Recent Developments in the Digital Asset Market

FTX is a cryptocurrency exchange based in the Bahamas that filed for bankruptcy protection together with over 130 affiliated entities on November 11th. While FTX accounts for under 10% of the total centralized exchange market share, it did have an outsized presence across the digital asset landscape due to its rapid rise, its charismatic founder/CEO and his vocal lobbying efforts for his vision of regulation in the cryptocurrency space. This outsized presence was further amplified by the rapid collapse of FTX from a perceived position of unassailable strength to a bankruptcy filing within a week.

We want our clients and investors to understand the impact of the FTX situation on their investments. Fortunately, we can share the following updates:

The Menai Funds have never held FTT, the native token of FTX. While we used FTX to transact and hold some of the Funds' tokens, the Menai team determined that the Funds' assets should be moved away from FTX on Sunday, November 6th, which was completed by the morning of the 7th. As such, none of the Funds' holdings are being held at the FTX exchange and the Funds have not incurred any permanent losses as a result.

By way of background, Sam Bankman-Fried (SBF) is the founder of Alameda Research and FTX. He graduated MIT with a major in physics and turned 30 earlier this year. Both his parents are professors at Stanford Law School. Sam started trading international ETFs at Jane Street after graduating from MIT in 2014. He left Jane Street in 2017 and founded Alameda Research, a quantitative trading firm specializing in cryptocurrencies, later that year. Alameda Research found early success in a few arbitrage trades. In April 2019, SBF founded FTX, and the exchange rapidly grew its volumes and user base, which resulted in successful VC funding rounds totaling a reported $2B. The last round of funding was a $400M raise in January this year at a $32B valuation with VC investors including Temasek, Softbank, Sequoia, and Tiger Global. Prior rounds had equally impressive lists of investors. It has been reported that SBF used his resources to further enhance his brand by becoming a big donor to politicians, providing rescue financing to crypto firms in trouble, investing in a number of new projects through FTX's VC arm and advertising widely (including renaming the Miami arena to the FTX arena, sponsoring a Formula 1 team and so on). SBF also spent time speaking with legislators and testified before Congress on matters related to crypto regulation. While SBF was viewed by some as serving his own narrower interests, he was still regarded as a very notable voice in the cryptocurrency space and one with significant resources to further his worldview.

With this contextual backdrop, the early indications of trouble reportedly began with a November 2nd CoinDesk article suggesting that Alameda Research's balance sheet had some questionable items; the most noteworthy of these was that Alameda Research held very large amounts of tokens issued by FTX (token ticker: FTT). This suggested potential weakness in the financials of Alameda Research and a closer relationship between FTX and Alameda, but it did not garner much immediate concern about the health of FTX. That changed when Binance, the largest cryptocurrency exchange, indicated it would sell all the FTT tokens it held (Binance received roughly $2.1B in FTT and stablecoin BUSD as part of its divestment of FTX equity in 2021); Binance stated this was a risk management measure. The resulting back and forth between FTX and Binance ultimately resulted in $6B in customer withdrawals from FTX within 72 hours. FTX halted withdrawals on November 8th and eventually filed for bankruptcy protection on November 11th.

The process is on-going, and there remain many unknowns. Based on reports, it appears that Alameda Research lost significant sums earlier this year due to the market downturn and its exposure to the collapse of Three Arrows Capital and Terra/LUNA. FTX may have improperly lent customer funds to Alameda to keep it afloat, resulting in a combined shortfall between the two entities that is estimated to be around $8B. Many retail investors and some institutional investors have been hurt. The crypto market has seen broad-based declines in the wake of FTX's collapse. The second-order effects are unclear, but there are some takeaways worth considering.

- **Counterparty credit risk and operational risk management is critical.** It is highly advisable to self-custody your cryptocurrencies if investing directly or select a fund manager committed to continued risk assessment to minimize counterparty exposure.

- **This is not only a crypto-specific story**. At best, the downfall of FTX was the result of a fast-growing start-up with poor operational practices; at worst, it entailed illegitimate movement of customer funds to hide trading losses. While this happened at an exchange that was in the cryptocurrency space, we have seen traders trying to hide losses in many past instances across every asset class. Larry Summers compared FTX to Enron, and many parallels are notable (not the least of which is that the man who led Enron through bankruptcy has been appointed as the CEO of FTX post its Chapter 11 filing). Enron was a case of "the smartest guys in the room" using their own equity as collateral for financing; they provided limited information but had a well-liked CEO and were very highly regarded by institutional investors. FTX used its token as collateral for financing, was very highly regarded despite providing limited data on their financials and had a complex corporate structure (the bankruptcy filing listed 130 related entities).

