⁰

F. Genesis

Following the FTX collapse, “[c]ryptocurrency lender Genesis told clients that it is suspending redemptions and new loan originations . . . [saying it] has hired advisers in the industry to explore all possible options.”¹⁴¹ *The Wall Street Journal* reported, “Genesis had \$2.8 billion in active loans outstanding at the end of September [2022], down 43% from \$4.9 billion at the end of June, the company said in its recent third-quarter report.”¹⁴² In addition, *The Wall Street Journal* reported:

[Genesis] has also been hurt by its involvement with Three Arrows Capital, a crypto hedge fund that filed for bankruptcy this summer. Genesis previously lent \$2.4 billion to Three Arrows, according to court documents. Genesis’s parent company, Digital Currency Group, has a \$1.2 billion claim against the bankrupt hedge fund.

The [Wall Street] Journal has previously reported that Genesis had loans outstanding to Alameda

139. Becky Yerak et al., *Bitcoin Miner Core Scientific Seeks Chapter 11 Bankruptcy*, WALL ST. J., Dec. 22, 2022, at B5.

140. *Id.*; see also Neal Newman & Lawrence J. Trautman, *Special Purpose Acquisition Companies (SPACs) and the SEC*, 24 U. PA. J. BUS. L. 639 (2022) (discussing SPACs and capital formation within the framework of the securities issuance process).

141. Caitlin Ostroff & Vicky Ge Huang, *Crypto Lender Genesis Suspends Withdrawals After FTX Collapse*, WALL ST. J. (Nov. 16, 2022, 12:44 PM), <https://www.wsj.com/articles/crypto-lender-genesis-suspends-withdrawals-after-ftx-collapse-11668607332>.

142. *Id.*

Research, an affiliated trading firm of FTX, with FTX's own cryptocurrency used as collateral.¹⁴³

On January 19, 2023, Genesis, a subsidiary of the Digital Currency Group, filed for bankruptcy.¹⁴⁴

G. Marathon Digital Holdings, Inc.

Cryptomining operator Marathon Digital Holdings, Inc., engaged in the business of Bitcoin mining, provides an assessment of certain cryptocurrency risks that may be considered applicable to many in the cryptocurrency ecosystem. Accordingly, Marathon observed on December 31, 2021, that “[u]ntil recently, little or no regulatory attention has been directed toward Bitcoin and the Bitcoin network by U.S. federal and state governments, foreign governments and self-regulatory agencies.”¹⁴⁵ However, the report also stated, “As Bitcoin has grown in popularity and in market size, the Federal Reserve Board, U.S. Congress and certain U.S. agencies (e.g., the CFTC, the Commission, FinCEN and the Federal Bureau of Investigation) have begun to examine the operations of the Bitcoin network, Bitcoin users and the Bitcoin exchange market.”¹⁴⁶

H. Silvergate Capital Corp.

Silvergate Capital Corporation described its wholly owned subsidiary, Silvergate Bank as a “leading provider of innovative financial infrastructure solutions and services to participants in the nascent and expanding digital currency industry.”¹⁴⁷ In addition, “[Silvergate] is a Maryland corporation whose assets consist primarily

143. *Id.*

144. See David Yaffe-Bellany, *Genesis, a Crypto Lending Firm, Files for Bankruptcy*, N.Y. TIMES (Jan. 20, 2023), <https://www.nytimes.com/2023/01/20/technology/genesis-bankruptcy-crypto.html>; Alexander Osipovich, *Genesis Demise Marks End of Era for Crypto's Pseudo-Banks*, WALL ST. J. (Jan. 22, 2023, 7:00 AM), <https://www.wsj.com/articles/genesis-demise-marks-end-of-era-for-cryptos-pseudo-banks-11674342330>.

145. Marathon Digit. Holdings, Inc., Annual Report (Form 10-K) 31 (Mar. 9, 2022)

146. *Id.*

147. Silvergate Cap. Corp., Annual Report (Form 10-K) 4 (Feb. 28, 2022),

of its investment in the Bank and its primary activities are conducted through the Bank. The Company is a registered bank holding company that is subject to supervision by the Board of Governors of the Federal Reserve.”¹⁴⁸ Regulatory supervision of the Bank is provided “by the California Department of Financial Protection and Innovation, Division of Financial Institutions (‘DFPI’), and, as a Federal Reserve member bank since 2012, the Federal Reserve Bank of San Francisco (‘FRB’). The Bank’s deposits are insured up to legal limits by the Federal Deposit Insurance Corporation (‘FDIC’).”¹⁴⁹ Silvergate describes significant aspects of its business plan as follows:

In 2013, we began exploring the digital currency industry and have significantly expanded and reoriented our product and service menus since that time to support our growing digital currency initiative, including the implementation of deposit and cash management services for digital currency related businesses, domestically and internationally. Because of our focus on the digital currency industry in recent years and the unique value-add solutions and services we provide, we have experienced a significant increase in our noninterest bearing deposits which has allowed us to generate attractive returns on lower risk assets through increased investments in interest earning deposits in other banks and securities.¹⁵⁰

I. Tether Holdings

On December 13, 2022, the same day as the FTX hearings in the U.S. House of Representatives, Tether Holdings disclosed that “it is winding down its practice of lending out its own stablecoins to customers by next year, addressing a broad risk to the wider crypto world.”¹⁵¹ *The Wall Street Journal* reported,

148. *Id.*

149. *Id.*

150. *Id.*

151. Peter Rudegeair & Jonathan Weil, *Tether Phases Out Lending of its Own Coins to Customers*, *Wall St. J.* (Dec. 13, 2022), <https://www.wsj.com/articles/tether-to-phase-out-lending-of-its-own-coins-to-customers-11670961469>.

With about \$66 billion tether in circulation, tether is the market's largest stablecoin, a digital asset that is supposed to have a fixed value pegged to the U.S. dollar. The appeal of tether is that, unlike Bitcoin and other cryptocurrencies that experience volatile price swings, one coin could be sold or redeemed for \$1. . . . Tether can't be certain the loans will be paid back, that it could sell the loans to a buyer for dollars in a pinch or that the collateral it holds will be adequate. That could make it difficult for Tether to cover a large volume of redemptions in a crisis.¹⁵²

VII. THE THRESHOLD QUESTIONS

In many ways, this paper is an homage to the tireless efforts of Senator Elizabeth Warren and SEC Chair Gary Gensler to protect investors from corrupt or simply incompetently managed investment offerings.

A. Letter from Senator Elizabeth Warren and Richard J. Durbin

In their letter dated November 16, 2022, to Sam Bankman-Fried and newly-appointed FTX CEO John Jay Ray, the Senators expressed concern that “while the full extent of the damage wrought by FTX and its affiliates continues to unfold, billions of dollars-worth of investor funds seem to have disappeared into the ether.”¹⁵³ The letter continued to state, “These massive losses raise questions about the behavior of former . . . company executives, the apparent lack of due diligence by venture capital and other big investment funds eager to get rich off crypto, and the risk of broader contagion across the crypto market that could multiply retail investors' losses.”¹⁵⁴ The Senators continued to

152. *Id.*

153. Letter from Elizabeth Warren & Richard J. Durbin, U.S. Sens., to Sam Bankman-Fried, Controlling Owner, Paper Bird, Inc., and John Jay Ray III, CEO, FTX Trading Ltd. 1 (Nov. 16, 2022), <https://www.warren.senate.gov/imo/media/doc/2022.11.16%20Letter%20to%20SBF%20%20FTX.pdf>.

154. *Id.* at 1–2.

express concern that “FTX customers around the world . . . fear that they will never get back the assets they trusted to FTX and its subsidiaries. These developments justify our long-standing concerns that the crypto industry is ‘built to favor scammers’ and ‘designed to reward insiders and to defraud mom-and-pop investors.’”¹⁵⁵

B. Request for Detailed Information

Senators Warren and Durbin explained, “We write to seek additional information on the shocking collapse of the cryptocurrency firm FTX Trading Ltd. (FTX), the loss of billions of dollars of customer funds, and the disturbing allegations that continue to emerge about the company’s fraudulent and illicit practices.”¹⁵⁶ The Senators further contended, “One thing is clear: the public is owed a complete and transparent accounting of the business practices and financial activities leading up to and following FTX’s collapse and the loss of billions of dollars of customer funds. We therefore request that you provide the requested documents and answers.”¹⁵⁷ Seeking answers no later than November 28, 2022, the requested information follows:

1. Please provide complete copies of all FTX and FTX-subsiary balance sheets, from 2019 to the present.
2. On November 10, Mr. Bankman-Fried tweeted that the liquidity crunch facing FTX was the result of “a poor internal labeling of bank-related accounts mean[ing] that [he] was substantially off on [his] sense of users’ margin.” Please explain, in detail, how Mr. Bankman-Fried’s alleged “poor internal labeling” led to FTX’s liquidity crisis?
 - a. Which other officials beside Mr. Bankman-Fried were responsible for this “poor internal labeling?”
 - b. How was this “poor internal labeling” discovered?

