



The collapse of FTX

Lessons and implications for stakeholders in the crypto industry

November 2022

Origins

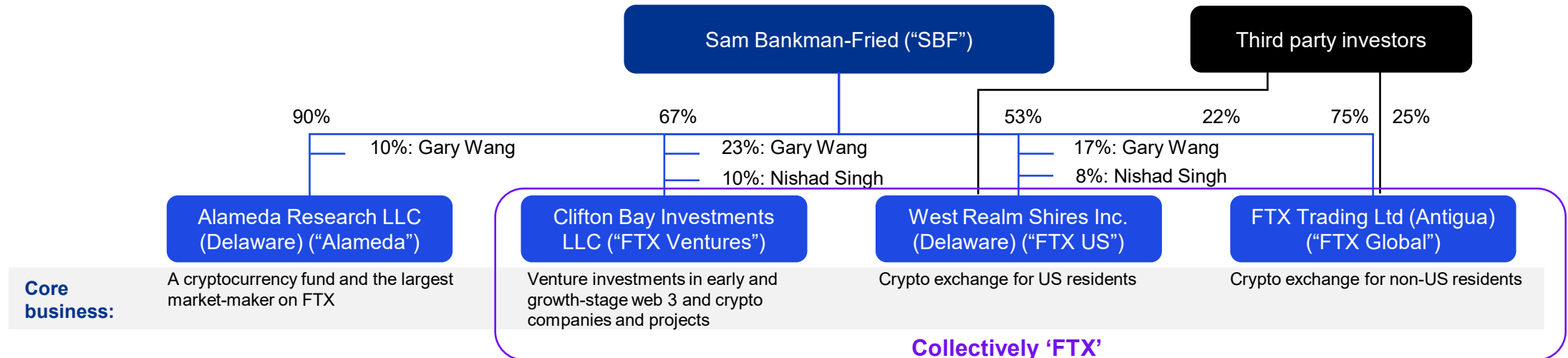
Origins and the relationship between FTX and Alameda

In 2017, Sam Bankman-Fried (“SBF”) co-founded Alameda Research (“Alameda”), a crypto fund. Alameda became a prominent market maker on crypto exchanges.

In 2019, SBF founded FTX, an crypto futures exchange built to meet the needs of serious traders (“by traders, for traders”). The FTX OTC desk was powered by Alameda and SBF was the CEO of both businesses. FTX launched it’s own token, “FTT”. FTT provided holders with a discount on trading fees and OTC rebates, with FTX buying back and ‘burning’ FTT tokens based on FTX profitability – reducing supply hence increasing token price.

By 2021, FTX had become one of the largest and most popular exchanges for professional traders due to its fast listing of tokens, user-interface, and high liquidity (driving tighter spreads between bid and ask prices). FTX’s market leading liquidity was in part due to its unique liquidation engine which effectively acquired holdings from sellers in the event of a large liquidation event – thus preventing collapse of prices. The backstop for this liquidation engine was Alameda.

