Evolution & Revolution

FTX fallout and the future of digital assets

Strategist views
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Introduction

I'm continuing to work on my second paper—part of a series of three—about technology megatrends. You can read my first paper, "Evolution of commercial technologies and impact on business delivery," that talks about the innovation cycles that gave rise to these megatrends. In the meantime, I'd like to share my thoughts on the recent collapse of digital currency exchange FTX and the impacts on the future of digital assets and cryptocurrency.

FTX implosion and three takeaways

FTX Chief Executive Officer (CEO) Sam Bankman-Fried was accused of wrongdoing, which resulted in the implosion of FTX as well as the bankruptcy of BlockFi, suspension of Genesis credit facilities, and losses for FTX investors and holders of the FTT token. Some investors have speculated about this event marking the potential end of the crypto markets "craze" and a rejection of the Web3 token-driven economic model. Such prognostications demonstrate a lack of understanding about the issues at the core of the FTX saga and the evolution of the Web3 ecosystem.

Three main takeaways about the crypto and Web3 domain should surface following the FTX fallout—all of which point toward the event as an important milestone likely to lead to greater understanding, professionalization and proper regulatory oversight of this emerging space. These developments will likely prove to be welcome in helping to cement the future of digital assets.

Takeaway #1: Centralized crypto exchanges do not operate with the same level of transparency that decentralized crypto exchanges offer

FTX was an exchange that allowed for the trading of digital asset and cryptocurrency tokens. There are two types of exchanges that facilitate such trading—centralized and decentralized models.

Decentralized exchanges that trade in digital and crypto assets use independent node verifiers to confirm transactions and list all transactions on a blockchain ledger that is transparent and instantly shared across all participants in the network.

Centralized exchanges that trade in crypto assets have an operating model that is much more akin to exchanges in the traditional financial realm. They confirm their own trades, maintain their own books and records, and apply their own oversight and compliance regime.

Yet, centralized crypto exchanges are different from centralized exchanges in traditional financial markets in two key aspects:

- Centralized crypto exchanges have opted for a vertically integrated model where they both facilitate the trading of customer assets and then act as the custodian for those assets. Third-party custody—a hallmark of the traditional financial markets—is not a standard part of the offering for centralized crypto exchanges. While individual customers can choose to self-custody or transfer their assets to a digital custodian, that is not the default option on centralized crypto exchanges.
- Regulations that spell out the required safeguards, standards and audit requirements for centralized crypto exchanges are still lacking, particularly in the United States. Whereas centralized exchanges in the traditional financial markets are subject to stringent reporting and oversight requirements, there are (as of yet) no similar requirements for centralized crypto exchanges in key jurisdictions including the United States. Customers must trust that the controls in place at these centralized crypto exchanges are adequate to ensure the proper administration of transactions and safekeeping of customer funds.

These factors are what allowed FTX to—knowingly or unknowingly—mishandle customer funds. FTX was a centralized crypto exchange. Without any outside oversight of their activities, the exchange was able to operate with what turned out to be a poor set of controls that allowed them to transfer customer funds to FTX's sister-trading company, Alameda Research, leaving a hole in the FTX balance sheet and ultimately leading to the collapse of the exchange.

As the FTX blow-up was occurring, volumes on decentralized exchanges trading crypto and digital assets exploded to four times their previous levels.[1] Yet, these decentralized crypto exchanges were able to handle that increase in the pace of transactions without any issues or concerns.

As the FTX blow-up was occurring, volumes on decentralized exchanges trading crypto and digital assets exploded to four times their previous levels.[1] Yet, these decentralized crypto exchanges were able to handle that increase in the pace of transactions without any issues or concerns. Moreover, every one of those transactions was affirmed by at least 51% of the network participants, and the entire ledger of trades and customer holdings were synchronized and shared across every network participant in close to real-time. This transparency was a marked contrast to the obscurity of the FTX ledger.

Thus, one takeaway from the FTX fallout should be that the transparency public blockchains offer can be seen as a significant deterrent to bad actors in terms of their access to and authority over customer funds.

Takeaway #2: Know your token and invest in tokens that reflect the value of the offering entity

Another facet of the FTX story was the use of the exchange's own token as collateral for leveraged loans and the broad purchase of this token as an investment vehicle by other investors.

FTX had issued its own token called FTT. FTT was a "utility" token—it did not represent a claim on the revenues or the profits of the FTX exchange, but rather, entitled the holders of the token to obtain discounts on their trading activity on the FTX exchange. In a sense, it was like a loyalty program.

Although the bids and offers on FTX and other exchanges determine the value of a token, the desire of FTT holders to transact on FTX wholly influenced its value. In other words, holders had taken a speculative bet based on their view that more and more participants would want to transact on FTX and thus drive up the value of their tokens.

FTX had transferred a large amount of these FTT tokens to the firm's sister trading company, Alameda Research. In turn, Alameda had used the tokens as collateral against which it took on leveraged loans. When customers began withdrawing funds from FTX as concerns about the stability of the exchange grew, the value of the FTT token began to fall precipitously.