155. *Id.* at 2.

156. *Id.* at 1.

157. *Id.* at 6.

c. What were the intended user margins that FTX attempted to maintain? What were the actual margins maintained?

3. *Reuters* reported that Mr. Bankman-Fried built a “backdoor” into FTX’s accounting system allowing him to “alter the company’s financial records without alerting other people.” Did Mr. Bankman-Fried implement the “backdoor” reported on by *Reuters*?

a. Did Mr. Bankman-Fried use this “backdoor” to transfer \$10 billion in FTX customer funds to Alameda without “trigger[ing] internal compliance or accounting red flags”?

b. If so, when and how did these transfers take place?

i. Which company officials were aware of this “backdoor”?

ii. Was this “backdoor” utilized to facilitate any other transactions beyond the \$10 billion transferred to Alameda?

4. Please provide a complete list of all FTX transfers to Alameda, including dates, amounts, and the reason for the transfer from 2019 to the present.

a. Which company officials were aware of these transfers?

b. At any point, did FTX notify customers that the company would use their assets to fund Alameda’s trading activity? If so, how was this notification made?

c. At any point, were customer funds on FTX US used to fund investments by FTX-affiliate companies?

5. Please provide complete copies of all written policies and/or procedures regarding the relationship between FTX and Alameda. If any such policies and/or procedures were made known to investors, please provide copies of those communications.

a. Did FTX share information about customers’ margins and trades with Alameda or any other FTX-affiliated entity?

b. Did FTX have policies in place to prevent front-running and other manipulative tactics by Alameda?

6. Please explain the \$1.7 billion in FTX customer funds that *Reuters* reported has gone missing.

a. According to Mr. Bankman-Fried's explanation, "We had confusing internal labeling and misread it." What, specifically, was confusing about the labeling? By whom and how was it "misread"?

b. Which officials were responsible for the labeling and the misreading of the labeling?

7. Please provide complete copies of all internal communications and/or materials related to the transactions that occurred on November 12, in which \$663 million in digital assets were moved from FTX wallets, including \$186 million in digital assets that were moved from FTX wallets and into 0x97f991971a37D4Ca58064e6a98FC563F03A71E5c.

a. Which company officials were aware of this transaction prior to the time it occurred?

8. Please provide a complete list of all multi-signature wallets that FTX and/or FTX subsidiaries had access to.

9. Please provide an accounting of the value in USD of FTX customer assets that have (1) been transferred to Alameda Research LLC, (2) been stolen, and (3) have otherwise become inaccessible to FTX from 2019 to the present. In your accounting, please do not combine these values.

10. Please provide complete copies of all internal anti-money laundering and countering financing of terrorism (AML/CFT) and know-your-customer (KYC) policies and procedures used by FTX and FTX subsidiaries.

11. Please provide a complete list of any and all U.S.-based platforms that have, at any point, utilized FTX.com for trading services, lending services, or any other products or services.

12. In September 2022, FTX US "was subsequently chosen as the winning bidder to purchase" the assets of now-bankrupt crypto lending firm Voyager, "in the amount of \$1.42 billion." Please provide a

complete copy of FTX’s balance sheets at the time of FTX US’ bid, as well as the company’s rationale for the \$1.42 billion bid.

13. In July 2022, FTX provided the struggling crypto firm BlockFi with a “\$400 million revolving credit facility,” and secured for itself the “option to buy [BlockFi] for up to \$240 million.” Please provide complete copies of the terms of all of the loans FTX and its subsidiaries have provided to firms from 2019 to the present.¹⁵⁸

VIII. THE SEC AND CRYPTO

We allege that Sam Bankman-Fried built a house of cards on a foundation of deception while telling investors that it was one of the safest buildings in crypto.

*Gary Gensler
Securities Exchange Commission Chairman*¹⁵⁹

“It was The Great Crash of 1929, failure of securities markets, and subsequent economic demise of the early 1930s that led to the need for a Securities and Exchange Commission.”¹⁶⁰ As Professor Galbraith wrote, “Wall Street . . . is of considerable importance in the American economy. The stock market crash and the speculation which made it inevitable had an important effect on the performance, or rather the malperformance, of the economy in the ensuing months and years.”¹⁶¹ “Job los[s] resulted, food lines and human suffering abounded, bank failures were widespread, all hampered by the ‘poor state of economic

158. *Id.* at 6–8 (alterations in original) (internal citations omitted).

159. Press Release, U.S. Sec. & Exch. Comm’n, SEC Charges Samuel Bankman-Fried with Defrauding Investors in Crypto Asset Trading Platform FTX, (Dec. 13, 2022), <https://www.sec.gov/news/press-release/2022-219>.

160. Neal F. Newman & Lawrence J. Trautman, *Securities Law: Overview and Contemporary Issues*, 16 OHIO ST. BUS. L.J. 149, 152 (2021); *see also* Hilary J. Allen, *The SEC as Financial Stability Regulator*, 43 J. Corp. L. 715, 728–29 (2018).

161. Newman & Trautman, *supra* note 160, at 152 (quoting JOHN KENNETH GALBRAITH, *THE GREAT CRASH: 1929* 3 (2d ed. 1961)).

intelligence.”¹⁶² The Securities Act of 1933 (the “33 Act”) is the starting point, born primarily due to the Great Depression of 1929, although there have been some amendments since that time.¹⁶³ The ‘33 Act is the first reference point when dealing with transactional matters such as issuing securities either publicly or privately.¹⁶⁴

A. Technological Challenges

The SEC’s Strategic Plan for Fiscal Years 2022-2026 recognizes that capital markets “are being shaped by innovation and new technologies. . . . [and] bring new financial products, business models, and competitors into the markets. At the same time, however, these dynamics place additional demands on SEC resources—not only in examinations and enforcement matters, but also in new rulemakings and policy areas.”¹⁶⁵ The international impact of the FTX failure stands as an example of how “markets are more interconnected and interdependent than ever. They function on a 24-hour cycle and cut

162. *Id.* (quoting JOHN KENNETH GALBRAITH, *THE GREAT CRASH: 1929* 3 (2d. ed. 1961)).

163. The Corporate Finance Institute (“CFI”) provides additional historical background to the 33 Act:

The 1933 Securities Act was the first major federal securities law passed following the stock market crash of 1929. The law is also referred to as the Truth in Securities Act, the Federal Securities Act, or the 1933 Act. It was enacted on May 27, 1933, during the Great Depression.

President Roosevelt stated that the law was aimed at correcting some of the wrongdoings that led to the exploitation of the public. The wrongdoings included insider trading, the sale of fraudulent securities, secretive and manipulative trading to drive up share prices, and other acts that some financial institutions and professional stock traders engaged in, to the disadvantage of ordinary individual investors.

CFI Team, *The 1933 Securities Act*, CFI, <https://corporatefinanceinstitute.com/resources/knowledge/trading-investing/1933-securities-act-truthsecurities/#:~:text=The%201933%20Securities%20Act%20was,1933%20during%20the%20Great%20Depression> (last visited Feb. 19, 2023).

164. *See* Securities Act of 1933, 15 U.S.C. § 77b.

165. U.S. SEC. & EXCH. COMM’N, STRATEGIC PLAN, FISCAL YEARS 2022-2026, at 10 (2022), https://www.sec.gov/files/sec_strategic_plan_fy22-fy26.pdf.

across geographic barriers. Information from one market travels to others in fractions of a second. Trillions of dollars of capital flow across markets each day—amounts . . . unimaginable only a few decades ago.”¹⁶⁶ The SEC recognizes that “[t]hese developments create regulatory and oversight challenges as the operations of large investment firms extend well beyond U.S. borders, and new entrants to U.S. markets seek to avoid or evade U.S. securities laws. The need for coordination with fellow financial regulators, including foreign regulators, will continue to rise.”¹⁶⁷

A major stated goal of the SEC’s Strategic Plan is to “[u]pdate existing SEC rules and approaches to reflect evolving technologies, business models, and capital markets.”¹⁶⁸ Accordingly, “[t]he ongoing movement of assets into private or unregulated markets, the continual creation of new financial instruments and technologies, and the challenges of increased globalization all require the agency to rapidly update and evolve.”¹⁶⁹ Therefore:

[T]he SEC must enhance transparency in private markets and modify rules to ensure that core regulatory principles apply in all appropriate contexts. To maintain the integrity of the markets, the SEC needs to develop specific regulations to ensure investors remain informed and protected via a broad-based disclosure frameworks.