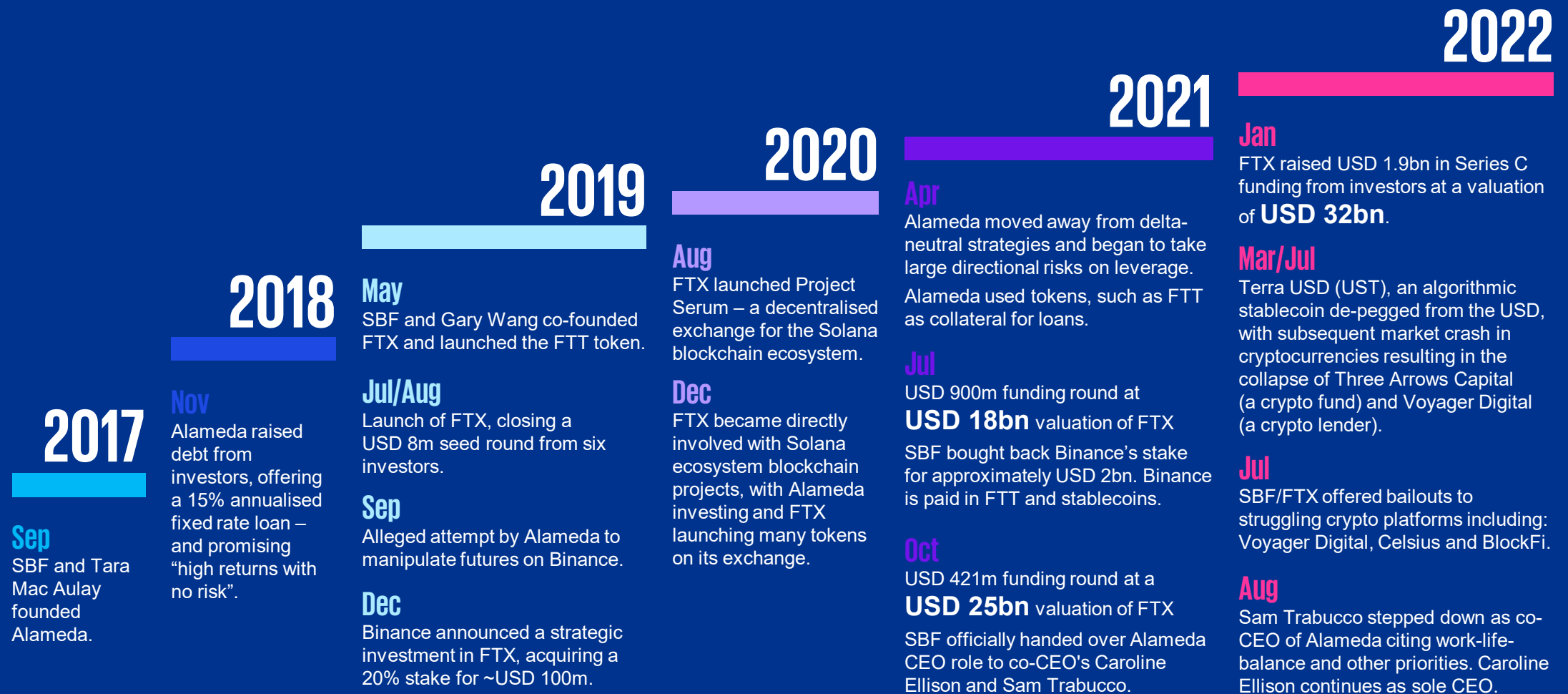
Simplified corporate structure^(a)



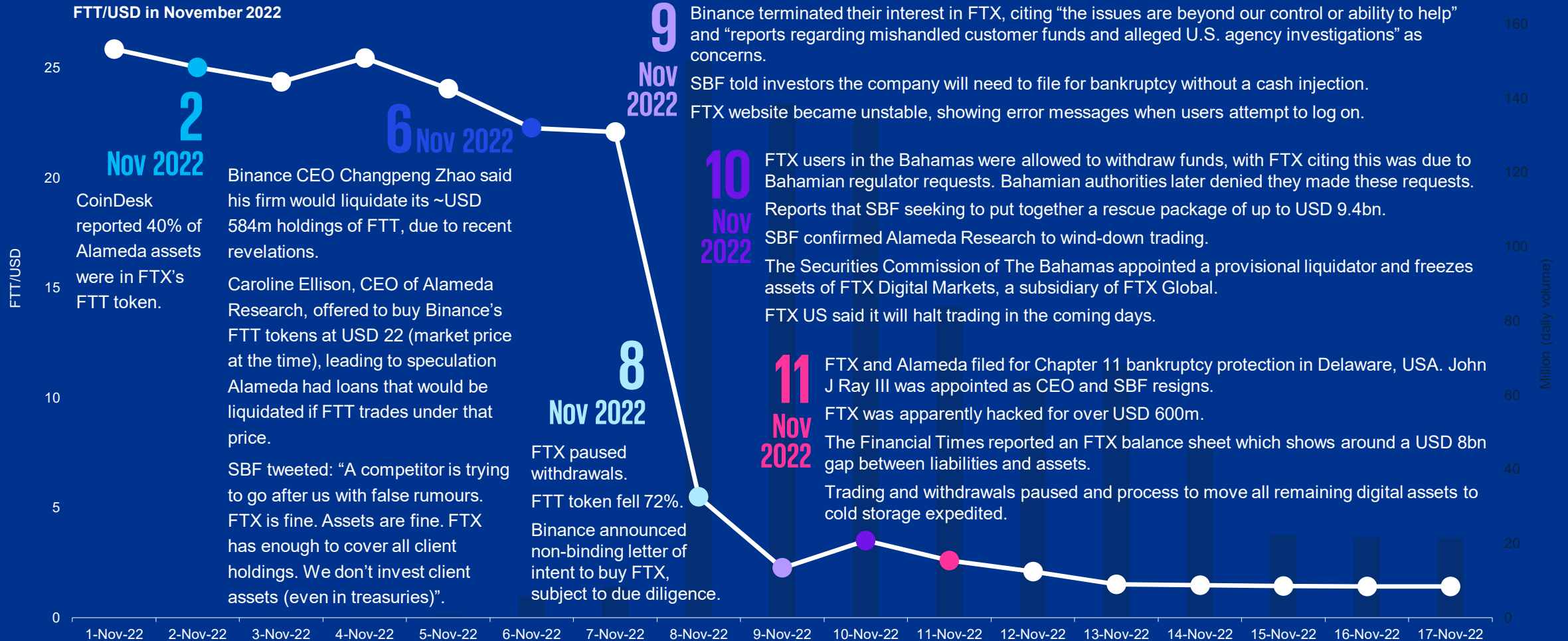
Source: Declaration of John J Ray III in support of Chapter 11 petitions ("the Declaration"), 17 November 2022

