

RETHINKING BOUNDARIES: THE FTX FIASCO AND THE IMPERATIVE OF REGULATING CRYPTOCURRENCY EXCHANGES

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Abstract

A turning point in the sector was the bankruptcy of FTX, a well-known cryptocurrency exchange, in late 2022. Sam Bankman-Fried founded FTX, which at first prospered with its cutting-edge offers. However, because of financial mismanagement and regulatory issues, FTX experienced a liquidity problem and widespread withdrawals. The collapse revealed regulatory shortcomings and generated demands for improved supervision and investor protection on a global scale. It is essential to implement swift changes, such as harmonized laws and transparent auditing, in order to reduce risks and promote market integrity. Nonetheless, regulatory obstacles continue to exist, necessitating a careful balancing act between innovation and supervision. The failure highlights the necessity of educating stakeholders and helping them adjust to the changing cryptocurrency environment. Regulations guarantee stability, investor trust, and institutional involvement, even though they may also present challenges. In the end, the crash of FTX steered the sector toward responsible expansion and emphasized the significance of strong regulatory frameworks in determining the course of cryptocurrency markets.

Keywords: *cryptocurrency, FTX, Sam Bankman-Fried, regulation, financial mismanagement*

JEL Classification: G0, G1

Introduction

The fall of FTX in late 2022 changed the game in the unstable cryptocurrency space. Sam Bankman-Fried, a visionary and motivating businessman, founded FTX, which soon became one of the most significant cryptocurrency exchanges globally. It was praised for its intuitive trading platform, cutting-edge trading options, and seeming stability in its finances. Beneath this triumph, though, a string of grave operational and moral errors festered, finally resulting in its precipitous collapse.

FTX's decline stemmed from a liquidity crisis sparked by customer withdrawals and concerns regarding its financial stability. Issues surrounding intertwined finances with Alameda Research raised alarms about potential mismanagement of client funds and conflicts of interest (Taylor & Johnson, 2023). The increased volatility and decreasing values within the broader cryptocurrency market exacerbated FTX's predicament. Its collapse, occurring amidst a cryptocurrency boom characterized by significant growth potential and minimal regulation, cast serious doubts on the sustainability and security of the cryptocurrency market (Lee & Kim, 2023). This study contends that the downfall of FTX serves as a clear impetus for the establishment of comprehensive regulatory frameworks within the cryptocurrency exchange sector. It underscores the urgent need for regulatory bodies to devise mechanisms capable of adapting to the rapid evolution of digital finance. Through an exhaustive examination of the FTX case, this research aims to illuminate the intricate dynamics between innovation, regulation, and market stability in the cryptocurrency domain (de Vries, 2022).

Background

Established in 2019 by Sam Bankman-Fried, renowned for his proficiency in crypto markets and algorithmic trading, FTX swiftly ascended as a prominent figure in the cryptocurrency exchange arena. Often dubbed 'SBF', Bankman-Fried steered FTX to eminence through a blend of inventive trading options, an intuitive platform, and dynamic marketing approaches. Within a brief span, FTX's valuation skyrocketed to billions, attracting a diverse pool of investors and establishing a global presence (Daughtridge, 2023). FTX's ascent in the cryptocurrency sphere