The agency must also continue to focus on supervising global entities appropriately. Inherent in the interplay with international markets is the challenge of protecting sensitive information when coordinating with other regulators. Consistent data protection policies are essential for this effort.¹⁷⁰

B. The SEC and Cryptocurrencies

Despite Chairman Gensler’s many prophetic media warnings about the potential dangers and risks of cryptocurrencies during 2021

166. *Id.*

167. *Id.*

168. *Id.*

169. *Id.*

170. *Id.* at 10–11.

and 2022,¹⁷¹ he became the subject of media criticism for lack of enforcement following the FTX collapse.¹⁷² For example, *The Wall Street Journal* described growing pressure on the SEC since, “FTX’s bankruptcy put the focus on crypto exchanges, the primary hubs for individual investors that offer such services as digital-coin sales, lending and the safekeeping of assets. Despite investigating parts of the industry for over six years, the SEC has yet to sue a major crypto exchange.”¹⁷³ It appears the SEC “has fined or sued dozens of token developers over the past six years. The SEC has said many cryptocurrencies qualify as securities that should have been sold under rules for stocks and bonds. SEC Chair Gary Gensler has said exchanges are breaking the law by selling those unregistered securities”¹⁷⁴ *The Wall Street Journal* reported:

The SEC has stepped up its warnings in the wake of FTX’s collapse. Mr. Gensler said in a recent interview that the “runway is getting shorter” for exchanges to register with the SEC and adopt rules that stock exchanges such as the Nasdaq Stock Market must follow

. . . .

Since 2017, the SEC has pursued issuers of digital tokens sold to the public, arguing that developers should have at a minimum registered the sales as public companies do with initial stock offerings. In some cases, the agency accused issuers of fraud.

Mr. Gensler put more enforcement emphasis on crypto exchanges and brokers when he took over, according to people familiar with the matter.

171. See *SEC In the News*, U.S. SEC. & EXCH. COMM’N, <https://www.sec.gov/spotlight/fireside-chats> (last visited Dec. 9, 2022) (listing examples of news coverage of the SEC).

172. See, e.g., Dave Michaels, *SEC Faces Calls to Boost Crypto Enforcement*, WALL ST. J., Dec. 9, 2022, at B1

173. *Id.*

174. *Id.*; see also Brian Elzweig & Lawrence J. Trautman, *When Does a Nonfungible Token (NFT) Become a Security?*, 39 GA. ST. U. L. REV. 295 (2023); Michael J. Conklin et al., *Legal Recourse for Victims of Blockchain and Cyber Breach Attacks*, 23 U.C. DAVIS BUS. L.J. 135 (2022–23).

Regulators knew building enforcement cases would take time, the people said. Cases against exchanges are more likely to require litigation, they added. Big exchanges are unlikely to settle with the agency because a deal would likely mean wholesale adoption of SEC rules and having to cut off some profitable activities.

In addition to its investigations, Mr. Gensler's agency has tried to negotiate with exchanges on a model for registering with the SEC.¹⁷⁵

C. Disclosure Guidance Issued

Due to the FTX and other recent crypto-related bankruptcies, the SEC Division of Corporation Finance issued disclosure guidance on December 8, 2022.¹⁷⁶ The Division guidance states that in addition to the information expressly required by the Securities Act of 1933 and the Securities Exchange Act of 1934, issuers “must disclose ‘such further material information, if any, as may be necessary to make the required statements, in light of the circumstances under which they are made, not misleading.’”¹⁷⁷ Moreover, “companies should evaluate their disclosures with a view towards providing investors with specific, tailored disclosure about market events and conditions, the company's situation in relation to those events and conditions, and the potential impact on investors. Companies with ongoing reporting obligations should consider . . . [updates to] existing disclosures[.]”¹⁷⁸ The guidance also provides:

In meeting their disclosure obligations, companies should consider the need to address crypto asset market developments in their filings generally, including in their business descriptions, risk factors, and management's

175. Michaels, *supra* note 172, at B1.

176. SEC Div. of Corp. Fin., *Sample Letter to Companies Regarding Recent Developments in Crypto Asset Markets*, U.S. SEC. & EXCH. COMM'N (Dec. 8, 2022), <https://www.sec.gov/corpfin/sample-letter-companies-regarding-crypto-asset-markets>.

177. *Id.* (quoting 17 C.F.R. § 230.408)

178. *Id.*

discussion and analysis. . . . [C]lear disclosure about the material impacts of crypto asset market developments . . . may include a company's exposure to counterparties and other market participants; risks related to a company's liquidity and ability to obtain financing; and risks related to legal proceedings, investigations, or regulatory impacts in the crypto asset markets.¹⁷⁹

Cryptocurrency platforms and holders have been the victims of a large number of hacking thefts. The Trautman and Newman proposal to investigate a standardized approach to data security disclosure may help to enhance a better understanding of this issue.¹⁸⁰ By January 2023, reports emerged that “[c]rypto-focused companies including Bullish Global, Circle Internet Financial and eToro group Ltd. [and others] have failed to secure the SEC approvals that are required of companies going public.”¹⁸¹ On February 9, 2023, the SEC announced a settlement with Kraken regarding the unregistered offer and sale of crypto assets.¹⁸²

IX. THE CFTC AND CRYPTO

It has been easy to fall into analysis paralysis, compelled to endlessly debate the utility of the underlying technology, how to ensure responsible innovation, and how flexible or restrictive regulation should be both exclusively around digital assets and inclusively amongst traditional financial instruments. Our highest priorities must be the protection of customer property and promotion of fair, stable, and resilient markets. If we are going to ensure that FTX and the other firms that are subjecting customers to billions in

179. *Id.*

180. See Lawrence J. Trautman & Neal F. Newman, *A Proposed SEC Cyber Data Disclosure Advisory Commission*, 50 Sec. Regul. L.J. 199 (2022).

181. Dave Michaels & Peter Rudegear, *SEC Stymies Crypto-Firm Listings*, WALL ST. J., Jan. 25, 2023, at A1.

182. Press Release, U.S. Sec. & Exch. Comm'n, Kraken to Discontinue Unregistered Offer and Sale of Crypto Asset Staking-As-A-Service Program and Pay \$30 Million to Settle Charges (Feb. 9, 2023), <https://www.sec.gov/news/press-release/2023-25>.

losses are appropriately regulated and held accountable, we need to act promptly to apply a comprehensive regulatory regime.

*Rostin Behnam
Chairman
Commodity Futures Trading Commission
December 1, 2022*¹⁸³

In his testimony before the U.S. Senate Committee on Agriculture, Nutrition, and Forestry, Commodity Futures Trading Commission (“CFTC”) Chairman Rostin Behnam concluded that the November 2022 events “embody—in the most regrettable way—the perilous state of the digital asset market. For years many have recognized that a patchwork of federal and state-based regulation is an unsuitable substitute for a comprehensive approach.”¹⁸⁴ Chairman Behnam reflected, “In the absence of stringent and uniform standards, the digital asset market rapidly expanded. With nominal barriers to entry for new products and new consumers, massive speculative interest has taken the place of legitimate market forces, putting the American public at significant risk.”¹⁸⁵ Chair Behnam testifies:

[m]any Americans invested in a novel product and will likely lose money because digital asset markets lack the basic protections that we have all come to expect and have made American financial markets the envy of the world.

. . . I strongly believe that we need to move quickly on a thoughtful regulatory approach to establish guardrails in these fast-growing markets of evolving risk, or they will remain an unsafe venture for customers and could present a growing risk to the broader financial system.¹⁸⁶

183. *Why Congress Needs to Act: Lessons Learned from the FTX Collapse: Hearing Before the S. Comm. on Agric., Nutrition, and Forestry*, 117th Cong. 3 (2022) (statement of Rostin Behnam, Chairman, Commodity Futures Trading Commission).

184. *Id.* at 1.

185. *Id.*

186. *Id.*

A. Lack of Regulatory Authority

Chairman Behnam explained that “[u]nlike other federal financial regulators, the CFTC lacks the necessary and direct authority to write rules and to oversee this marketplace. Instead, we may only reach it through more limited authority activated when fraud or manipulation has already occurred.”¹⁸⁷ Unfortunately, while the CFTC “can and do[es] hold perpetrators accountable when we find fraud or manipulation, for the victims of the scheme, it is already too late.”¹⁸⁸ In sum:

As anticipated, the swift adoption of digital asset derivatives signaled that scaling in the underlying cash or spot digital asset market would be quick. Our vigilance was necessary, but our regulatory authority beyond the bounds of the U.S. derivatives market was, and remains nonexistent.

The CFTC does not have direct statutory authority to comprehensively regulate cash digital commodity markets; instead, the Commission’s jurisdiction resides with its more limited fraud and manipulation enforcement authority. In the absence of direct regulatory and surveillance authority in an underlying cash market, CFTC enforcement activity begins with a referral or whistleblower tip from an external source. Despite this limitation, the CFTC has brought more than 60 enforcement cases in the digital asset space since 2014, with total penalties of just over \$820 million. In fiscal year 2022, more than 20% of our 82 enforcement actions involved digital assets.