- **Cryptocurrencies will be negatively impacted**. Many proponents of cryptocurrencies are arguing that FTX is the perfect example of a centralized institution (CeFi) behaving badly because it is driven by the decisions of a few people and that provided very little information. Crypto-native DeFi solutions, on the other hand, arguably provide far greater transparency and are far less likely to be the subject of ongoing malfeasance. We are sympathetic to this view, but we believe FTX is so closely aligned in investor minds with the crypto space that sentiment towards cryptocurrencies will be negatively impacted for some time. This is most regrettable as we were seeing signs of strength within the space prior to the FTX news (lower correlation with other asset classes, lower volatility, and materially better performance versus debt and equities).

- **Contagion vectors**. We see three main areas of concern for contagion. The first is institutions that had exposure to FTX and/or Alameda and have funds stuck there for the duration of the bankruptcy with unclear recoveries at the end of the process. These institutions could fail or become forced sellers of assets to manage their liquidity needs. The second source of contagion is projects that may have maintained their treasury assets on FTX (particularly entities that received funding from FTX Ventures). These projects may need to seek new funding or they may be forced to abandon their projects. FTX was also a large holder of a few assets, and there may be selling pressure as these are sold during bankruptcy proceedings. Notable among these is Solana (SOL) which comprises 3.7% of the Menai Index. The third major source of possible contagion is leverage. Price declines could force the closure of levered long positions as losses overwhelm collateral thresholds (this could work in reverse if prices start increasing and short positions need to be covered). So far, the indications are that these contagion vectors are well contained, but this could change, and other contagion vectors may exert pressure.

- **The asymmetry to the upside remains intact**. The market cap of all cryptocurrencies has fallen by about $250B in the last 10 days predominantly due to the downfall of FTX. This compares to the $8B reported shortfall on FTXs balance sheet. Some of the larger declines in overall cryptocurrencies are arguably merited because second-order contagion effects are not yet fully clear; there may be more forced selling, and the FTX collapse will very likely push back the entrance of new investors into this market for some time. That said, the underlying growth in the space continues. The market cap has already taken a sizable hit, and investors allocating fresh capital may find the entry levels very attractive by the time they deploy capital. There is also continued evidence that the potential for upside remains undiminished when news is supportive; we saw cryptocurrencies rise by over 15% from Wednesday evening to Thursday evening as better-than-expected inflation numbers supported risk assets despite FTX hurtling towards bankruptcy.

- **The Lehman moment**. Another analogy that has been made is that the collapse of FTX is the Lehman moment within the crypto space. To an extent, this seems fitting. The corollary would be that Three Arrows and Celsius' demise earlier this year were the Bear Stearns moment, and those underlying weaknesses reverberated several months later into a larger enterprise failing. The actionable takeaways from this analogy are unclear. However, the period post the Lehman collapse provided a tremendous investment opportunity, and we remain hopeful that the same may be true for crypto now. We have seen valuations go back to levels two years ago when many of these projects were ideas as compared to the current functional solutions with growing use cases and more robust systems.

- **Regulation**. The need for sensible regulation is clear. Regulation cannot fix malfeasance and may have had limited success in stopping bad behavior at FTX. That said, many investors were incentivized to go to an exchange in the Bahamas because the absence of clarity regarding regulations limited their investment options in US onshore exchanges. FTX has a US arm (aptly named FTX US). This US arm, however, has far fewer investment alternatives and far less volume, in part because it is subject to US regulations, but much of this regulation is unclear. In an ideal world, FTX US would have been a well-regulated viable option for investors so that they wouldn't have to look to offshore solutions. We hope to see continued progress on greater regulatory clarity in the US but do not anticipate legislation in the short term.

The decline of FTX was spectacular in its speed, the drama, the personalities involved, and the damage it has done to industry participants. More news is expected, and further price declines are possible. That said, unlike prior downturns, we have not seen any suggestions that crypto will not continue to grow. Anecdotal evidence suggests macro investors and hedge funds continue to view this as an attractive investment vehicle. Traditional service providers like Mastercard, Visa and many others continue to integrate further into the cryptocurrency space. Solutions providers like decentralized application protocols and infrastructure projects continue to build new capabilities. DeFi builders appear more energized in their belief that a more transparent system with less centralization is the path forward for a growing subset of use cases. In a similar vein, Menai Asset Management views this dislocation in the market as an opportunity to identify attractive investment opportunities with long-term potential to generate very high returns for our investors. We remain zealous in our efforts to safeguard investor capital and optimistic that current price levels will prove very attractive in the months to come.

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