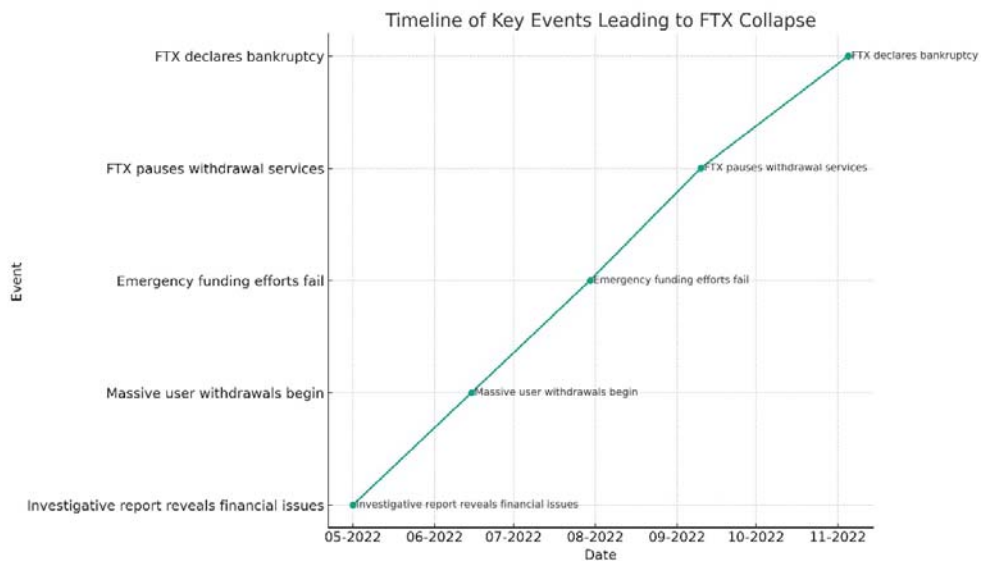
can be attributed to various strategic endeavors. The platform offered a wide spectrum of products, spanning futures, options, and leveraged tokens, catering to both novices and seasoned traders. Its steadfast commitment to user security and upholding stringent liquidity standards distinguished it from competitors. Furthermore, strategic alliances and high-profile sponsorships significantly bolstered FTX's standing and visibility within the crypto domain. However, the regulatory framework governing FTX's operations was intricate and fragmented. Prior to its collapse, the cryptocurrency market operated under relatively lenient regulation, owing partly to the nascent nature of the technology and the rapid pace of innovation within the sector. Regulators worldwide encountered challenges in overseeing a market characterized by its borderless, diverse, and volatile nature. The absence of standardized regulatory protocols allowed exchanges like FTX to operate with considerable autonomy, often in jurisdictions with lax oversight (PWC, 2023).

The background provides context for FTX's rapid rise in the cryptocurrency exchange market under Bankman-Fried's leadership. It highlights the regulatory challenges in the crypto industry that may have contributed to the exchange's eventual collapse.

The Collapse

The collapse of FTX, formerly a dominant player in the cryptocurrency exchange arena, unfolded dramatically and swiftly. It commenced with a cascade of investigative reports and disclosures from whistleblowers, casting doubt upon the financial integrity of both FTX and its affiliate, Alameda Research. These revelations exposed a convoluted network of internal financial arrangements, suggesting that FTX utilized customer deposits to finance speculative ventures via Alameda Research. This disclosure starkly contradicted the perception of stability and transparency that FTX had projected (Lang, Howcroft, and Wilson, 2023). As these reports gained momentum, they precipitated a massive wave of withdrawals from FTX users, apprehensive about the safety of their assets. The exchange, built upon user confidence and trust, encountered a profound liquidity crisis. Despite attempts to secure emergency funding, potential investors and partners distanced themselves due to mounting allegations of financial mismanagement. The situation escalated when FTX suspended withdrawal services, citing liquidity concerns, exacerbating panic among its user base (Zetzsche et al., 2023).

The key factors contributing to the failure of FTX included a lack of financial transparency, the commingling of customer funds with risky investment ventures, and an apparent absence of a robust internal control system. The shockwaves of FTX's collapse were felt across the cryptocurrency market, leading to a significant drop in the value of major cryptocurrencies and eroding investor confidence in other crypto exchanges. This event exposed the vulnerabilities of the crypto market and highlighted the risks associated with a lack of regulatory oversight (U.S. Securities and Exchange Commission, 2022).



Graph 1. The timeline graph illustrating key events leading to the collapse of FTX. This graph visually depicts the rapid progression of events over a short time frame, starting from the release of investigative reports revealing financial issues to the eventual declaration of bankruptcy by FTX.

Following FTX's collapse, numerous investors suffered substantial losses, with billions of dollars in customer assets frozen. The broader cryptocurrency market witnessed increased volatility, as the failure of a major exchange raised concerns about the stability and security of digital asset platforms (Yousaf, Riaz, & Goodell, 2023).

Regulatory Shortcomings

FTX's collapse highlighted regulatory shortcomings in the cryptocurrency market. Despite the market's rapid growth to a \$3 trillion valuation, regulatory frameworks lagged behind. In 2022, only a minority of countries had established comprehensive cryptocurrency regulations, resulting in a fragmented global regulatory landscape (Shirakawa & Korwatanasakul, 2019).