But as I suggested over a year ago, the fraud that we are able to prosecute is likely a fraction of what exists in the shadows. Limited enforcement authority is no substitute for comprehensive regulation in which trading platforms, dealers, custodians, and other critical infrastructure participants are required to be registered

187. *Id.*

188. *Id.*

and subject to direct oversight by a regulator such as the CFTC. By the time the CFTC is able to exercise its fraud and manipulation authority, it is already too late for defrauded customers.¹⁸⁹

B. CFTC and Ledger X, LLC

During his testimony, Chairman Behnam explained that “[t]o understand why comprehensive regulation of trading platforms is critically important to protect the largely retail customer base of these speculative digital commodity markets, one need look no further than where the CFTC’s regime intersected with FTX.”¹⁹⁰ During November 2022, “[m]ost of the coverage about FTX . . . has focused on the over 130 different entities that filed for bankruptcy, which includes an offshore-based exchange for trading digital assets and digital asset-based derivatives, a highly leveraged market making firm trading throughout the digital asset market, and a U.S.-based spot exchange.”¹⁹¹ Chairman Behnam explained to the Senate committee that “[o]f significantly less focus is the entity registered with and overseen by the CFTC—a derivatives exchange and clearinghouse called LedgerX LLC” (“LedgerX”).¹⁹² Here, the CFTC role is explained as follows:

Since 2017, LedgerX has been registered with the CFTC as a designated contract market (DCM), swap execution facility (SEF), and derivatives clearing organization (DCO). LedgerX is one of the few FTX entities to *not* file for bankruptcy. The CFTC has been in near-daily contact with LedgerX as well as the third-party custodians it uses to hold cash and digital assets. Based on the information presented to us, at this time, LedgerX customer property remains secure and LedgerX has the financial resources to continue operating for the foreseeable future.

189. *Id.* at 2.

190. *Id.* at 3.

191. *Id.*

192. *Id.*

In compliance with applicable core principles for DCOs under the Commodity Exchange Act, LedgerX is required by CFTC regulations to ensure segregation and security of customer property (including digital assets), maintain capital to cover up to a year's worth of projected operating costs on a rolling basis, and maintain accurate books and records, in addition to numerous other important requirements. Among other things unique to LedgerX's DCO registration order as required by the Commission, LedgerX must engage an independent certified public accountant to audit its digital asset balances and issue an opinion on accounting treatment of digital assets held by LedgerX annually. Many public reports indicate that segregation and customer security failures at the bankrupt FTX entities resulted in huge amounts of FTX customer funds being misappropriated by Alameda for its proprietary trading. But the customer property at LedgerX—the CFTC regulated entity—has remained exactly where it should be, segregated and secure. This is regulation working.

• • •

. . . The lesson here is clear: thoughtful, comprehensive regulation works to protect customers and prevent the type of events that have befallen the other FTX entities.¹⁹³

X. THE FEDERAL RESERVE AND CRYPTO

Over the last several years, we have seen crypto-asset activity grow rapidly and experience periods of significant stress. Some financial innovations offer opportunities, but as we have recently seen, many innovations also carry risks—which can include liquidity runs, the rapid collapse of asset values, misuse of customer funds, fraud, theft, manipulation, and money laundering. These risks, if not well controlled, can harm retail investors and cut against the goals of a safe and fair financial system. Most of this activity is occurring outside of the ambit of banking regulation. But recent events remind

193. *Id.* at 3–4.

us of the potential for systemic risk if interlinkages develop between the crypto system that exists today and the traditional financial system. Crypto-asset-related activity requires effective oversight that includes safeguards to ensure that crypto companies are subject to similar regulatory safeguards as other financial services providers.

*Michael S. Barr
Vice Chair for Supervision
Federal Reserve System
November 15, 2022¹⁹⁴*

As would be expected, the growth of cryptocurrencies during recent years has drawn the close attention of the U.S. Federal Reserve System.

During testimony before the U.S. House Committee on Financial Services given months before the FTX implosion, Federal Reserve Board of Governors Vice Chair Lael Brainard observed that “[t]here has been explosive growth in an emergent digital financial system built around new digital assets and facilitated by crypto-asset platforms and stablecoins as settlement assets.”¹⁹⁵ Vice Chair Brainard stated:

In recent weeks, two widely used stablecoins have come under considerable pressure. One widely used algorithmic stablecoin declined to a small fraction of its purported value, and the stablecoin that is the most traded crypto asset by volume temporarily dipped below its purported one-to-one valuation with the dollar.

These events underscore the need for clear regulatory guardrails to provide consumer and investor protection, protect financial stability, and ensure a level

194. *Oversight of Financial Regulators: A Strong Banking and Credit Union System for Main Street: Hearing Before the S. Comm. on Banking, Hous., and Urb. Affs.*, 117th Cong. 4–5 (2022) (statement of Michael S. Barr, Vice Chair for Supervision, Federal Reserve System).

195. *Digital Assets and the Future of Finance: Examining the Benefits and Risks of a U.S. Central Bank Digital Currency, Before the H. Comm. on Fin. Servs.*, 117th Cong. (statement of Lael Brainard, Vice Chair, Board of Governors of the Fed. Reserve Sys.) (May 26, 2022).

playing field for competition and innovation across the financial system. The recent turmoil in crypto financial markets makes clear that the actions we take now—whether on the regulatory framework or a digital dollar—should be robust to the future evolution of the financial system. The rapid ongoing evolution of the digital financial system at the national and international levels should lead us to frame the question not as whether there is a need for a central-bank-issued digital dollar today, but rather whether there may be conditions in the future that may give rise to such a need. We recognize there are risks of not acting, just as there are risks of acting.¹⁹⁶

XI. CONGRESSIONAL INQUIRIES

The recent fall of FTX.com . . . is just the latest example in a string of incidents involving the collapse of cryptocurrency companies and the impacts these failures have on consumers and investors. . . . FTX's FTT tokens are now worthless, and even worse, FTX.com customers are completely unable to access their funds. Now more than ever, it is clear that there are major consequences when cryptocurrency entities operate without robust federal oversight and protections for customers.

*Congresswoman Maxine Waters
Chair, House Financial Services Committee
November 10, 2022¹⁹⁷*

The FTX saga dominated financial service media coverage after November 12, 2022. Just weeks after the FTX bankruptcy filing, both the House and Senate held hearings to investigate the crypto giant's collapse.

196. *Id.*

197. Press Release, U.S. H. Comm. On Fin. Servs.: Democrats, Chairwoman Maxine Waters' Statement on Recent Binance and FTX Events (Nov. 10, 2022), <https://democrats-financialservices.house.gov/news/documentsingle.aspx?DocumentID=409888>.

A. House Financial Services Committee

John J. Ray III has served as Chief Executive Officer or Chief Restructuring Officer of “several large and vexing corporate failures involving allegations of criminal activity and malfeasance, including the Enron bankruptcy. [He] also [has] experience in bankruptcies involving novel financial and cross-border asset recovery and maximization.”¹⁹⁸

During his testimony of December 13, 2022, Chief Restructuring Officer John J. Ray III attributed the root cause of FTX Group’s failure to “the absolute concentration of control in the hands of a very small group of grossly inexperienced and unsophisticated individuals who failed to implement virtually any of the systems or controls that are necessary for a company that is entrusted with other people’s money or assets.”¹⁹⁹ Within weeks of the Chapter 11 filing, Mr. Ray determined that included among the unacceptable management practices were:

- The use of computer infrastructure that gave individuals in senior management access to systems that stored customer assets, without security controls to prevent them from redirecting those assets;
- The storing of certain private keys to access hundreds of millions of dollars in crypto assets without effective security controls or encryption;
- The ability of Alameda, the crypto hedge fund within the FTX Group, to borrow funds held at FTX.com to be utilized for its own trading or investments without any effective limits;
- The commingling of assets;
- The lack of complete documentation for transactions involving nearly 500 investments made with FTX Group funds and assets;
- The absence of audited or reliable financial statements;

198. *FTX Hearing, supra* note 5, at 1 (statement of John J. Ray III, CEO, FTX Debtors).

199. *Id.* at 2.

- The lack of personnel in financial and risk management functions, which are typically present in any company close to the size of FTX Group; and
- The absence of independent governance throughout the FTX Group.²⁰⁰

The proposed restructuring plan has five core objectives: implementation of controls; asset protection and recovery; transparency and investigation; efficiency and coordination; and maximization of value.²⁰¹

B. Revelations to Date

Within weeks, Mr. Ray and his team of seasoned restructuring and forensic accounting professionals have been able to conclude:

First, customer assets from FTX.com were commingled with assets from the Alameda trading platform.

Second, Alameda used client funds to engage in margin trading which exposed customer funds to massive losses.

Third, the FTX Group went on a spending binge in late 2021 through 2022, during which approximately \$5 billion was spent buying a myriad of businesses and investments, many of which may be worth only a fraction of what was paid for them.

Fourth, loans and other payments were made to insiders in excess of \$1 billion.

Fifth, Alameda's business model as a market maker required deploying funds to various third-party exchanges which were inherently unsafe, and further exacerbated by the limited protections offered in certain foreign jurisdictions.²⁰²

200. *Id.* at 2–3.

201. *Id.* at 3–4.

202. *Id.* at 6–7.

