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Venture capitalists appear to have an excessively deferential attitude towards the so-called "rock star" founders of crypto firms, regardless of their credentials as business leaders. FTX's Sam Bankman-Fried (left) is a case in point.
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FTX: Lessons for governance of crypto startups

Investors should look out for the ability of a company to issue as many tokens as it wants and treat them as assets, even if they have not been purchased by a third party. BY UMAKANTH VAROTTIL AND HANS TJIO

THE bankruptcy filing of FTX, made through its newly appointed chief executive officer, is a damning indictment of the company's governance practices. John Ray III, a turnaround specialist with 40 years of experience, including in high-profile cases such as Enron, noted: "Never in my career have I seen such a complete failure of corporate controls and such a complete absence of trustworthy financials as occurred here".

Governance missteps at FTX include not maintaining centralised control of cash or appropriate books and records, engaging in transactions afflicted by severe conflicts of interest, and the lack of any lasting records of decision-making. Such an outcome is attributable to the fact that the control of FTX was concentrated "in the hands of a very small group of inexperienced, unsophisticated and potentially compromised individuals", Ray said.

This is despite about 80 investors, including blue-chip ones, having poured in close to US$2 billion over two years. Institutions such as Sequoia and Temasek have already fully written down their investment in FTX. Several questions emerge. Why did FTX display dismal governance despite the presence of experienced venture capitalists and institutional investors? What lessons does the implosion of FTX offer regarding the governance of startups in the cryptocurrency sector? If there is one red flag to look out for, what is it?

The FTX episode accentuates the specific governance considerations at play in the crypto sector, which have eluded significant analysis thus far. As it turns out, crypto startups operate in a grey governance zone by which founders, such as FTX's Sam Bankman-Fried, have been able to leverage their control and dominance over their companies with minimal checks and balances. Given the nascence of the crypto industry, these companies are able to avoid the full force of securities laws, corporate governance codes and listing rules as they are not listed on the stock exchange. Hence, the founders and controllers are not subject to any form of regulatory governance. It appears that FTX may have even acted like an unregulated bank, with its customers' monies and assets treated as belonging to FTX, which could use them as it pleased.

The startup sector, though, typically relies on contractual governance, by which venture capitalists and institutional investors rein in the founders through legal agreements, not regulation. Investors are often conferred rights to nominate members to the board of directors, or to exercise veto rights in respect of key decisions relating to the company, all of which provide them with oversight of management. Strikingly, there was an abysmal failure of contractual governance in FTX, which is symptomatic of the broader trends in crypto startups. This can be attributed to a combination of structural and practical considerations.

Structurally, the shareholding pattern and consequent governance conflicts in crypto entities such as FTX appears closer to the arrangements in companies with dispersed shareholding than in startups; founders have a significant controlling interest, while a large number of outside investors each hold a small chunk of shares. As FTX's CEO indicates in the bankruptcy filing, "no single investor other than the co-founders owns more than 2 per cent of the equity", even though the ticket sizes of some of the investments ran into hundreds of millions of dollars. The crypto industry's blistering pace of growth has necessitated multiple rounds of funding with the induction of an unusually large number of investors. The resulting equity structure not only entrenches the founders and offers them free rein, but it also provides limited incentives to individual investors, even if they are sophisticated, to oversee management.

Unsurprisingly, the board of FTX and its group of companies consisted solely of the founder and his closest allies, with no investor presence whatsoever. This is evident in Temasek's statement while writing off its investment in FTX: "As we only had a ~1 per cent stake in FTX, we did not have a board seat". The unique nature of shareholding in crypto entities, therefore, enables them to engage in governance arbitrage by avoiding both regulatory and contractual governance.

From a practical standpoint, several factors have compelled investors in crypto entities to cede control to the founders. As hordes of investors had been chasing too few crypto startups, the founders enjoyed an unparalleled bargaining position. The competitive nature of the crypto investment phenomenon ensured that if investors insisted on substantive oversight protection in the company, they were bound to lose out on investment opportunities to others. This meant that investors had to be satisfied with a light-touch contractual approach.

Studies have also demonstrated that venture capitalists tend to be "repeat players" who are keen to participate not only in future rounds of a specific company, but also in other companies. Their reputation could be at stake if they are perceived to be intrusive in nature, thereby motivating the investors to adopt a friendly attitude towards founders. There is also talk that some venture capitalists have themselves issued tokens and produced do-it-yourself videos to show how to create tokens. Evidence also suggests that venture capitalists tend perhaps to hold an excessively deferential attitude towards the so-called "rock star" founders, regardless of their sophistication as business leaders. The undue trust and reliance placed on FTX's Bankman-Fried is a case in point.

Unlike other startups, the crypto industry has also spawned an aversion among investors in nominating individuals to the board. The ambivalent nature of the regulatory framework surrounding cryptocurrency activity, and the heightened sense of risk, likely operate as impediments to attracting more seasoned professionals as directors of crypto companies, thereby raising questions regarding the quality of governance.

It is clear that the FTX debacle represents an existential crisis for the crypto industry, which is bound to attract greater regulatory scrutiny and a more cautious outlook from investors. At the same time, it has also shone the spotlight on questionable governance practices in the sector. The unique governance model created for the crypto industry, whether by default or by accident, is no longer sustainable. There is a strong case for investors to insist on robust contractual governance practices in a manner that is prevalent in the rest of the startup industry, and to eliminate any governance arbitrage.

If there is one thing investors should look out for, it is the ability of a company to issue as many tokens as it wants and treat them as assets, even if they have not been purchased by a third party (or are even in demand). In a recent podcast, a group of venture capitalists said that FTX was more an Enron than a Lehman event. One thing that Enron did was to issue its shares to related companies in exchange for debt in those firms. This boosted the balance sheet of both sides. FTX used its own token, FTT, in its dealings with its related proprietary trading arm Alameda Research, which allowed it to patch up losses in the latter. If you can create assets out of thin air, you can be infinitely rich. Until no one sees them as assets, and then you have absolutely nothing.

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