CASE COMMENT: THE FTX COLLAPSE (2022): REGULATORY OVERSIGHT FAILURES IN GLOBAL CRYPTO MARKETS

Anubhuti Misra*

INTRODUCTION

The downfall of FTX in November 2022 is fundamentally the book of why crypto can go bad. It created a massive loophole in the way we are in control of these markets. FTX was previously a leading exchange, but now it is a multi-billion-dollar fraud, and all the concepts of governance, risk management, and the legal system, as we know it is highly doubted. In this case study, the poor nature of the internal controls and the regulation allowed customer money to be misappropriated, got into contact with Alameda, and led to the entire system wobbling.

BACKGROUND OF THE CASE

FTX began with Sam Bankman-Fried, of the name SBF and soon turned into one of the largest crypto exchanges, with Alameda Research, a trading division, sitting beside it. The two were basically mixing staff and finances, which became a great catalyst when the disaster struck. A liquidity crisis struck in November 2022, when a ton of clients attempted to withdraw their funds, revealing a hole in the balance sheet of FTX. Their employee who was hired to run the bankruptcy, John J. Ray III, described it as the ultimate failure of corporate control and indicated that they had virtually no trustworthy financial information.

FACTS OF THE CASE

On November 2, 2022, CoinDesk published an article stating that Alameda owned huge quantities of FTX native token, FTT, and that was a huge red flag of risk. The clients began to withdraw, and FTX was unable to cope with them. On November 11, FTX and Alameda declared themselves bankrupt. The poor quality of the controls was demonstrated by the fact that in their first statement on bankruptcy, FTX stated that they used QuickBooks to account,

*HIMACHAL PRADESH NATIONAL LAW UNIVERSITY, SHIMLA.

which is software designed for small businesses, not a multibillion-dollar exchange. The customer money was everywhere: the deposits at FTX seem to have been used by Alameda to trade and speculate. They had almost no governance; they were chatting on auto-deleting platforms, had poor recordkeeping, and no concrete risk-management system. There were also clear conflicts of interest within the model of the business, which, being an exchange, a trader and a hedge fund, all in one, was not separated properly in legal terms.

LEGAL PROVISIONS INVOLVED

Commodity Exchange Act (CEA): CFTC regulates some of the crypto derivatives via the CEA, and FTX seemingly violated these provisions. CFTC Regulations: FTX Trading Ltd. and Alameda Research received a consent order by CFTC that required restitution, disgorgement, civil penalties, and injunctions. Securities Laws: Although not every crypto is subject to the same securities law, the structure of FTX and the way that they discussed their operations with investors created disclosure and potential fraud concerns. (Hey, SEC is investigating as well.) Corporate Governance / Audit Rules: FTX had failed to maintain proper books, auditing supervision and accounting systems, which is a classic example of corporate governance expectations.

ARGUMENTS OF THE PARTIES

Regulators (CFTC, etc.): In the indictment, the CFTC alleged that FTX and Alameda spent their client funds improperly, contravened the CEA, and failed to separate assets. Commissioner Kristin Johnson noted that this crash revealed huge regulatory loopholes that enabled FTX and Alameda to loot billions of dollars from clients. GAO and others argue that the U.S. simply lacks a single state regulator of spot crypto markets, which contributed to FTX acting almost unregulated.

FTX / Defence (SBF, Management): On the inside, they claimed that whilst they had weak controls, it was not entirely fraudulent. Prosecutors and regulators testified that SBF did defraud the customers by transferring their deposits to support trades Alameda made and to himself. What they knew and when more particularly came to light later, in the legal team, in the questioning of what was known by them as a back-door code, which permitted Alameda to have special access. (Litigation is still going on.)

ARBITRATION/REGULATORY DECISION

In 2024, the CFTC obtained a consent order (No. 22 1:22003 -PKC) against FTX Trading Ltd. and Alameda Research LLC, requiring restitution and disgorgement of US12.7billion. The order effectively prevented repeated violations of the CEA and any rules by FTX of the CFTC and prohibited future trading or registration of specific digital assets. Commissioner Kristin Johnson remarked that this ruling indicates that we should have more significant reforms so that no gaps are left in oversight and keep customers safe. At criminal court, SBF was found guilty of wire fraud, securities fraud, commodities fraud, and money laundering and was sentenced to 25 years of prison.

ANALYSIS

The FTX case demonstrates that regulation can backfire in very drastic ways: the use of the reality that spot crypto markets lack a well-organised, holistic regulatory system. Under the CFTC having no jurisdiction over spot markets, FTX operated under little supervision, with exchange and proprietary trading co-mingled under Alameda and embezzled user funds. The collapse of governance was extreme- According to the testimony by Ray, there were no real internal controls, audited statements or separation of trust accounts. These types of business collapses would have been uncovered early on in a more strictly regulated organisation.

In addition to this, trading risky business with the customer funds and using FTT as collateral highlights the conflicts of interest that would have been alleviated with an adequate separation-of-functions regime. The case also drives home the fact that international cooperation is needed: FTX was based in the Bahamas, yet had clients all over the world, making it even more difficult to regulate and assist in the case of a failure.

Lastly, the penalties and the incarceration reveal that the system is reactive, rather than proactive. The ruling, though historic, was issued following colossal losses of investors, and this highlights the fact that regulation was ineffective, in pieces, and very sluggish.

CONCLUSION

The bankruptcy of FTX is fundamentally a gigantic warning signal to authorities, investors, and the entire crypto community. It was not only the outcome of bad entrepreneurship or misfortune, but it also revealed fundamental regulatory, governance, and structural weaknesses. In the absence of any significant reforms, such as a tighter regulation of exchange activities, obligatory separation of customer funds, harder audit and reporting requirements, and explicit control of the spot markets, similar disasters may occur again. This case highlights the urgency of the world to collaborate, establish regulatory systems, and enhance corporate governance in crypto. The only way in which we can safeguard customers, as well as reduce systemic risk in the fast-changing reality of digital finance, is through a comprehensive regulatory reform.

REFERENCES

1. CLS Blue Sky Blog, The FTX Collapse: Why Did Due Diligence, Regulation, and Governance Evaporate? (Nov. 30, 2022).
2. David Vidal-Tomás, Antonio Briola & Tomaso Aste, FTX's Downfall and Binance's Consolidation: The Fragility of Centralised Digital Finance, arXiv (Feb. 22, 2023).
3. Shange Fu, Qin Wang, Jiangshan Yu & Shiping Chen, FTX Collapse: A Ponzi Story, arXiv (Dec. 19, 2022).
4. "Complete Failure of Controls": Inside the Fall of FTX, Testimony from John J. Ray, III. As reported by The Times of India.
5. IMA, Ethical Failure Led to the FTX Scandal (Jan. 2024).
6. U.S. Government Accountability Office, Risks to Investors from the Lack of Regulation over Crypto Asset Spot Markets (GAO Report).
7. British Accounting Review, The Collapse of the FTX Exchange: The End of Cryptocurrency's Age of Innocence (2023).
8. VitalLaw, Consent Order in CFTC v. FTX Trading Ltd. & Alameda Research LLC, No. 1:22-cv-10503-PKC (S.D.N.Y.).
9. CFTC, Statement of Commissioner Kristin N. Johnson: Prioritising Customer Protection and Combating Fraud by FTX and Alameda (Aug. 2024).