Ordinary Investors Who Jumped Into Crypto Are Saying: Now What?

"The long-term success of a relationship depends far more on avoiding the negative than on seeking the positive." – Daniel Kahneman

WOW... EMBEZZLE 1000 BUCKS, AND YOU'RE A CRIMINAL. EMBEZZLE 10.000.000 BUCKS, AND YOU'RE A MEDIA SUPERSTAR!

CartoonStock.com

As 2022 draws to a close, we are taking time to reflect on this past year, while also looking towards the future with optimism.

For many of us, 2022 proved to be a difficult year in financial markets as the Federal Reserve embarked on its monetary tightening campaign, which then impacted markets across the globe. Outside of cash, pretty much all major asset classes registered declines to varying degrees. Going forward, no one can predict what the future will bring, however, our clients can rest assured we will continue to focus on both preserving and growing your wealth under all market conditions.

Markets go up and markets go down. Getting the proper risk versus reward balance is key to successful portfolio management. Most of the time we are pretty good about getting things right, however this past year proved to be among the most challenging I have seen.

With that said, no one in our business is perfect and if anyone ever attempts to make a convincing argument to the contrary it is best to run the other way – and fast.

The recent drama unfolding in the crypto currency market appears to be a good old-fashioned mix of greed and fraud. I truly feel horrible for the investors who have lost money (in some cases all of it) to criminal operators.

In our world of traditional sleepy finance, we are regulated by multiple organizations. Client assets are held and custodied by our independent third-party clearing firm (Fidelity Clearing & Custody Solutions) and client protection always comes first, which is how it should be.

The New York Times recently published a good article on ordinary investors who piled into cryptocurrencies on FTX and then lost much of their savings. Most of the time these articles are written from the perspective of law enforcement against the perpetrators. I like this article because it focuses on the victims.
*****

Ordinary Investors Who Jumped Into Crypto Are Saying: Now What?

Many small investors who piled into cryptocurrencies on FTX, BlockFi and other platforms are recognizing the perils of investing in an unregulated industry.

By Matthew Goldstein
The New York Times
December 5, 2022

In early November, Adrian Butkus, a 43-year-old father of two, put $600,000 — much of his life savings — into an account at BlockFi, a cryptocurrency trading firm. BlockFi had marketed the account as risk free, yielding 6.5 percent interest, more than Mr. Butkus could get anywhere else.

Just days later, as the collapse of the cryptocurrency exchange FTX shook the entire crypto industry, Mr. Butkus asked BlockFi for his money back. But the firm had suspended customer withdrawals, citing its close financial ties to FTX. By late November, BlockFi, too, had filed for bankruptcy.

Mr. Butkus doesn't know when — or if — he will see his money again. He is one of millions of individual investors around the world who poured money into digital assets, believing the cryptocurrency industry was a stable financial system. They were

cleareyed about the volatility and big price swings of Bitcoin and other cryptocurrencies. But what has come as a big surprise to many is that the firms where they deposited their money lacked the basic protections offered by a brokerage or a bank.

As companies like FTX took on the marketing tactics and girth of mainstream financial firms, their customers came to believe they were safe places to deposit cash in exchange for cryptocurrency. The fact that big-name venture capital and other funds backed some of these companies only added to their allure.

“It just angers me,” Mr. Butkus said. “Now I’m in a fight to get back some of my money.”

Cryptocurrency firms, led by FTX, exploded into the mainstream in the past couple of years, pitching their products in extensive advertising campaigns as stable and safe investments. Unlike traditional banks and brokerages, which are limited in what they can say, the crypto firms aren’t subject to the same rules.

“These companies are all giving the impression of banklike security,” said Joshua Fairfield, a professor at Washington & Lee Law School who specializes in technology issues. “These companies want to have customer trust but with none of the responsibility that comes with a regulated financial entity. And that just doesn’t work.”

Moreover, when a bank or brokerage fails, there are government-guaranteed funds to ensure that investors generally get their money back. The cryptocurrency industry, for the most part, has no such guardrails. And with the companies in bankruptcy and the value of some crypto assets uncertain, ordinary customers stand at the end of a long line when it comes to getting their money back, behind the large trading firms and lenders.

Mr. Butkus said he had invested with BlockFi even though he knew the accounts weren’t insured. Under BlockFi’s offering, he lent it his $600,000 for six months, in return for a 6.5 percent yield. BlockFi converted that money into a digital asset that it used to conduct its cryptocurrency trading business.

When BlockFi’s marketing materials and sales agents said his investment was safe and redeemable at any time, he took them at their word.

“They sold it to me, that there was no risk,” Mr. Butkus said, adding that he was unaware that BlockFi, which had borrowed money from FTX, was so closely tied to the exchange.

Much of the money that Mr. Butkus, a self-employed businessman, invested came from the recent sale of his home in Plainfield, Ill. He was hoping to increase his savings with the interest on his BlockFi loan and then use the money to build a new home for his

family. Now he wonders where his family, who are temporarily staying with his in-laws, will ultimately live.

Lawyers for FTX and BlockFi did not respond to requests for comment.

FTX, founded by Sam Bankman-Fried and once a behemoth of the crypto industry, imploded last month after some big trading firms withdrew their money amid allegations that the exchange had used billions of dollars in customer deposits to bail out Alameda Research, the crypto trading firm that he co-founded. The exchange's fall was all the more stunning because FTX had acquired an air of legitimacy through a splashy advertising campaign showing off its product as safe, fun and easy to use.

The federal authorities in New York are now trying to determine whether criminal charges should be filed against Mr. Bankman-Fried and others over the company's collapse and the potentially inappropriate use of customer deposits. Mr. Bankman-Fried, during a media blitz this past week, has insisted he never intended to defraud anyone and was not fully aware of how much customer money had been transferred to Alameda.

