What To Pay Attention To In FTX Fraud Probe

By Steven Lee and Sean Shecter (November 21, 2022)

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Did FTX founder Sam Bankman-Fried improperly use billions of dollars of customer funds to prop up a trading firm he also founded, Alameda Research? That is the central question swirling around Bankman-Fried as the U.S. Department of Justice and the U.S. Securities and Exchange Commission begin their investigations.

FTX was the third-largest cryptocurrency exchange by volume before plunging from $32 billion to bankruptcy in a matter of 10 days, causing investors to withdraw their funds from other crypto exchanges in panic.

On Nov. 10, Genesis Trading, one of the largest crypto lending institutions, temporarily suspended customer withdrawals and new loan originations as a result of FTX's rapid collapse. On Nov. 11, crypto lender BlockFi paused client withdrawals. On Nov. 12 and 13, Crypto.com saw withdrawals increase and its native cryptocurrency token drop 28% to a 22-month low.

FTX filed for **bankruptcy** in the U.S. Bankruptcy Court for the District of Delaware on Nov. 11 after it was unable to meet demand for customer withdrawals after allegedly having misused customer funds for risky investments.

To add insult to injury, John Ray III — a veteran insolvency professional who oversaw the liquidation of Enron and is FTX's new CEO — **said** in a Delaware bankruptcy court filing that "[n]ever 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."

This may be just the tip of the iceberg. On Nov. 16, a class action **lawsuit** in the U.S. District Court for the Southern District of Florida seeking $11 billion in damages was filed against Bankman-Fried and a number of celebrities who endorsed FTX, such as Tom Brady of the Tampa Bay Buccaneers and Stephen Curry of the Golden State Warriors. The lawsuit alleges Bankman-Fried and the celebrities named in the lawsuit facilitated FTX, a fraudulent scheme "designed to take advantage of unsophisticated investors from across the country, who utilize mobile apps to make their investments."

Federal authorities have started **investigating** FTX. On Nov. 15, Reuters reported that the U.S. Attorney's Office for the Southern District of New York started a criminal investigation of FTX for the firm's handling of its customer funds.

FTX's case may be a classic case of wire fraud, one of the most commonly charged crimes by federal prosecutors in fraud cases. FTX's terms of service, Section 8.2.6.(B), states, "None of the Digital Assets in your Account are the property of, or shall or may be loaned to, FTX Trading; FTX Trading does not represent or treat Digital Assets in User's Accounts as belonging to FTX Trading."

Therefore, under FTX's own terms of service, it appears on its face that FTX was not allowed to use customer funds for outside investments, and by doing so, the company would be improperly misappropriating the funds. The authorities will focus on these and other documents in determining whether Bankman-Fried committed wire fraud in violation of Title 18 of the U.S. Code, Section 1343, and improperly used FTX customer funds for Alameda's investments.

The authorities will also examine any public statements and communications made by Bankman-Fried, including but not limited to the following.

When interviewed by The New York Times, Bankman-Fried indicated that Alameda had accumulated a large margin position on FTX, indicating that Alameda had borrowed FTX's customers funds, and that he believed "it was substantially larger than [he] had thought it was."[1] On its face, such acts would appear to be in direct violation of the previously cited language of Section 8.2.6.(B) of FTX's terms of service.

Moreover, when asked whether FTX had loaned money to Alameda for investments, Bankman-Fried told Vox via Twitter he "also thought Alameda had enough collateral to [reasonably] cover it."[2]

When asked why he had not realized what was happening until it was too late, Bankman-Fried said, "Sometimes life creeps up on you." He also said he "fucked up. Big. Multiple times."

Such statements will surely put Bankman-Fried in the crosshairs of investigators and could potentially be used against Bankman-Fried in any civil and criminal matters against him.

In order to gauge whether Bankman-Fried acted with the requisite criminal intent to violate the law, the DOJ will also likely examine whether FTX, as Ray suggested, lacked corporate controls in how it handled customer funds. Presumably, a lack of corporate controls could seem to indicate that Bankman-Fried may have sought to handle customer funds without restriction.

If the authorities confirm that Bankman-Fried used billions of dollars of FTX customer funds to improperly prop up his other investments through Alameda Research, such facts would potentially meet the elements of a crime of wire fraud.

These elements are:

- That the defendant knowingly devised or participated in a scheme to defraud someone by using false or fraudulent pretenses, representations or promises;
- The false pretenses, representations or promises were about a material fact;
- The defendant acted with the intent to defraud; and
- The defendant transmitted or caused to be transmitted by wire some communication in interstate commerce to help carry out the scheme to defraud.

The DOJ will also potentially evaluate other criminal charges, including the crime of conspiracy. If Bankman-Fried was involved with anyone else in improperly misusing FTX customer funds, both Bankman-Fried and anyone else involved could be charged with conspiracy under Title 18 of the U.S., Section 371.

The elements of criminal conspiracy are:

- Two or more persons in some way agreed to try to accomplish a shared and unlawful plan;
- The defendant knew the unlawful purpose of the plan and willfully joined in it;
- During the conspiracy, one of the conspirators knowingly engaged in at least one overt act; and
- The overt act was committed at or about the time alleged and with the purpose of carrying out or accomplishing some object of the conspiracy.

While, according to public accounts, Bankman-Fried is attempting to raise $8 billion to pay back FTX customers, recouping lost funds may only help Bankman-Fried in a civil case. Such efforts are unlikely to affect the criminal investigation on Bankman-Fried.

Furthermore, the DOJ will also likely attempt to seize property or assets belonging to Bankman-Fried under the forfeiture provisions of Title 18 of the U.S. Code, Sections 981 and 982. The government would have the burden of proving the forfeitability of the property by a preponderance of the evidence standard, and may proceed under the theory that such assets were acquired using ill-gotten gains.

Multiple federal agencies, including but not limited to the DOJ, SEC and the Federal Trade Commission, will mostly likely work jointly and conduct parallel civil and criminal investigations involving the handling of customer funds in the case of FTX.

Lastly, in the event that Bankman-Fried is indicted by the DOJ and is found to be physically present in the Bahamas, as is reported, the DOJ will likely move to extradite Bankman-Fried under the extradition treaty between both countries. Public reports indicate that the DOJ may seek to extradite Bankman-Fried for the purpose of an interview, which is possible, as the extradition treaty between both countries does not preclude such a possibility.

As such, crypto companies, or any company managing consumer funds, ought to carefully examine its terms of service to ensure that they are not misrepresenting to customers how their funds may be used. Violating such terms could potentially lead to significant criminal exposure, such as the case with FTX, even when the cryptocurrency market is unregulated by the financial authorities and not subject to the regulations that have traditionally applied to financial institutions.

Any crypto company would be well advised to reevaluate its own policies in conjunction with regulations that currently apply to financial institutions. Even more pressing, and heeding the recent statement of Ray, crypto-based companies should ensure in implementing corporate controls that proper checks are in place when handling consumer funds to ensure such funds are not misappropriated, as was allegedly the case with FTX.

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[1] https://www.nytimes.com/2022/11/14/technology/ftx-sam-bankman-fried-crypto-bankruptcy.html.

[2] https://www.vox.com/future-perfect/23462333/sam-bankman-fried-ftx-cryptocurrency-effective-altruism-crypto-bahamas-philanthropy.