During the hearings, Congressman Loudermilk, while questioning Mr. Ray, stated:

[Mr. Fried] gave investors a one-day warning to allow investors within the Bahamas to withdraw their funds. No one else outside the Bahamas was able to withdraw funds before the bankruptcy was filed. Mr. Fried said he allowed the withdrawals because “it was critical to the exchange to be able to have a future because that’s where I am right now and you don’t want to be in a country with a lot of angry people in it.”

Is this explanation accurate?²⁰³

Raising the specter of preferential treatment in contemplation of bankruptcy, and perhaps payments to governmental officials, Mr. Ray testified:

MR. RAY: What we . . . know, is the liquidation proceeding in the Bahamas was filed effectively twenty-four hours before our Chapter 11 proceeding. During that time period . . . and we’ve documented this in our court filings as of last night, the accounts were unfrozen just in the Bahamas and over \$100 million was released to approximately 1,500 customers in the Bahamas. These are approximate numbers and then the doors were closed about the time of our Chapter 11 filing. And there were communications between Mr. Bankman-Fried and the Bahamian government specifically related to this leakage of assets.

CONGRESSMAN LOUDERMILK: So, Mr. Fried would have known that the bankruptcy filing was imminent when he did this?

MR. RAY: Yes.²⁰⁴

203. *Id.* at 2:19:35.

204. *Id.* at 2:19:40; see Hannah Miao & Caitlin McCabe, *FTX Founder’s Arrest Offers Cold Comfort*, WALL ST. J., Dec. 16, 2022, at B1.

Raising the question of whether violations of the Foreign Corrupt Practices Act (“FCPA”)²⁰⁵ have taken place, House Committee members Mr. Jake Auchincloss, Ms. Madeleine Dean, Mr. Mike Garcia, Mr. Vicente Gonzalez, Ms. Alexandria Ocasio-Cortez, and Mr. Bryan Steil focused their questioning about post-bankruptcy. During a time when the automatic stay was in place, and “[a]ided with resources of FTX’s former management, the Bahamian government took control of certain crypto assets The Bahamian Commission instructed Messrs. Bankman-Fried and Wang to mint a substantial number of new tokens and transfer [approximately \$300 million] of the new [FTT] coins to cold storage for their benefit.”²⁰⁶

C. Senate Committee

A day following hearings by the House Financial Services Committee, the Senate Committee on Banking, Housing, and Urban Affairs heard testimony from Professor Hilary J. Allen,²⁰⁷ Mr. Keven O’Leary, Ms. Jennifer J. Schulp, and Mr. Ben McKenzie Schenkan.²⁰⁸

205. The Foreign Corrupt Practices Act of 1977 (FCPA), Pub. L. No. 95-213, 91 Stat. 1494 (1977) (codified as amended in scattered sections of 15 U.S.C.); see also Lawrence J. Trautman & Joanna Kimbell, *Bribery and Corruption: The COSO Framework, FCPA, and U.K. Bribery Act*, 30 FLA. J. INT’L L. 191 (2018); Lawrence J. Trautman & Kara Altenbaumer-Price, *Lawyers, Guns and Money: The Bribery Problem and the U.K. Bribery Act*, 47 INT’L LAW. 481 (2013); Lawrence J. Trautman & Kara Altenbaumer-Price, *Foreign Corrupt Practices Act: An Update on Enforcement and SEC and DOJ Guidance*, 41 SEC. REGUL. L.J. 241 (2013); Lawrence J. Trautman & Kara Altenbaumer-Price, *The Foreign Corrupt Practices Act: Minefield for Directors*, 6 VA. L. & BUS. REV. 145 (2011); Lawrence J. Trautman, *Rapid Technological Change and U.S. Entrepreneurial Risk in International Markets: Focus on Data Security, Information Privacy, Bribery and Corruption*, 49 CAP. U. L. REV. 67 (2021).

206. *FTX Hearing*, *supra* note 5 (statement of John J. Ray III, CEO, FTX Debtors).

207. For examples of Professor Allen’s scholarship, see Hilary J. Allen, *DeFi: Shadow Banking 2.0?*, 64 WM. & MARY L. REV. 919 (2023); Hilary J. Allen, *Regulatory Sandboxes*, 87 GEO. WASH. L. REV. 579 (2019); Hilary J. Allen, *Sandbox Boundaries*, 22 VAND. J. ENT. & TECH. L. 299 (2020); Hilary J. Allen, *Regulatory Innovation and Permission to Fail: The Case of Suptech*, 19 N.Y.U. J.L. & BUS. 237 (2023).

208. See *Crypto Crash: Why the FTX Bubble Burst and the Harm to Consumers: Hearing Before S. Comm. on Banking, Hous., and Urb. Affs.*, 117th Cong. (2022), <https://www.banking.senate.gov/hearings/crypto-crash-why-the-ftx-bubble-burst-and-the-harm-to-consumers>.

During opening remarks, Senator Sherrod Brown, Chairman of the Senate Committee on Banking, Housing, and Urban Affairs, emphasized that “[t]he things that look and behave like securities, commodities, or banking products need to be regulated and supervised by the responsible agencies who serve consumers. Crypto doesn’t get a free pass because it is bright and shiny. Or because venture capitalists think it might change the world.”²⁰⁹ In his opening statement, ranking member Pat Toomey urged policymakers to “remember to distinguish between human failure and the instrument with which the failure occurred. In this case the instrument is software. And the code committed no crime. . . . [I]t is very important we do not convict the code of anything but preserving and protecting individual autonomy.”²¹⁰

American University Washington College of Law Professor Hilary J. Allen provided an extensive and detailed analysis in her prepared remarks. While time limitations allowed her to discuss only a small portion of her recommendations, her complete transcript referenced below is recommended for its detailed analysis.²¹¹ Professor Allen concluded her analysis by observing, “As with securities registration requirements, robust enforcement of broker/dealer registration requirements against crypto exchanges will keep some of those exchanges out of the markets. For those exchanges that do register, investors will have more information about conflicts of interest, and their assets will be more secure.”²¹²

209. *Id.* (statement of Sherrod Brown, Chairman, U.S. Senate Committee on Banking, Housing, and Urban Affairs), <https://www.banking.senate.gov/imo/media/doc/Brown%20Statement%2012-14-221.pdf>.

210. *Id.* (statement of Pat Toomey, Ranking Member, U.S. Senate Committee on Banking, Housing, and Urban Affairs), <https://www.banking.senate.gov/imo/media/doc/Toomey%20Statement%2012-14-2233.pdf>.

211. *See id.* (statement of Hilary J. Allen, Professor of law, American University Washington College of Law), <https://www.banking.senate.gov/imo/media/doc/Allen%20Testimony%2012-14-22.pdf>.

212. *Id.*

XII. REGULATORY IMPLICATIONS AND DEBATE

Digital assets have grown significantly in scale and scope over recent years. They have attracted a large amount of capital and interest from both retail and institutional investors. At the same time, we have seen very significant shocks and volatility within the crypto-assets system, particularly over the last year. . . . [C]rypto-asset activities could pose risks to U.S. financial stability if their interconnections with the traditional financial system or their overall scale were to grow without adherence to or being paired with appropriate regulation, including enforcement of the existing regulatory structure.

*Janet L. Yellen
Secretary of the Treasury
October 3, 2022²¹³*

Mining operation Marathon Digital Holdings, Inc. provided an example of how cryptocurrency ecosystem participants have been facing regulation during recent months when it disclosed, “Government regulation of blockchain and cryptocurrency is being actively considered by the United States federal government via a number of agencies and regulatory bodies, as well as similar entities in other countries.”²¹⁴ Marathon also observed, “State government regulations also may apply to our activities and other activities in which we participate or may participate in the future. Other regulatory bodies are governmental or semi-governmental and have shown an interest in regulating or investigating companies engaged in the blockchain or cryptocurrency business.”²¹⁵ In addition:

Businesses that are engaged in the transmission and custody of Bitcoin and other digital assets, including brokers and custodians, can be subject to U.S. Treasury Department regulations as money services businesses as

213. *Remarks by Secretary of the Treasury Janet L. Yellen at Financial Stability Oversight Council Meeting*, U.S. DEP’T OF THE TREASURY (Oct. 3, 2022), <https://home.treasury.gov/news/press-releases/jy0990>.

214. Marathon Digit. Holdings, Inc., Annual Report (Form 10-K) 21 (Mar. 9, 2022).

215. *Id.*

well as state money transmitter licensing requirements. Bitcoin and other digital assets are subject to anti-fraud regulations under federal and state commodity laws, and digital asset derivative instruments are substantively regulated by the U.S. Commodity Futures Trading Commission. Certain jurisdictions, including, among others, New York and a number of countries outside the United States, have developed regulatory requirements specifically for digital assets and companies that transact in them.

....

