LESSONS FROM THE TRIAL OF SAM BANKMAN-FRIED

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Only a year after the dramatic collapse of FTX, the federal trial of its co-founder Sam Bankman-Fried ("SBF") commenced in New York at the end of September 2023. After a month-long trial in which most of the FTX management team gave evidence against SBF (having entered guilty pleas),a jury found SBF guilty at the start of November 2023, on all 8 counts on the indictment. SBF awaits sentencing in March 2024, a potential further trial (on separate charges) to take place prior to sentencing has now been ruled out.

But as the dust settles and the testimony of the key witness is examined, what are the key lessons for fraud practitioners or regulators? Does a post-mortem of FTX offer any useful information for the crypto industry?

Arguably the most significant overall 'takeaway', particularly from the perspective of fraud lawyers, is how little of the testimony feels new or unfamiliar in the context of director frauds. The new asset class of digital assets and the flamboyant character of SBF drew a lot of interest in the collapse and the trial. However, notwithstanding the backdrop of the charges being FTX (which was in reality a large group of associated companies) and Alameda Research (an affiliated entity), the evidence was of behaviour at FTX management levels which is all-too-familiar in cases of corporate fraud or breaches of fiduciary duty by directors. As well as the familiarity, the relative lack of sophistication of the fraudulent activity is also striking.

Early impressions 'behind the scenes'

Almost immediately after the FTX collapse John Ray III took over as the new CEO of FTX. It is worth recalling the early comments made by Ray – who, having "worked around the clock with teams of professionals…" for just a week – observed,

"*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, the situation is unprecedented*".

The implication of the speed at which Ray was able to reach that conclusion (which was contained in a sworn declaration to the Delaware bankruptcy court), was that the wrongdoing was not difficult to see with a small degreeof scrutiny of internal documents, systems and communications. On the basis offthat comment, the natural inference was that this would probably not be a case where the central fraud involved the careful and discreet pilferingof assets away from the companies and into a complex trust structure (for example).

And so the prosecution case and testimony have proved. The charges on the indictment against SBF principally related to the misappropriation and misuse of customer deposits (using these to pay expenses and debts, and loan obligations of Alameda), providing false and misleading information to investors, and conspiracy charges on the same underlying facts. The open and blatant ways in which that misappropriation, misuse and misrepresentation was carried out might well seem to investors and customers who lost money in the collapse[1] to show a huge missed opportunity for even light-touch regulation to prevent flagrant risk-taking by the FTX management team.

The Alameda Relationship

The relationship between SBF, FTX and Alameda were at the heart of the wrongdoing. SBF held ultimate decision-making power, seemingly unchecked in any real sense, across the whole business. Gary Wang, co-founder and CTO of FTX, gave evidence that "(w)e gave special privileges to Alameda Research on FTX which allowed it to withdraw unlimited amounts of funds from the platform, and we lied about this to the public."

(1) Subject to what the Ray investigations and recovery process recovers, which may in the event be a significant proportion of the losses initially feared.

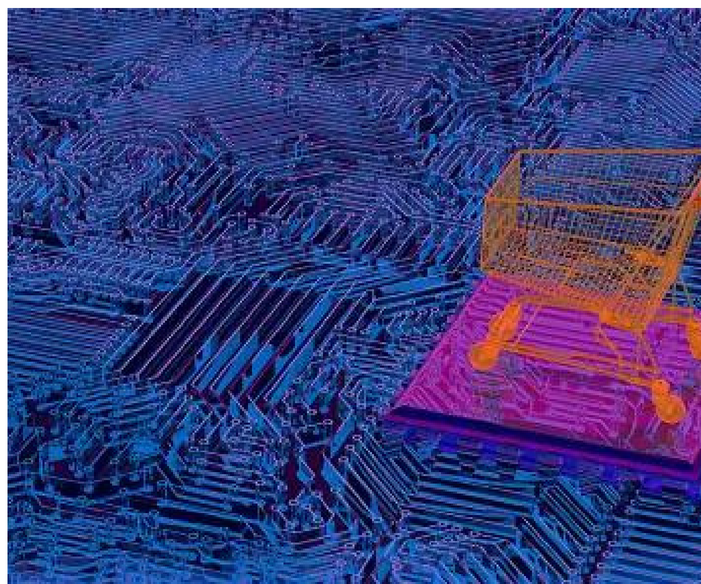
Specifically, Alameda – uniquely of all of FTX's customers – was able to go into the negative on its account, was extended an unlimited line of credit, was not required to provide collateral in order to trade, and received FTX customer deposits of US dollars directly into its accounts (i.e. without first being deposited into FTX's accounts and then diverted), and it was able to place orders faster than other accounts. According to Wang's testimony these permissions and facilities were built into FTX's code, a feature which will probably be considered by future regulators of crypto exchanges or services, including whether it will be possible to monitor coding (which may be proprietary) or only the outcomes of coding, and the degree to which individual coders might be divorced from knowledge of wrongdoing when they are given instructions to amend code.