This triggered a chain reaction that resulted in Alameda needing to increase the amount of collateral it had posted to maintain its leveraged loans. The size of such collateral calls quickly ballooned. Speculation is that the transfer of customer funds from FTX to Alameda was done in part to plug this collateral hole. Investigators have yet to determine all the details of what had occurred.

This aspect of the FTX story highlights two issues. First, in traditional financial markets, firms would be discouraged from using their own stock to finance leveraged loans for the very issue Alameda faced. Because a drop in the value of the stock could result in a short squeeze that requires more assets from the organization to maintain its position at a time when the balance sheet is under pressure. However, this issue was exacerbated by the fact that Alameda was using the FTT token as the basis of their collateral. This asset did not reflect the value of the FTX exchange or represent any claims on the FTX balance sheet. A utility token's value is likely to disappear altogether if the sponsoring entity is seen as having failed. It is not backed by any actual assets.

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Thus, a second takeaway from the FTX fallout is that investors and financing partners need to understand the nature of the token that they are utilizing as collateral and determine whether that token is reflective of the sponsoring entity's business value rather than just being a utility or entertainment token (e.g., Dogecoin or Shiba Inu). Moreover, the excessive buildup of a position in FTT on Alameda's balance sheet would have been spotted far earlier if those transactions were occurring and being validated on a public blockchain.

Takeaway #3: A crypto investment is still an investment and requires adequate diligence and oversight

FTX had raised nearly US$2 billion from over 80 investors in just over two years,[2] including brand-name firms from the traditional financial ecosystem and several institutional investors. The charismatic personality of Sam Bankman-Fried, his pitch about the complexities and nuances of the digital asset ecosystem, his high-profile marketing deals, and the welcome reception he got from legislators and regulators, prompted many investors to take a bet on his venture. Taking such bets is the essence of venture capital and of private investing, and the desire to support emerging businesses and entrepreneurs should be celebrated.

Yet, many of those that invested in the FTX venture did so without insisting on the financial modeling, controls, disclosures and diligence that investments in the traditional start-up space typically entail. Like the rush to lock-in capacity at hedge funds in the early 2000s, there was a similar rush by venture and private investment firms to obtain exposure to crypto-native offerings as quickly as possible; often based on their belief in a visionary founder—a profile that fit Sam Bankman-Fried, according to multiple reports. Fear of missing out on an investment is not reason enough to ignore potential warning signs.

Belief in the founder was described as a bedrock requirement for FTX. News analysis indicated that the company's 30-year-old former CEO, Sam Bankman-Fried, insisted that he be the only one to run the company. Requests to install a more experienced executive resulted in the exclusion of potential investors from the pool.[3] He allegedly informed existing investors that they should "support him and observe."[4] He refused to allow investors to create an independent board of directors and appoint representatives to ensure adequate oversight.[5] Moreover, he was not pushed to disclose other potential business conflicts of interest, including his ownership and relationship with Alameda Research.[6]

Finally, although audited financials were created for 2020 and 2021, two different auditors for different FTX entities—FTX US and FTX Trading—prepared these reports. Neither auditor provided an opinion on internal controls over accounting and financial reporting[7]—in and of itself an unusual move. Both audit firms had few public company clients and none with the scale and complexity of FTX. Both auditors were small enough that the firms themselves were only audited every three years and each had poor track records with the Public Company Accounting Oversight Board (PCAOB).[8] These audit reports were released in April 2022, but the results did not trigger any red flags.

The final takeaway from the FTX fallout is that the digital asset and crypto domain are still business ventures, and although they may have slightly different operating and payment models, these differences should not exempt those seeking capital from providing disclosures and transparency to potential investors nor allow them to operate without adequate corporate governance and oversight.

Conclusion

The collapse of FTX and the resulting impacts are creating a reckoning in the digital asset and crypto domain. However, rather than marking the end of investment interest in this emerging ecosystem, the event is instead likely to prompt a deeper understanding of nuances within the space between decentralized and centralized exchanges, the relationship of a token to its issuing entity, and most importantly, the need for due diligence and proper oversight—hallmarks of what active managers should provide for their clients.

Though the FTX fallout may slow the growth of the crypto economy, in my view, it is unlikely to derail the path of evolution that these new technologies offer. Just as the hedge fund industry survived Bernie Madoff and emerged stronger for the new oversight and controls put into place in the wake of that fraud, the digital asset and crypto industry is likely to enter a more professional and regulated phase as a result of the FTX collapse.

Endnotes

1. Source: Dune.com @hagaetc / Dex metrics.
2. Source: Vitosha Venture Partners, "The Importance of Governance and Due Diligence: The FTX Case," November 22, 2022.
3. Ibid.
4. Ibid.
5. Ibid.
6. Ibid.
7. Source: Coindesk, "A Complete Failure of Corporate Controls: What Investors and Accountants Missed in FTX's Audits," November 18, 2022.
8. Ibid.

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