Lessons From the FTX Cryptocurrency Exchange Collapse

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EXECUTIVE SUMMARY

Governments and market regulators are debating and deliberating on matters of concern and benefits of treating cryptocurrencies as an asset or a currency so that they can tax them accordingly. 2022 has shaken the financial markets with the onset of the worst crypto winters in cryptocurrency history on one hand and the collapse of a few cryptocurrencies and the exchanges that facilitate investing and trading in them. These events brought chills to the stakeholders, who began questioning the stability of the cryptocurrency and the functioning of various exchanges. Cryptocurrencies promise to be the future of currency, and hence, there is an immediate need to protect investors by regulating them – especially those cryptocurrency exchanges running in a centralized form. The case examines the collapse of FTX and other financial institutions because they exposed the structural weaknesses existing in the system. The case also examines competitor business strategies to protect themselves from such incidents and stresses the need for governmental and regulatory interventions.

INTRODUCTION

"A year ago, Sam Bankman-Fried ditched his trademark shorts and T-shirt for a suit and sat before the U.S. House of Representatives as the acceptable face of crypto. Lawmakers could not see that, under the table, his shoelaces were untied." — Joshua Oliver & Stefania Palma, Financial Express Weekend, U.K., December 17, 2022

The financial services industry has transformed due to innovative and disruptive financial engineered products that use emerging technologies of Web 3.0 and the Metaverse era. These have given rise to new-generation financial instruments such as cryptocurrencies and Non-Fungible Tokens (NFTs) that are backed by the fundamental concepts of blockchain and Distributed Ledger Technology (DLT). These digital currencies and assets have led to the emergence of newer forms of businesses, such as cryptocurrency exchanges and Distributed Autonomous Organizations (DAO). Cryptocurrency exchanges, also known as Digital Currency Exchanges (DCE), are online marketplaces that let investors purchase and sell cryptocurrencies in return for fiat money or other cryptocurrencies.

THE DILEMMA

FTX is the world's second-largest cryptocurrency exchange. Its sudden and surprising collapse before the end of 2022 affected millions of its investors globally and has put billions of dollars invested by them into limbo. The unprecedented situation pushed the cryptocurrency community to review the concept of cryptocurrencies, the industry, and the dangers of centralized exchanges. Their faith and confidence levels were already put to the test as cryptocurrencies were experiencing the most prolonged crypto winter period. The previous crypto winter was in 2017 and lasted several months, and the present ongoing one started at the end of 2021. Extreme turbulence in the cryptocurrency markets was observed in 2021 and 2022 - particularly between May to June 2022. The bearish trend was ongoing till November 2022. Some leading digital asset market players, including Vauld, Three Arrow Capital, Terra-Luna, Celsius Network LLC, BlockFi Inc, Voyager Digital Ltd, Genesis Global Holding LLC, and Gemini Trust, have collapsed due to the crypto meltdown. Experts believe that another year of crypto winter is likely before a turnaround can be seen (Cornelius, 2022). This means crypto asset traders and investors face a wall of worries until the digital asset market revives. The investigations into the activities of FTX were univocally pointing toward the biggest fraud in American history! Parallels were drawn to the Ponzi scheme architect Madoff and the bankruptcy of Enron. The poster boy who sat before the U.S. House of Representatives giving visionary speeches is now testifying about what exactly led to the collapse of his own FTX.

INDUSTRY DYNAMICS

"The great crypto crisis is upon us." — Hyun Song Shin, Financial Express Weekend, U.K., December 17, 2022

Cryptocurrency origins can be traced to 1998. However, they emerged as an instrument for alternative investment after the post-Financial Crisis of 2008. While Cryptocurrencies have had a tumultuous journey so far, they are undoubtedly considered marvelous creations of technology. However, their global acceptance is still debatable because of the lack of proper acceptance or support, particularly by Governments and regulators of various countries. Due to the complexity of the instrument, only some countries could take a clear stand. Some have officially accepted them (such as El Salvador), and few ban them (such as in China and Turkey, amongst others) or make moves towards regulating them (U.S., U.K., South Africa, South Korea, India, amongst others). Despite the mixed reactions and actions by

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