Frank Friemel, 39, is among the FTX customers wondering whether they will get back any of their money from the now-bankrupt exchange. When he opened an account with FTX in March, Mr. Friemel said he knew it was unregulated but wasn't too concerned.

He figured that, as the second-biggest cryptocurrency trading platform in the world, with the financial backing of well-known professional investment firms like Sequoia and SoftBank, FTX was on solid footing.

"I'm a seasoned investor and I knew who was investing with them," said Mr. Friemel, a technology professional who lives in Jena, Germany. "If big investors are putting money with them, then they must know that the company is good."

After seeing reports that FTX could collapse, Mr. Friemel tried to get his money out on Nov. 8, but it was too late. He said he got a notification that the withdrawal was being reviewed but never heard from FTX again. Mr. Friemel did not want to disclose his losses but said the collapse of FTX had led to an "erosion of trust" in crypto.

Because FTX is based offshore in the Bahamas, most of its customers come from Europe, Asia and well-known tax havens like the Cayman Islands and British Virgin Islands. Only 2 percent of its customers are in the United States, where they trade through FTX US, a subsidiary, according to its bankruptcy filings.

In the days leading up to FTX's bankruptcy filing, the U.S. unit told customers they were free to withdraw their money. It's unclear how many did; FTX US has since also filed for bankruptcy.

Mashood Alam, an actor from Pakistan who lives in North Hollywood, Calif., and was an FTX US customer, said he wasn't fully aware of the problems at the company until the bankruptcy filing. Mr. Alam, 32, said he hoped to get back $20,000, but the experience has soured him on crypto. He had been planning to use that money to help pay a lawyer to work on his naturalization and citizenship application. Now Mr. Alam said he will have to find another way to come up with the money.

Scott Jerutis, 58, a real estate broker in Queens, has about $33,000 of the digital currency Ethereum in a frozen BlockFi account, he said. He called himself an experienced investor who had made profitable crypto trades in the past, and said he understood that losses were part of the game.

But, he added, "I never thought if you had a debacle like this, they wouldn't let you withdraw your funds." Mr. Jerutis said he now believed that regulation was needed to safeguard customer money.

Angry investors are only now finding out that they have little recourse. Andrew Stoltmann, a securities litigation lawyer, said that his firm had been getting about 10 calls a day even before the FTX collapse — "ever since the crypto winter began," he said, referring to the early wobbles in the market last spring as investors turned away from risky assets.

Many customers want to know if they can sue to recover lost or stolen money, Mr. Stoltmann said. Since traditional Wall Street firms have stayed away from providing financing to crypto firms, he said, there are few other stable financial institutions to tap.

So far, about two dozen individuals have filed claims in bankruptcy court seeking to reclaim money they lost on FTX. Most are from Taiwan, and have losses ranging from just a few thousand dollars to tens of thousands.

One of those customers, Chen Mei-Sha, filed a claim for $5,600. After FTX stopped allowing withdrawals, she said in an email, she began to suspect that most of Mr. Bankman-Fried's "Twitter posts and speeches were lies." Ms. Chen described herself as a housewife who has invested in cryptocurrencies on three other trading platforms and believed FTX "misappropriated" customer money.

FTX was particularly effective at cultivating its brand. Beginning last year, it signed multiyear naming-rights deals worth more than $100 million with a professional basketball arena in Miami and for a football stadium at the University of California, Berkeley. The company also struck marketing deals with Major League Baseball and the Golden State Warriors basketball team.

FTX signed up a number of well-known athletes and celebrities, including Stephen Curry, Tom Brady, Gisele Bündchen and Larry David as “brand ambassadors,” who made humorous TV commercials or other ads for the company. In one of the company’s best-known commercials, Mr. Brady and Ms. Bündchen, who were married at the time, are seen calling lots of friends — and even some frenemies — with a simple question: “Are you in?”

The ad’s tagline was: “Crypto. FTX. You in?”

Since September 2021, FTX spent $60 million on TV advertising with its last commercial featuring Mr. Brady airing from Sept. 11 to Nov. 4, according to EDO, a data and analytics company.

Nathaniel Whittemore, who was FTX’s director of marketing, said the U.S. marketing and ad campaign was focused primarily on “brand building” and raising the “profile of FTX and crypto overall.”

Eric Goldman, a professor at Santa Clara University School of Law and a director of its High Tech Law Institute, said big marketing and sports stadium branding campaigns are a popular way for tech start-ups to convey that their businesses are there for the long haul.

“It sends a signal to consumers that the advertiser has enough money and is staking enough of its fortune on advertising to say that it will be around,” Mr. Goldman said.
*****

ASSET CLASS & SECTOR OPINIONS		
OVERWEIGHT	**NEUTRAL**	**UNDERWEIGHT**
Cash	International Developed Market Equities	Small Capitalization Stocks
U.S. Treasury Notes & Bonds	Emerging Markets Equities	Financial Services Sector
Investment Grade Corporate Bonds	Consumer Discretionary Sector	Leisure & Hospitality
U.S. Real Estate & Related Equities	Consumer Staples	Materials Sector
Large Capitalization Technology	Communication Services Sector	Energy Related Equities
Healthcare	Mortgage-Backed Securities	Leverage Loans (Floating Rate Debt)
Aerospace & Defense	Local Currency EMG Bonds	Treasury Inflation Protection Securities
Utilities	Gold & Gold Miners	High Yield Corporate Bonds

Sincerely,
Justin Kobe, CFA
Founder, Portfolio Manager & Adviser
Pacificus Capital Management