Bullish insights

FTX Unfolded
November 9, 2022

Bullish

Timeline

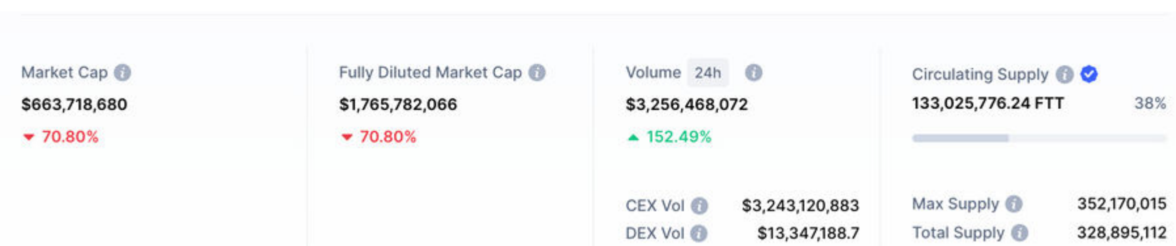
2nd November: headlines highlighted Alameda Research and its potential insolvency rumours These allegations began when Coindesk released an article pointing at Alameda's Q2, 2022 "leaked" balance sheet citing the company had $14.6bn in assets and $8bn in liabilities.

Total Assets: $14.6bn	Total Liabilities: $8bn
$5.8bn in FTT tokens	$7.4bn in loans
$1.2bn in SOL tokens	$292mn in FTT tokens owed
$3.4bn in unidentified crypto held	Remainder unidentified
$2.0bn in equity securities	-
$134mn in cash equivalents	-
$2.2bn in other assets	-

Source: Dirtybubblemedia, as at 4 November 2022.

The biggest concern the article highlighted was under the asset component of a heavily dominated FTT holding that Alameda may have borrowed against. Subsequently, other tokens held on its balance sheet SOL, SERUM, MAPS, OXY and FIDA also came into question. All in all, the headwind was the ability for the hedge fund to repay its debt obligations should the token price of its largest denominated asset fall.

How much is $FTT actually worth? Considering it's low float and high FDV (Fully Diluted Value), 133,025,776 FTT in circulating supply with a total supply of 328,895,112 FTT, means that almost 60% of FTT supply that has yet to hit the market. A compelling theory is that FTX created FTT so that Alameda would be able to borrow against the collateral which Alameda had access to at a low price, holding it on their balance sheet then receiving FTX customer deposits against a pumped up valuation of FTT.



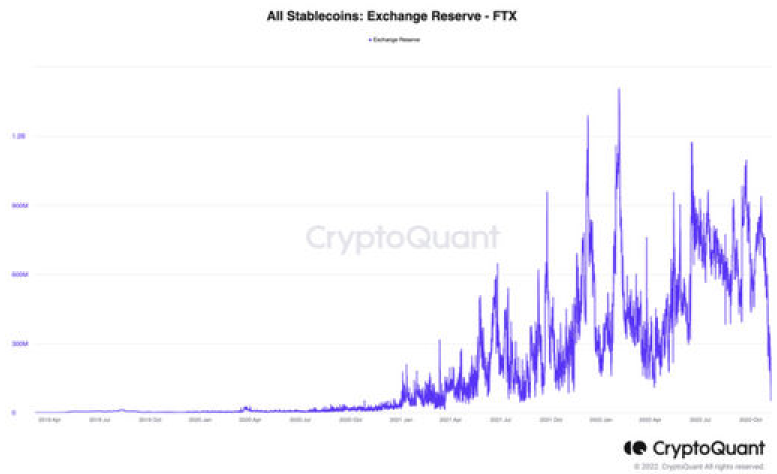
Source: Coinmarketcap, accessed as at 9 November 2022.

6th November: CEO of Alameda Research, Caroline Ellison tweeted to defend the company's insolvency rumours by stating that the company had over $10bn of assets that was not reflected in the circulated "leak".

Fast forward about an hour later, Binance CEO, CZ tweets that the company is looking to liquidate its FTT holdings. He went on to state that Binance "...will try to do so in a way that minimizes market impact." Bearing in mind though, if a trader intends to exit their position they would typically do so before announcing publicly else risk a worse off execution price.

