



The Downfall of FTX: A Case for Good Governance

Malk Insights — November 23, 2022

Key Takeaways

- The crash of FTX, one of the world's largest cryptocurrency exchanges, can be attributed in large to a lack of good governance at the company and in the crypto world more broadly.
- The regulatory environment in traditional banking does not extend to the crypto industry, leaving consumers and investors vulnerable to corporate misconduct.
- Stronger internal and external governance structures are needed to ensure consumer and investor money is safe in the hands of cryptocurrency executives.

For those not steeped in the environmental, social and governance ("ESG") universe, the G – governance – may seem the most elusive. Environmentally and socially conscious investments are somewhat self-explanatory, but governance can often seem nebulous at best. Few contemporary examples illustrate the importance of governance like the recent downfall of FTX, one of the world's largest cryptocurrency exchanges.

The article focuses on two key features:

1. The lack of good governance in the cryptocurrency industry and at FTX in particular
2. The implications of a lack of good governance for consumers and investors

What is FTX and who is involved?

To explain the FTX crash, it's important to first identify the players and how they are interconnected. FTX is a cryptocurrency ("crypto") exchange based in the Bahamas. Customers can deposit and trade their crypto currencies like Bitcoin or Ether through FTX's platform. FTX also issues its own token called FTT, the value of which was loosely related to the health of FTX's business. FTX was founded in 2019 by Sam Bankman-Fried, commonly referred to as SBF. Now 30 years old, SBF has been credited with bringing the crypto-verse into the mainstream, launching a star-studded marketing campaign for the company. Over the last year, FTX has become a household name, with celebrity spokespeople like Tom Brady, Steph Curry, and YouTube star Kevin Paffrath endorsing the platform. SBF has also rose to prominence, lauded as the "next J.P. Morgan" of the financial world, and more recently as the "savior of crypto," after FTX bailed out numerous struggling crypto firms.

The Downfall of FTX

Before starting FTX, SBF founded Alameda Research, a trading firm that was purportedly separate from FTX. However, on November 2nd of this year, [a leaked report](#) showed that Alameda's \$14B in assets were made up largely of FTT tokens, suggesting the two firms were more intertwined than previously publicized, sparking concerns among

investors. Four days after the leaked Alameda report, Changpeng Zhao, the founder of the world's largest cryptocurrency exchange and FTX's top competitor, Binance, tweeted that it would offload over \$300M of its FTT tokens, citing concerns about FTX and Alameda. Zhao's tweet set off mass withdrawals from FTX customers, wanting to retrieve their crypto assets before potentially deeper problems surfaced. The withdrawals, which amounted to \$6B in one day, created an immediate liquidity problem for FTX. Because FTX had been lending out customer money, much like a bank does, it didn't have the assets on hand to pay out its customers all at once. Seeing the financial pressure that FTX was facing, Binance offered to step in, signing a non-binding letter of intent ("LOI") to acquire FTX and solve its liquidity problem, pending due diligence. However, the following day, after beginning diligence, Binance backed out of the deal, citing a "black hole" in FTX's financial statements. One day later, on November 11th, FTX and Alameda Research both filed for bankruptcy with SBF resigning as FTX's CEO.

The same day, the Wall Street Journal reported that FTX used customer deposits to make loans to Alameda, secured in large measure by FTT tokens that Alameda owned. Alameda in turn used the loans to make risky investments or shore up bad investments it previously made. The Journal also reported that [multiple executives at both companies were aware that FTX was lending customer funds to Alameda](#) on this poorly secured basis. The extent to which this is true will prove crucial in subsequent court proceedings, as FTX explicitly stated it did not lend out customer funds; if this claim is false, FTX activities may be considered fraudulent. Both the U.S. Department of Justice and the Securities Exchange Commission have now launched investigations into FTX, Alameda, and SBF. Lawsuits have been filed on behalf of FTX's customers, and countless others are bound to follow. As of now, FTX, whose value recently stood at \$32B, is essentially worthless, and it is uncertain how much of their deposits FTX customers stand to recover.