A significant regulatory gap in the cryptocurrency market was the absence of standardized transparency and auditing requirements. While traditional financial institutions are mandated to maintain strict transparency, crypto exchanges like FTX often operated with minimal transparency. Reports indicated that in 2022, less than 25% of crypto exchanges adhered to transparency standards equivalent to those in traditional finance (Hallak & Salén, 2023).

The intertwined financial ties between FTX and Alameda Research highlighted the repercussions of regulatory deficiencies. While conventional financial sectors uphold rigorous conflict-of-interest standards, the cryptocurrency realm notably falls short in this regard. More than 90% of regulated institutions in traditional finance adhere to such protocols, yet the crypto industry lacks equivalent regulations. The mingling of FTX's and Alameda's finances, which contributed to FTX's downfall, emphasizes the imperative for robust conflict-of-interest regulations within the crypto sphere (Han et al., 2023).

The disparity in auditing and financial reporting standards is striking. In traditional finance, nearly all major institutions undergo rigorous independent financial audits annually. Conversely, in the cryptocurrency sphere, only around 40% of exchanges subject themselves to such scrutiny. The absence of independent audits, as seen in the case of FTX, created an environment where financial irregularities could go unnoticed until they led to catastrophic failures (Martino, Nabilou, & Paccès, 2023).

The regulatory deficiencies within the cryptocurrency market, as demonstrated by the collapse of FTX, resulted in significant losses of around \$8 billion in customer assets. This event emphasized the necessity for comprehensive regulatory frameworks that prioritize investor protection and market integrity. Following the FTX incident, there was a surge in demands for regulatory reform, seeking to implement standards comparable to those in traditional finance while accommodating the distinct features of digital assets. Achieving a balance between innovation and investor protection became essential for ensuring the longevity and stability of the cryptocurrency market (Baker et al., 2023).

The global disparity in cryptocurrency regulation was evident, with some countries implementing strict frameworks while others lacked oversight. This inconsistency hindered international cooperation in financial oversight and allowed regulatory arbitrage. Entities like FTX could strategically position themselves in lenient jurisdictions. International financial bodies and regulators aimed to establish a more harmonized regulatory landscape for cryptocurrencies (Narain & Moretti, 2022).

Global Responses and Broader Implications

The collapse of FTX, a major player in the cryptocurrency exchange market, elicited significant responses from financial authorities and governments globally. In the United States, the Securities and Exchange Commission (SEC) and the Commodity Futures Trading Commission (CFTC) intensified their scrutiny of cryptocurrency exchanges. These agencies advocated for stricter compliance with financial regulations, emphasizing the need for greater investor protection in the crypto market. Similarly, in Europe, the European Securities and Markets Authority (ESMA) called for harmonized crypto regulations across member states, focusing on transparency and financial stability (McCrank & John, 2022).

In Asia, responses to the FTX collapse varied. Japan and South Korea accelerated efforts to regulate digital assets, while other countries reconsidered lenient stances. The People's Bank of China maintained strict cryptocurrency policies, citing the FTX collapse (Wang & Lee, 2023).

The collapse of FTX had a significant impact on investor sentiment in the cryptocurrency market. Many investors became more risk-averse, reevaluating their exposure to digital assets. This shift in sentiment led to increased volatility in cryptocurrency markets, with major cryptocurrencies like Bitcoin and Ethereum experiencing significant price declines in the aftermath of the FTX collapse (Almeida & Gonçalves, 2023).

The broader implications for the cryptocurrency industry were profound. The FTX collapse served as a wake-up call, highlighting the vulnerabilities in the market and the urgent need for regulatory reform. It prompted a reevaluation of the decentralized finance (DeFi) sector, with stakeholders acknowledging the necessity for balancing innovation with risk management. Additionally, the incident spurred discussions about the role of cryptocurrency in the global financial system, questioning its viability as a mainstream financial instrument (Manda & Yadav, 2023).

Moreover, the FTX incident catalyzed a shift towards more sustainable and responsible growth models in the crypto industry. Startups and established players alike began prioritizing transparency and compliance, recognizing that these elements were crucial for long-term success and public trust. This shift also opened up dialogues about consumer education in the cryptocurrency space, emphasizing the need for investors to be better informed about the risks associated with digital assets (de Vries, 2022).

