Legacy Trust

Investment Perspectives

Five Lessons from FTX

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Key Takeaways

- When management teams act unethically, everyone loses.
- Robust corporate governance is a must, even for startups in unregulated spaces like cryptocurrency.
- Beware of financial products and services endorsed by celebrities.
- Avoiding permanent loss of capital is a key to building long-term wealth.
- Regulation and regulatory bodies exist for a reason – to protect investors.

Cryptocurrency exchange FTX and founder Sam Bankman-Fried rose to fame almost as rapidly as things unraveled. A story of magnificent wealth, philanthropy, and entrepreneurship quickly turned into one of mismanagement, fraud, and the perils of unregulated investments. Once endorsed by influencers including Larry David and Tom Brady, now account holders wonder what, if anything they'll recover from accounts. As investors, what can we carry forward from an experience that was painful for some?

In July 2021, FTX founder Sam Bankman-Fried (SBF) fielded questions from partners at revered venture capital firm Sequoia Capital. It was the last question that sealed it: "So everything you're building is great, but what is your long-term vision for FTX?"

"I want FTX to be a place where you can do anything with your next dollar. You can buy bitcoin. You can send money in whatever currency to any friend anywhere in the world. You can buy a banana. You can do anything you want with your money from inside FTX," remarked SBF. What transpired in that Zoom meeting on a warm Friday afternoon left the investors in awe. In a now deleted profile of the founder on Sequoia's website, the feedback from the partners was unanimous. "I love this founder" typed one partner, "I am a 10 out of 10" from another, a third exclaimed "YES!!!". Only adding to the folklore, it was later discovered that SBF was multitasking the entire meeting, engrossed in the online multi-player game League of Legends.

The spectacular rise and subsequent unraveling of FTX and SBF has been covered extensively since its collapse in November of 2022. As bankruptcy courts continue to sort through the wreckage, creditors and customers with accounts are left wondering if they'll ever recover their funds.

As investors, we were not necessarily taught new lessons from the collapse, but instead reminded of things we already knew. Topics like corporate governance and avoiding permanent loss of capital should always be in the forefront of decision making as investors. Going forward in both cryptocurrency and traditional finance, these 5 lessons will continue to hold true…

1. When management teams act unethically, everyone loses.

In hindsight, the red flags seem obvious, but even some of the most sophisticated investors were defrauded. A few things are clear - fraud and the absence of ethical decision making were the root causes of the collapse and there were no 'winners' as a result.

A single tweak of the cryptocurrency exchange's software allowed essentially unlimited lending of FTX customers' deposits to Alameda Research, a hedge fund owned by SBF. Customer funds were then inappropriately used to make undisclosed venture investments, purchase luxury real estate, and donate to political parties.

In the end, there are no net beneficiaries of misappropriating funds. The customers and creditors are victims and await bankruptcy proceedings to find out how much if any of their funds they will recover. Despite FTX operating properly as an

exchange, Sequoia was forced to write down their investment from $210mm to $0. Stakeholders in unrelated blockchain and cryptocurrency projects will be met with additional skepticism because of the unraveling.

Most importantly, not even those who carried out the misdeeds benefitted. SBF has been charged with an eight-count indictment by the DOJ with charges including wire fraud, conspiracy to commit securities fraud, conspiracy to commit money laundering, and conspiracy to defraud the Federal Election Commission and commit campaign finance violations. Other executives didn't escape unscathed either - Gary Wang, who co-founded FTX, and Caroline Ellison, the former CEO of Alameda Research, both pleaded guilty to fraud charges and are cooperating with prosecutors.

2. Robust corporate governance is a must, even for startups in unregulated spaces like cryptocurrency.

John Ray III replaced SBF as CEO after the bankruptcy filing. A specialist in recovering funds from failed businesses, Ray was chosen to wind down operations at Enron. What he had to say about FTX gives a glimpse into how bad governance really was.