Shortly, about 15 minutes after CZ's tweet, Ellison came to defend Alameda by offering to buy up Binance's bag at $22, at the time $FTT was trading ~$23.

7th November: a chart by CryptoQuant highlights that the stablecoin reserve on FTX had plummeted to a year low. In the two week period it saw a ~93% reduction down to ~$51mn.



Source: CryptoQuant, accessed as at 7 November 2022.

CZ later defends his FTT liquidation statement by stating it was taken out of risk management precautions "learning from LUNA". In the tweet he highlights "...we won't support people who lobby against other industry players behind their backs."

Bank run continues...

FTX's official Twitter account releases a series of tweets claiming the company is processing withdrawals. In an attempt to calm the masses they tweeted that the “queue is decreasing and getting back to more reasonable levels; nodes and banks catching up”

SBF and Ellison cease tweets on this day.

The community of BitDAO asked alameda for proof of reserves. BitDAO gave them an ultimatum to show proof or they’ll sell off $FTT. (back story: BitDAO and Alameda exchanged a swap in 100 million BIT tokens for 3,362,315 FTT tokens. The two parties publicly committed to hold each other’s tokens for three years until Nov. 2, 2024)

8th November: Rumours that SBF was asking for help from silicon valley investors of $1bn later increased to $5bn to $6bn.

CZ goes on to calm Binance customers by tweeting the exchange holds its customer assets in cold wallets with “$8bn worth of ETH in cold wallets 1 & 2” hinting that FTX may not have done the same.

Later that evening, SBF announces a “strategic transaction” with Binance pending DD. GG…

CZ announces that Binance has signed a non-binding LOI with FTX amid its “liquidity crunch”. The key thing to note here is that he goes on to state that they have the “discretion to pull out of the deal at any time”

Meanwhile Elon Musk announces that Twitter reached an all-time high usage.

After thoughts

S**omething doesn’t add up here.**

If FTX did not rehypothecate client assets then they would have the ability to fulfil all withdrawal requests (which wasn’t even 100%). The on-going theory is that FTX may have been using up client capital to reinvest elsewhere without a sufficient reserve balance to facilitate withdrawals for what was a bank run. Generally in traditional banks that’s what they do. They have a portion of reserves (10% is the required rate in the US) with the rest loaned out . But...for a crypto firm, especially post Luna, you would think FTX made appropriate risk precautions around this. The fact they could not produce proof-of-reserves was concerning.

The creditor

From Alameda's leaked balance sheet we see that there's about $8bn in outstanding liabilities, if we write off $FTT to zero would the company be liquid enough to meet its short-term debt obligations? If they had sold off total assets (liquid and illiquid and still unable to meet its total debt then they would be classified as insolvent). The bigger question is, who was on the other side of that deal?

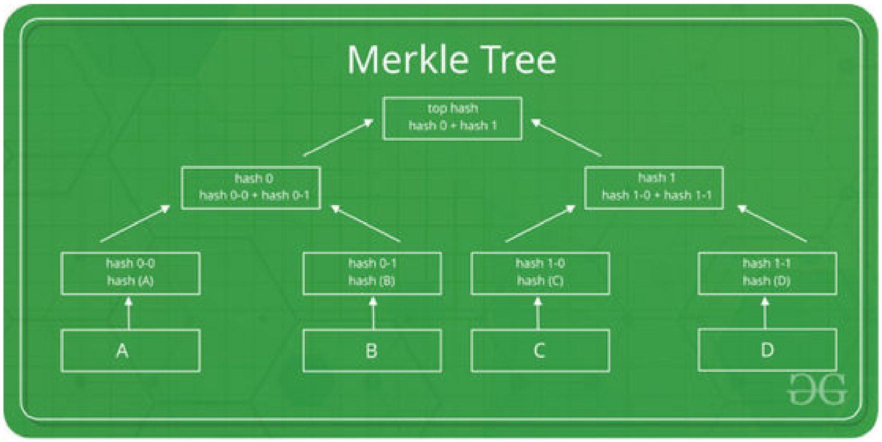
The deal

This deal is bad news for the crypto community. Monopolies are even worse for consumers. Competition is imperative for a free market. Give any one player too much control and we increase the risk of it being abused. Antitrust concerns are looming as US and EU have laws in place to protect consumers. Should Binance go ahead with the deal, it also risks being blocked by regulators should it be in breach of the Sherman Antitrust Act. Maybe they pre-empted this as SBF did tweet " FTX US and Binance US are two separate companies...not currently impacted by this" Might seem like they technically haven't breached the act if they were discussing off-shore entities in their tweets.