Note: (a) Simplification on Exhibit A and Exhibit B from the Declaration.

The rise



The fall



Sources: Coindesk, Financial Times, Reuters, Bloomberg, Messari Research

What went wrong? (1/2)



While the exact sequence of events leading up to the collapse of FTX and Alameda is unknown, the sheer size of the asset gap – USD 10bn – narrows the possibilities to either blatant misappropriation of funds, significant absorbed liquidation losses, or some combination of both.”

Messari Research



Commingling of company and customer funds

FTX appears to have lent billions of dollars in customer funds to Alameda Research.

Commingling customer funds with counterparties and trading them without consent is illegal according to US securities law and violates FTX’s terms of service.



Conflicts of interest

The collapse of Tera/Luna and UST in May 2021, is likely to have led to trading losses for Alameda either due to its role as backstop to FTX’s Liquidation Engine or due to losses on investments impacted by the market collapse.

As majority owner of both FTX and Alameda, and given the central role Alameda played in FTX’s competitiveness – it would have been in SBF’s interest to use customer funds to bail-out Alameda.



Use of native tokens as collateral

FTX’s native FTT token was used as collateral by Alameda for leveraged trading.

FTT’s value was dependent on FTX being a going concern.

When the price of FTT fell below USD 22, Alameda’s loans were liquidated as they could not repay their debts.



Token concentration and valuation

In addition to making venture investments in private companies, balance sheet disclosures show FTX had a high concentration of holdings (reported value USD 5.4bn) in low float, high fully diluted value (FDV) tokens – including FTT and Serum where the fair value in a liquidation scenario is significantly below the reported value.

Sources: Financial Times, Messari Research



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What went wrong? (2/2)



I have over 40 years of legal and restructuring experience. I have been the Chief Restructuring Officer or Chief Executive Officer in several of the largest corporate failures in history... Never in my career have I seen such a complete failure of corporate controls and such a complete absence of trustworthy financial information as occurred here.”

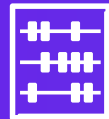
John J. Ray III, Chief Restructuring Officer to FTX and Alameda



Absence of corporate governance

No 3rd party investors had seats on FTX’s board.

Concentration of control in “...a very small group of inexperienced, unsophisticated and potentially compromised individuals,” Ray said.



Lack of records

Inadequate financial reporting systems infrastructure and corporate controls resulted in unavailability of trustworthy financial information

Incomplete records of payments, employees hired and assets purchased, etc.

FTX is reported to have no accounting function or CFO.



Limited diligence by 3rd party investors

Given recent disclosures regarding the absence of corporate controls and financial information it appears prominent investors acquired holdings in FTX with limited due diligence.