"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, from compromised systems integrity and faulty regulatory oversight abroad, to the concentration of control in the hands of a very small group of inexperienced, unsophisticated and potentially compromised individuals, this situation is unprecedented." – John Ray III

Ray noted that many of the entities tied to FTX didn't have appropriate corporate controls and many had never held a board of directors meeting or lacked a board entirely. It is no surprise then that FTX assets were commingled with Alameda and that when evaluating the balance sheet, it was unclear what and how valuable those assets were.

There is also a story to be told about a young and inexperienced management team. A common thread amongst FTX and Alameda executives was their relative inexperience in management positions. The untested management team responded poorly in crisis and refused to act until it was too late.

3. Beware of financial products and services endorsed by celebrities.

During the 2022 Superbowl FTX aired a commercial featuring Larry David, creator of Seinfeld and the star in HBO's Curb Your Enthusiasm. In the commercial, Larry dismisses a series of history's greatest innovations: the wheel, the light bulb, portable music, etc. At the end of the commercial, FTX is introduced as a "safe and easy way to get into crypto" to which Larry responds "ehhh I don't think so. And I'm never wrong about this stuff. Never." After, the commercial warns viewers "DON'T MISS OUT" on crypto, NFTs, on the next big thing.

Larry was just one of many celebrities and professional athletes paid to promote FTX. Quarterback Tom Brady and supermodel Giselle Bundchen were paid as brand ambassadors and spoke at the FTX SALT conference in the Bahamas. Others included Shaquille O'Neal, Naomi Osaka, Steph Curry, and David Ortiz. FTX also bought naming rights to Miami's sports arena and sponsored teams and events for the popular Formula 1.

Even prominent investor and Shark Tank personality Kevin O'Leary was involved. O'Leary was paid $15mm as spokesman with part of his compensation coming as equity in the parent company of FTX.

Now the athletes and celebrities face a class action lawsuit for their role in driving the platform. Celebrities, athletes, and influencers have a long history of involvement in advertising. While all is well when they peddle headphones or value meals, be wary of any paid promotion for any financial product or financial services firm.

4. Avoiding permanent loss of capital is a key to building long-term wealth.

It's a simple concept, but one that rears its ugliness over and over. Regardless of what account holders and creditors recover after bankruptcy proceedings, the lessons will hold true. Whether it's cryptocurrency or more traditional securities like equities or bonds, an irreversible loss of capital can be crippling to achieving long-term goals of building wealth.

While each investor has a unique appetite for risk, the math holds true for everyone, whether venture capital, savings for retirement, and everything in between. After a 50% write-down, it takes a 100% gain to just break even. If recovery is 10%, 10x to get back to flat.

This is not to say that there isn't merit to taking on risk or investing in something nascent like FTX was at one time. A better approach is to control risk and be sure to run through all

possible scenarios, including a loss of the entire investment. There are many instances in cryptocurrency (Celsius, Voyager Digital, 3 Arrows Capital) and traditional finance (Theranos, Madoff, Lehman Brothers) where investments faced permanent impairment.

Investors must consider a limit for how much they can afford to put into speculative assets and be sure their broader portfolio is properly diversified.

5. Regulation and regulatory bodies exist for a reason – to protect investors.

FTX and much of cryptocurrency remains unregulated. To some, the lack of regulation and law is a plus as some remain wary of government and long for a bank-free, libertarian-style financial system. However, lack of regulation and oversight tends to attract bad actors and opens the door to fraud and scams.

Perhaps the very first red flag for investors and account holders should have been FTX seeking jurisdictions that have the least oversight. In 2021 headquarters was moved from Hong Kong to the Bahamas with FTX incorporated in Antigua and Barbuda.

Domiciling outside the U.S. had a slew of consequences, intentional or not. Its location put operations outside the purview of U.S. government watchdogs. The company also didn't need to meet U.S. standards on financial reporting requirements and didn't have to open its books to U.S. regulators.

Framework for regulation will continue to develop as time and adoption go on, but investors should always be aware of what protections they are afforded should things go awry.