The collapse of FTX highlights the urgent need for comprehensive regulation in the cryptocurrency exchange sector. Such regulation is crucial for protecting investors, ensuring market integrity, and promoting a stable environment for sustainable growth.

Enhanced transparency and reporting standards are essential in the cryptocurrency exchange sector. Regulations should require exchanges to regularly disclose financial information and undergo independent audits, fostering trust among users. Crucially, customer funds should be kept separate from exchange operational funds to protect user assets in case of financial difficulties.

Enhanced auditing and strict compliance with anti-money laundering (AML) and know your customer (KYC) regulations are critical. Regular, independent audits should be mandatory to ensure exchanges operate transparently and legally. Implementing measures to prevent market manipulation and maintain fair trading practices is vital for market integrity, including monitoring and addressing fraudulent activities and extreme market volatility.

Proposals for regulatory reform in the cryptocurrency sector encompass the development of a global regulatory framework. Spearheaded by international financial bodies, such a framework would strive to standardize regulations across various jurisdictions, thereby mitigating the risks stemming from regulatory inconsistencies. Another significant proposal involves the establishment of a licensing system for cryptocurrency exchanges. This initiative would mandate exchanges to satisfy specific operational and financial criteria to obtain a license, thereby bolstering overall market integrity. The potential ramifications of these regulatory measures are multifaceted. On one hand, they hold the promise of bolstering investor confidence, curbing fraudulent activities, and fostering a more resilient and trustworthy cryptocurrency market. Conversely, there exists a risk that overly rigid regulations could stifle innovation and impede the dynamic growth characteristic of the digital asset sector. Implementing these regulations poses several challenges.

Achieving the delicate balance between regulation and innovation is paramount. Regulations must be stringent enough to ensure safety and transparency while remaining adaptable to accommodate the rapidly evolving nature of digital assets. Additionally, the global nature of cryptocurrency necessitates international cooperation for effective regulation, a daunting task given the diverse legal and economic landscapes across countries.

Moreover, staying abreast of technological advancements in blockchain and digital assets is imperative for regulations to remain pertinent and efficacious. Lastly, educating all stakeholders, including regulators, investors, and operators, about the risks and obligations associated with digital assets is indispensable for the successful implementation of these regulations.

The journey towards robust regulation in the cryptocurrency exchange sector is complex and multifaceted, requiring careful consideration and collaboration across various domains to ensure effectiveness and sustainability in the rapidly evolving digital asset market.

The collapse of FTX, a leading cryptocurrency exchange, highlights the risks in the largely unregulated crypto space. It resulted from financial mismanagement, lack of transparency, and inadequate regulatory oversight. This underscores the need for robust cryptocurrency exchange regulations to protect investors and ensure market stability.

The significance of FTX's collapse extends beyond its immediate financial repercussions. It has served as a catalyst for a global reassessment of how cryptocurrency exchanges operate and are regulated. The incident highlighted glaring gaps in existing regulatory structures, particularly in areas of transparency, auditing standards, and the safeguarding of customer assets. It also brought to light the necessity of international cooperation in formulating and enforcing regulations in a market that is inherently borderless and diverse.

The urgency and importance of regulating cryptocurrency exchanges have never been clearer. Effective regulation is crucial not only for protecting investors but also for ensuring the stability and integrity of the broader financial system. The implementation of comprehensive regulatory measures, adapted to the unique characteristics of digital assets, is essential for mitigating risks and fostering sustainable growth in the cryptocurrency market.

Looking towards the future, the cryptocurrency markets under enhanced regulation hold both challenges and opportunities. While stricter regulations may impose certain constraints on the operations of cryptocurrency exchanges, they also

offer the potential for greater stability, investor protection, and legitimacy. A well-regulated market could attract more institutional investors, contributing to the maturity and mainstream acceptance of cryptocurrencies. Additionally, effective regulation could spur innovation, encouraging the development of new and safer financial products within the crypto space.

Conclusion

In conclusion, the FTX collapse serves as a pivotal moment in the history of cryptocurrency markets, marking a turning point towards more responsible and robust regulatory approaches. The future of these markets, under the auspices of enhanced regulation, promises greater security for investors and a more stable foundation for the continued growth and innovation in the world of digital finance.

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