Proof-of-reserves

All this drama might have been avoided if FTX posted proof-of-reserves. Might be good business practice for any custodial business to consider transparently creating a publicly available attestation to reserves held where customers can see proof-of-reserves available for withdrawal. CZ tweeted on November 9, "Banks run on fractional reserves. Crypto exchanges should not...Binance will start to do proof-of-reserves soon. Full transparency."

A Merkle Tree is a cryptographic proof of summarized data where users are able to verify their individual accounts that are included in liabilities. This would mean every user would need their own Merkle Leaf hash followed by every peer user on the exchange which will be a Sibling Leaf hash that then forms the Merkle Root.



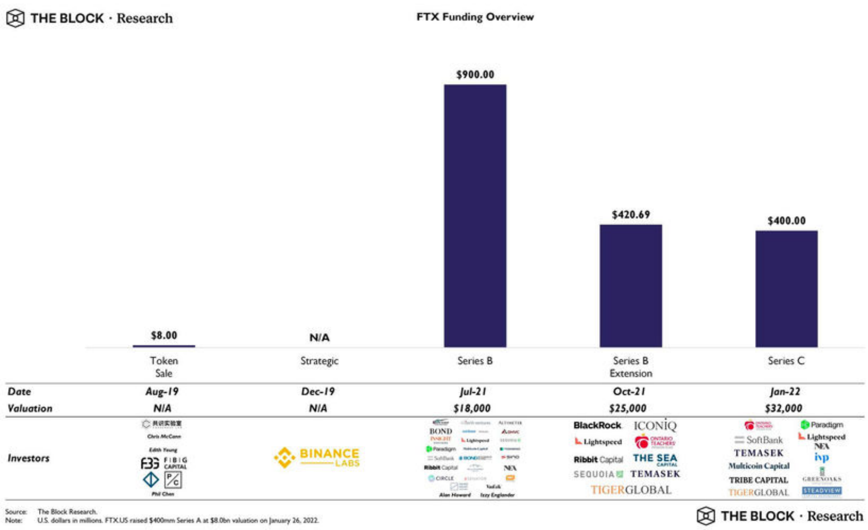
A downside is that an exchange may still have unaccounted liabilities that might not be captured (unless the creditor asks to be added to the Merkle Tree). Therefore the accounts should need to be audited against the exchange's liabilities which would be good house-keeping.

Ripple effect

It's probably an important time to start discussing counter-party risk. Lenders across CeFi and DeFi may be impacted and its not a 3AC kind of domino effect, it could be much larger. Who are the creditors who have lent to FTX/Alameda? Uncollateralized lending protocols or larger tradfi institutions? Its largely unknown at the moment but we do know that someone was on the other side of that credit and this will have its domino effect on the industry as a whole.

The Solana ecosystem is expected to suffer mounting headwinds from this. Projects on the platform intertwined with market makers and VCs that have made investments into layer-1 and projects developed/developing on there could also be at risk.

A dive into the investors of FTX include BlackRock, Sino Global Capital, Sequoia Capital, Temasek, Coinbase Ventures, Tiger Global, Paradigm, Alan Howard, Ontario Pension Fund, Circle, SoftBank, Multicoin etc. Yes, big names in the industry who will be suffering no doubt from this event.



Source: TheBlock Research, accessed as at 9 November 2022.