In addition, since transactions in Bitcoin provide a reasonable degree of pseudo anonymity, they are susceptible to misuse for criminal activities, such as money laundering. . . . In January 2021, the Biden Administration issued a memorandum freezing federal rulemaking, including these proposed FinCEN rules, to provide additional time for the Biden Administration to review the rulemaking that had been proposed by the Trump Administration. As a result, it remains unclear whether these proposed rules will take effect.²¹⁶

Shortly after the FTX failure, reports emerged that the “Biden administration is laying the groundwork to target nonbank firms with stricter federal oversight as regulators grow concerned about financial threats from companies operating outside of the tightly supervised banking system.”²¹⁷ *The Wall Street Journal* reported:

The move from the Financial Stability Oversight Council, a panel of top regulators tasked with monitoring the stability of the financial system, would likely ease or repeal Trump-era restrictions that sought to limit the regulation of nonbanks, according to people familiar with the process.

216. *Id.*

217. Andrew Ackerman, *Biden Officials to Target Nonbanks for Tougher Oversight*, Wall St. J. (Nov. 23, 2022, 8:25 AM), <https://www.wsj.com/articles/biden-officials-to-target-nonbanks-for-tougher-oversight-11669209928>.

The aim, the people said, would be to make it easier to label nonbank firms as systemically important financial institutions, or SIFIs, a designation that currently applies only to the nation's largest banks and imposes extensive oversight in an effort to rein in risks to financial stability.

The coming regulatory effort reflects the administration's intensifying focus on potential systemic risks tied to nonbanks—financial firms that include hedge funds, asset managers, insurance companies, mortgage companies and cryptocurrency exchanges. The effort is likely to generate pushback, potentially even legal challenges, from industry firms and Republican officials who view the panel with skepticism, portraying it as unaccountable and nontransparent.

Regulators have been on heightened alert about financial stability since March 2020, when investors' fears about the Covid-19 pandemic sparked a dash for cash and liquidation of even super safe assets such as Treasury securities. Officials have scrutinized several nonbank risks from that period, including open-end mutual funds, where forced sales of fund assets to meet redemptions contributed to a deterioration in fixed-income market liquidity. More-recent concerns revolve around the rise of stablecoins and other cryptocurrencies.²¹⁸

CFTC Chairman Behnam observed, "Invariably, the questions we are all obligated to answer as regulators are: 'How did you let this happen?' and 'How will you prevent this from happening again?' In the pivotal moment we find ourselves in, the answer to both questions is comprehensive, market regulation."²¹⁹

218. *Id.*

219. *Why Congress Needs to Act: Lessons Learned from the FTX Collapse: Hearing Before the S. Comm. on Agric., Nutrition, and Forestry*, 117th Cong. 4 (2022) (statement of Rostin Behnam, Chairman, Commodity Futures Trading Commission).

A. Policy Statement by Coinbase

Just a month or so before the FTX collapse, Coinbase issued its Third Quarter 2022 Shareholder Letter, stating “[w]e believe crypto policy in the United States is at an inflection point. Bipartisan Senators introduced the Digital Commodities Consumer Protection Act (DCCPA) in August 2022, which could lead to meaningful regulation and clarity on the treatment of digital assets.”²²⁰ Coinbase contends that “legislation would establish the Commodities Futures Trading Commission as the primary regulator of digital asset commodities, and would thus close one of the biggest gaps in the existing regulatory system for digital assets[,] . . . represent[ing] a potential leap toward crypto policy progress.”²²¹ Releasing the statement just weeks before the FTX implosion, Coinbase wrote:

However, this legislation is not yet in place, and we are concerned that the regulation by enforcement practices of U.S. regulators create an incentive for crypto developers and issuers to leave the U.S. crypto industry. We are seeing this in conversations with certain market participants who are concerned about a hostile regulatory environment for those operating in the U.S. This ultimately harms retail investors by pushing them to unregulated exchanges, and penalizes U.S. based exchanges seeking to follow the law.

U.S. policy should incentivize crypto market participants to operate in the U.S., but a policy of regulation by enforcement has the opposite effect. That’s why we filed a petition directly with the SEC in July 2022 requesting they create clear rules for the digital asset securities market. Those new rules, if created, would address directly when a digital asset is a security or a commodity, and allow companies like Coinbase to offer a broader range of assets and products.

220. COINBASE, SHAREHOLDER LETTER: THIRD QUARTER 2022, at 4 (2022), https://s27.q4cdn.com/397450999/files/doc_financials/2022/q3/Q32022-Shareholder-Letter.pdf.

221. *Id.*

Meanwhile, leading economies, including the European Union, Australia, Japan, the U.K., Switzerland, and Brazil, are taking substantial regulatory steps to secure their role as leaders in crypto. More specifically, the text of the European Union’s Markets in Crypto Assets (MiCA) framework was finalized in October 2022, and will be applied throughout the E.U.’s 27 Member States in 2024. The Indian Government also resolved to champion the development of an international crypto regulatory framework as part of their forthcoming G20 presidency during 2023.

....

Despite our expectation that sensible U.S. policy efforts will prevail, we can’t ignore that our business opportunity is rapidly evolving outside the U.S. and this trend causes us to revisit aspects of our international strategy which we plan to share with you in future quarters.²²²

A December 9, 2022, interview with Coinbase Global Inc. Chief Executive Brian Armstrong disclosed that he “believes that regulation will help fuel the rise of a stablecoin backed by his exchange. [And the] USD Coin will become ‘the de facto central bank digital currency’ of the U.S.”²²³

B. Congressional Action Needed

Congressional action is needed to provide clarity among the current dysfunctional federal regulatory schematic that has enabled so many American investors to become victims of the FTX implosion. The U.S. financial infrastructure—CFTC, Federal Reserve, SEC, Treasury, and others—requires clarity. As CFTC Chair Behnam stated, “We lacked the authority to comprehensively regulate the digital commodity market, and to prevent this from happening again, we must

222. *Id.*

223. Vicky Ge Huang, *Coinbase CEO Brian Armstrong Says Regulation Could Boost USD Coin Usage*, WALL ST. J. (Dec. 9, 2022, 7:21 PM), <https://www.wsj.com/articles/coinbase-ceo-brian-armstrong-says-regulation-could-boost-usd-coin-usage-11670631712>.

be provided appropriate authority by Congress. Without new [CFTC authority] there will remain gaps in a federal regulatory framework, even if other regulators act within their existing authority.”²²⁴

XIII. FAILURE OF CORPORATE GOVERNANCE

Sarbanes-Oxley established requirements regarding corporate governance and accountability to help ensure that the incentives of executives, boards, accountants, and investors were better aligned. . . . Sarbanes-Oxley also added requirements for corporate boards and their audit committees. . . . Specifically, boards need to disclose whether there is a financial expert on the audit committee. This audit committee is responsible for hiring and firing auditors, determining auditors’ compensation, and approving any non-audit services provided by the firm. Public companies also are required to disclose the fees paid to, and services delivered by, their audit firms.

Gary Gensler
Chairman,
U.S. Securities and Exchange Commission
July 27, 2022²²⁵

In retrospect, as John J. Ray stated, “Many of the companies in the FTX Group, especially those organized in Antigua and the Bahamas, did not have appropriate corporate governance. I understand that many entities, for example, never had board meetings.”²²⁶

The failure of FTX highlights the importance of internal controls. The bankruptcies overseen by Mr. Ray “share common characteristics, ranging from gross mismanagement, excessive leverage, failures of internal controls, failures of external checks as a

224. *Why Congress Needs to Act: Lessons Learned from the FTX Collapse: Hearing Before the S. Comm. on Agric., Nutrition, and Forestry*, 117th Cong. 4 (2022) (statement of Rostin Behnam, Chairman, Commodity Futures Trading Commission).

225. Gary Gensler, Chairman, Sec. and Exch. Comm’n., Prepared Remarks at Center for Audit Quality “Sarbanes-Oxley at 20: The Work Ahead” (July 27, 2022), <https://www.sec.gov/news/speech/gensler-remarks-center-audit-quality-072722>.

226. Declaration of John J. Ray III in Support of Chapter 11 Petitions and First Day Pleadings ¶ 46, *In re FTX Trading Ltd.*, No. 22-11068 (JTD) (Bankr. D. Del. 2022).

result of audit firm failures, or insufficient board governance.”²²⁷ As discussed previously,²²⁸ shortly after FTX entered bankruptcy, Mr. Ray stated that the FTX operations apparently had “a complete failure of corporate controls.”²²⁹

A. Independent Outside Auditors?

In any financial failure such as FTX, among the first questions to be asked are “Where were the independent outside auditors?” and “Where was the board’s audit committee?” During his testimony before the U.S. Senate Committee on Banking, Housing, and Urban Affairs, Mr. John J. Ray III stressed that the lack of an independent board was a major problem, stating, “I don’t trust a single piece of paper in this organization.”²³⁰

For purposes of reorganization efficiency, Mr. Ray has chosen to group operating entity assets by similar lines of business he refers to as “Silos.” For the period ending December 31, 2021, “[t]he FTX Group received audit opinions on consolidated financial statements for two of the Silos—the WRS Silo and the Dotcom Silo.”²³¹ Mr. Ray stated, “The audit firm for the WRS Silo, Armanino LLP, was a firm with which I am professionally familiar. The audit firm for the Dotcom Silo was Prager Metis, a firm with which I am not familiar”²³² During his first day bankruptcy proceeding declarations, Mr. Ray stated:

I have substantial concerns as to the information presented in these audited financial statements, especially with respect to the Dotcom Silo. As a practical

227. *FTX Hearing, supra* note 5, at 2 (statement of John J. Ray III, CEO, FTX Debtors).