Why the crash matters

Clearly, a lot went wrong. Multiple factors contributed to FTX's downfall, but perhaps the single greatest element of the FTX crash was governance – or more aptly, a lack thereof. The crypto industry has not been subject to significant government regulation thus far. Crypto executives and investors alike have touted the industry's libertarian environment, especially in contrast to the heavy regulation and close government oversight of the rest of the financial sector. That oversight exists for a reason. Traditional banks and brokerage firms in the U.S. are overseen by the Federal Reserve and/or the SEC and a significant portion of customers' money is insured by the federal government. The regulation, enhanced after the Great Recession, assures the soundness of financial institutions by prescribing minimum capital levels and sound business practices, while also creating significant adverse legal and financial consequences for serious violations by individual executives. That alone makes it all but impossible for a single tweet – like Changpeng Zhao's – to start a "run on the bank." Even if a run on the bank did occur, the Federal Reserve stands ready to be the "lender of last resort" to assure the availability of liquidity for the bank. History has proven these controls necessary for the health of financial sector and the protection of the average consumer, but currently, none apply to the crypto world.

In the fallout of the FTX crash, many are calling for the SEC, the Fed, or the Commodity Futures Trading Commission (CFTC) to take action to prevent irresponsible practices in the crypto world. Nonetheless, crypto insiders, particularly executives at U.S.-based crypto companies, question the extent to which U.S. regulators could have prevented FTX's downfall, given FTX is based outside the U.S. This point highlights the pressing need for internal governance mechanisms at crypto exchanges, especially in the absence of stringent regulation. Without a government mandate, private companies employ several voluntary structures to maintain oversight and ensure good governance. These include establishing a board of directors, implementing whistleblower policies, and conducting and disclosing internal financial audits.

The consequences of a lack of governance

FTX operated largely without a board of directors; its U.S. entity had a board, but it was only announced in early 2022. A board of directors would have looked out for shareholders' interests, creating better controls to navigate risky investment strategies, and making it more difficult to commit fraud (if fraud, in fact, occurred). Further, initial evidence conveys a total absence of even basic corporate controls at FTX. [In a court filing with the U.S. Bankruptcy Court for the District of Delaware](#), John Ray III – SBF's replacement as CEO of FTX – revealed the company failed to keep proper books or records of customer funds and seemingly used software to conceal the misuse of customer money. Internal disclosure requirements and whistleblower policies could have helped to mitigate the fallout, but clearly, FTX was a long way from instituting such internal structures. Strong corporate controls, disclosure practices, board oversight, and government oversight would have also protected the venture capital investors that bet on FTX and lost billions in the crash. In the unregulated, fast-moving rise of crypto, VC investors often rushed the due diligence process for fear of losing the deal entirely. Better governance structures would have slowed down this process, making the diligence process more transparent and providing investors with a holistic picture of the investment risks.

Whether the chaos at FTX represents intentional fraud and theft or egregiously reckless business practices remains to be seen. In the meantime, observers lack sympathy for FTX investors and customers alike who lost money in the fallout; they argue that crypto is known to be the "Wild West" of the finance world, and those who choose to get involved do so at their own risk. But that implies that there was no other conceivable outcome for FTX, which isn't necessarily true. Governance underpins an entity's ability to do right by its stakeholders. With good governance structures in place, FTX may have avoided this catastrophe, in part if not altogether. The future of crypto is now uncertain, but one can hope that the FTX crash leads to greater corporate accountability and good governance in the crypto world.

Authors



Julia Lamorelle
Vice President
e: jlamorelle@malk.com



Avery Kayle
Associate
e: akayle@malk.com

Malk Partners does not make any express or implied representation or warranty on any future realization, outcome or risk associated with the content contained in this material. All recommendations contained herein are made as of the date of circulation and based on current ESG standards. Malk is an ESG advisory firm, and nothing in this material should be construed as, nor a substitute for, legal, technical, scientific, risk management, accounting, financial, or any other type of business advice, as the case may be.

About Malk Partners

Malk Partners is the preeminent advisor to private market investors for creating and protecting value through environmental, social, and governance ("ESG") management and impact investing. Founded in 2009, Malk Partners advises many of the world's leading alternatives managers investing across private equity, growth equity, venture capital, and private credit by helping them define ESG goals, achieve ESG results, and guide their portfolio companies in driving value creation and mitigating risks. The firm is headquartered in La Jolla, California with a second office located in New York. For more information about Malk Partners, please visit www.malk.com.