There was also an example of an FTX loss of $800 million,caused by a customer who was able to exploit al loophole in the FTX risk engine, was covered by Alameda in order to keep the loss off the books and out of sight of FTX investors, with investor fundraising being carried out by SBF on behalf of Alameda immediately thereafter.

Missed Opportunities

What may be surprising to some was that FTX (at top level) did not operate in a regulation-free environment. SBF was in fact on record as being pro-regulation, and having moved FTX's headquarters from Hong Kong to The Bahamas because it was a regulated jurisdiction. The Bahamas had introduced the Digital Assets and Registered Exchanges Act ("DARE") in 2020, one of the first countries in the international crypto regulation landscape to create a framework for the registration and oversight of digital assets businesses. DARE included:

- Powers for a regulatory and enforcement body, the Securities Commission of The Bahamas ("SCB");
- Requirements for the registration of digital asset businesses, with registration being conditional upon demonstration of a number of core (values) including having "appropriate and sufficient systems and controls to…manage its risks", and a digital asset framework addressing governance; and
- And a duty to maintain professional conduct, including adequate financial resources and solvency, and to act honestly and fairly and with due skill, care and diligence.



However, as comments from Ray indicate (as well as the real world failure to prevent behaviours which the testimony clearly reveal were standard practice), the adequacy of the first iteration has been severely criticised. Even before the FTX crash, the ability of the SCB to engage in effective monitoring, at registration stage and beyond, might have been queried on the basis that the funding to do so was not there. The highest fees associated with the registration process for any entity were set at $15,000, and so on any analysis robust enforcement would require significant additional resource for SCB.

The public pro-regulation stance taken by SBF was also revealed as a 'PR position'. He accepted in his evidence that in private he had said, of regulation, "…Just PR. Fuck regulators". The extremes between the public and private positions – the full extent of later may never be known, as the top team at FTX regularly communicated via the 'Signal' messaging service, with messages set for 'auto delete' – is a recurring feature in the testimony. The prosecutor's cross-examination was effective in putting examples to SBF where he had said one thing publicly, and in fact the very opposite was demonstrated to have been taking place behind the scenes.

Regulating the Low-Hanging Fruit

To fraud practitioners, and those who regularly represent parties in proceedings where breaches of directors' duties are alleged, the SBF trial may have the feel of 'nothing new under the sun'. Investors put money in, customers put money in. Loans are made to a person/ entity connected with the founders. Money is used in a way it should not be, and in a way the company explicitly says it will not. Documents are created to conceal the true position, records are deleted, and investors are lied to. Eventually the truth comes out and there isn't enough in the pot to cover the losses.

Without engaging in a philosophical exercise about the degree to which a regulation-free environment actually facilitates fraudulent or risk-taking behaviours if those in charge are determined to misappropriate assets, it seems obvious that an careless and reckless treatment of customer assets, disregard of risk, blatant lies, and a lack of oversight of top-level decisions making, should be avoidable with even limited – but properly enforced – regulation.

The likelihood is that the type of egregious behaviour which the SBF trial has revealed should be capable of regulation and enforcement, with a consequential deterrent effect. Regulators may be encouraged that initial regulatory oversight can effectively prevent this type of 'insider' fraud so that crypto exchanges are governed in a professional and responsible way, with oversight of decisions, and so that decision-making power is not concentrated into the hands of a single (or small group of) bad actors. The next, and more difficult, challenge will be to identify regulations which will protect investors from scammers outside the crypto exchanges.

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