Well known private equity, venture capital, pension and sovereign wealth funds have publicly disclosed they have now written-off these investments.



Lack of risk management policies and framework

FTX and Alameda lacked robust asset-liability and liquidity risk management policies.

Putting customer deposits into illiquid investments and using those investments as collateral resulted in high leverage which appears to have been misunderstood by SBF.

Source: Declaration of John J Ray III in support of Chapter 11 petitions (“the Declaration”), 17 November 2022

Considerations for stakeholders (1/2)

Corporate governance, compliance and risk management

Other

Regulators



- Active monitoring and review of licenced Centralised Crypto Finance (“CeFi”) operators.
- Review of regulations, oversight framework and licencing regime in light of FTX failings.

CeFi operators



- Implement appropriate governance arrangements which factors segregation of duties, appropriate board composition, internal audit, etc.
- Ensure appropriate policies and procedures are in place to segregate customer funds and company funds and that this is regularly monitored.
- Effective cash management processes are also essential to ensure visibility and control over operational funds.
- Review risk management framework in light of the issues leading to FTX’s collapse (e.g. market risk, custody risk, technology/cyber risk, reputational risk, credit risk, etc).
- Strengthen and enforce security protocols.

- Recruitment of blockchain subject matter experts to enable proactive monitoring of market developments and risks, including contagion events from FTX.
- Crypto’s cross sector and cross border nature limits the effectiveness of uncoordinated national approaches. Work with other regulatory authorities to develop a risk-based global regulatory framework and standards for CeFi.
- Consider approaches to give investors and customers confidence that these controls are robust, this may include:
 - on-chain proof of assets and liabilities
 - external audits by reputable firms
 - being licenced by reputable authorities
- Don’t use native assets as collateral.
- Set up insurance fund/insurance to protect customer deposits in the event of loss.

Considerations for stakeholders (2/2)

Corporate governance, compliance and risk management

Other

CeFi users



- Where assets are held with third parties consider if these operators:
 - are licenced by an established regulatory authority
 - provide proof of reserves and liabilities
 - are audited by a reputable firm
 - have deposit protection or an insurance fund mechanism
- Consider diversification in custody arrangements to minimise counterparty exposure.

CeFi investors



- Conduct comprehensive diligence on CeFi platforms where amounts invested are material, which contemplates matters such as their risk management framework and related party arrangements.
- For existing portfolio companies consider conducting formal risk assessments to identify any deficiencies in their risk management framework, cyber security, management reporting, and/or vulnerabilities to bank style runs.
- Attain a level of control at board level to ensure appropriate governance procedures are undertaken and decisions are made with suitable due process. Representative is most likely not required unless you have >50% holdings.

- Consider cold-storage / self custody depending on level of sophistication and understanding.
- Actively monitor market risk including contemplating the extent of possible contagion across: centralised crypto funds, CeFi, Decentralised Finance (“DeFi”) platforms and underlying crypto protocols.
- Ensure blockchain subject matter experts are engaged to assist in due diligence.
- Have sufficient warranty and legal protection terms in share purchase agreements.
- Review crypto asset allocation framework / investment thesis in light of changed market dynamics and the probability of significantly increased levels of regulation across the crypto industry.

How KPMG can help – reviews of CeFi operators

Regulatory and Compliance

- Licensing services with applicable regulators in areas such as VATP/VASP, and STO issuance and assessments.
- Advice on compliance with key regulatory requirements including client asset custody and segregation, prevention of market manipulation, and token due diligence.
- Design and/or review internal regulatory reporting and compliance processes and controls.

Corporate Governance

- Design and/or review governance structures and frameworks on an enterprise-wide scale.
- Design effective three lines of defense structure with clear authorities and effective segregation of duties.
- Review and assess business activities for potential conflicts of interests, including fraud mitigation, and controls to prevent misuse of customer funds.

Risk Frameworks

- Design and/or review policies, procedures and controls, in areas including but not limited to operations, finance, risk management, legal and compliance.
- Contingency planning, recovery planning, and resolution planning services.

Risk Modelling

- Design and/or review risk models in areas of liquidity risk, interest rate risk, market risk, credit risk.
- Design and/or review stress and scenario tests.
- Risk modelling resource and capability assessment.
- Model governance and control assessment.

