Key Questions

December 5, 2022

Who Is Sam Bankman-Fried and Why Should Investors Care?

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The Key Wealth Institute is a team of highly experienced professionals from across wealth management, dedicated to delivering commentary and financial advice. From strategies to manage your wealth to the latest political and industry news, the Key Wealth Institute provides proactive insights to help grow your wealth.

Thus far, the collapse of crypto giant FTX appears to have had a minimal impact on the broader economy. But because this scandal is still evolving investors should remain attentive.

Investors, even those *without* exposure to bitcoin or other cryptocurrencies, are closely monitoring the carnage in the crypto market for signs of potential contagion to traditional assets. The crisis started with an epic collapse of FTX, a now-bankrupt cryptocurrency exchange and futures market that was run by crypto-golden-boy-turned-villain Sam Bankman-Fried.

Sam Bankman-Fried, more commonly known as SBF, is at the center of this still-unfolding scandal. Before establishing FTX in 2019, SBF made a name for himself as the founder of a proprietary crypto trading firm called Alameda Research, which was established in 2017 to exploit an arbitrage of bitcoin prices that were persistently trading 10% higher in Japan than they were in the US. SBF leveraged this initial success to start an exchange, FTX, which was domiciled offshore to allow for cutting-edge functionality with sophisticated derivatives.

Wall Street and Silicon Valley Fueled SBF's Rise

Venture capital firms on Wall Street and Silicon Valley lined up to partner with SBF and fund his growth plans. In private markets, FTX's valuation ballooned to more than $32 billion with storied investors listed as its shareholders. In just five years SBF had amassed a net worth of over $25 billion and was featured as a crypto golden boy on the cover of many prestigious magazines.

But the wheels fell off dramatically in early November. A leaked balance sheet of Alameda Research was published online, where crypto sleuths pieced together large transactions between FTX and Alameda Research. FTX allegedly was lending substantial customer deposits to Alameda, backed only by a thinly traded token called FTT (itself created by FTX!).

This accusation sparked mass customer withdrawals from FTX and a collapse in the price of FTT, as crypto investors raced to get ahead of potential insolvency. It was a classic run on the bank. And since there are no lenders of last resort in crypto, FTX was forced to freeze customer withdrawals and ultimately file for bankruptcy in its various jurisdictions. According to The Wall Street Journal, approximately one million investors are directly affected by frozen accounts. The historical precedent of failed crypto exchanges suggests depositors frozen out likely will lose it all.

The Great Contagion Risk

So why should investors care about this? Is this not a sideshow for an overextended investment theme that deserves it? Maybe. But the challenge here is contagion risk.

Certain venture capital (VC) firms have publicly disclosed their write-downs of investment in FTX to zero, but it potentially extends further. FTX was perceived as one of the most trustworthy crypto exchanges, built by a crypto whiz kid, and underwritten by Silicon Valley's finest.

This perceived seal of approval might have steered traditional and crypto-native institutional investors to use FTX to trade and clear derivatives. Case in point: BlockFi, a leading crypto lending firm, recently cited the FTX bankruptcy in its own Chapter 11 bankruptcy filing on Nov. 28. Rumors are swirling for others.

The biggest source of contagion is the potential for disorderly deleveraging since major segments of the crypto ecosystem are leveraged and interconnected. In essence, loans taken from one crypto platform are invested and deployed elsewhere, and so on, like a chain. But since there is no lender of last resort (such as the role the Federal Reserve plays within the US banking system) to smooth out the liquidity crises, illiquidity in one link of the chain can quickly lead to a cascade of insolvency down the line.

Key Takeaways

To date, the impact has been limited to select VC funds and crypto-native lenders, but investors should remain attentive to the potential that insolvencies spread into traditional assets. Thus far, exposure to the broader economy appears to be minimal.

For more information, please contact your advisor.

About the Authors

Justin Tantalo has 15 years of experience in investment management, both in Asset Allocation and Fund Management. As a Senior Vice President with Key Private Bank, Justin applies his expertise in Asset Allocation and helps oversee the equities and alternatives third-party manager research effort. Justin received an MA in Economics from the University of Waterloo (Canada) and BA in Economics from the University of Western Ontario (Canada). Justin is a CFA Charterholder.

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