FTX Trading Ltd. (0MK0TP-E) - Holding Company | VC-Backed | FactSet Private Equity

Investors

Active Investors 44 | Total Investors 44

Investor Name	Investment Type	Aggregate Amount	Status	Board
Insight Venture Management ...	Series C, Series B3, Series B2	1,720.69	Active	No
Lightspeed Management Co ...	Series C, Series B3, Series B2	1,720.69	Active	No
Temasek Capital Pte Ltd.	Series C, Series B3, Series B2	1,720.69	Active	No
NEA Management Co. LLC	Series C, Series B2	1,300.00	Active	No
Paradigm Medical Industries, ...	Series C, Series B2	1,300.00	Active	No
SB Investment Advisers (UK) ...	Series C, Series B2	1,300.00	Active	No
Tiger Global Management LL...	Series C, Series B3	820.69	Active	No
Institutional Venture Partners	Series C	400.00	Active	No
Lux Capital Group LLC	Series C	400.00	Active	No
Ontario Teachers' Pension Plan	Series C	400.00	Active	No
Steadview Capital Managem...	Series C	400.00	Active	No
Ribbit Management Co. LLC	Series B3, Series B2	1,320.69	Active	No
Sequoia Capital	Series B3, Series B2	1,320.69	Active	No
BlackRock Private Equity Par...	Series B3	420.69	Active	No
ICONIQ Capital (Private Equity)	Series B3	420.69	Active	No
Sea Capital	Series B3	420.69	Active	No
Teachers' Venture Growth	Series B3	420.69	Active	No
40 North Ventures	Series B2	900.00	Active	No
Alan Howard	Series B2	900.00	Active	No
Altimeter Capital Managemen...	Series B2	900.00	Active	No
BOND CAPITAL MANAGEM...	Series B2	900.00	Active	No
Circle Internet Financial Ltd.	Series B2	900.00	Active	No
Coinbase Ventures	Series B2	900.00	Active	No
Hudson River Trading LLC	Series B2	900.00	Active	No
Izzy Englander	Series B2	900.00	Active	No
Multicoin Capital Managemen...	Series B2	900.00	Active	No
Paul Tudor Jones II Family Of...	Series B2	900.00	Active	No
Senator Investment Group (P...	Series B2	900.00	Active	No
Sino Global Capital	Series B2, Series B1	900.00	Active	No
Third Point Ventures LLC	Series B2	900.00	Active	No
Thoma Bravo LP	Series B2	900.00	Active	No
Van Eck Associates Corp.	Series B2	900.00	Active	No
Willoughby Capital Holdings ...	Series B2	900.00	Active	No
Gisele BÃ□Â¼ndchen	Angel	-	Active	No
Tom Brady	Angel	-	Active	No
Binance Labs	Series A	-	Active	No
Consensus Lab	Seed	8.00	Active	No
FBG Capital	Seed	8.00	Active	No
Galois Capital Alpha Fund LP	Seed	8.00	Active	No
Proof Systems	Seed	8.00	Active	No
Abstract Ventures LLC	Pooled SH	-	Active	No
Plexo Capital Management LLC	Pooled SH	-	Active	No
Race Capital	Pooled SH	-	Active	No
Robot Ventures	Pooled SH	-	Active	No

Values represent total amount of all rounds or transactions in which an investor participated.
USD in millions.

Investments

Est. VC Raised (M) 1,728.69 | # Invt. 8 | Last Invt. 31 Jan '22 | First Invt. 11 Aug '19

Invt. Date	Investment T...	Amount	Exit Date
31 Jan '22	Series C	400.00	Active
21 Oct '21	Series B3	420.69	Active
20 Jul '21	Series B2	900.00	Active
30 Jun '21	Angel	-	Active
02 Mar '20	Series B1	-	Active
20 Dec '19	Series A	-	Active
11 Aug '19	Seed	8.00	Active
Undisclos...	Pooled SH	-	Active

USD in millions

Source: FactSet, accessed as at 9 November 2022.

The downfall

To conclude CZ left us with some food for thought that is “1: Never use a token you created as collateral. 2: Don’t borrow if you run a crypto business. Don't use capital "efficiently". Have a large reserve.”
He seems to be alluding to Alameda in point one and FTX in point two, which is fair play. He must have had some time to look under the hood of FTX and Alameda’s balance sheet by now to see where it all went wrong for them. The first point alludes to the downfall of posting $FTT as collateral for Alameda and the second point to FTX for rehypothecating assets without holding sufficient reserves.

Whether or not Binance will take the deal or walk away is a huge question. If you were CZ what would be your risk reward ratio? Consolidate market share but take on a mount of potential regulatory scrutiny along with a list of creditors or deploy your liquidity elsewhere in a world where liquidity is scarce garnering higher borrow rates.

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