Due Diligence

- Pre- and post-investment Integrated Due Diligence services (capturing financial, technology, regulatory compliance, risk management, tax, forensics, HR and so on).
- On-chain validation of ownership and control of crypto assets

Balance Sheet Management

- Balance sheet review and optimization services.
- Hedging and insurance program effectiveness review.
- Collateral review and optimization services.

Internal Audit

- Assessment of level of adherence of BAU activities to policies, procedures, and industry best practices.
- Assessment of control implementation status and effectiveness.

Cyber Security

- Assessment of technology risk and security controls with reference to regulatory requirements, common security threats and industry best practices.
- Technical security review covering application security controls, configuration review, vulnerability assessment, penetration test and source code review.

Restructuring & insolvency implications of FTX's collapse (1/2)

Events over the last few weeks have shown just how quickly crypto-related businesses can fail. Management and investors therefore need to be aware of the various risks mentioned elsewhere in this document, but should also be able to identify warning signs that may indicate more serious issues are in play, and how to mitigate the risks indicated by these red flags.

Key takeaways for company management



- First and foremost, management, especially directors, must understand the duties that they owe to the legal entities over which they preside. These duties will vary jurisdiction by jurisdiction, but typically require management to adhere to a number of principles relating to sound financial stewardship of the legal entity for the benefit of the company as a whole. The concepts of balance sheet and cash flow insolvency apply irrespective of industry and legal jurisdiction. Management must also be aware that transactions processed in the days leading up to an insolvency event might be retrospectively challenged if the business is subsequently found to have been insolvent at the relevant time.
- Understanding of your liquid asset position in the event of customer withdrawals, whether this is in the form of crypto assets or cash that could be used to facilitate customer withdrawals. Knowledge of this position, and the additional capital required to cover a rapid increase in withdrawals is essential.
- The same applies to your operating cash position. Visibility and control over cash is critical when the economic situation darkens. This includes knowledge over key cash flow drivers, how much cash the business has and where it is, and an overview of facilities, headroom and sources of potential additional funding. Regular stress testing of the cash position should be undertaken in times of volatility.
- Given the relative infancy of regulations and the variance of the regulatory environment for crypto businesses across different markets, it is essential that management remain on top of developments in the regulatory position in the markets in which they operate.

Restructuring & insolvency implications of FTX's collapse (2/2)

Key takeaways for investors



- As part of your pre-investment due diligence, some knowledge of what would occur in the event of stress, distress or insolvency at the investee entity is key. The cross-border nature of the insolvencies that we have seen in the crypto industry to date, in which different courts are asserting jurisdiction over different entities within the same group, only increases the level of complication in what can be a very technical area. Appropriate legal advice, relevant contingency planning, and an understanding of what an investor's potential areas of real monetary recourse may be in the event of insolvency should all be factored in.
- In the event that Board seats are taken by investors, these should not be perceived simply as a tool to oversee an investment. Such positions carry a duty to the investee company as a whole (not just to the investor that director was nominated by), and directors will need to be aware of their responsibilities, as well as the need to be seen to be actively discharging those duties.
- A detailed legal review of the contracts under which crypto assets are held (either as a client or custodian) is a vital risk mitigation step. This would include an understanding of the governing law under which investments and or deposits will be treated in the event of an insolvency, and the likelihood of a investor / claimant having a proprietary or unsecured claim against a failed counter-party.

How can KPMG help?

If your business, an investee company or indeed a counter-party holding your crypto assets might potentially be in some form of stress or distress, KPMG's Restructuring professionals have the capability and experience, working alongside our crypto industry specialists, to perform detailed business reviews and options analyses to facilitate informed decision making in these fast moving situations.

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Glossary

BAU	Business-as-usual
BTC	Bitcoin
CeFi	Centralised crypto finance
DeFi	Decentralised finance
ETH	Ethereum
FTT	FTX token
OTC	Over-the-counter
SBF	Sam Bankman-Fried
SPA	Sales and purchase agreement
STO	Security token offering
UST	Terra USD
VASP	Virtual asset service providers
VATP	Virtual asset trading platform

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