228. *See* discussion *supra* Section V.A.

229. Declaration of John J. Ray III in Support of Chapter 11 Petitions and First Day Pleadings ¶ 5, *In re FTX Trading Ltd.*, No. 22-11068 (JTD) (Bankr. D. Del. 2022).

230. *FTX Hearing, supra* note 5, at 1:30:20 (statement of John J. Ray III, CEO, FTX Debtors).

231. Declaration of John J. Ray III in Support of Chapter 11 Petitions and First Day Pleadings ¶ 55, *In re FTX Trading Ltd.*, No. 22-11068 (JTD) (Bankr. D. Del. 2022).

232. *Id.*

matter, I do not believe it appropriate for stakeholders or the Court to rely on the audited financial statements as a reliable indication of the financial circumstances of these Silos.

The Debtors have not yet been able to locate any audited financial statements with respect to the Alameda Silo or the Ventures Silo.

The Debtors are locating and securing all available financial records but expect it will be some time before reliable historical financial statements can be prepared for the FTX Group with which I am comfortable as Chief Executive Officer. The Debtors do not have an accounting department and outsource this function.²³³

The complaint filed on December 13, 2022, against Mr. Bankman-Fried, captioned Securities and Exchange Commission v. Samuel Bankman-Fried, stated, in relevant part:

FTX investors were provided with FTX’s audited financial statements, and FTX represented in its purchase agreements that those financial statements “fairly present in all material respects the financial condition and operating results of” FTX. These audited financial statements, which do not include information about Alameda’s undocumented “line of credit” from FTX and other information discussed herein, were, at the very least, materially misleading. Indeed, FTX’s current CEO has voiced ‘substantial concern as to the information presented in these audited financial statements.’²³⁴

B. Accounting Pronouncements in Flux

On December 15, 2021, The Financial Accounting Standards Board (“FASB”) responded to feedback on its *Agenda Prioritization* invitation to comment by adding “a project to improve the accounting

233. *Id.* ¶¶ 56–58

234. Complaint at 15, SEC v. Samuel Bankman-Fried, No. 22-cv-10501 (S.D.N.Y. Dec. 13, 2022).

for and disclosure of certain crypto assets.”²³⁵ This project on Accounting for and Disclosure of Crypto Assets (formerly known as Accounting for and Disclosure of Digital Assets), was last updated on October 12, 2022.²³⁶ The October 12, 2022, meeting updated the project as follows:

The Board discussed how entities that hold crypto assets within the scope of this project should measure those assets.

The Board decided to require an entity to:

- a. Measure crypto assets at fair value, using the guidance in Topic 820, Fair Value Measurement,
- b. Recognize increases and decreases in fair value in comprehensive income each reporting period,
- c. Recognize certain costs incurred to acquire crypto assets, such as commissions, as an expense (unless the entity follows specialized industry measurement guidance that requires otherwise).

The Board also considered:

- a. Various measurement alternatives for crypto assets with inactive markets and decided not to pursue those alternatives.
- b. Whether to provide implementation guidance relative to the application of fair value measurement of crypto assets and decided not to provide additional measurement guidance as part of this project.
- c. Whether there should be a difference for private companies for the measurement of crypto assets and decided that the measurement and recognition requirements should be the same for all entities.

235. See *Accounting for and Disclosure of Crypto Assets Tentative Board Decisions to Date as of October 12, 2022*, FASB, <https://www.fasb.org/Page/ShowPdf?path=Accounting%20for%20and%20Disclosure%20of%20Crypto%20Assets%E2%80%94Tentative%20Board%20Decisions%20to%20Date.pdf&title=Accounting%20for%20and%20Disclosure%20of%20Crypto%20Assets%E2%80%94Tentative%20Board%20Decisions%20to%20Date> (last visited Mar. 7, 2024).

236. See *id.*

The Board will consider presentation, disclosure, and transition at a future meeting.²³⁷

By mid-December 2022, reports emerged that “Mazars, a midsize accounting firm[,] . . . withdrew from its website a report of reserves at Binance and other cryptocurrency-trading companies. . . . This past week, Binance experienced a sharp increase in customer withdrawals, with roughly \$6 billion in net outflows between Monday and Wednesday.”²³⁸ Also on the same date, “[a]ccounting firm BDO, which recently signed off on reserves reports for Tether [the world’s largest stablecoin], said it is reconsidering its work for crypto companies. ‘In common with several other professional services firms, we are currently evaluating our approach to this sector’”²³⁹

C. New Post-Bankruptcy FTX Board

Elsewhere, the Honorable Bernice Donald, professors Brian Elzweig, Neal F. Newman, H. Justin Pace, and Lawrence J. Trautman have written, “Cyber risk is quickly becoming ‘mission critical’ for *all* large companies.”²⁴⁰ One prominent commentator on directors’ and officers’ (“D&O”) insurance listed cybersecurity as one of the top ten D&O issues for both 2020 and 2021.²⁴¹ As such, it is demanding board-

237. *Id.*

238. Caitlin Ostrhoff & Jean Eaglesham, *Accounting Firm Halts Reports for Binance, Other Crypto Clients*, WALL ST. J., Dec. 17, 2022, at A1.

239. *Id.*

240. Hon. Bernice Donald et al., *Crisis at the Audit Committee: Challenges of a Post-Pandemic World*, REV. BANKING & FIN. L. (forthcoming 2024) (citing H. Justin Pace & Lawrence J. Trautman, *Mission Critical: Caremark, Blue Bell, and Director Responsibility for Cybersecurity Governance*, 2022 WISC. L. REV. 887 (2022)).

241. Kevin LaCroix, *The Top Ten D&O Stories of 2021*, D&O DIARY (Jan. 3, 2022), <https://www.dandodiary.com/2022/01/articles/director-and-officerliability/the-top-ten-do-stories-of-2021>; Kevin LaCroix, *The Top Ten D&O Stories of 2020*, D&O DIARY (Jan. 4, 2021), <https://www.dandodiary.com/2021/01/articles/director-and-officer-liability/the-top-ten-do-stories-of-2020>.

level attention.²⁴² Due to significant risk exposure, many companies plan to “assign cyber risk oversight to the audit committee.”²⁴³

Faced with the daunting task of identifying missing assets spread across numerous global jurisdictions, the new FTX board of directors is comprised of individuals having many years of complex bankruptcy restructuring experience. Accordingly, the primary companies in the FTX Group have appointed the following new independent directors:

WRS Silo: Mitchell I. Sonkin: Mitchell Sonkin is currently a Senior Advisor to MBIA Insurance Corporation in connection with the restructuring of the Firm’s insured portfolio exposure of the Commonwealth of Puerto Rico’s \$72 billion of outstanding debt. He is also currently Chairman of the Board of the ResCap Liquidating Trust, successor to ResCap and GMAC Mortgage Corporations. Before joining MBIA, Mr. Sonkin was a senior partner at the international law firm, King & Spalding, where he was co-chair of King & Spalding’s Financial Restructuring Group

Alameda Silo: Matthew R. Rosenberg: Mr. Rosenberg is a Partner at Lincoln Park Advisors, a financial advisory firm that he founded in 2014. He has more than 25 years of restructuring, corporate finance, principal investing, operating and board experience. . . . His restructuring advisory experience includes such companies as OSG, Supermedia, Nortel, Trinity Coal, USG Corporation, JHT Holdings, Inc., Covanta Energy, Sirva, Lodgian, Inc., ContiGroup Companies, Inc., Fruit of the Loom, Ltd. and Recycled Paper Greetings.

242. See, e.g., *Firemen’s Ret. Sys. of St. Louis v. Sorenson*, No. 2019-0965-LWW, 2021 WL 4593777, at *1 (Del. Ch. Oct. 5, 2021) (“Cybersecurity has increasingly become a central compliance risk deserving of board level monitoring at companies across sectors.”).

243. Pace & Trautman, *supra* note 240, at 937 (citing Lawrence J. Trautman, *Who Qualifies as an Audit Committee Financial Expert Under SEC Regulations and NYSE Rules?*, 11 DEPAUL BUS. & COM. L.J. 205, 233 (2013); Lawrence J. Trautman, *Who Sits on Texas Corporate Boards? Texas Corporate Directors: Who They Are and What They Do*, 16 HOUS. BUS. & TAX L.J. 44, 76–77 (2016)).

Ventures Silo: Rishi Jain: Mr. Jain is a Managing Director and CoHead of the Western Region of Accordion, a financial and technology consulting firm focused on the private equity industry. He has more than 25 years of experience supporting management teams and leading finance and operations initiatives in both stressed and distressed environments. Prior to joining Accordion, Mr. Jain was part of Alvarez & Marsal’s corporate restructuring and turnaround practice for over 10 years

Dotcom Silo: The Honorable Joseph J. Farnan (Lead Independent Director): Mr. Farnan served as a United States District Judge for the District of Delaware from 1985 to 2010. He served as Chief Judge from 1997-2001. During his tenure, Mr. Farnan presided over numerous bench and jury trials involving complex commercial disputes. . . .

Dotcom Silo: Matthew A. Doheny: Mr. Doheny is President of North Country Capital LLC, an advisory and investment firm focused on challenging advisory assignments and investing private investment portfolios in special situation opportunities. . . .²⁴⁴

According to Mr. Ray, it is only with the appointment of this new board of directors that “the FTX Group will have appropriate corporate governance for the first time.”²⁴⁵ It is now anticipated that the new Directors will:

hold joint board meetings of the Debtors on matters of common interest, including (a) the implementation of controls, (b) asset protection and recovery, (c) the investigation into claims against the founders and third parties, (d) cooperation with insolvency proceedings of subsidiary companies in other jurisdictions and (e) the maximization of value for all

244. Declaration of John J. Ray III in Support of Chapter 11 Petitions and First Day Pleadings ¶ 47, *In re FTX Trading Ltd.*, No. 22-11068 (JTD) (Bankr. D. Del. 2022).

245. *Id.* ¶ 48.

stakeholders through the eventual reorganization or sale of the Debtors' complex array of businesses, investments and property around the world. The Directors will implement appropriate procedures for the resolution of any conflicts of interest among the Silos and, if necessary, within the Silos as the case progresses, including the potential engagement of independent counsel to represent various Debtors in the resolution of intercompany claims against other Debtors.²⁴⁶

XIV. THE ARREST, CHARGES, TRIAL, AND VERDICT

On December 12, 2022, Mr. Bankman-Fried was arrested in the Bahamas following criminal charges being brought against him in relation to the collapse of FTX.²⁴⁷

A. SEC v. Samuel Bankman-Fried

In an action filed on December 13, 2022, the SEC charged violations of "Section 17(a) of the Securities Act of 1933 ('Securities Act') [15 U.S.C. § 77q(a)]; and Section 10(b) of the Securities Exchange Act of 1934 ('Exchange Act') [15 U.S.C. § 78j(b)] and Rule 10b-5 thereunder [17 C.F.R. § 240.10b-5]."²⁴⁸ The complaint states:

From at least May 2019 through November 2022, Bankman-Fried engaged in a scheme to defraud equity investors in FTX Trading Ltd. ("FTX"), the crypto asset trading platform of which he was CEO and co-founder, at the same time that he was also defrauding the platform's customers. Bankman-Fried raised more than \$1.8 billion from investors, including U.S. investors, who bought an equity stake in FTX believing that FTX had appropriate controls and risk management measures.

246. *Id.* ¶ 49.

247. Alexander Saeedy et al., *Former FTX CEO Sam Bankman-Fried Arrested in Bahamas*, WALL ST. J. (Dec. 12, 2022, 9:26 PM), <https://www.wsj.com/articles/ftx-founder-samuel-bankman-fried-arrested-in-bahamas-11670890250>.

248. Complaint at 3, SEC v. Samuel Bankman-Fried, No. 22-cv-10501 (S.D.N.Y. Dec. 13, 2022).

Unbeknownst to those investors (and to FTX's trading customers), Bankman-Fried was orchestrating a massive, years-long fraud, diverting billions of dollars of the trading platform's customer funds for his own personal benefit and to help grow his crypto empire.²⁴⁹

The New York Times reported that the charges allege, “[f]rom the founding of his cryptocurrency exchange FTX in 2019, Mr. Bankman-Fried engaged in widespread fraud, the federal authorities charged . . . and used his customers’ deposits to finance his political activities, buy lavish real estate and invest in other companies.”²⁵⁰ In sum:

In a 13-page criminal indictment, Mr. Bankman-Fried was charged with eight counts, including wire fraud against customers and lenders, as well as conspiracy to defraud the United States and violate campaign finance laws. A civil complaint filed by the Securities and Exchange Commission laid out a detailed narrative of FTX's collapse, claiming that for three years Mr. Bankman-Fried had misappropriated billions in customer deposits to fund his business and political activities.²⁵¹

Just days later, the SEC “charged Caroline Ellison, the former CEO of Alameda Research, and Zixiao (Gary) Wang, the former Chief Technology Officer of FTX Trading Ltd. (FTX), for their roles in a multiyear scheme to defraud equity investors in FTX.”²⁵² The SEC's complaint charges that “between 2019 and 2022, Ellison, at the direction of Bankman-Fried, furthered the scheme by manipulating the

249. *Id.* at 1.

250. David Yaffe-Bellany et al., *Prosecutors Say FTX Was Engaged in a ‘Massive, Yearslong Fraud’*, N.Y. TIMES (Dec. 13, 2022), <https://www.nytimes.com/2022/12/13/business/ftx-sam-bankman-fried-fraud-charges.html>.

251. *Id.*

252. Press Release, U.S. Sec. and Exch. Comm’n, SEC Charges Caroline Ellison and Gary Wang with Defrauding Investors in Crypto Asset Trading Platform FTX (Dec. 21, 2022), <https://www.sec.gov/news/press-release/2022-234>.

price of FTT, an FTX-issued exchange crypto security token, by purchasing large quantities on the open market to prop up its price[,] . . . [and] Ellison and Wang were active participants in the scheme to deceive FTX’s investors.”²⁵³ Further, FTX’s minted cryptocurrency, “FTT served as collateral for undisclosed loans by FTX of its customers’ assets to Alameda . . . [which was] owned by Wang and Bankman-Fried and run by Ellison. The complaint alleges that, by manipulating the price of FTT, Bankman-Fried and Ellison caused the valuation of Alameda’s FTT holdings to be inflated.”²⁵⁴ On January 17, 2023, FTX disclosed that “a probe of its balance sheet showed holdings of customer funds were lower than the exchange’s internal accounts had indicated, acknowledging for the first time that there was a shortfall of funds at the U.S. exchange.”²⁵⁵ In addition:

[A] hack of the Company’s crypto wallets two days after the Company’s bankruptcy filing in November led to the theft of around half of the crypto assets stored on the U.S.-based exchange, valued at about \$90 million before the Company’s collapse. The same hacker took about \$323 million of crypto from FTX’s international exchange, representing about 20% of that exchange’s total crypto assets.

FTX also said it found that a small group of individuals at the company had the ability to remove digital assets from the exchange without any record-keeping.²⁵⁶

B. The Verdict

On November 2, 2023, the jury in Mr. Bankman-Fried’s case issued a verdict finding him guilty of the following seven counts of fraud:

253. *Id.*

254. *Id.*

255. Alexander Saeedy, *FTX Discloses Shortfall in Client Holdings*, WALL ST. J., Jan. 18, 2023, at B1.

256. *Id.*

1. Count 1: Conspiracy to Commit Wire Fraud on Customers, in violation of 18 U.S.C. § 1349;
2. Count 2: Wire Fraud on Customers, in violation of 18 U.S.C. §§ 1343 and 2;
3. Count 3: Conspiracy to Commit Wire Fraud on Lenders, in violation of 18 U.S.C. § 1349;
4. Count 4: Wire Fraud on Lenders, in violation of 18 U.S.C. §§ 1343 and 2;
5. Count 5: Conspiracy to Commit Commodities Fraud, in violation of 18 U.S.C. § 371;
6. Count 6: Conspiracy to Commit Securities Fraud, in violation of 18 U.S.C. § 371; and
7. Count 7: Conspiracy to Commit Money Laundering, in violation of 18 U.S.C. § 1956(h).²⁵⁷

As to Count 7, the jury answered a special verdict question that it was a unanimous verdict based on both concealment money laundering and wire fraud proceeds money laundering.²⁵⁸

XV. CONCLUSION

For the past fifteen years, technologists have touted the promise of blockchain and its numerous use cases, including cryptocurrencies. The demise of FTX and its many related crypto entities created contagion and collateral damage for other participants and investors in the cryptocurrency community. It is likely that the U.S. bankruptcy proceedings of many FTX related entities, scattered across many jurisdictions worldwide, will take years to sort out. However, just like the previous high-profile frauds committed by Enron, WorldCom, Adelphia Communications, and Bernard Madoff, the events surrounding the FTX collapse will challenge financial regulators worldwide to craft solutions that work.

257. See Sealed Indictment, *United States v. Bankman-Fried*, 1:22-cr-00673 (S.D.N.Y. Dec. 9, 2022), ECF No. 1.

258. *United States v. Bankman-Fried* (1:22-cr-00673), COURT LISTENER, <https://www.courtlistener.com/docket/66631291/united-states-v-bankman-fried/?page=2> (last updated Mar. 7, 2024) (choose “page 2”, then scroll to second listing of “Nov. 2, 2023”).